



Expansion & Relocation

California's Economy Bounces Back

After years of economic struggles, the Golden State is back in business

By Barry Saywitz

The California commercial real estate market is rebounding after seven years of economic struggles and a prolonged period of increased vacancies, decreased rental rates, and devaluation of commercial properties. So has California's economy turned the corner, and if so, how will it affect commercial real estate markets throughout the state?

The answer is that the economic recovery of the entire country has finally reached the West Coast, and all indicating factors point toward a strong economic recovery for the state. This has spurred an increased demand

Orange County has seen dramatic rebounds in its economy, among other things.

for commercial real estate throughout the state by investors around the globe. The past 12 months have seen rental rates for office, industrial, retail, and apartment space increase dramatically. Current interest rates and increased lending by financial institutions have allowed purchasers of commercial properties a better ability to acquire new properties and expand their portfolios. In addition, the resurgence of the REITs and their abundant source of capital — combined with offshore and Wall Street money — have created an excess supply of capital and have driven prices for commercial properties to all-time highs for the 1990s.

The state's economic and demographic growth will continue to spur advances in the real estate market and create a new phase in this cycle of the real estate economy. As vacancy rates continue to drop and rental rates and purchase prices continue to increase, demand will continue to exceed supply, thereby creating the need for build-

to-suit and speculative development in the later half of 1998 and early 1999.

Following is a brief look at each of the state's major economic centers and the factors driving those particular markets.

San Diego

The southernmost economic center of the state is San Diego County, comprised of approximately 10 submarkets, each with its own unique focus and pricing schedules. The downtown, UTC, and Carlsbad markets comprise the majority of the office sectors. Miramar, Kearny Mesa, Poway, and Oceanside comprise the warehousing and manufacturing sectors, while the Torrey Pines, Sorrento Valley, and portions of the Carlsbad market comprise the biotech and R&D components of the market. While each of these submarkets focuses on specific pricing, the San Diego commercial real estate market as a whole was rated as the No. 1 market in the country for the first half of 1997 by one of the nation's largest real estate magazines for increased rental rates overall. The majority of large blocks of office, industrial, and R&D space are not available, and many users are looking to build-to-suits to accommodate their needs.

A majority of the land owners in San Diego County have recently refrained from selling raw land to users and developers because prices for raw land have increased dramatically, and these large land owners would rather build and hold the property than short-sell it today and preclude themselves from future benefits. Most of the new development in San Diego County appears to be in North County, where the majority of the residential development is as well. Prospects for the San Diego commercial real estate market are high, as it continues to be one of the most desirable places in the country to live and work.

Orange County

Orange County has seen dramatic rebounds in its economy, governmental stability, and commercial real estate viability.

Real estate continues to be one of the highest driving forces in the overall economy, and future speculative development in North and South Orange County continues to pave the way for growth. The region's bankruptcy appears to have been put to bed, and stability has returned.

Orange County has seen increases across the board in office, industrial, and retail pricing. The John Wayne Airport area has seen one of the highest increases in office rental rates in the entire country. Over the past six months, office rents have increased in excess of 25%, and in some cases almost 100%. Office vacancy in Class A product is in single digits, and rental rate pricing has reached levels that will now justify future developments. The industrial sector is just beginning its rent spike now that vacancy rates have dipped below 10%. A majority of the big box users are looking to build-to-suits, because the product available for them simply does not exist. Expect rental rates and purchase prices to continue to increase in Orange County, and look for a significant amount of new build-to-suit and speculative development, particularly in South Orange County.

Los Angeles

Los Angeles County is the largest economic center in the state, if not the country. Along with its neighboring counties, it is comprised of numerous submarkets, too many to outline in detail. The L.A. commercial real estate market is just now coming into its own in terms of increased rental rates. The significant amount of over-supply during the early 1990s and widespread default of overleveraged properties put L.A.'s commercial real estate markets in the doldrums for an extended period of time. However, the commercial real estate market is back, and industry-watchers can expect prices to continue to rise at a rapid pace over the next 12 to 18 months. As older and dilapidated projects continue to be rehabilitated and redeveloped, this creates a new market and pricing structure.

In addition, there are new developments of previously uninhabited land throughout Los Angeles that bring new economic prosperity to that particular region. The resurgence of growth in the North Valley — particularly in the Northridge, Encino, and Woodland Hills areas — continues where the earthquake had caused problems with older properties. Office prices on L.A.'s west side are rising rapidly and should reach the figures that we saw in the late 1980s within the next 12 to 24 months.

Downtown Los Angeles, which has suffered for a number of years, has now reached a point of equilibrium, where rental rates are increasing at a steady pace. The number of mergers, acquisitions, and consolidations among corporate headquarters downtown has stunted this area of L.A.'s recovery; however, the availability of quality office facilities downtown continues to dwindle, which will aid in this area's recovery.

Many of the manufacturers and distributors previously headquartered in Los Angeles made a mass exit during the early 1990s to more cost-effective parts of the country, such as Las Vegas, Arizona, Colorado, and Northern California. For the most part, the exit of these companies is over, and those businesses that remain in Southern California are here to stay. However, a good number of such companies have chosen to relocate to more cost-effective parts of Southern California to provide them greater economic profitability.

Inland Empire

The Inland Empire consists of Riverside and San Bernardino Counties and is located south and east of Los Angeles and east of Orange County. It has continued to thrive over the past few years, and possesses great potential for economic growth and continued development due to the vast amount of vacant land and affordable pricing. Many companies have chosen to relocate regional distribution centers due to the ease of accessibility to San Diego, Los Angeles, and other states via freeway access and rail. The vast amount of vacant warehouses has continued to decrease and is at the point now where new speculative development is being seen. Much of this area's growth is attributed to low-income, affordable housing. As the migration further east continues, more businesses will look to be located in this area.

San Jose & Silicon Valley

The San Jose commercial real estate market has seen dramatic changes over the past 18 months. The continued population growth and technological advances of computer and high-tech companies have caused a shockwave throughout the commercial real estate markets. Pricing for office space has increased in excess of 30%, and in some cases in excess of 100%, from previous years. The lack of available land for development

of commercial properties and the increased needs for expansion of Silicon Valley's commercial inhabitants have caused a serious shortage of available product, both for office and industrial space. This increased demand has driven rental rates and purchase prices to astronomical levels relative to previous pricing. Vacancy is in the low single digits and new speculative development is continuing to increase. This real estate market is one of the hottest suburban office markets in the country, and rental rates are some of the highest in the nation.

San Francisco is currently one of the state's hottest real estate markets.

Look for the commercial real estate market in San Jose to continue to thrive as new developments in and around central San Jose continue to flourish. As for the Peninsula and Silicon Valley, the lack of available land for development creates additional strains on the equilibrium of supply and demand. Ultimately, companies headquartered in these areas will look to relocate portions of their operations outside of the area because there is physically no place for them to be located.

San Francisco

San Francisco, which has been rated as the most expensive place to live in the country, is now probably the most expensive place to work as well. The cost of commercial office space downtown has reached an all-time high, with rents for Class A office space in the financial district in excess of \$5 per square foot/month. The dramatic increase in rental rates in the downtown area have not only reached all-time highs, but the recovery from the rental rates and vacancies of the early 1990s hit with such swift impact that many companies were faced with rental rate increases of 50% to 100% overnight.

The vacancy rate for downtown San Francisco is also one of the lowest in the country with availability for apartment housing in San Francisco at less than 1%. Many companies located in San Francisco are forced to relocate operations across the bay, where there is a greater supply of land and pricing is moderately more inexpensive. San Francisco continues to be the hottest real estate market in the country in terms of pricing and vacancy rates.

East Bay

The East Bay is comprised of Oakland and the surrounding cities. The region has, for the past several years, struggled in terms of vacancy rates and pricing. However, many companies have chosen to locate along the east side of San Francisco Bay due to more favorable pricing, available opportunities, and lack of other places to go. The overall

economic rebound has significantly helped revitalize downtown Oakland rental rates and the vacancy rates in surrounding cities. Although rental rates are significantly less than those on the Peninsula or in downtown San Francisco, they are continuing to rapidly increase as the vacancy rates continue to drop. Many companies whose employees commute from the East Bay will choose to locate here instead of other parts of the Bay due to decreased commute times and more favorable real estate costs.

Sacramento

The state capital, long considered an agricultural area and government headquarters, has continued to develop its own identity and business community. Again, the forces driving businesses out of the San Francisco Bay Area have brought many distribution and manufacturing companies to Sacramento. The availability of vacant land, decreased pricing in terms of rental rates, and availability of a more inexpensive labor force provide positive economic factors which corporations have taken advantage of. The continued population growth and the relocation of many firms have driven rental rates upward over the past 12 months. Vacancy rates in Sacramento for office space continue to decline at a steady pace, and rental rates continue to increase. The availability of land for master-planned development and its comparatively less-expensive pricing have allowed this region to continue to flourish.

An Optimistic Outlook

California is one of the most diverse states in the country and continues to be one of the highest growth states as well. While national sources expect economic growth across the country to increase at 3.5% to 3.75%, inflation remains around 2.2%. Consumer confidence is at an all-time high, and demand for commercial real estate remains increasingly optimistic.

While we must learn from our mistakes and experiences in the 1980s, the economic growth of the 1990s and into the 21st century will provide a new list of issues and circumstances. For investors and users of commercial real estate, their goals and objectives — as well as future trends in the market — must be examined by both today's standards and future projections. Those who elect to invest in commercial real estate and apply a solid set of investment techniques and applications will prove to have made wise investments decisions.

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