Wayne Mascia Associates

perspective

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SERVING THE INTERESTS OF SILICON VALLEY

Reading the Tea Leaves

ARTICLE BY JOE LEWIS | OWNER AND PRESIDENT | ORCHARD COMMERCIAL

Joe Lewis is the owner and President of Orchard Commercial in San Jose, CA, with responsibility for all the firm's operations in Silicon Valley commercial real estate. He is an active member of BOMA, IREM, NAIOP, ASVB and the UC Berkeley Fisher Center Advisory Board. He and his wife Elizabeth make their home in Atherton, CA where Elizabeth is active in residential construction.

The commercial real estate market is, by nature, in a state of constant flux, ebbing and flowing as those who occupy space and those who provide it never seem to reach any semblance of balance. With change the only constant, the Silicon Valley is driven by the warp speed innovations and market forces that alternately balloon and constrict individual companies and whole industry sectors. In such a dynamic market the ability to achieve balance is constrained by the realities of lag time in responding to change.

In both the short term and long term these inherent characteristics of commercial real estate create one of the most cyclical environments in capitalism as the market constantly and predictably swings between decline and recovery, never achieving equilibrium for any sustained period. Accordingly, success in commercial real estate investing hinges on anticipating the future direction and, more critically, the turning points of a given cycle.

Historically, Silicon Valley commercial real estate has passed through four major boom/bust cycles over the last several decades, each having left their mark on the Valley and each leaving clues to the next cycle. The start of a bust cycle, such as the most recent beginning in 2001, is not too difficult to identify, although it is painful. Similarly the collapses of 1974, 1984 and 1990 were broadly recognized within six months of their inception, but some investors hung onto their portfolios for years, riding the market down. Such psychological denial can be catastrophic and as local real estate icon Louis Belmonte famously advised, "Get ugly early" in a collapsing market. Equally astute developer Ned Spieker, famous in the sales of Spieker Properties to Equity Office in 2000, defined his timing with the observation: "We just didn't see how it could get any better and, if it can't get any better, it will get worse because real estate is a cyclical business."

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The start of a recovery is harder to identify and quantify. True to human nature, fear seems to trump greed as market players remain fearful from years of depressed values. As anticipated recovery seems at hand today, Silicon Valley real estate offers unique benchmarks based on historical patterns of past cycles that can be perceived by astute investors. It is usually characterized as a "rolling recovery" that has a decidedly geographic bent based on the earliest development of Silicon Valley, beginning in Palo Alto and proceeding south through Mountain View, Sunnyvale, Santa Clara and, finally San Jose.

The geographic pattern of today's market recovery, characterized by rising rents and declining vacancies, is rapidly coming into focus. Witness statistics quoted in the San Jose Mercury News at the end of July: Palo Alto R&D space was fetching $1.94 NNN in the face of a 3.9 percent vacancy rate, Mountain View R&D was going for $1.51 with 5.1 percent vacancy, Sunnyvale commanded $1.30 with 13.5 percent vacancy, continuing south, Santa Clara averaged $1.26 with 16.7 percent vacancy and North San Jose lagged with $1.06 NNN continuing to carry a 22.8 percent vacancy rate.

These markets are all within a half hour's drive of each other and two years ago rents in each were virtually the same. While there isn't a completely rational explanation of why rents in older research and development buildings in Palo Alto command almost double those of similar building in North San Jose, this north to south geographic pattern is both obvious and historic. As recovery builds momentum and becomes more apparent, it doesn't take much analysis to reach the conclusion where rents will be higher and vacancy lower down the road.

Of course, every cycle has changed the face of the Valley and reflects its unique circumstances as the market has evolved and matured. Today, office and R&D space has morphed into an office building. A quarter century ago, a typical research and development building was single story and divided into three approximately equal parts: office, manufacturing and warehouse. Google, Yahoo, Adobe, eBay and the whole crop of today's market leaders that didn't even exist a couple of decades ago all occupy purely office space. The typical new R&D building is multi-story, probably steel frame, and has little in the way of manufacturing and warehouse that characterized bygone tilt-ups. The extent that older buildings can be renovated to reflect office qualities—features such as windows, high ceilings, open interiors and modern fixtures—will heighten their potential success in the recovering marketplace.

In the newer Silicon Valley frontier of North San Jose, the last quarter century has witnessed the complete transition from orchards to a sea of concrete tilt-up electronics facilities. These traditional R&D buildings are progressively being replaced by multi-story office buildings, a trend that actually predated the latest bust cycle, but surely will accelerate with the coming recovery. Both the public sector and the development community have already made major commitments toward a San Jose of multi-story office buildings with nearby housing, retail and public transportation, a commitment that can only grow in a recovering environment.

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Yes, recovery is coming to Silicon Valley from its traditional cradle in Palo Alto to its new horizon in San Jose. The market is heading south, certainly not in an economic sense but geographically, and it is simultaneously going vertical. Serious bets on a robust, geographically shifting and urbanized future are already being made and promise to be redoubled as the tea leaves become more focused.

"Golden Triangle" HWY 101/N. First Street/HWY 237 (1978)

"Golden Triangle" HWY 101/N. First Street/HWY 237 (present)