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Office Market Continued Slump in Third Quarter

By Mark Mueller - 10/13/2008

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A handful of high-profile leases couldn't stop the bleeding from Orange County's battered office market, which saw another quarter of rising vacancies and falling rents.

The county's office market, which totals about 100 million square feet, ended the third quarter with a vacancy rate close to 16%, based on a polling of the area's brokerages.

That's up about 1% from three months ago and is an increase of nearly 50% from a year ago. Vacancy rates here now are at their highest point since early 2003.

Rents dropped about 3% during the past quarter and have fallen back to early 2007 levels. Some brokers think now is even a better time for tenants considering generous tenant concessions that are being offered.

The county's vacancy rate rose thanks to 400,000 to 500,000 square feet of negative absorption in the quarter, as fewer leases were signed and companies cut back on space, brokerages said.

'Cautious'

Increasing economic woes across the country likely won't help turn things around for the office market. The operative word for the quarter is "cautious," said Jeff Osborn, managing director for the Anaheim office of CB Richard Ellis Group Inc., and the head of the company's office division in Southern California.

Tenants that are looking for space "are operating conservatively and demonstrating a concerned outlook," Osborn said.

It is "for all the wrong reasons, but this is the best tenant market I've seen in 10 years," said Randall Parker, managing director for the Newport Beach office of Los Angeles-based Travers Realty Corp.

The fallout from the mortgage implosion continues to be felt locally, as financial institutions vacate space in Central Orange County and around John Wayne Airport, CB Richard Ellis officials said. More than 3 million square feet of space on the market is for sublease—an increase of 8% from a quarter ago.

Among big space give-backs in the third quarter, Washington Mutual Inc. vacated nearly 100,000 square feet of Irvine office space prior to its acquisition by JPMorgan Chase & Co.

All told, the office availability rate—which measures space that is available or is soon to be—ticked up about 1% in the past quarter, to nearly 21%.

On the bright side, there were more multifloor, big-dollar office leases signed in the third quarter than OC's seen in more than a year.

Hyundai Motor Finance Co. signed the largest lease for any new Irvine office tower in more than two years, with a nearly 100,000-square-foot deal at Maguire Properties Inc.'s 3161 Michelson property.

Sources say Hyundai likely paid in excess of \$4 per square foot for the high-profile lease at Maguire's Park Place campus, although the landlord offered a heavy concession package to land the marquee tenant, which will be moving operations from Fountain Valley.

Maguire also signed Raytheon Co. for a 78,000-square-foot lease in Brea near the start of the quarter. Elsewhere in North County, Beckman Coulter Inc. signed a three-year deal in Fullerton for 89,000 square feet.

"The velocity of the Orange County market is fairly stable. There's good activity, but it is mostly all lateral

movement," said Kurt Strasmann, managing director of OC brokerage operations for Santa Ana-based Grubb & Ellis Co.

Despite the recent slate of bigger leases, most deals being struck still are for 2,000 to 10,000 square feet, Strasmann said.

The average lease that CB Richard Ellis worked on last quarter was for 7,200 square feet. It worked on some \$385 million of office leases and sales in the quarter, officials said.

Rents

Asking lease rates continued their downward slide in the third quarter, with about an 8 cent drop from the second quarter, CB Richard Ellis reported. Office space in the county now has an average asking lease rate of about \$2.60 per square foot, which is about 6% below a year ago and is close to what landlords were asking at the start of 2007.

Factoring in landlord concessions to get deals done, the effective lease rate has dropped more than 10% in the past year, tenant brokers said.

More rent declines could be on the way.

Grubb & Ellis' Strasmann predicts that a year from now, effective lease rates in the county's offices will be 10% to 15% below where they are now, while leasing activity will continue to be flat.

Strasmann said he believes vacancy rates will bottom out at about 20% in a year and that 2009 will see another year of negative absorption in the range of 1.5 million square feet.

That would be the third straight year of negative absorption for the county—a historical rarity for the local office market.

Following the recent tumult on Wall Street, it is less likely that a turnaround in the office market will happen in early 2009.

Tenants and landlords alike "are going to be taking the (fourth) quarter off" while the economy shakes out, said Donald Yahn, director at Cushman & Wakefield Inc.'s Irvine office.

"It will take more time to make deals," he said.

Landlords are likely to work increasingly hard to keep existing tenants, meaning that rates are likely to keep dropping through the next year, Travers' Parker said.

On the downside for tenants, cash-strapped landlords might become less likely to pay heavy tenant improvement costs, Parker said.

If there's a silver lining for OC's office market, it's that the area has already seen most of the bad news, while other Southern California markets likely are to face an even harder future.

Los Angeles' office market, which has held up much better than OC in the past 18 months, now is starting to show more signs of weakness. And in the Inland Empire, overbuilding and a soft local economy could lead to office vacancy rates approaching 25% in the next year, Strasmann said.

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