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A Review of California Office Activity in 1987

Office space in metropolitan California increased by 37 million square feet in 1987 to over 400 million square feet of space, a 10% increase over 1986 (see Figure 1). This was a continuation of a pattern of strong office construction activity begun in the early 1980s. Net absorption—the overall increase in office space occupied—was at the highest level it has reached in the 1980s, at almost 33 million square feet. Nevertheless, net absorption still lagged behind construction activity, and vacancies remained at 18% by the end of 1987. Based on historic absorption rates, it would take two to three years to absorb the existing inventory of vacant space, which exceeded 70 million square feet in December 1987.

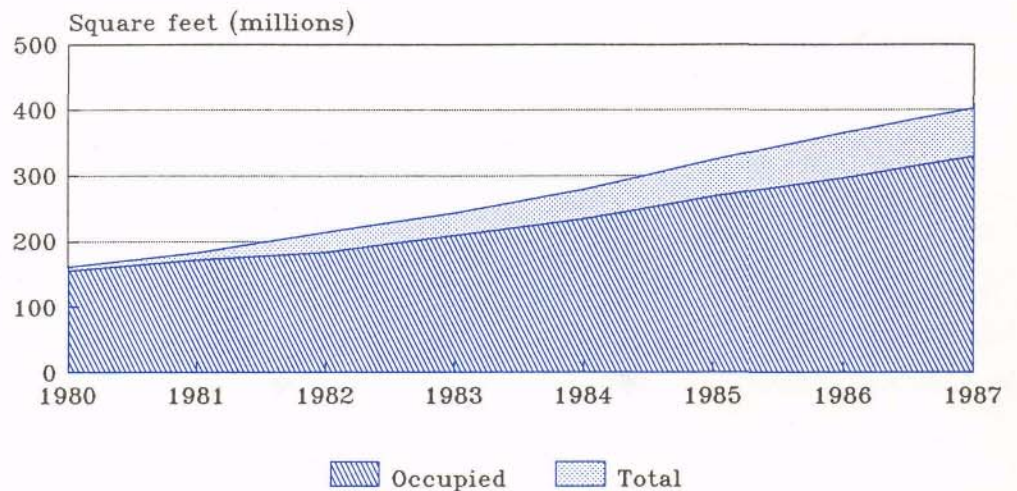
The increase in absorption in 1987 was paralleled by strong growth in office employment statewide in 1986 and 1987. Statewide, office employment grew by 5.4% in 1986 and 5.6% in 1987, an increase from an annual average rate of growth of 4.2% in the first half of the 1980s. Even with these increases, there con-

the rate of growth of office-type employment (finance, insurance and real estate, business services, and other office services) and the rate at which building activity has

proceeded. Since 1980, California's employment in office-using sectors has increased by 37% while office square footage has grown by 140%.

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FIGURE 1
Total and Occupied Office Space
California Metropolitan Areas, 1980-1987
(Millions of square feet)



Sources: California commercial brokerage firms and business organizations, including Coldwell Banker, Grubb & Ellis, Greater San Diego Chamber of Commerce, San Mateo County Economic Development Corporation, Newport Economics Group, Charles Tingey Asso., Cushman and Wakefield, and Kegan and Coppin.

Note: California metropolitan areas include Los Angeles, Orange, San Bernardino, Riverside, Ventura, San Diego, Sacramento, Kern, Fresno, San Francisco, San Mateo, Marin, Contra Costa, Alameda, and Santa Clara counties.

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Still, occupancy levels have grown by over 100% since 1980, indicating that other factors in addition to traditional office employment influence the demand for space. These may range from pent up demand in the early 1980s, to technological changes demanding more workspace per employee in more recent years. Very favorable lease agreements associated with soft markets have also encouraged firms to absorb more space than their employment growth alone would warrant.

While growth of inventory and absorption have been strong throughout California, overall conditions vary among and within regions of the state (see Table 1a). At over 20%, vacancy rates are highest in the Central Valley, which has also had the most rapid growth in office inventory, increasing square footage by about 14% in the past year. Southern California growth was also quite high, with a 13% increase in square footage in 1987 and overall vacancies of 18.5%. The San Francisco Bay Area has the lowest vacancy rate, 17%, while inventory increased by only 6% in 1987.

The Southern California Market

Southern California has a large and growing share of the California office market. The six counties of Los Angeles, Orange, San Diego, Riverside, San Bernardino and Ventura account for 57% of all office employment in the state, and 54% (almost 220 million square feet) of all metropolitan office space. The region has accounted for 58% of the statewide increase in office square footage since 1980.

The rate of growth of traditional office using jobs in Southern California has been slightly below the statewide average but close to the average rate for the state's larger metropolitan areas (see Figure 2). The growth of office jobs has been slowest in Los Angeles County, expanding at a rate of 2.8% in 1987; nevertheless, Los Angeles County has added 165,000 jobs in traditional office sectors since 1980, over 45% of the 360,000 office jobs added in Southern California. Figures from Grubb & Ellis indicate that Los Angeles County accounts for more than half of Southern California's office space and for a similar share of new square footage.

Office jobs grew rapidly in other Southern California counties. In 1987, office jobs grew by 6.3% in Orange County, by 8.3% in San Diego County, by 8.0% in the Riverside/San Bernardino metropolitan area, and by 11.3% in Ventura County.

Orange and San Diego are the most heavily overbuilt of Southern California counties. Vacancies in Orange County are over 20% according to the Newport Economics Group, slightly below last year's 21% but above the 16% level measured in 1985. San Diego's office vacancies were at 24% in September 1987, down from 27% in 1985 and 26% in 1986, as tracked by the Greater San Diego Chamber of Commerce. More than five million square feet of space were absorbed (net) in Orange County and over three million square feet were absorbed in San Diego in 1987. Nevertheless, even if these peak rates of absorption continue, Orange County has almost a two year supply of space and San Diego County has greater than a two year supply. At average absorption rates for the past five years, both counties have greater than a three year supply of vacant space.

In contrast, the smaller markets of Riverside, San Bernardino and Ventura, although expanding rapidly, have lower than average vacancy rates—15% in the Riverside/San Bernardino market and 17% in Ventura. The Ventura area appears to have about a two year supply of vacant space, while the Riverside/San Bernardino market has less than a two year supply of space.

The San Francisco Bay Area

Office stock in the San Francisco Bay Area has doubled from 75 million square feet in 1980 to almost 150 million square feet at the end of 1987. About 25 million square feet, or 17% of the space is vacant. With average absorption in the region at about eight million square feet annually over the past five years, the region has about a three year supply of space vacant. The market has begun to respond to the signs of overbuilding, as evidenced by the slowing in the expansion of office stock. Office stock increased by a rate of almost 12% annually in the first half of the 1980s but by only 6% in 1987.

Traditional office employment grew by 4.1% in 1987, a strong increase compared to historic averages, with the fastest growth occurring in business services and the slowest growth in finance, insurance and real estate. Significant redistributions of activity continue within the region. For example, San Francisco had no net increases in employment in finance, insurance and real estate in 1987 and Alameda County lost over 3% of its employment in this sector, while Contra Costa County had a 10.8% increase in finance, insurance and real estate employment.

Highest vacancies are in Alameda, Contra Costa, and Santa Clara Counties, all at about 20% according to data compiled by

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TABLE 1A
Office Square Footage, Vacant Space, and Vacancy Rates
California Metropolitan Areas, 1985-1987
(Millions of square feet)

Region	1985			1986			1987		
	Total Stock	Amount Vacant	Percent Vacant	Total Stock	Amount Vacant	Percent Vacant	Total Stock	Amount Vacant	Percent Vacant
Southern California									
Los Angeles*	102.7	17.0	16.6	112.5	18.5	16.4	125.6	21.0	16.7
Orange	35.9	5.9	16.3	42.0	8.8	21.0	48.4	9.9	20.4
San Diego	23.5	6.4	27.3	25.7	6.6	25.7	29.4	7.2	24.4
Riverside/San Bernardino	6.8	1.5	21.5	9.8	1.9	19.0	10.9	1.6	15.0
Ventura	3.2	0.3	10.5	3.5	0.6	18.0	4.3	0.7	17.3
<i>Total</i>	172.1	31.1	18.1	193.5	36.4	18.8	218.6	40.4	18.5
Central Valley									
Sacramento	18.2	4.6	25.0	20.6	4.8	23.1	23.8	4.8	20.2
Kern	3.9	0.9	22.4	4.1	1.1	26.0	5.0	1.3	26.0
Fresno	N/A	N/A	N/A	6.3	1.1	17.4	6.5	1.2	17.7
<i>Total**</i>	22.1	5.4	24.5	31.0	6.9	22.3	35.3	7.3	20.5
Bay Area									
San Francisco	55.9	6.9	12.3	59.5	9.2	15.5	61.8	8.3	13.4
San Mateo	13.4	2.0	14.7	14.7	2.9	19.8	15.0	2.7	18.0
Contra Costa†	16.2	3.2	19.5	19.3	4.8	24.9	22.1	4.5	20.4
Alameda†	19.2	4.7	24.0	20.0	4.6	23.0	20.5	4.2	20.5
Santa Clara***	22.1	6.2	28.0	24.4	8.0	32.7	26.4	5.2	19.6
Marin	2.2	0.6	27.9	2.4	0.4	16.4	2.5	0.3	11.0
<i>Total</i>	129.3	23.5	18.2	140.3	29.9	21.3	148.3	25.1	17.0
Total**	323.5	60.0	18.6	364.8	73.2	20.1	402.1	72.8	18.1

Notes:

* Los Angeles data differ slightly from earlier CREUE summaries because of a change in the data source used.

** Totals are for areas with complete data only (i.e. Fresno is not included in Central Valley and California totals for 1985).

*** The sharp drop in Santa Clara County vacancies in part is the result of a change in the definition of vacant space used by the brokerage firm providing the data.

† Contra Costa figures include the Alameda County portion of the 680 corridor. These are excluded from the Alameda County totals.

Sources: CREUE, from data provided by Grubb & Ellis (Los Angeles, Riverside/San Bernardino, Ventura, Fresno, and Santa Clara), Coldwell Banker (Sacramento, Alameda, and Contra Costa), Greater San Diego Chamber of Commerce (San Diego), Newport Economics Group (Orange), Charles Tingey Associates (Kern), Cushman and Wakefield (San Francisco), San Mateo Economic Development Board (San Mateo), and Kegan & Coppin (Marin).

Coldwell Banker and Grubb & Ellis. Alameda County has more than a three year supply of space vacant, while Contra Costa and Santa Clara each have about a 2.5 year supply of vacant space. San Mateo County has a slightly lower vacancy rate, 18% as tracked by the San Mateo County

Economic Development Corporation, but absorption was modest in 1987, at about a half million square feet, and historical average absorption indicates that there is at least a three year supply of space in the county. Marin County represents a very small share of the region's

stock and has an 11% vacancy rate according to Keegan and Coppin.

The San Francisco market did well in 1987, absorbing over three million square feet of space—a large increase following three below

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average years in absorption. The city's office vacancy rate dropped from 15.5% in 1986 to 13.4% in December 1987, according toushman and Wakefield figures. The long term future for the market, however, remains uncertain. The city had 8.3 million square feet of space vacant in December 1987. Even at the 1987 rate of absorption, this would be more than a two year supply of space. In fact, absorption in the 1980s has averaged less than 1.5 million square feet annually, implying that San Francisco's office market may be the most heavily overbuilt in the region.

The Central Valley

The state's fastest growing office markets are in California's Central Valley, with the largest base in the Sacramento metropolitan area. Coldwell Banker figures indicate that Sacramento's office stock has grown from under five million square feet of space in 1980 to almost 24 million square feet at the end of 1987. Other Central Valley counties are also developing significant office bases. Fresno, for example, now has 6.5 million square feet of space according to Grubb & Ellis, and Kern County has five million square feet in the Bakersfield area, according to Charles Tingey Associates.

With 4.8 million square feet vacant, Sacramento has a vacancy rate of 20%.

While this is still a very high rate, there are some signs that the market is beginning to tighten. First, current vacancy levels are below the peak level of 25% reached in 1985.

Second, based on historical trends of the past five years, the metropolitan area has absorbed over 2.5 million square feet annually. If absorption continues at this rate, there is less than a two year supply of space currently vacant in the metropolitan area.

Less complete histories are available on other Central Valley office markets, making it harder to assess current levels of activity in the market. Kern County has one of the highest vacancy levels in the state, at 26%, while Fresno's is a more

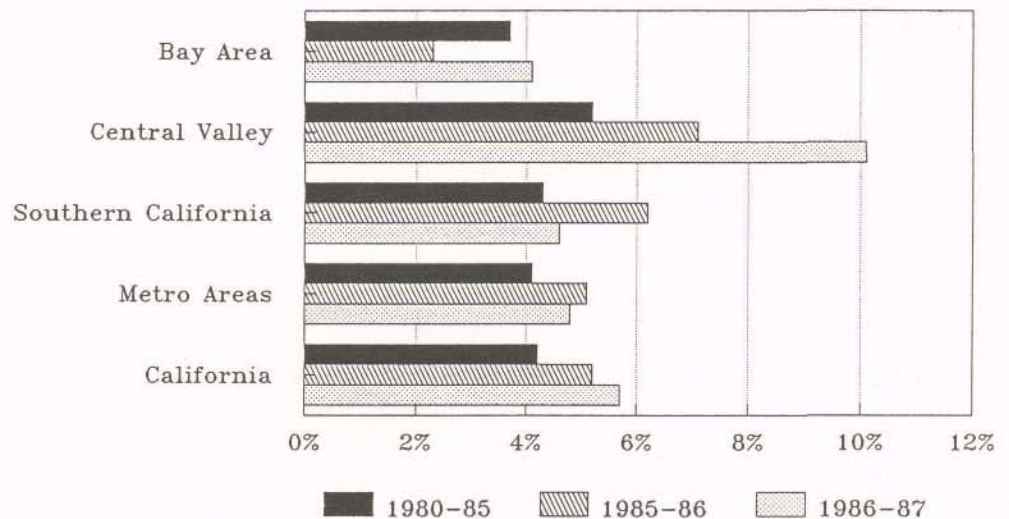
moderate 18%. Both markets appear to be well-supplied for the next two to three years.

The Outlook

While stock remains plentiful in the California market, the extreme levels of overbuilding of the mid-1980s are beginning to abate. The total amount of vacant stock statewide remained steady in 1987 compared to 1986, while the overall amount of space occupied rose strongly. However, conditions vary significantly within the state. Building activity cut back most sharply in the San Francisco Bay Area, where the inventory of vacant space

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FIGURE 2
Office Employment Annual Rate of Growth
California Metropolitan Areas



Note: Office Employment includes SIC's 60-67, 73, and 81-89

Source: CREUE from California Employment Development Department data.

The Effect of Asbestos on the Value of Commercial Property

It is widely reported that the presence of asbestos containing materials (ACMs) is having a profound effect on real estate markets with large discounts on sale prices for well-known ACM properties becoming increasingly common. Some large institutional investors are reputed to be unwilling to buy or make loans on ACM properties because of potential liability. At least one major tenant, IBM, has been cited as unwilling to lease space in asbestos buildings if other space is available.

Recently conducted interviews with property managers, investors, lenders, and realtors indicate that the effect of asbestos on value, which only began to show up in the early to mid-1980s, varies depending on the type and amount but could be substantial. The survey also indicated that the effect of asbestos on current property income in the form of lost revenues or higher expenses (excluding abatement costs) is small. However, apparently because of the difficulty in selling and financing ACM properties, removal has moved to the fore as the abatement method of choice, and dollars spent to remove ACMs are increasingly viewed as an inescapable cost of doing business.

Size and Timing of Asbestos Effect

To find out the effect of ACMs on commercial property values, a set of personal interviews of active practitioners in the real estate field was conducted in late 1987 in connection with a court case. The relevant issues were whether property damage, in the form of diminution of value,

had been caused by the presence of asbestos, and when the damage actually occurred. Interviews were conducted with real estate investors, managers, lenders, and brokers in several different metropolitan areas around the country. The properties included office and apartment buildings, a retail mall, and a piece of vacant land. Because asbestos is an extremely sensitive subject, strict confidentiality of all interviewees and properties has been maintained.

The results of the small but significant sample indicate that the effect of asbestos on commercial property values varies widely, but in some cases is quite substantial (see Table 1b). The median effect reported was about 7% of value. In general, the size effects fell into two main groupings, with about a third of the responses in the 3-5 percent range and another third in the 10-16 percent range. The range was large and generally associated with the type and extent of ACM, as would be expected.

The smallest effect noted, .3%, was in an office building in which the only ACM was a small amount of pipe and boiler covering. At the other extreme, the effect on the anchor store of a vacant retail mall was estimated to be 130% of value—i.e., the cost of removal for this property, riddled with asbestos in beams, ceilings, and generally throughout the building, was more than enough to wipe out its economic value.

In general, those interviewed indicated that the effect of asbestos on value was essentially the cost of removal, including the costs of relocation of tenants. Other forms of

abatement (encapsulation or enclosure combined with an operating and maintenance program) were usually seen as only stopgap responses that were unacceptable to many buyers and lenders.

All respondents indicated that the effect began to show up in the marketplace relatively recently, with the earliest date cited as 1982 and the latest as around 1986. The median response was about 1984. From the point of view of establishing responsibility for property damage, the issue of timing is important because many property insurance policies were revised in the early 1980s with the intention of specifically excluding diminution of value from toxic materials, including asbestos.

Source of the Effect

The source of the impact on value appears to be the impact on potential sale price and financing rather than on current net operating income (NOI). Most interviewees said that they had no more difficulty renting space in ACM properties than in non-ACM properties, and thus there was little or no effect on gross effective income, despite some published reports to the contrary. Interviewees also denied that ACMs had much impact on expenses (other than the cost of abatement itself). Nevertheless, building owners felt abatement was necessary, most typically because the property would be hard or impossible to sell or refinance with ACMs.

An obvious question is how can ACMs have a small impact on NOI but a large effect on market value,

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Asbestos...

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which should be the capitalized value of NOI? While interviewees were not asked this directly, possible reasons for this seeming discrepancy include estimates that *future* NOI will be more greatly affected than current NOI because of the possibility of more severe regulation or increased sensitivity to ACMs on the part of potential tenants. Other possibilities are fear of potential future liability for asbestos-caused disease on the part of a buyer or lender, and greatly increasing cost of abatement over time due directly to tighter regulation (more expensive requirements) and indirectly to increased abatement activity and bottlenecks in expanding the number of qualified abatement personnel.

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dropped in every county. In contrast, the three largest southern California counties all continued to add more space than they absorbed in 1987, despite having a strong year for net absorption. The Sacramento metropolitan area added space at a level equal to net absorption, while the other Central Valley counties

added considerably more space than was absorbed.

In summary, it appears that opportunities for new office development will once again begin opening up in parts of California. With planning horizons of several years required for major office projects, the market should begin to brighten for long term investment. However, at least two caveats are important in viewing the outlook. First, current conditions and future expectations differ sharply among regions within

the state as well as within sub-regions of the state. Some markets may be ready to expand in the next two years, while others face much longer periods of stagnation. Second, the overall rate of growth of demand in office space will be significantly less than it was in the past decade. Thus, any increase in investment from levels of the past year could easily increase overbuilding in the marketplace once again.

**Cynthia A. Kroll
Ignacio Dayrit**

TABLE 1B
Effect of Asbestos on Value of Surveyed Properties

Property Type	Effect on Value	Date of Effect, This Transaction	Earliest Date Effect Noted on any Transaction
Office	4%	85	83-84
Office	8-9%	87	83
Office	10%	87	84
Office	10-20% ¹	84	84
Vacant land	Sale will fall through	87	N/A
Apartment	4-5%	84-85	84-85
Retail ²	3-3.5%	87	83-84
	130% ³	87	—
Office	.3% ⁴	82-87	82
School	N/A	87	N/A
Office	14-18%	86-87	Early 80s
Office	5%	86-87	85-86
Office	N/A	87	N/A
Apartment	±20%	87	85
Office	2.5%	86-87	86
Office	Cost of Removal	83	N/A

¹ Estimate based on information given for effect on NOI and/or costs of removal.

² Two part property.

³ Cost of removal was 30% greater than estimated value without ACM—i.e., property had negative value, so seller would have to compensate purchaser to take property.

⁴ Estimate.