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Landlords Lower Expectations With Debut of Office Towers

By MARK MUELLER - 9/3/2007

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The developers of Orange County's latest batch of office towers are opening their doors with much lower leasing expectations than when they broke ground.

Developers have just finished construction or are nearing completion on six office towers—totaling 85 floors and about 2 million square feet of space—near John Wayne Airport and in the Irvine Spectrum.

By the Business Journal's count, only 15% of the new office tower space has been leased. That estimate includes a handful of deals, totaling close to 50,000 square feet, which should be finalized soon, according to local brokers.

The culprits behind the slow pace: tepid job growth, upheavals in the financial markets, continued space give-backs by mortgage companies and persistent tenant hopes for lower rents in the next year.

The result: A slow leasing market for the remainder of the year, and perhaps for much of 2008, market watchers said last week at a real estate industry conference in Irvine.

"It's clear we're in a changing time," said Bill Flaherty, senior vice president of leasing and marketing for Los Angeles-based Maguire Properties Inc., which opened the doors on its 3161 Michelson project last month.

The 530,000-square-foot building only is about a quarter leased, after its intended anchor tenant, New Century Financial Corp., filed for bankruptcy.

Like other area landlords, Maguire will have to hunker down for the time being, Flaherty said last week during the RealShare Orange County conference. Whether that mentality lasts for two quarters or six remains to be seen, he said.

Other developers are re-adjusting their projections.

Opus Center Irvine III, the 314,074-square-foot tower that the local arm of Phoenix-based Opus West Corp. is building next to John Wayne Airport, is about 16% leased, according to Matt Montgomery, the company's director of real estate development.

The developer now is hoping to get leasing up to about 25% by the time the building opens next month, Montgomery told the conference. In May, the company said it was looking to have preleasing closer to 40% or 50% by this time.

The slow rate of leases isn't just affecting the high-rises. Another million square feet or so of low- and mid-rise space being built on a speculative basis in Aliso Viejo and Irvine is nearing completion. But only a few notable lease deals have been signed.

It's no surprise the market is stalling, considering the heavy amount of local space taken up by the battered mortgage and real estate sectors, said Tom McCarthy, co-president of McCarthy Cook and Co., a Costa Mesa-based real estate investment company.

"This is the scene of the crime," McCarthy said.

Peaked for Investors

From an investment perspective, the local market has likely peaked, McCarthy said at the conference. His company sold off much of its local portfolio more than a year ago, and has been looking instead at markets such as Seattle, San Francisco, West Los Angeles and Silicon Valley, he said.

Most local industry players don't have a view that pessimistic. Assuming even moderate absorption below the extraordinary levels of recent years, the local market could stabilize in 2008, with rent growth starting again in 2009, said Bill Halford, chief executive for Newport Beach-based Bixby Land Co.

But that stabilization won't be a smooth climb.

OC "is the choppiest of all the markets in Southern California," said Joe Vargas, executive managing director and area manager for Cushman & Wakefield Inc.'s Southern California operations.

If the downturns in the real estate and mortgage markets play out to their extremes, the county's office vacancy rate could nearly rise to about 15%, Vargas said.

Right now, vacancy rates in the county stand at a little more than 9%, up from just more than 7% in early 2007 but still considered strong. The market usually swings from one the landlords like to favoring tenants when vacancy rates start rising above 10%.

Three or four months ago, developers could ask for sky-high rents and not be challenged. That's not the case now, Vargas said.

"If I'm a tenant (in the market for space), and we are, I'm taking a step back. In the short term, we're in for a wild ride," Vargas said at the conference.

Brokers who represent tenants are keeping an eye on the amount of concessions landlords offer for new tower space.

"There's been a reluctance of landlords to face the music. But a lot of people are pulling back (on making lease deals) because of the thought that a precipitous drop in rents is coming," said Jeff Manley, chief executive for Newport Beach-based Cresa Partners LLC.

Most landlords are acknowledging market changes though "quiet concessions," such as free rent, moving allowances, furniture and tenant-improvement money. Rents are effectively down 10% for the year after factoring in these types concessions, McCarthy said.

But to date, landlords haven't dropped their asking rents, especially for the new offices. That's likely coming soon, tenant brokers say.

"(Leasing) volume in the marketplace is slow. At some point, the landlord community has to acknowledge this," said Randall Parker, managing director for the Newport Beach office of Travers Realty Corp. "There has not been a better time to be a tenant in the last three years than today."

If a company has a lease expiring in the next two to three years, now is the time to start negotiating for better rents, he said.

Courting From L.A.

Developers of the area's high-rises have made most of their lease deals to date with local companies. But they are still looking for that next big company from outside the area to relocate.

The office market needs a big lease by a Fortune 500-type company to provide some stability, Vargas said.

It's only a matter of time before the area grabs that type of tenant, said Kevin McKenzie, president for Aliso Viejo-based developer Parker Properties LP.

"Mark my words, there's going to be a defection of a (big) L.A. firm" in the next few years, he said.

What type of company that would be remains to be seen. West L.A. office space is dominated by the entertainment industry, which isn't going anywhere, Vargas said. Central L.A. space is often cheaper than in OC, making a move unlikely.

"We used to apologize for downtown Los Angeles," Flaherty said. "And now we apologize for Orange County and the subprime mortgage market. Downtown Los Angeles looks pretty good to us."

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