

# Commercial real estate rises

## Valley commercial real estate market sees long-awaited growth, but still faces challenges

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For Jere Hench, "there's no way to go but up, from death." And death would be his description of the Silicon Valley commercial real estate market from 2001 to 2003.

As senior vice president of Wayne Mascia Associates, a Santa Clara based commercial real estate brokerage, Hench reports "the market is picking up, though it's still a very tough marketplace."

Of the four commercial real estate markets -- industrial, warehouse, office, and research and development (R&D) -- the warehouse and industrial sectors are seeing the growth, said Geoff Davis, president and managing broker of DBC Real Estate Services Inc. in San Jose.

To Davis and others in the field, it seems logical that these areas expand first. In Silicon Valley, when companies, such as Santa Clara-based Intel Corp., increase production and product shipping, companies supporting them, in turn, ramp up their businesses.

"That's why you see the warehouse [industry] increasing first," Davis said. "This means growth is on its way."

At last summer's market bottom, industrial vacancy rates in Silicon Valley were 12.6 percent, which in August was down to 10.5 percent, Davis said. As for warehouse space, 14.8 percent is now available, compared to 16.7 percent last year.

That leaves R&D and office space to catch up later. While office vacancy has improved slightly to 21.4 percent this August, from 24.5 percent in August 2003, most of the activity stems from companies trading up to fancier digs, Davis said. Class-A property is usually in fancier, newer and larger buildings in a good location.

That demand has increased Class-A rents about 10 percent during the past year, said Andres Claure, executive vice president of Wayne Mascia Associates. Most of the

demand is for spaces less than 5,000 square feet, holding 25 to 30 workers.

Growth is flat for R&D property. The vacancy rate for that sector is 24.5 percent. Similar to office space, the 2,000-square-foot to 4,000-square-foot spaces are moving more quickly.

Businesses looking for commercial space should pounce now.

"Landlords will do almost anything to get someone in there," Davis said.

This includes free rent, lower rent, tenant improvement allowances, a smaller security deposit and shorter leases, he said.

And the realtor who places tenants in a large institution's property could be rewarded with a trip to Hawaii, a car or a double commission, Claire said.

Davis noted that in the past few years, landlords who were willing to forgo a profit, just covering the mortgage and overhead, are faring the best today.

"Those waiting for a good tenant are having tough times," he said.

A smaller security deposit of one month to four months rent, instead of the previously required 12 months, is a generous concession, Hensch said.

Between 1999 and 2000, landlords wanted to lock in high rates for five to seven years, whereas they're now happy to do short-term deals.

"If landlords are lucky, they'll get a two- or three- year lease, which is good for a startup," Davis said.

Given the lower rental rates, some established companies are locking in rates. "Stable companies want to sign long-term leases to take advantage of these low rates," Hensch said.

During the dot-com boom, tenants looked as much at amenities as they did location. Now they're looking at price.

"There's a lot less location, location, location" than during the dot-com era," Davis said. "Price is probably the most important item."

Davis estimates the recovery won't be complete for another three years to five years. That's when he figures the office and R&D vacancy would be a "reasonable" 10 percent to 12 percent.

"You need enough [space] on the market that landlords don't overcharge, and you need to

have a vacancy factor low enough so that the landlords get enough income to pay off their mortgages," Davis said.

While the growth isn't quick, the jobless rate is improving. "From what we're seeing, jobs are definitely on the rise, based on the amount of activity of those looking for space," said Wayne Mascia's Claire. "It's the first time we're seeing growth in four years."

But it won't happen quickly. To trickle down to filling 11 million square feet of empty office space in the valley, Claire estimates it will take 55,000 additional workers.

The Valley also has 8.78 million square feet of industrial space available, 30.88 million square feet of R&D space and 5.77 million square feet of warehouse space. A lot of that will sit vacant, especially old or obsolete property. Rezoning the land for residential space is one option, if the city will allow it.

Cities like San Jose and Santa Clara don't want to lose their manufacturing bases, but they realize there's a big need for housing and are willing to make concessions in rezoning land for residential development, Hench said. Earlier this year, San Jose rezoned an industrial BFI storage yard to residential use in the North San Jose area.

"Even with that site being a logical conversion site, there was concern by elected officials that they'd lose their manufacturing base," Hench said.

There's another concern with rezoning -- many of the industrial areas are far removed from the services needed for homes, Davis said. Those services include schools, markets and retail.

Some office buildings are being converted into condominiums.

Depending on the location, it can be a good investment, or at least a wash financially, Davis said.

And some landlords are selling their properties -- many to companies already leasing it.

"As landlords go longer without any income, some of them will get in trouble and have to sell," Davis said, noting that the asking prices have finally fallen.

Davis cautioned that the smaller buildings with 5,000-10,000 square feet are rarely for sale, due to the high demand for buildings that size.

Real estate is cyclical, and in the long term, the valley will do well, Hench said.

"Cycles are part of life of the real estate business as they are in all kinds of businesses," he said. "Over the long haul, Silicon Valley will do great."