ORANGE COUNTY

By Kevin Turner, Matt Didier, Joe Leon and Mathew Mousavi

Orange County is still one of the West's most desirable submarkets, and its high barriers to entry are only driving up demand — and price. The multifamily market is doing very well, especially among Millenials, and retailers are snatching up spaces just as quickly as they become available.

More than 100 transactions have closed in Orange County in the 50,000-square-foot-and-above range in the past 24 months. This includes a new 5-year lease of an 85,000-square-foot industrial building at 2900 McCabe Way in Irvine that is owned by Crown Associates Realty.

INDUSTRIAL

The Orange County industrial market continues to demonstrate its resilience. The market has posted more than 4 million square feet of positive absorption since 2010, and it continues to display positive rent and sale price growth, along with decreasing vacancies. Demand for mid-sized industrial space remains strong, while interest in larger, big-box product is on the rise.

Industrial consolidation has become a clear trend in Orange County and throughout Southern California. In the past 24 months, more than 100 transactions have closed in Orange County in the 50,000-square-foot-and-above range, which is considered big box inventory in the market. In line with this trend, more than 30 transactions in the 500,000-square-foot-and-above range have closed in the Inland Empire during the same period.

Turner

A portion of this demand for large space is the result of an increase in domestic manufacturing and near-shoring, which is a direct correlation to the recent spike in Chinese labor costs. With free trade agreements with Canada and Mexico, as well as the KORUS agreement with South Korea, more home electronics will begin to be manufactured in South Korea and Mexico as companies relocate manufacturing operations.

For example, Visio recently made a significant investment to expand its planned operations in Mexico. As manufacturing moves toward Mexico and Canada, more companies will seek industrial product in Orange County and throughout Southern California.

The core of the Orange County manufacturing market lies in pharmaceutical, medical device and instrumentation. The intellectual talent pool in this market is second to none as it relates to high-tech and manufacturing expertise, as well as process management.

With that in mind, the challenge in Orange County is supply. As a two-tiered market, Orange County industrial product can typically be classified as Class A and "everything else." While Class A product is always in play regardless of market conditions, there is a limited supply of these available spaces.

In addition, the availability of land is highly constrained in Orange County. Infill sites only occasionally become available, providing the opportunity for a new building to be developed.

This lack of supply will drive industrial rents and sale prices up in Orange County, provided that the U.S. economy continues its recovery.

The fragility of the economy is still evident, even as market conditions steadily improve. Corporate and mom-and-pop users alike continue to behave conservatively, and uncertainty remains as the country awaits the upcoming election. That said, once accretive job growth is underway, and the GDP growth increases to above 3 percent, Orange County will experience a substantial spike in industrial rents and the market will be able to fully recover.

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OFFICE

The overall Orange County office market continues to bounce along as a lack of demand from tenants is the main issue hampering an otherwise healthy, yet steady rebound. The office market realized 1.85 million square feet of positive absorption, relative to an 80-million-square-foot inventory in 2011, with most institutional investors bullish on a 2012 recovery. Absorption, however, has slowed dramatically with only 326,000 square feet of positive absorption year to date. Current activity has seen its typical summer slowdown which has been compounded by tenants awaiting election results to better understand government policies moving forward. The majority of larger corporate users in the market are also looking for similar amounts of space, so we are not anticipating significant positive absorption over the next 12 months.

Average asking rents have stabilized countywide over the past 12 months. They currently stand at $1.89 per square foot, which is down from $1.91 from the end of 2011. Effective rental rates are between 10 percent and 15 percent below asking rates depending on the quality of the project, its location and the required capital. We anticipate rents will remain stagnant through the end of the year, and probably through at least the first half of 2013 as well.

The capital markets have seen a rollercoaster ride similar to the office leasing market, as there is capital available and larger office projects on the market. However, there is too often a disconnect on pricing. Several larger trophy assets have traded in the past 12 months but just as many assets failed to meet sellers' expectations and were removed from the market. The Michelson, a 536,000-square-foot, Class A high-rise office in the John Wayne Airport submarket, is currently under contract for a price supposedly approaching $281.4 million, which would be a high-water mark since the height of the market. The Michelson is arguably the best office building in Orange County and boasts a rent roll including Hyundai Capital, Jacobs Engineering, LA Fitness, Bryan Cave and Gibson Dunn.

One of the leading indicators for the office market is job growth, which drives corporate expansion and positive absorption. The unemployment rate in Orange County was 7.9 percent in June 2012, which was up from a revised 7.5 percent the prior month and well below the 9.1 percent estimate a year ago. This compares with an unadjusted unemployment rate of 10.7 percent for California and 8.4 percent nationally during the same period. Between June 2011 and June 2012, total nonfarm employment increased by 31,500 jobs, or 2.3 percent. As is typical of Orange County's diversity, job growth came from several industries, with the drivers being professional and business services, leisure and hospitality, and trade, transportation and utilities. Construction and government are the only two industries to post negative job growth over the past 12 months.

While speculative development has gained momentum in the industrial market given the lack of available functional inventory, the office market has seen little new construction in recent years. The lone project under construction is the 380,000-square-foot, build-to-suit property in Newport Center by Irvine Company. It will soon serve as the new corporate headquarters for PIMCO, one of the world's largest investment management firms.

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