Lee County Office Market Review: 2008

By Mark Alexander, CCIM

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 lead us to this point.

Office Supply:

Lee County had 13 million square feet (SF) of office space at the end of 2005. During the next two years, we added a “half-million SF per year” to reach 14 million SF total by the end of 2007. We apparently got bored with this “half-million SF 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 January 31, 2007 deadline…and you had to obtain county approval by June 29, 2007…in order to keep the old lower impact fee schedule. The impact fees for general office construction tripled when they went from $2,336 per 1000 square feet to $7,305 per 1000 square feet. So let’s say you were planning to build a 10,000 SF office building, your impact fees (i.e. part of your cost of construction) jumped from $23,360 to $73,050 on June 30th, 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 since medical impact fees jumped from $7,716 per 1000 SF to $24,126 per 1000 SF. 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 SF 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 1000 SF) compared to a general office impact fee of just $7,305 (per 1000 SF). 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 1000 SF) 34% lower than medical impact fees (of $24,126 per 1000 SF)? 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 don't make it right. Doctors have already been squeezed each year for many years by Medicare cut backs. I know our county government has proudly proclaimed that our taxes (i.e. millage rates) have not been raised in years. I guess if you call it an impact fee instead of a tax, they can still say at election time, "We have not raised taxes." Regardless of what you call it, it still dents the bank account and raises blood pressure. I know we can't blame the county for developers who decided to build more office space than market demand would support. After all, each of us is responsible for our own actions. But the tide of discontent is rising over taxes. Lips are being smacked in anticipation of the next election. Political salvation lies in real tax reform…soon.

Office Demand:

Lee County had 12.7 million SF of occupied office space at the end of 2005 to give us a wonderfully low 3% vacancy factor with 300,000 SF 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 SF 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% in 4Q 2005 to 10% in 4Q 2007 with 1.3 million SF 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 SF of occupied space through the end of 2008, then we will still reach a 17% vacancy factor in our office market by the end of this year. That's what happens when you start with 1.3 million SF of vacant office space (like Lee County had at the end of 2007)…and then build another 1.365 million SF 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% by the end of this year. Only time will tell for sure. Please excuse this tired, worn out cliché…but I think our Lee County office market is going to get worse before it gets better.

Market Correction:

I spoke with long time 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 located. 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 can help owner/occupants:
At the end of the 1980's, there was a boom in real estate prices, just like we saw in 2005. (History tends to repeat itself.) But there was also an exodus of medical office tenants at this same time, as doctors migrated south from Central Ft. Myers (behind the Edison Mall) to the College Parkway corridor. Spurred by good economic times, many physicians moved their offices south in the late 80's following demographic shifts along improved road linkages to be more central to all county hospitals and their patient base. This created much vacant medical office space in Central Ft. Myers at the beginning of the 1990's 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 Ft. Myers office market in the early 1990's. 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 credit rating & 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…whether they be medical, general office, retail or

industrial… can help insure survival and even prosperity through slow economic times. I sold my first medical sale/leaseback transaction (with 56 to follow in five different states) on Central Avenue in Ft. Myers for a 4 MD dermatology practice back in 1992 for good value created by the new 5-year term, triple net lease back…while nearby vacant buildings were trading at 50 to 75 cents on the dollar amidst weak market conditions (i.e. high vacancy). The sale/leaseback has many diverse financial benefits which are the reason Fortune 500 companies have been using them for so many decades…through good economic times and bad. If you wish to borrow a play from the play book of Fortune 500 companies, the sale/leaseback can be a very empowering and helpful tool for the commercial property owner/occupant.

SW Florida Wild Card: Hurricane

Although statistically unlikely (in my opinion), if we were to get another devastating hurricane in SW Florida during the summer of 2008 like "Hurricane Charley", it could dramatically change our office, industrial and residential "supply & 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 SW Florida 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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