

Landlords Beware

Tenants may feel shut out of some of the most popular office markets, but overall the Bay Area still has lots of available space.

By Craig Zodikoff, Janna Luce and Scott Kinder

Earlier this year, there were clear signs that the national economy was improving and the Bay Area commercial real estate market was heating up. Companies were adding jobs, vacancy was declining, and demand for space was on the rise. After a long period of frustration, many landlords and their brokers became more bullish and promoted a return to a landlord's market.

Then, in August and September, a wave of global financial instability left a chill in its wake. The IMF warned of a world-wide, double-dip recession. In most of California and corporate America, office tenants have become more cautious.

Now, amid reports of continued torrid office demand in some parts of the Bay Area, the question arises: Are we immune to the uncertainty and volatilities in the larger markets? That depends. Overall recent regional statistics suggest the following: The Bay Area is a stark example of bifurcation, with premium Class A and creative warehouse and R&D space in high demand in pockets such as Palo Alto, Mountain View and South of Market in San Francisco, while Class B and Class C space in outlying submarkets often languishes. Those dichotomies are likely to continue.

The tech sector has fueled an explosion of local activity, particularly along the Peninsula in areas near Caltrain such as Palo Alto, Menlo Park and San Carlos. Giants in the social media, gaming, Internet, cloud computing, storage and hand-held device industries have chosen to establish their corporate headquarters in this region. Google Inc., Apple Inc., Microsoft Corp., VMware Inc., Motorola Mobility, Hewlett-Packard Co., and Symantec Corp. all signed major deals in the last two quarters and control much of the market. Investors are diving in. Some are paying what might be considered inflated rates. To justify their investments, they will try to drive up their rents.

A market is considered balanced when vacancy reaches 10 percent. While R&D vacancy is less than 6 percent in Palo Alto, less than 9 percent in Mountain View, and well below 5 percent in Cupertino, it's a different story as we head away from the Peninsula and further into the South Bay. In San Jose and most of southern Silicon Valley (North Santa Clara, San Jose, Milpitas and Fremont), vacancy is currently within a few points of where it was a year ago, and in any case

remains well into the double-digits in many markets. In San Francisco, vacancy for the most sought-after brick-and-timber space South of Market may be 5 percent, but office vacancy is 12 percent in the Financial District.

High-quality space is becoming increasingly sparse, with fewer larger blocks of contiguous space available to growing companies, forcing many corporations into submarkets where they typically find commodity, inferior Class B space that needs tenant improvements. As demand increases throughout the area, speculative development may bring more quality space online.

While national unemployment is now 9.1 percent, the Bay Area is faring better than the rest of the state, showing modest job growth of 0.4 percent in August, with unemployment of 8.8 percent in San Francisco's metro area and 10 percent in Greater San Jose. But until jobs



reach their pre-recession level, which might take another couple of years, a full Bay Area market recovery probably won't come.

Average asking rents for Class A buildings in downtown Palo Alto are now \$78 a square foot a year, almost double the rate of two years ago. In SoMa, which is comprised mostly of converted warehouses, rents are \$45 a square foot to \$50 a square foot a year, up 30 percent in the last 12 months. The average San Francisco CBD Class A asking rents are \$39, up nearly 20 percent in a year, and high-rise view space is up to \$70 a square foot a year. At the same time, asking rents for Class A office space in San Jose's central business district have seen only moderate increases in the last couple of quarters, now tracking at \$32 a square foot a year.

Looking ahead, are we really headed for a double-dip recession? Will Greece inevitably default? The visibility on these questions is hazy at best. Other perspectives are clearer. In most markets in California, the current slowdown will probably hinder recovery. But in

the choicest Bay Area markets, we probably should not expect weakening demand. So as quality space availability tightens and prices escalate, even as leasing metrics for lesser space improve slowly, tenants must search to find the best of both worlds: cool digs at fair prices. Those who find success will be nimble and lock into leases before prices hit the roof, not making the mistake of many companies that sit on the fence too long. Also, they will be flexible about geography.

Companies that are already leasing space in the desired markets should consider early lease renewal before expected spikes in rental market rates. They also should negotiate for longer-term deals (seven to 10 years) if they have strong, long-range business plans.

Companies looking to break into the hot pockets can expect slim pickings. In San Francisco, that means SoMa wannabees will likely need to check out the Mid-Market, Yerba Buena and South Financial submarkets. For those who covet Palo Alto and Mountain View, the next Peninsula stops are Sunnyvale and Santa Clara. Then, it's down the South Bay to San Jose and up the horseshoe to Milpitas and Fremont. Tenants will pay considerably less for rent in these submarkets, but if they insist on high-image creative space and other amenities, in most cases they will need to upgrade the available space, adding amenities and optimizing efficiency through alternative workplace strategies.

Many buildings are still under heavy debt and at risk for delinquency, so smart tenants won't make assumptions about the landlord's financial stability. Credit-worthy tenants should stress their own stability, knowing that landlords prefer strong companies. They also will plan ahead for an infrastructure to accommodate wireless environments, office sharing, smaller workstations and sustainable features.

It's understandable why companies want to stay in the Bay Area. Maybe the Rolling Stones had it right: "You can't always get what you want, but if you try sometimes, you just might find, you get what you need."

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