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Commerical Connection

Lee office space overbuilt as economy slows

By Mark Alexander
Originally posted on January 13, 2008

I wish there was some positive news about our Lee County office market to report. It had been much fun watching the office market values and occupancy rates climb steadily over the first half of this decade. But the second half is not fun so far.

Our soft Lee County office market at the beginning of 2008 is about to get weaker from a flood of new office construction due for completion this year. It may be easier to understand our present office market state by first reviewing the conditions of the past two years that led us to this point.

Office supply

Lee County had 13 million square feet of office space at the end of 2005. During the next two years, we added a "half-million square feet per year" to reach 14 million square feet total by the end of 2007. We apparently got bored with this "half-million square feet per year syndrome" because we ramped up and currently have a whopping 1,365,000 square feet of new office construction due for completion in 2008. This equals almost three times our previous annual rate of new office construction.

You might be wondering why we suddenly decided to nearly triple our rate of annual office construction in 2008 considering the state of today's economy. I was sure curious. It appears that many office developers may have been distracted by a county deadline to raise impact fees — and took their eye off the ball momentarily while they rushed to build. Instead of focusing on the supply and demand dynamics of our rapidly changing office market — which dictate how much rent you can charge and how fast you can rent space — many seemed to be focused on simply beating a deadline to retain lower impact fees.

There was a mad rush to file applications in Lee County for building permits and development orders by the Jan. 31, 2007, deadline — and you had to obtain county approval by June 29, 2007, to keep the old lower impact fee schedule. The impact fees for general office construction tripled when they went from $2,336 per 1,000 square feet to $7,305 per 1,000 square feet. So let's say you were planning to build a 10,000-square-foot office building, your impact fees (i.e. part of your cost of construction) jumped from $23,360 to $73,050 on June 30, 2007. Admittedly, this was good motivation to move quickly if you were thinking of building. But it was even more motivating if you were constructing a medical building because medical impact fees jumped from $7,716 per 1,000 square feet to $24,126 per 1,000 square feet. I know of four different medical groups in Lee County who built (or are still building) a new office building for their practice that beat this deadline. Their construction cost savings was substantial since a typical 10,000-square-foot new medical office building owner would pay impact fees of just $77,160 if they beat the deadline, instead of paying $241,260 if they missed the deadline. But it does not seem fair to me that doctors get charged a much higher medical office impact fee of $24,126 (per 1,000 square feet) compared to a general office impact fee of just $7,305 (per 1,000 square feet). I believe one of the reasons for this impact fee disparity between medical and general office construction is that medical offices typically draw more traffic than general office buildings. But then why are the new shopping center impact fees (of $15,837 per 1,000 square feet) 34 percent lower than medical impact fees?

It would appear our county government follows the path of least resistance when setting these impact fee rates. There may not be much public empathy for doctors paying higher impact fees so it may have been easier to politically get this exorbitant medical impact fee schedule approved. But that doesn't make it right.

Office demand

Lee County had 12.7 million square feet of occupied office space at the end of 2005 to give us a wonderfully low 3 percent vacancy factor with 300,000 square feet total vacant. This was a major green light for developers to build new office product. The problem is that two years later we still have the same (demand) 12.7 million square feet of occupied office space in Lee County at the end of 2007 (per Co-Star). So Lee County had no growth in office demand over the past two years while we were building new office developments like crazy. Because of this high level of new office construction, our vacancy rate jumped from 3 percent in fourth quarter 2005 to 10 percent in fourth quarter 2007 with 1.3 million square feet now vacant in Lee County.

We know that business is slow now due to the economy. Based on previous slow economic cycles, we can expect to see some office tenants try to remain solvent by reducing their space needs and a few may even go out of business. One need only look today at the mortgage brokerage market for painful examples. But if we wear our favorite rose-colored glasses (and you know you have a dusty old pair tucked away someplace) and assume that our county office demand will remain unchanged at 12.7 million square feet of occupied space through the end of 2008, then we will still reach a 17 percent vacancy factor in our office market by the end of this year. That's what happens when you start with 1.3 million square feet of vacant office space (like Lee County had at the end of 2007) — and then build another 1.365 million square feet in 2008. To make matters worse, I think it is realistic to expect some businesses will downsize in 2008 (so much for the rose-colored glasses) which should lead to lower office demand (i.e. occupied space shrinks compared to last year) — which could make Lee County office vacancy rates higher than 17 percent by the end of this year. Only time will tell for sure. Please excuse this tired, worn out cliche, but I think our Lee County office market is going to get worse before it gets better.

Market correction

I spoke with longtime local appraiser Michael Maxwell as part of my market research. Mike said that one indicator in the office market was seen in the World Plaza office subdivision off College Parkway where his own office happens to be. He said sale prices peaked in World Plaza in late 2005 around $200 per square foot (psf). Mike had even listed his own World Plaza office condo for sale last year at $190 psf. But the best offer he had received to date was $150 psf, which he turned down. Mike said the office condo next door to him recently sold for $145 psf.

Buckle your seat belts and hold on tight for this bumpy 2008 office market ride. Office rents will be discounted this year as owners fight over the existing tenant base — in hopes of reshuffling the deck of current tenants to fill their vacancies. As rents go down, so will values, because commercial properties are primarily valued by the income approach to valuation. Rent is directly proportional to sales price in the commercial real estate world via the cap rate formula.

Office owners will have a tougher time, but tenants with leases expiring in 2008 will get better deals on rent to help them through this economic slowdown.

Sale/leasebacks

At the end of the 1980s, there was a boom in real estate prices, just like we saw in 2005. But there was also an exodus of medical office tenants at this same time, as doctors migrated south from central Fort Myers (behind the Edison Mall) to the College Parkway corridor. Spurred by good economic times, many physicians moved their offices south in the late '80s following demographic shifts along improved roads to be more central to all county hospitals and their patient base.

This created much vacant medical office space in central Fort Myers at the beginning of the 1990s when the recession started. A slow economy back then coupled with all this sudden vacant medical space created deep discounts in rental rates and sale prices in the central Fort Myers office market in the early 1990s. Having worked through this previous recession, I witnessed some office owner/occupants using sale/leaseback transactions to create strong office property values in the face of weak office market conditions at the time. When using a sale/leaseback transaction for an owner occupied building, the owner gets to pick his lease back rental rate. Since rent is directly proportionate to sales price (using the cap rate formula), the owner effectively chooses the sales price by picking the corresponding rent level for his company. The sale/leaseback helps owner/occupants to:

• minimize personal bank debt (property mortgage gets paid off at closing which helps boost the credit rating and borrowing power)

• maximize cash liquidity (deposit your profit from sale proceeds in the bank as a nice cash flow cushion)

• provide good tax benefits (your new rent payments are fully deductible against ordinary income) and reduce personal liability by guaranteeing a lease (which does not get reported to credit agencies) instead of guaranteeing that existing mortgage on the property.

The financial benefits afforded by sale/leaseback transactions for owner/occupants of commercial buildings can help ensure survival and even prosperity through slow economic times.

Wild card: hurricanes

Although statistically unlikely (in my opinion), if we were to get another devastating hurricane in Southwest Florida during 2008 like Hurricane Charley, it could dramatically change our office, industrial and residential "supply and demand" dynamics overnight — for the better.

When a hurricane damages one town, the next closest town usually benefits economically for a stressful year or two after the hurricane passes. Hurricane Katrina in New Orleans was a good example. Nearby Baton Rouge saw its residential and commercial vacancies evaporate within a month after Hurricane Katrina hit the Big Easy. This sudden increased demand caused Baton Rouge property values and rents to quickly rise across the board. Nobody wants a hurricane. But if a high category storm passes through again, as long as the eye does not hit you directly, the rest of the area and nearby towns will benefit economically as reconstruction commences due to sudden higher demand.

Whatever comes our way, I am confident the American spirit will persevere and weather any storm. It is our nature.

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