HEAVY HITTERS
in Commercial Real Estate

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The world of commercial real estate is a complex and provocative field that demands expertise in areas from development and capitalization to legal and regulatory issues to long-term investment strategies and short-term speculation. We asked a select group of professionals to give us their perspectives on the local industry’s significant rebirth after the devastation of the economic recession. Their insights into this high stakes realm give a glimpse into where the region has been and the far-reaching plans for its future.

CONTRIBUTORS

PAUL KOMADINA
Managing Director
CBRE

Paul Komadina is the managing director of the San Diego Region of CBRE where he oversees the owner/investor side of the business with a specific focus on office, industrial, and retail agency leasing as well as capital markets including investment properties and debt and equity finance. Komadina splits his time among three offices in Southern California where he spearheads and implements many of the company’s key strategic initiatives, coordinating the collaboration of CBRE professionals across multiple business lines including investment sales, agency leasing, asset services and debt and equity finance.

NEIL HYYTINEN
Partner
Hecht Solberg Robinson Goldberg & Bagley LLP

Neil Hyytinen has been an attorney with Hecht Solberg Robinson Goldberg & Bagley LLP in San Diego since 2002. He practices in the areas of land use, planning and entitlements, including environmental and municipal law. Hyytinen is active in several professional associations and received his Juris Doctor, cum laude from the University of San Diego School of Law and has a degree in political science from the University of Minnesota.

LAUREN KELLY
Senior Vice President/Chief Marketing Officer
Irvine Company

Lauren Kelly joined Irvine Company in 2014 as Senior Vice President and Chief Marketing Officer of the Office division. In her position, Kelly is responsible for all aspects of marketing and brand performance for Irvine Company Office Properties. She also oversees New Development and Portfolio Marketing; Customer and Marketplace Insights; Product Innovation; Creative Services and Interactive Marketing. Previously, Kelly led Global Strategy for Dell’s Commercial Business, representing over $60 billion in revenue across all lines of business. Kelly holds a BA in psychology from Harvard University and an MBA from Harvard Business School.

MICKEY MORERA
Executive Vice President
Kidder Mathews

Mickey Morera has more than 28 years of experience in San Diego commercial real estate. He specializes in both landlord and tenant representation in the areas of R&D/flex and industrial facilities sales and leasing. Morera has extensive knowledge of the Poway/I-15, Miramar, Sorrento Mesa, Kearny Mesa and Otay Mesa submarkets of San Diego County. Morera has consistently been the top industrial producer for the San Diego region and over the course of his career has successfully negotiated leases and sales in excess of 25 million square feet with a total consideration of more than $2.5 billion. Recent transactions have included the sale and leasing of 600,000 square feet of flex/office space in Poway to General Atomics Aeronautical Systems.

MICHAEL MURPHY
CEO
Murphy Development Company

Michael Murphy, CEO of Murphy Development Company has master planned or completed more than nine million square feet of corporate quality industrial and technology buildings. The company was formed in 1984 and has since entitled more than 500 acres of projects in the City of San Diego. The company has three current projects — Siempre Viva Business Park, Brown Field Technology Park in Otay Mesa, and Scripps Ranch Technology Park in Scripps Ranch. Murphy Development will be starting a 122,000 square-foot speculative industrial building in Fall 2015 — its first building in eight years. After this project Murphy is building an additional one million square feet of industrial build-to-suit and spec buildings at the Siempre Viva and Brown Field Technology projects. The third project is Scripps Ranch Technology Park on 31 acres for one million square feet of technology buildings.

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MORERA: San Diego County’s industrial market continues its hot streak through the second quarter of 2015 remaining on pace to be a record-setting year. Countywide vacancy has plummeted to 5.76 percent due to another quarter of strong leasing and owner/user activity.

The majority of San Diego’s industrial absorption has occurred at the fringes of the county. The southernmost submarket being Otay Mesa which has been a historical laggard witnessed a flurry of leasing activity during the first half of 2015. The drivers for Otay Mesa’s demand are high quality large blocks of space, proximity for companies with maquiladora operations in Mexico and companies migrating out of expensive central submarkets in search of value.

Additionally, several major defense contractors are back in the market and San Diego’s high tech and flex markets are also witnessing a strong rebound with several major life science and pharmaceutical companies expanding their campuses in La Jolla, University Towne Centre, Sorrento Valley, Sorrento Mesa, Oceanside and Poway. The industrial market in San Diego is in record territory. Industrial vacancy is at 5.8 percent, the lowest level ever recorded in San Diego according to the Q2 DTZ report. There is strong and increasing demand for industrial space, with very little supply. Very few class A industrial buildings remain in all of San Diego’s industrial markets. Double digit rent increases are being driven by modern industrial facilities, which remain in short supply, but high demand. The scarce supply of entitled industrial land in the pipeline will not be enough to meet the demand in this cycle and demand is on the upswing with rising rents. The average age of available space is 30-years-old, South County is home to the region’s oldest average inventory. As a result, rental rate growth will continue to accelerate as quality space becomes increasingly scarce. Until new speculative construction returns, the steady absorption of industrial space will continue to drive vacancy rates lower.

MURPHY: Where are we today? During the downturn, only a few large owners of entitled land were willing to protect their entitlements, an expensive and time-consuming process. The few land owners that did so now control a very rare San Diego commodity – entitled land, properly zoned with appropriate land uses. Supply and demand forces are now fully in play — entitled land costs are rising on the little remaining employment land. Instead of three to five years to map raw land before 2008, it now takes five to seven years, and the costs and risks are significantly higher. There is no assurance that an economically feasible final map can be secured.

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For the first time in almost ten years there is some speculative industrial development breaking ground in the county. First Industrial Realty Trust and McDonald Property Group have tilted walls on First Park @ Ocean Ranch in Oceanside. The three building 237,000 square foot project has received strong preleasing activity from users that like the northern San Diego location as a launching point to serve San Diego, Orange County, Riverside County and Los Angeles. Most importantly new projects like First Park offers state of the art features that tenants are looking for. Features such as ESFR sprinkler systems, thirty foot minimum clear height and energy efficiency features which don’t exist in most of the older existing inventory.

Owner/user activity has never been stronger in San Diego with many companies utilizing their strong balance sheets and very attractive financing to purchase buildings. Owner/user pricing has exceeded previous peak pricing. High demand, lack of available land, skyrocketing construction costs, and limited available inventory have constrained any new supply while driving up pricing.

Industrial land pricing has exceeded $20 per square foot in virtually all markets with the exception of Otay Mesa. Some high demand submarkets like Kearny Mesa, Miramar and parts of Carlsbad have seen land pricing reach well over $35 per square foot.

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Additionally, several major defense contractors are back in the market and cautiously expanding after years of downsizing and belt tightening through the ugly days of sequestration. San Diego has always been a big defense and military town and that will continue for the foreseeable future.

We’ve been very conservative, we have the two parks in Otay Mesa — Siempre Viva of 155 acres and 2.2 million square feet with completed buildings for 2 million square feet. We are starting a speculative building for 122,000 square feet in Siempre Viva that will be followed by another 80,000-square-foot speculative building. The other park in Otay Mesa is Brown Technology Park on 50 acres that is entitled for two million square feet. We will build an additional million square feet of industrial buildings on that property.

Murphy Development is breaking ground this fall on a 122,000 SF spec industrial building at Siempre Viva Business Park in Otay Mesa.

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What developers crave is greater predictability in the entitlement process — both in terms of processing times and costs. Given the relative roles they play, there is always some push and pull between developers and the local permitting authority; but the end goal should be the same: to provide well-planned and designed, economically viable development. Working collaboratively, prescribing mandatory staff response times and exploring fixed-fees and other mechanisms to incentivize the process are critical components to increasing the level of predictability in the entitlement process. Another challenge affecting the bottom line is court-imposed or supported costs and conditions, and in particular changes to the way courts evaluate them. For example, California courts have traditionally reviewed affordable or inclusionary housing requirements as a development impact fee or exaction — which requires that the condition mitigate the project’s impacts. A recent California Supreme Court decision turned that analytical framework on its ear by holding that affordable housing requirements are not really an impact fee or exaction but rather merely an exercise of local jurisdiction’s police powers, effectively rendering them beyond challenge.

KOMADINA: We’re seeing more new construction underway or being talked about across all product types in San Diego than we have in many years. The reasons for it, depending on the product type, continue to be significant demand from a multifamily perspective, we have a shortage of housing in San Diego and we’re seeing a significant amount of new multifamily units in various stages of development (coming to market) during the next 56 months. We are expecting another 20,000 apartment units (in San Diego County) to be delivered. As a percentage, it’s not a huge percentage, but I think it’s a pretty good number. What I think is significant is that 9,000 of those units are in downtown alone.

The other opportunity that we are seeing is a fair amount of repositioning of existing product and construction of new retail being developed here in San Diego concentrated in central San Diego, like UTC, and all the way up to North County, Carlsbad and along the 78 corridor. Much like the office world is changing, the retail centers being developed today are all about the experience. It’s all about the customer feeling like they are being taken care of, it’s a place they want to go to and spend time in. No longer is it a thing where the customer goes into a store and then just leaves. All of the retail stores are trying to develop a product where customers go to shop and then they go have a cup of coffee and they stay there for three hours as opposed to an hour-and-a-half like they traditionally used to. Not only is that having a significant impact on the customer, but it is having a significant impact on the type of real estate that is being delivered to the market. A great example is the UTC mall; they’re beginning an $800 million renovation. I don’t want to quote sales-per-square-foot, but I do know them and in many cases sales-per-square-foot of the retailers in that shopping center are more than doubling from what they were pre-renovation. That’s significant.

When we look at challenges in the market in terms of rising costs of development, I would categorize it as two things: one of the unknowns is the timing of getting through the development process and two, what are the costs going to be? For a developer those types of issues are really challenging to get your arms around whether they are building a $50 million project or a $500 million project, they need known quantities, they need to know what they’re dealing with so they can budget and plan accordingly. The City of San Diego is working very hard to make sure that they shore that up and can give developers competent answers such as ‘here are the costs you can expect and here are the steps that you are going to have to go through to get your project...'

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Irvine Company Office Properties is excited to be part of the collective commercial investment in UTC, which includes upgraded and expanded retail.
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developed.' If the city can provide confidence to the development communities, that goes a long way toward developers being willing to finish up all the groundwork that needs to be done to deliver the project the customers want.

And the second unknown: The county is out of good quality developable land. We can’t sprawl like a Phoenix can. We’re now talking densification of land sites and when we’re talking about densification, neighborhoods and communities and planning groups get nervous and band together. These groups can oppose these projects and can have significant impact on costs, timing and scale of these projects. The developers want to build these projects, so it is very important for the developer to work with these communities from the get go, so they have the community input on the project and don’t face this diversity down the road.

One Paseo is a good example of this. Ultimately, the developer Kilroy Realty negotiated and reduced the scale of the One Paseo Project in Del Mar to meet the desires of the community. Most of it was around the average daily trips and traffic.

Another example is Caruso Affiliated Holdings LLC who is in the early stages of a development in Carlsbad. They are a great developer who delivers an exceptional product. They are having challenges themselves, but they are very proactive and there is a lot of advertising promoting the product, embracing the community and embracing the environmental nature of the development and they are doing a good job of that.

MURPHY: Pre 2008, traditional San Diego land investors followed the mapping cycle — the first step taken in the development process that leads to a final map necessary to deliver entitled land to the development market. This process continued steadily through the growth years and slowed during the economic downturns. When the 2008 recession began, there was an oversupply of buildings across all categories. Most land mapping investors stopped mapping land until they were certain a market for new mapped land would reappear. Buildings remained vacant and most markets languished with a very slow recovery until late 2014–2015. The net result is that there is very little new mapped land in the cycle. Further complicating the mapping process, post 2008, new statewide habitat regulations were adopted that lengthened the period of time to map land, and increased the costs and risks dramatically.

The environmental challenges including habitat mitigation, which requires a developer to purchase additional offsite mitigation land, can dramatically increase risk and ultimate land costs. New stormwater regulations further increase costs and the time to secure approvals. Once maps and entitlements are secured, projects need to be designed to include bioswale and stormwater compliance, then securing grading and land improvement permits takes additional time and engineering/legal costs. The risks are high because all mapping is a discretionary process. By discretionary I mean that in order to proceed, the company has to seek approval from a number of different agencies. Even though you own the land these agencies must give their approval, it is not just a matter of right. Just when you get to the finish line, there could be CEQA (California Environmental Quality Act) challenges by environmental groups. And finally, construction activity and pricing is on the rise. As you can imagine, all of these factors are putting upward pressure on land costs and rents. Smart tenants will complete lease or build-to-suit transactions as soon as possible. In summary, a limited supply of land, with increasing land and building improvement costs with surging tenant demand suggest that rents will continue to escalate, perhaps dramatically.

Conceptual view of the entrance to Building 1 at Scripps Ranch Technology Park. Murphy Development.
HYYTINEN: The majority of recent private development has been multifamily (including for-rent and for-sale condominiums), mixed-use development with a heavy residential component and hotels. While development is ultimately driven by market considerations, it’s important for the City and Civic San Diego to encourage and promote new office, industrial and other employment uses. Such diversity of uses is consistent with the goals and policies of the Downtown Community Plan to create a vibrant and diverse regional hub to live, work, shop and play.

From a land use perspective, sites with “historic” structures can be much more complicated to redevelop due to associated regulatory constraints, which dictate what an owner can or can’t do. While it is important to preserve truly historic structures as a part of our history or cultural fabric, “historicity” can be in the eye of the beholder and I’ve seen a few questionable designations of marginal structures that resulted in great cost and expense to the property owners.

KOMADINA: We anticipate the population of downtown to double between now and 2020. That is why we’re seeing a lot of construction downtown, we’re seeing a lot more people who want to live downtown and it’s really across all ages and demographics, from right out of college all the way through retirement, we’re seeing a good cross section of everybody.

From an office perspective we are absolutely seeing new space being developed. Right now of the projects under construction, very little of it is speculative, but there is a lot of speculative office development being discussed. We anticipate a significant amount of product being delivered during the next 36 months.

There is more activity and excitement about downtown today than there has been in 30/40/50 years....

For a number of years it was the exit out of downtown and now we are seeing companies really looking hard at downtown again. Because they like the environment and the amenities for their employees, so we’re seeing a significant amount of excitement and that is why new office development will occur during the next three or four years downtown.

The other gaps to fill in downtown are education and retail. For education, there are two schools of thought. One is we really need a higher education system to have a big presence downtown, whether that is a research institute or an extension of one of the universities. Downtown needs something like that to really draw students and intellectual capital. We need that as an anchor to really take downtown to the next level. In the next 12 months there will be a big announcement about higher education making a presence felt downtown. The other feature of education is the elementary/pre-school grades. What we have seen historically is people move downtown when they graduate college, they’re there for four, five, six, seven years. When they’re ready to have a family they say ‘we need to move to the suburbs because we don’t have the education downtown to raise a family.’ Downtown needs that education piece for younger age children to keep the younger people downtown beyond their single years and into their married and family raising years.

The new library has a school and that has been a big success. There is an East Village charter school under construction in Maker’s quarter that will have a significant positive impact on East Village and greater downtown. We’re starting to see the beginnings of that but we really need it to mature in order for it to take hold.

Downtown’s retail is primarily bars and restaurants. What we need to really bolster the residential community is true retail — with additional grocery, big retailers like Target and Home Depot, not just a place to eat and drink, but the things that we need for daily life. Rather than driving to Mission Valley to go to Target, it would be nice to go out the front door and walk three blocks into an entry level Target and then walk home. We will see a larger presence from the bigger retailers downtown during the next 12 months.

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HYHTINEN: One of my biggest concerns is that there is a very limited supply of industrial-zoned lands to meet the future expansion needs of the life science and biotech industries. Perhaps more devastating is the fact that much of the prime industrial areas in the City of San Diego are severely constrained by various zoning and planning overlays that significantly reduce the amount of development intensity allowed on a given site. Such overlays include the MCAS Miramar Airport Land Use Compatibility Plan which limits R&D uses within certain safety zones to a small fraction of what would otherwise be allowed, and the City’s Coastal Height Limit Overlay Zone which limits buildings and other structures to a maximum height of 30 feet. City policy makers and planners should look for any available opportunities to reduce the impact of such overlays on future life science and biotech development.

I believe it will be difficult because one of the main components that fostered the growth of these life science clusters was their close proximity to and collaborations with world-class academic institutions such as UCSD, the Salk Institute, the Scripps Research Institute and Sanford-Burnham. That said, local jurisdictions may be able to foster growth in other areas by creating incentives for key life science companies or research institutes to locate facilities within target areas – and then letting the market and the desire for collaboration stimulate other smaller life science companies to locate there.

KOMADINA: Much like the physical needs of offices are changing, so too are the physical needs of life science. Life science companies are often employing people in their first 10 years out of school. Life science companies have a younger demographic in their employee base and they want the same type of amenities that are off-campus like full service restaurants, bars, pubs, bocce courts and workout facilities.

Three major landlords in this space are Alexandria Real Estate Equities, BioMed Realty Trust Inc. and HCBP Life sciences. They have all heard (the demand for amenities) loud and clear and we’re seeing them take their amenities packages on life science campuses to a whole other level to attract those companies and the talent that they are trying to retain.

The other piece is that technology and infrastructure are vitally important to the life sciences industry. From an infrastructure standpoint, for a lot of these companies it’s about gas and water and single pass air through the suites and all of that is being delivered to the spaces in a much more efficient manner. The change in technology and the change in the way infrastructure is delivered to the spaces allows life science companies to be much more efficient in the space they occupy.

Life science companies of many kinds are becoming more efficient in their use of space thanks to improvements in technology and infrastructure required by these companies.

There continues to be a significant demand for space for life science companies beyond La Jolla, Torrey Pines and Carlsbad. We are starting to see lack of good quality supply. The next significant area will be in the downtown corridor. When we look at the demographics of these company’s employees, many of the employees live downtown and are commuting up to Torrey Pines to work. The life science companies are taking a hard look at downtown and trying to figure out a way to be there.

We will see life science downtown in a significant way in the next 12 months. We may not see them opening for business in the next 12 months, but during the next 12 to 24 months we’ll see them open for business downtown — which is exciting.

Another trend in life science is we are just now starting to see vertical life science facilities in buildings of five to six stories or more in San Diego. We will see this much more on a go forward basis.

MURPHY: We are so lucky in San Diego to have all of these life science and biotech companies along with the telecommunication and other technology companies. They are all looking for the same thing, they all want sites and buildings and amenities that will allow them to attract and retain their most important asset — bright personnel. If they can keep their existing employees and attract new ones they are way ahead of the competition. What Murphy Development did is buy 31 acres from Intel in Scripps Ranch about 10 months ago. It was a unique property that Intel acquired in 2000, originally planning to build a one million square foot campus there and chose not to build any buildings on it. Now, we are going to build those buildings. It is really a phenomenal spot — it’s surrounded by 24 acres of eucalyptus trees, parks, jogging trails — all of which are at the top of the lists of these tenants.

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**EXPERIENTIAL ENVIRONMENTS**

**Amenities. Customized Work Spaces.**

**KELLY:** Extensive research with customers, their workforce and overall marketplace trends has guided our focus on delivering modern and engaging amenities for the companies of tomorrow. As small to midsize companies compete for top talent, Irvine Company is able to offer centralized community amenities, such as fitness, cafes and recreational areas at scale and at a higher quality level than any one business could offer alone. We are investing heavily in unique experiences that create a vibrant workplace community for our customers.

One La Jolla Center will offer The Commons, a unique open-air gathering place featuring a covered conference room with Wi-Fi, casual workspaces, a comfortable outdoor “living room” and the gourmet café, Bistro 24. The Commons will enable individuals to work al fresco and seamlessly blend work with an enhance lifestyle.

We will also bring Irvine Company’s workplace wellness program, Kinetic, to customers at One La Jolla Center, which blends a state-of-the-art onsite fitness center with wellness services from premier partners. Irvine Company chooses to build, own and operate a portfolio of architecturally timeless buildings with efficient and flexible floor plans. This long-term approach directly supports our customers’ vision of a workspace that expresses their brand and culture, supports their evolving work style and has adaptability for growth or reconfiguration. We work closely with our customers to ensure that the workplace they create with Irvine Company elevates their business success.

**KOMADINA:** We expect about 1.5 million square feet of new office development, currently in various stages of development, downtown during the next three to four years. In the Sorrento Mesa and UTC area — particularly UTC — there is a significant amount of demand for quality office product that gives an experiential environment, and that is one of the themes that we’ll hear over...
The need for outside amenities is increasingly important as companies continue to focus on the employee experience. At the end of the day, the employee is the single most expensive line item on an expense statement, so it is all about the employee.

The employees of today desire lifestyle balance in an experiential environment, they’re socially conscious, they are always connected through various technological devices. As these employers battle for top-tier talent, finding a space that satisfies those needs and transcends the boundaries that allow people to work when they want and where they want — those are the companies that will win the war for talent. That’s why we see developers deliver that type of product to the market because that is how they lease space faster and get higher rates to meet the demand for employees who demand that type of environment.

MURPHY: Buildings and projects that can combine all of the amenities that employees want will drive companies to locate in those projects.

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