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Prepping for re-entry

Equastone eyes move back to S. California buildings

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January 8, 2008

Over the past few years, David Bourne and Chad Carpenter have sold 13 of the 14 office buildings their firm owned in San Diego County, cashing in on the sky-high prices that investors were paying for Southern California commercial real estate.

Now the co-founders of Equastone, a local real estate investment company that owns 58 buildings in eight states, are watching closely to see if they'll soon be able to buy again in San Diego at a discount.

K.C. ALFRED / Union-Tribune
Equastone's Chad Carpenter (left) and David Bourne seek to buy buildings for less than it would cost to rebuild.

Office buildings saw a huge run-up in prices in the past three years, particularly in places such as Southern California that experienced a housing boom. Some San Diego towers sold multiple times, or flipped, at ever higher amounts. Rents kept rising to justify the price tag for the buildings.

Now, however, demand for office space, which had been on the rise nationwide since early 2003, has stalled across many parts of the country, according to a report released yesterday by Torto Wheaton, the research arm of brokerage CB Richard Ellis.

Equastone has yet to see any distress sales. The company and other real estate experts don't expect to see a widespread implosion in the value of office buildings, such as the one that occurred in the early '90s following the savings-and-loan debacle.

But Bourne and Carpenter think there could be isolated good deals from landlords in formerly red-hot markets such as San Diego.

“I think personally that people who did pay the high prices, if they need to sell in the next couple of years, they will probably lose money,” said Carpenter, chief executive of Equastone. “Now if they don't have to sell, they'll be fine. They can ride it out. But I think some of the best buying opportunities are going to be in Southern California – Orange County and San Diego County.”

In August, Equastone bought 13 buildings in suburban Dallas, including this one in Richardson, Texas.

If so, that would allow Equastone to return to its roots. Founded in 1993, the 60-employee firm specializes in buying offices that are either under-priced or distressed – meaning they need repairs or significant leasing. It seeks to buy at prices below what it would cost to rebuild. In addition, it seeks to purchase “ahead of the curve” with regard to a rebound in tenant demand.

The company found easy pickings in San Diego during the economic downturn of the mid-90s, buying several buildings in Carlsbad, Kearny Mesa and Rancho Bernardo.

But in recent years, as prices for office buildings followed the home prices ever higher, Equastone sold off its Southern California holdings. It also mostly sold out of the Phoenix and Las Vegas markets.

Instead, it has been investing in areas without significant housing booms. They include Colorado, Texas and Portland.

About a year ago, Equastone paid more than $50 million for the 28-story Pan American Life tower in downtown New Orleans. It was the first large sale of an office building in the city since Hurricane Katrina in August 2005.

Last August, the company paid $382 million to buy 13 top-quality office buildings in suburban Dallas. The deal also included 43 acres of land.

Real estate experts have long considered Dallas a precarious market because of abundant land and few restrictions on building.

But for Equastone, the price was right.

“We thought it was less risky to invest in Dallas at $130 a square foot than Orange County at $300 a square foot,” said Bourne, chairman of Equastone. “Now we may be big investors in Orange County six or 12 months from now at $200 a foot. . . . But we're going to have to wait for those prices to adjust.”

Equastone raises capital from wealthy individuals and institutions. Of its active funds, Equastone Value Fund I raised $53.5 million, which it used to buy $250 million in buildings. Equastone Value Fund II raised $172 million to buy $550 million in properties.

The company is raising money for a third fund, which Bourne and Carpenter declined to discuss.

Buying in downtown New Orleans was risky. Since the hurricane no other major office buildings have been sold in the city's downtown, which has yet to experience a major rebound in office demand, said Wade Ragas, a real estate consultant based in New Orleans.

Equastone recently signed a new tenant to the Pan American tower, said Carpenter, after the tenants' current office building was converted to residential use.

“The supply in New Orleans is going down when actually demand is fairly stable right now,” Carpenter said. “We don't think there's going to be new supply in New Orleans for many, many years.”

In Dallas, where few barriers exist for developers to build new offices, the office vacancy rate held steady in the third quarter at 17.2 percent, according to CoStar, a real estate research firm.

But Bourne sees the market starting to improve in terms of demand. And he doesn't expect a major increase in competition from new construction. “Dallas rents are very low, and it's hard to justify new construction at very low rents,” he said.

Cities such as Dallas and New Orleans are considered secondary markets by some pension funds and other big institutional buyers of office buildings, said Louay Alsadek, an investment broker with CB Richard Ellis in San Diego.

“The issue that happens in some of these markets, the risk you take, is there's not a lot of buyers,” Alsadek said.

But Carpenter and Bourne believe the risk is mitigated by the fact that they purchased the buildings below replacement costs.

Regions in the grip of serious housing slumps are experiencing the largest spike in office vacancy rates, according to Torto Wheaton, as home builders, mortgage companies and real estate agents shed space.

Although San Diego wasn't specifically mentioned by Torto Wheaton in a report yesterday – it listed Orange County, Phoenix and Las Vegas as office markets hurt most by the housing meltdown – San Diego is experiencing a similar phenomenon.

Office vacancy in the fourth quarter surged to 14 percent, the highest level since 1996, according to CB Richard Ellis. At the start of last year, the vacancy rate was about 10 percent.

In Orange County, the heart of the subprime mortgage lending industry, office vacancies surged from 8.3 percent to 14.5 percent, Torto Wheaton said.

The spillover from the housing downturn into the office market may create some good deals closer to home for Equastone in the next few months.

“I don't see the whole market crashing,” Bourne said. “But I do see rents coming down and values coming down in these over-extended markets.”

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