

Market could force landlords to make more concessions

LANDLORDS: Silicon Valley vacancy rates ended on flat note, with a slight uptick from Q3 to Q4

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More space; uptick in vacancy rates

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Silicon Valley landlords for now are keeping their checkbooks closed, as tighter vacancy rates have meant fewer tenant improvement dollars flowing to companies leasing space. And those companies seeking out Class A space can expect to pay more for their own improvements, as the construction material costs continue to rise.

But as more prime space comes on the market — more than a dozen office projects, including a number of speculative projects, were on the drawing board or breaking ground in 2007 — landlords could once again find themselves with too much space on their hands, meaning a return to the days of extreme concessions.

"All of the tech companies I talk to are doing well, the VCs are funding and there's no let up in terms of demand," says Dave Lichtenger, founder of Integrated Facility Solutions. The Palo Alto-based company

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provides turnkey services for relocation, renovation, expansion and consolidation projects for everything from clean rooms to office space.

"It might be a different story for landlords with a 40-year-old tilt-up that needs seismic upgrades, but for Class A space, there's a real demand and a real shortage right now," Lichtenger says. "If you have a 'warm shell' in Class A space in a desirable building, landlords might not be very flexible on tenant improvement budgets. And if the space is already built out and a tenant needs to make changes, landlords might not be flexible at all."

According to a report released by CB Richard Ellis in early January, office vacancy rates for Silicon Valley closed at 9.7 percent in the last quarter of 2007, while rents for Class A space averaged \$3.50 per square foot.

John M. Sobrato, CEO of Sobrato Development Companies, noted that during the same time, construction costs rose dramatically ("many times the rate of inflation") and that landlord contributions dropped while total costs rose.

Combined vacancy rates between office and R&D space are down to about 17 percent, he says.

"I think it will continue to trend down modestly because the market has been improving on a slow but steady basis," Sobrato says. "But everything is negotiable. Certainly as tenants move toward increasingly improved office space, landlord contributions go down."

The year 2007 ended on a flat note, as the 9.7 percent vacancy rate in Q4 was a slight uptick from the 8.6 percent vacancy rate in Q3.

"But we had a solidly improving market in the valley. If you look at that, it's logical to follow that inducements such as TI budgets would be reduced as landlords gain more traction in negotiations," says Gregory M. Davies, a vice president with

commercial real estate firm CPS/Corfac International.

Davies noted that the TI market is part of an intricate formula, one that includes the tightening of the credit market and the decrease in the amount of capital available to investors. Equity requirements have gone up to 90 percent of total project costs, Davies says, based on what CPS clients are telling their brokers.

"How this translates into the TI market is that likely it will have more material impact on landlord tolerance for non-credit tenants, and on landlord's tolerance for risk," Davies says. "It's not a

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negative picture because leasing fundamentals remain solid. Landlords are not saying universally 'no TI allowances, but rather they are focusing on tenant credit.'

Most landlords are offering between \$20 to \$30 a

square foot on top of a cold shell, while the cost to go from a cold shell to a fully ready shell runs about \$75 a foot, costing a tenant \$50 a foot out of pocket, Davies says.

"Is the landlord going to amortize that? I would doubt it. A tenant renting one of these trophy buildings will have access to cheaper capital than a tenant improvement amortization from the landlord," he says. "Landlords are not shooting for suspect tenants on these deals. They aren't going to want pets.com as a tenant."

Mike Parker, managing partner of ExTerra Realty Partners LLC, says the amount of construction planned for the next few years, as well as the amount of product coming online, could put pressure on concessions.

"We had several strong quarters and then all of a sudden the economy had a burp. There's not a whole lot of vacancy for class A space and rents are pretty strong and concessions are low," says Parker. "But there's a lot of steel in the air right now and a lot of product coming on line. It doesn't take a rocket scientist to figure out that could put pressure on concessions."

ExTerra broke ground in July on the first of three buildings at Java Metro Center, a phased redevelopment on the site of the former Sandisk Corp. campus in Sunnyvale. The 115,000-square-foot, five-story building is expected to become available in August.

Parker says rents for Class A space, such as the Jay Paul Co's Moffett Towers in Sunnyvale, are averaging about \$3.25 per foot triple net, with TI's of \$25 a foot offered over a warm shell.

"When the market really gets soft, the incentives can get as high as turnkey," Parker says. "I can tell you that 10 years ago we were also getting \$25 for TIs, so there's no accounting for inflation."

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