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The Office Glut: End or Upswing in '89?

Vacancy rates for California's leasable office space fell in 1988 for the second consecutive year. As of December 1988, 16.6% of office space in the state was vacant. This is the lowest rate of vacancy since 1984, down from 20.1% in 1986 and 18.1% in 1987. The lower vacancy rate reflects the much closer balance between new supply and net absorption that has been achieved in many markets during the past two years.

This is welcome news in a state that has experienced a large and increasing surplus of office space for much of the 1980s. However, a closer look at recent statistics indicates that in some parts of the state, the leveling off of vacant office square footage may be a brief hiatus in a market that continues to build new supply.

Building activity in 1988 pushed office supply in California's major metropolitan markets to almost 440 million square feet. While vacancy rates have stopped rising, the actual amount of space available for lease has decreased only slightly, and the state continues to have over 70 million square feet of vacant office space.

Rising building permit values indicate that growth in office stock may take an upswing again in 1989. Statewide, commercial building permit values jumped to \$6.1 billion in 1988. While this is below the 1985 peak of \$6.2 billion, it is well above the 1986 and 1987 values of \$5.8 billion and \$5.6 billion respectively. Furthermore, in some regions 1988

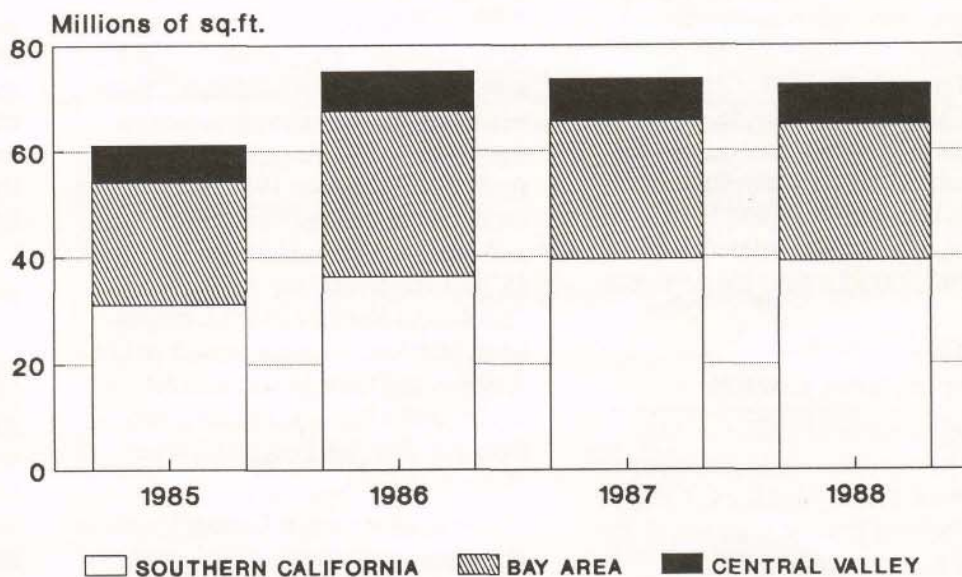
commercial permit values exceed the previous 1985 peaks.

Shifting Economic Sectors and Office Space Demand

Concern over excess supply does not imply that demand for office space is weakening. On the contrary,

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FIGURE 1
Estimate of Vacant Office Stock in California



Source: Center For Real Estate and Urban Economics

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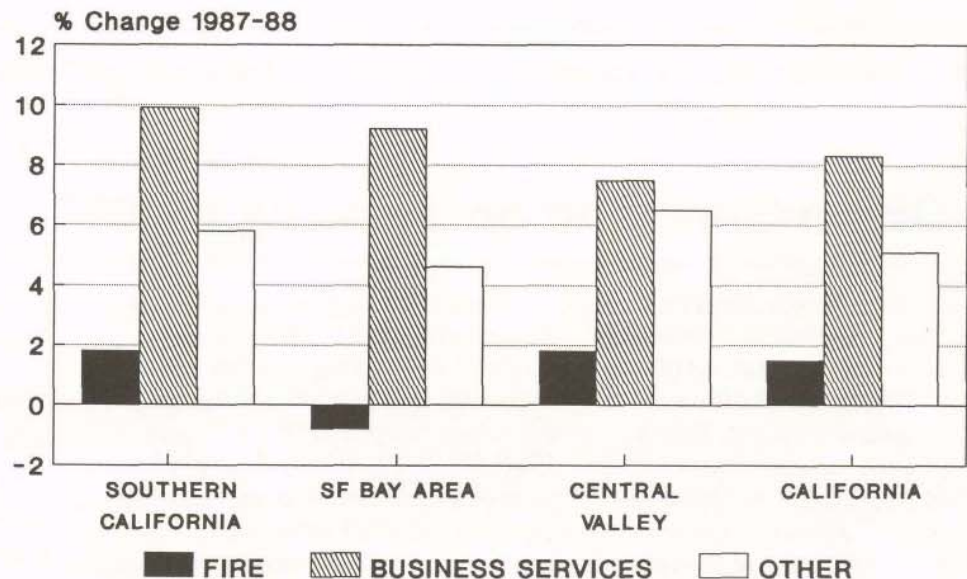
1988 office-related employment continues to expand more rapidly than overall employment in California. Statewide, office employment grew at 4.9% in 1988 while total employment increased by 3.4%.

Last year's growth, however, indicates that growth in office demand is not spread evenly among all sectors (see Figure 2). Finance, insurance and real estate (FIRE), which accounted for just over one-third of office-related employment statewide in 1987, grew much more slowly than other office sectors in 1988. Expanding by only 1.5% between 1987 and 1988, employment gains in FIRE accounted for only 10.4% of all office employment growth in the state. Business services employment had the fastest rate of increase in 1988. Growing by over 60,000 jobs statewide, business services employment accounted for over half of all office employment growth between 1987 and 1988. Finally, other office-related services added 40,000 jobs over the past year.

Regional Differences in Employment Growth

The most rapid gains in office employment occurred in Southern California. During 1988, over 75,000 office-related jobs were added, at an annual growth rate of 5.7%, as shown in Table 1. Office employment growth rates in the individual counties ranged from 5.4% in Los Angeles and Orange to 6.4% in San

FIGURE 2
Growth Rates of Office Employment in Major Metropolitan Areas, 1987-88



Source: Center For Real Estate and Urban Economics

Diego, 7.4% in the Riverside/San Bernardino metropolitan area, and 7.8% in Ventura County. Growth rates of major office sectors varied significantly within Southern California. FIRE employment growth was very slow in Los Angeles County (only 0.3% between 1987 and 1988), moderate in Orange County (1.6%), and much more rapid in San Diego (5.3%), Riverside/San Bernardino (8.3%) and Ventura (8.7%). In contrast, business services growth in Los Angeles and Orange counties (at 10.2% and 11%) was far stronger than in either San Diego (5.7%) or Ventura (8.9%).

In the four major Central Valley metropolitan markets, office employment growth averaged 5.2% from 1987 to 1988, an increase of almost 9,000 jobs. While all office activity had solid growth in 1988 in the

Sacramento metropolitan area, FIRE jobs declined in Fresno County and jobs in the other services category declined in Kern County. San Joaquin County lagged behind statewide trends in FIRE and business services employment growth, but exceeded the statewide rate in other office-related services.

The San Francisco Bay Area had the slowest rate of office employment growth of the three major regions, at 4.3% between 1987 and 1988, but nevertheless added over 28,000 new office-related jobs. Only the East Bay (Oakland metropolitan area) and the Santa Rosa metropolitan area (Sonoma County) had positive growth in FIRE, while only the East Bay and the San Jose metropolitan area exceeded

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statewide growth rates for the other services category. In the Napa/Solano portion of the North Bay, where office markets are not yet tracked on a regular basis, no increase occurred in office-related employment.

New Space in Southern California

Office square footage in Southern California rose to an estimated 231 million square feet by December 1988, accounting for more than half of the state's office square footage, as shown in Table 2. The region's 39.2 million square feet vacant is close to the 39.6 million square feet available in December 1987. However, the stable level of vacant stock in fact masks the differences in construction, net absorption and growth in vacant space that occur by county.

Construction slowed from earlier averages in Los Angeles County in 1988, according to Grubb and Ellis figures, while net absorption (the net change in square footage occupied) exceeded construction levels for the first time in the 1980s. This led the amount of vacant space to drop by about 1.5 million square feet and the vacancy rate to drop from 16.7% in 1987 to 14.6% in December 1988. In contrast, Orange and San Diego counties continued to add more space than was absorbed, and the amount of vacant space rose in both counties. In both Orange and San Diego, the amount of vacant space in December 1988 was more than three times the average annual net absorption for the county. Riverside/San Bernardino and Ventura counties had construction levels matching net absorption rates in 1988, and both counties have substantially smaller

TABLE 1
Total Employment and Office Sector Growth, 1987-1988

County/MSA	OFFICE EMPLOYMENT*		TOTAL EMPLOYMENT		PERCENT CHANGE 1987-88	
	1987	1988E	1987	1988E	Office	Total
Southern California	1333.5	1409.8	6817.3	7066.0	5.7	3.6
Los Angeles	820.9	865.3	4011.9	4121.8	5.4	2.7
Orange	222.6	234.7	1094.9	1140.3	5.4	4.1
Riverside/San Bern	81.2	87.2	627.5	648.6	7.4	3.4
San Diego	174.3	185.4	862.9	924.7	6.4	7.2
Ventura	34.5	37.2	220.1	230.6	7.8	4.8
San Francisco Bay Area	632.9	660.1	2801.0	2882.5	4.3	2.9
Fairfield/Vallejo/Napa MSA**	15.6	15.6	129.3	134.4	0.0	3.9
Oakland MSA**	150.3	161.9	814.2	844.5	7.7	3.7
San Francisco MSA**	287.3	292.3	934.7	946.5	1.7	1.3
San Jose MSA**	158.7	168.1	793.9	823.4	5.9	3.7
Central Valley	164.0	172.6	1159.2	1196.3	5.2	3.2
Fresno	31.4	33.0	256.1	264.5	5.1	3.3
Kern	21.9	22.5	190.2	190.7	2.7	0.3
Sacramento MSA+	89.0	94.7	556.9	578.3	6.4	3.8
San Joaquin	21.7	22.4	156.0	162.8	3.2	4.4
California	2364.3	2479.2	12023.5	12435.7	4.9	3.4

Notes:

* Includes finance, insurance, real estate, business services, legal, educational and social services, membership organizations, museums, zoos and botanical gardens, and miscellaneous services.

E 1988 figures are estimates from monthly preliminary data provided by the California Employment Development Department, Employment Data and Research Division.

** The nine San Francisco Bay Area counties are included in 5 MSAs, as follows: Fairfield/Vallejo/Napa (Napa and Solano counties), Oakland (Alameda and Contra Costa), San Francisco (Marin, San Francisco and San Mateo), San Jose (Santa Clara County), and Santa Rosa (Sonoma).

+ The Sacramento MSA includes El Dorado, Placer, Sacramento and Yolo counties.

Source:

Computed from data provided by the California Employment Development Department, Employment Data and Research Division.

proportions of excess supply than do most of the larger markets.

Although vacancy rates have been stable or declining in most Southern California counties, oversupply is by no means a concern of the past. Building plans continue to be optimistic in the region. After adjusting for inflation in building costs,

the value of commercial building permits for the region rose by 7.5% in 1988, surpassing the previous peak in 1985. Signs of potential overbuilding are further apparent in under construction and planned square footage figures. Grubb and Ellis estimates

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that the Los Angeles area will add 10.4 million square feet in 1989, while the Newport Economics Group reports 4.9 million square feet of space under construction in Orange County as of December 1988 and an additional 9 million planned through mid-1990. Plans for San Diego and the Riverside/San Bernardino areas appear equally optimistic according to figures from Coldwell Banker (San Diego) and the Newport Economics Group (Riverside/San Bernardino). Thus, the amount of square footage vacant in Southern California is likely to rise again by the early 1990s.

San Francisco Bay Area Moves Towards Closer Balance

The San Francisco Bay Area has almost two-fifths of the state's office square footage. While the city of San Francisco continues to be the region's largest office center, with 39% of the region's space, its share has dropped substantially since 1980, as centers in the East Bay and South Bay grew to account for half of the region's office square footage (see Figure 3).

The past two years of building activity and demand growth in the Bay Area have brought the region's office market into closer balance. As in Southern California, office vacancy rates have dropped regionwide. Net absorption equalled or exceeded construction in 1987 and 1988 in the East Bay, Marin and the Peninsula,

TABLE 2
California Office Space, Major Metropolitan Markets

Location	Stock December 1988	Percent Of State December 1988	Percent Vacant 1988	Average Increase In Stock 1980-88	Average Net Absorbed 1980-88	Vacant Sq. Ft. December 1988
Southern California	231.0	52.9	17.0	18.6	14.1	39.2
Los Angeles	128.0	29.3	14.6	9.8	7.6	18.7
Orange	52.3	12.0	20.3	4.3	3.2	10.6
Riverside/San Bernardino	12.2	2.8	14.1	1.2	1.0	1.7
San Diego	33.8	7.7	22.1	2.8	1.9	7.5
Ventura	4.7	1.1	15.7	0.5	0.4	0.7
San Francisco Bay Area	163.3	37.4	15.7	11.1	8.3	25.7
Alameda (880 Corridor)	20.0	4.6	20.2	1.5	1.1	4.1
Contra Costa (680 Corridor)	29.6	6.8	16.2	3.2	2.7	4.8
Marin	3.6	0.8	10.2	0.3	0.2	0.4
San Francisco	63.6	14.6	13.2	2.4	1.5	8.4
San Mateo	15.5	3.5	15.4	1.1	0.8	2.4
Santa Clara	31.0	7.1	18.1	2.8	2.1	5.6
Central Valley	42.7	9.8	17.8	NA	NA	7.6
Fresno	6.6	1.5	17.9	NA	NA	1.2
Kern	5.1	1.2	27.0	0.3	0.2	1.4
Sacramento	25.9	5.9	17.1	2.6	2.1	4.4
San Joaquin	5.1	1.2	12.0	NA	NA	0.6
Total, Major Metropolitan Areas	437.0	100.0	16.6	NA	NA	72.5

Source:

Compiled and estimated by CREUE, using data provided by:
Canaan Land Properties (San Joaquin)
Charles Tingey & Associates (Kern)
Coldwell Banker (Contra Costa, Sacramento, San Diego 1988)
Cushman & Wakefield (San Francisco, Alameda)
Greater San Diego Chamber of Commerce (San Diego, earlier years)
Grubb & Ellis (Los Angeles, Ventura, Riverside, Santa Clara, Marin, Fresno)
Newport Economic Group (Orange, Riverside/San Bernardino—part of 1988)
San Mateo County Economic Development Association (San Mateo)

as indicated by inventories conducted by Coldwell Banker, Cushman and Wakefield, Grubb and Ellis, and the San Mateo County Economic Development Association. In San Francisco, Cushman and Wakefield figures show that new construction in 1988 slightly exceeded net absorption, largely because of an excess of sublease space coming on the market. Grubb and Ellis figures indicate that Santa Clara County also had slightly stronger construction than

net absorption in 1988, but this followed a year of almost no new construction and strong net absorption. In both San Francisco and Santa Clara County, the difference between construction and net absorption was small enough to lower vacancy rates (the percentage of space vacant) from their 1987 levels.

In contrast to Southern California, the Bay Area's slowdown in
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building activity appears to be longer term. Commercial building permits in the San Francisco Bay Area dropped for the third consecutive year, with the 1988 annual level of \$888 million at only half the inflation adjusted 1985 peak level. Building permit levels dropped most sharply in Contra Costa and San Mateo counties. Contra Costa, at \$98 million in 1988, was 45% below the 1987 commercial permit value and less than one-fourth of its 1985 permit level, while San Mateo County's 1988 commercial permit value, at \$74 billion, was half of its 1987 level and one-third of its 1985 level. Commercial permits also show a steadily downward trend in Santa Clara County, where \$151 million in 1988 permits are three-fifths of its 1987 level

and two-fifths of its 1985 level. In San Francisco, commercial building permit value reached \$235 million, more than twice the 1987 level but still substantially below 1985 and 1986 levels.

Slower building activity in the San Francisco Bay Area will offer the opportunity for the region's office market to achieve a closer balance between supply and demand. With average annual net absorption still at less than one-third the amount of space vacant, it is not surprising that construction plans remain cautious.

Broadening Markets In the Central Valley

The Sacramento market is the dominant Central Valley office market, with three-fifths of the office stock in central California's major markets (see Figure 4). Kern, Fresno and San Joaquin counties have also developed significant office markets

over the past few years. Trends vary significantly within the Central Valley, with vacancy rates ranging from a low of 12% in San Joaquin County, as estimated by Canaan Land Properties, to a high of 27% in Kern County, as reported by Charles Tingey Associates.

According to Charles Tingey Associates, high vacancy rates in Kern County represent a combination of heavy investment in the first half of the 1980s in oil related stock in response to the oil boom, and vacated single-tenant buildings that are considered functionally obsolete for multi-tenant use. In contrast, San Joaquin County's low vacancy rates may reflect a diversifying economy and a rapidly growing population base. Fresno County, according to Grubb and Ellis data, saw slower absorption and construction in 1988, but the vacancy rate, at 17.9%, remains close to the 1986 and 1987 levels.

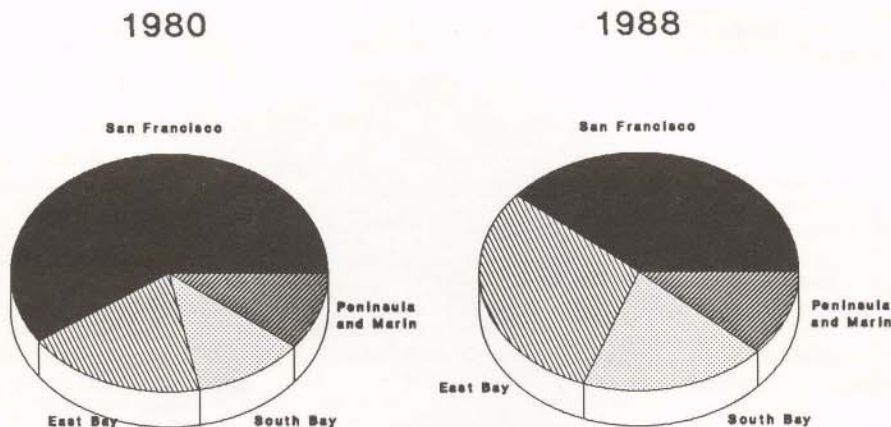
While Sacramento continues to have more than a two-year supply of vacant space, Coldwell Banker surveys indicate that vacancy rates have dropped annually since 1985, and the amount of vacant space dropped by 8% in 1988. Optimistic building plans for the metropolitan area are likely to further challenge the market over the next year or longer. Sacramento County's commercial building permit value was up by 45% in 1988 and was 42% above the previous peak of 1986.

Opportunities and Concerns in the Coming Year

California's office markets may take divergent paths in 1989. In Southern California, new building activity may well outpace the

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FIGURE 3
Office Market Shares in the San Francisco Bay Area, 1980-1988



Source: Center For Real Estate and Urban Economics

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growth in demand despite a job base that is expanding at a healthy pace. Contributing to the continued spurt of office construction in Southern California may be the ever present threat of growth restricting initiatives — an “under the wire” effect similar to that which occurred in San Francisco and Contra Costa County earlier this decade.

In contrast, Northern California office markets appear more likely to move towards a tighter balance. While demand in these markets is growing more slowly than in Southern California, the pace of construction has also slowed, only partly as a result of growth restrictions already in place in San Francisco and some of the other Bay Area markets.

Speculative investments are likely to be quite restricted in the southern part of the Central Valley, where the economies remain heavily dependent on agriculture and other natural resource bases. The Sacramento and San Joaquin markets, drawing on a more diversified base of activities and offering a less restricted building environment than in many other parts of the state, will continue to attract new development.

In conclusion, the office glut is receding in California, but its further resolution will be played out independently in the state's different metropolitan areas. Building activity in 1989 and 1990 will determine which regions of the state can achieve a closer balance between supply and demand and which will move towards new levels of over-supply.

Cynthia A. Kroll
Karen Lopilato

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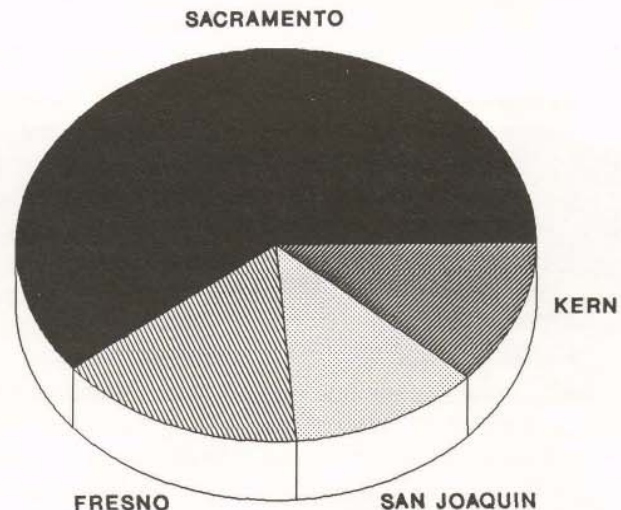
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FIGURE 4
Geographic Distribution of Central Valley
Office Square Footage, 1988



Source: Center For Real Estate and Urban Economics