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Reprinted from October 2007

SUBPRIME MESS' EFFECT ON SOUTHERN CALIFORNIA MARKET

With subprime lenders filing for bankruptcy faster than movie stars are getting DUIs, it is natural to wonder how the negative mortgage trend will affect the Southern California office market. Will the market direction lead to office vacancies of 18 percent like the days after the dot-com implosion earlier this decade?

Prior to this financial hiccup in fourth quarter 2006, the office vacancies in Los Angeles, Orange and San Diego counties averaged 6 to 10 percent. This low vacancy spurred the construction of approximately 7.9 million square feet, including 3.4 million square feet in Orange County. This new construction represents 2 percent of the 347 million square feet of total inventory in these markets. This is not a large percentage statistically; however, the percentages should cause some concern because most of the space under construction is speculative with little or no pre-leasing.

In mid-2007, the financial market fallout increased in velocity with subprime lenders, such as New Century and Ameriquest, filing for bankruptcy and releasing more than 1 million square feet back on the office market. Despite that, new construction is still underway with the majority of the space unspoken for.

Given all this bad news, how is office space going to fare? Amazingly, the impact is projected to be localized in specific areas such as Orange County, where the majority of the subprime lenders were headquartered. As it turns out, the impact may be less than expected due to the fact that housing-related companies in general occupy less office space, compared to the professional, pharmaceutical and medicine, computer and technology sector. For example, in 2005, 48 percent of all housing-related jobs were in construction, 26 percent were in professional and business services, and 13 percent in trade and financial activities. Consequently, only 39 percent of all the housing jobs require office space. Construction jobs that account for almost half of the total are project-related and have no office requirement. An additional 13 percent of housing-related jobs — title insurance, real estate agents, etc. — are in industrial or retail space. In contrast, 39 percent of all technology jobs were part of professional and business service sectors, 31 percent are manufacturing, 25 percent information and 5 percent in wholesale trading. This results in 64 percent of all technology jobs requiring office space.

Typically the leading indicator for office occupancy has been job growth in management, financial services, technology, telecommunication and the various sectors enumerated earlier. At present, the job growth for these sectors in California is expected to decline by 1 percent or remain static until mid-2008. The weak job growth along with completion of the 7.9 million square feet of office space under construction will tend to increase vacancy.

What does this all mean? The slowdown of the housing market and implosion of the subprime lending sector in specific areas such as Orange County will add additional pressure to office vacancy. However, in contrast, the impact should be negligible in other western markets, correlating with the area's general job growth.

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