Outlook for the San Diego Metro Office Market with Green and Medical Office Breakdown

By Norm Miller, PhD, with Bryan Masters, Lawrence Kopp and Charles Tu, PhD

Preface: The purpose of this report is not to replace the forecasting work of the excellent consultants and real estate firms in the region. Rather, it is intended to provide an independent, aggregate and longer-term outlook on the health of the office market.

Demand and Supply: San Diego appears to be on a good track with respect to the metro office market. Normal additions to supply run about 2 percent of the stock each year and that suffices for normal wear and tear and attrition of the old stock—estimated at 1 percent per year—as well as new demand from normal business growth. Exhibit 1 shows net new office space demand in San Diego projected to 2020, based on the employment growth projections of SANDAG\(^1\) and using our own estimates for office space per worker. In Exhibit 2, using CoStar, Bureau of Labor Statistics (BLS) and SANDAG data, we project the new supply based on a combination of historical trends, and in our model take into consideration, rents, vacancies and office space per worker. The last three years have been well below normal in terms of new supply. We expect this below normal new supply trend to continue for the next several years. The majority of new construction that has been produced since 2008 has been build-to-suit for specific tenants. Very little speculative development has occurred as a result of the challenges of financing such investments. There are a few exceptions such as the new net zero energy La Jolla Commons II by Hines that is likely to be LEED Gold, as was La Jolla Commons I, both located in University Town Centre (UTC) where rents have been rising for several months in line with vacancy declines.

Based upon data from the BLS and SANDAG, San Diego is poised to continue to expand demand for professional office space, despite attempts by Governor Rick Perry to lure businesses away from California to Texas. Absorption was positive in 2011 and is expected to stay positive for the next several years. Nearly a million square feet per year will likely be added to the metro stock each year, although this remains near replacement levels assuming a 100 year life on all office space. Therefore, although these projections may be conservative, they are tempered by the fairly high metro office vacancy rates. Exhibit 3 using CoStar data and our own model shows vacancy rates being projected to stay in double digits for quite some time. Nonetheless, average rents in the stronger submarkets are expected to continue to climb, exceeding an average metro rent of $30 by 2020, and far higher in markets like UTC and the Central Business District.

Value Trends: Values of new high quality office space will continue to climb through 2020. Productive space that allows for greater utilization rates will experience escalations in value that exceed the overall numbers. What tenants seem to want is more collaboration space, more natural light, better ventilation, less noise and better temperature controls—all within a more energy and water efficient package. However, attempts to satisfy these tenant demands will require greater parking ratios than those required by current zoning and building codes. Moreover, the values supported by current and future cap rates estimated at 6.5 percent to 7.0 percent will not be sufficient to support new development if impact fees and the costs and hurdles of entitlement processes are not reduced. When interest rates increase, as they certainly will, these value

\(^1\) SANDAG is the San Diego Association of Governments, see www.sandag.org. The Chief Economist is Marney Cox.
projections will need to be adjusted downward. At that point, the only factor bringing the market back toward equilibrium will be a reduction in land costs.

On a more positive note, in a separate report, Medical Office Building (MOB) demand will parallel our aging population, if seniors don’t all move to tax havens. At the same time, a reduction in Medicare support by the federal government could spur medical professionals to take early retirement and might presage a temporary increase in vacancy of MOB soon after any significant cuts in Medicare are implemented as part of a comprehensive budget deal.

We will also be providing a separate report on Medical Office and Green Office patterns, again at the aggregate level.

Exhibit 1
Exhibit 2

Supply of Office Space in San Diego County
Actual 2003-2012 and Projected 2013-2020

Data Source: CoStar, Bureau of Labor Statistics and SANDAG
San Diego Metro Projected Office Rents and Vacancy Rates (Actual through 2012 and Projected 2013-2020)

Data Source: CoStar
San Diego Office Stock and Value Per Sq. Ft
Actual 2008-2012 and Projected 2013-2020

Data Source: CoStar and BMC
Outlook for the San Diego Green Office Market

Demand and Supply: The San Diego Green office market appears to be recovering at a more rapid pace than the general metro office market. Most green buildings are already superior in quality with a large proportion of Class A quality inventory. Many tenants realizing the historically low rental rates bargains in the past few years have made the “flight to quality.” The overall vacancy rate for green buildings has come down faster than the overall market. Normal additions to supply run about 2.8 percent of the stock each year in San Diego County, included in this figure is the addition of new construction and existing building conversion. Exhibit 5 shows net new office space demand in San Diego projected through 2020, based on the employment growth projections of SANDAG and using our own estimates for office space per worker. In Exhibit 6, using CoStar, BLS and SANDAG data, we project the new supply based on a combination of historical trends, as well as rental rates, vacancies and office space per worker.

The last three years have been well below normal in terms of net new supply. Due to the lengthy permitting process for new construction, we expect this below normal new supply trend to continue for the next several years. In regards to office buildings, the majority of new construction since 2008 has been green buildings. We expect this trend to continue, whether or not the owner decides to certify the building is their decision. Those few projects currently under construction are green buildings including La Jolla Commons II in the UTC submarket, which is likely to be LEED Gold and will be one of the largest ‘net-zero’ buildings in the United States. The other, the FBI headquarters building in Sorrento Mesa, is projected to be LEED Gold. In addition, Rio San Diego I, a Class A building in Mission Valley, achieved LEED EB certification last year.

Based upon data from the Bureau of Labor Statistics and SANDAG, San Diego is poised to continue to expand demand for professional office space. Absorption in green buildings has been positive in 18 of the last 20 quarters and is expected to stay positive for the next several years. Just under three million square feet per year will likely be added to the green metro stock each year, this includes about two million square of existing construction being retrofitted to meet green standards. Exhibit 7 using CoStar data and our own model shows the vacancy rate for green space is projected to reach single digits again in 2014. With this trend, the average green rental rate is expected to climb, exceeding an average metro rent of $47 by 2020, with some of the stronger submarkets like Del Mar Heights and UTC being even higher.

Value Trends: Values of green office buildings will continue to climb through 2020 as seen in Exhibit 8. Buildings that offer the greatest amenities and are in premium locations will experience escalations in value that exceed the average price per square foot. More tenants that desire to be in more convenient locations, require more collaborative space, better natural lighting, better ventilation, less noise and better temperature controls, along with more energy and water efficient package will be attracted to green buildings. Moreover, as land availability is limited in the ideal locations for green buildings and land values and entitlement costs remain high, especially in the desirable submarkets, the feasibility of new construction will be limited. In addition, when interest rates increase, the interest of new spec office development will be reduced. We anticipate that with the demand and land shortage, that the spread between green building and non-green building values will become greater before green becomes the standard benchmark required for all competitive buildings.
Exhibit 6

Supply of Green Office Space in San Diego County
2003-2012

Data Source: CoStar, Bureau of Labor Statistics and SANDAG

Exhibit 7

San Diego Metro Green Rental Rates and Vacancy Rents

Data Source: CoStar
Exhibit 8

Forecasted Value for Green Office Stock

- **Total Supply**
- **Forecast Values**

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Data Source: CoStar and BMC
Outlook for the San Diego Medical Office Market

Supply and Demand: The San Diego medical office market has been performing relatively well in the past few years. It has experienced only one quarter of negative net absorption in the trailing 12 quarters ending in the fourth quarter of 2012. This increase in absorption may be attributable to a recent phenomenon, brought to our attention by Charlie Abdi, principal at Finest City Realty Advisors, of large healthcare providers to master lease or buy medical office space close to their campuses or in their immediate districts. They are not necessarily acquiring this space for immediate use, but for long term need. Given the shortage of land zoned for medical office, they see this acquisition as a concrete possibility for expansion in the future. Among the certain hospital systems that have been observed doing this are Sharp Memorial and Rady’s Children Hospital, both in Kearny Mesa. If this tendency continues, we may see a much higher rate of absorption in medical office space in San Diego County. With this inherent need for larger healthcare providers to find sufficient land or medical office space for their operations, we may see a suburban move in order to meet their appetite for space and to be closer to patients.

Construction is nowhere near pre-fall 2008 highs when Lehman Brothers went under, but over 300,000 square feet of medical office space was delivered last year in San Diego County. “As a result of tightening vacancy and rising rents, providers are facing rising occupancy costs and declining reimbursement rates, so being creative with their space design and strategic with their leases and acquisitions is as important as ever,” says Chris Ross, vice president of Healthcare Real Estate Services at Colliers International. “Developers have noticed the increased demand for space and are getting more innovative as well, repurposing office buildings, integrating medical office into retail centers and re-zoning property that otherwise would not allow medical use. These actions will improve the overall health and balance of the medical office market.” Over the past decade, medical office space has represented an average of about 11.75 percent of the total office market. This percentage has been increasing gradually, and we expect that trend to continue in the coming decade, reaching almost 13 percent in 2020.

Using several market condition factors, we forecast an increase of 14.7 percent from 2013 to 2020 in medical office inventory. This equates to an average annual increase of 2 percent. The growth rate and space trends are shown in Exhibit 9. The rate of growth will remain positive but slow for a while. The 2 percent average increase will result in an average of 300,000 square feet of deliveries per year until 2020.

The Altarum analysis of Bureau of Labor and Statistics and the U.S. Census Bureau data, as illustrated in Exhibit 10, indicates an average annual growth rate in health care employment of 2.1 percent over the course of 2006 to 2011, with a high of 2.8 percent in 2008, as seen in Exhibit 11. We expect to see a higher figure than the 2.1 percent growth rate going forward averaging 2.4 percent over the next eight years and rising to 2.8 percent in 2020. According to data from the Center for Disease Control, the population segment aged 65 and over visit their health care provider more frequently than their younger counterparts. With an aging demographic in San Diego, as well as in the United States, there will undoubtedly lead to increased demand for health care. The Affordable Health Care Act known as Obamacare increases coverage of the population and could shift demand away from emergency rooms to clinics and regular physicians. At the same time Medicare reimbursement rates, expected to be reduced will also play a part in the future demand for medical office space.
Reimbursement rates are simply the payment a doctor receives for a particular procedure performed on a patient in the Medicare system. The lower reimbursements suggested by current policy strategies and the greater the regulatory reporting and billing costs burden imposed, the less incentive doctors have to accept and treat such patients. With an aging physician population, many of them may decide retirement or selling their practice to larger hospitals and clinics is a better alternative to staying in private practice. This may shift some of the demand away from smaller medical office tenancy towards larger facilities affecting the vacancy rates of the lower quality smaller scaled and generally older medical office stock. In the past few years, there have also been reports of Medicare dependent doctors and their practices entering into financial difficulties due to not being able to cover their operating expenses with declining reimbursement rates. Smaller medical office tenants, especially those with a heavy Medicare practice, may not be as reliable and secure as they once were. “With the uncertainty of the future of this country’s healthcare system, it is more important than ever for physicians to control their overhead costs and reduce their risk exposure in order to most effectively position their practices for the future,” added JP Roach of Hughes Marino.

**Value Trends:** Characteristics of highly-sought after medical office space includes higher quality space with more efficient layouts and close proximity to hospitals. We will see a premium being paid for these buildings. In regards to multi-tenant medical office spaces, we see a continued trend of preferences for ancillary services to be located in the same building. In 2012, vacancy for medical office buildings in San Diego was 12.2 percent. We expect this vacancy rate to increase in 2013. In the long term, vacancy rates will decline, reaching a low of 9.4 percent by the end of the decade. According to our model, average rental rates will rise as vacancy falls, reaching $37.65 in 2020. This analysis is shown in Exhibit 12. This rental rate, of $37.65, is 36 percent higher than the average rental rate of $27.64 observed in 2012. In the value analysis, seen in Exhibit 13, average price per square foot for medical office space in San Diego County is forecast to rise to $457 by 2020. This is a 38 percent increase from our 2013 values. Although this is an optimistic scenario, we believe that the fundamental trends show us that values will reach that vicinity later this decade. At the same time, there will be a high dispersion of medical office property values with the new on-campus facilities at high premiums compared to that of older medical office buildings. Technological advancements and flight to quality will add to the price dispersion observed.
Exhibit 9

Supply of Medical Office Space, SD County

Data Source: CoStar and BMC

Exhibit 10

Demand for Medical Office Space, SD County

Data Source: Altarum Analysis of Bureau of Labor Statistics and U.S. Census Bureau data
Data Source: Altarum Analysis of Bureau of Labor Statistics and U.S. Census Bureau data
Exhibit 12

Vacancy Rates and Rental Rates, SD County

Data Source: CoStar and BMC

Exhibit 13

Medical Office Values Forecast

Data Source: BMC