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Bringing the Bay Area 'Back from the Stratosphere'

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Though several recent deals have fallen apart and the pace of activity has slowed, the Bay Area office investment market stills appears to be thriving following a three-year period of intensity unmatched in recent history.

Momentum peaked in 2007 as the market, in the words of the **Grubb & Ellis** research department, "vaulted into the stratosphere," achieving more than $15 billion of total sales. While San Francisco accounted for more than half the total, the $7.2 billion figure for the rest of the region was still impressive, topping the previous record set in 2005 by close to 30 percent.

With probably close to half the market's existing inventory having traded at least once since 2004 - and a few properties having sold three times - a slowdown seemed inevitable, especially in light of the problems in the capital markets. But in the view of the general brokerage community, the region retains its investment appeal.

"It's still a good market for sellers," said Eric Hallgrimson, senior vice president and principal in the Santa Clara headquarters of **Commercial Property Services/Corfac International**. "Deals are a little trickier. Sellers are very concerned with a buyer's assurance of closing. But most sales are still getting done."

Hallgrimson acknowledged several recent deals have fallen out due to an inability to line up acceptable financing, including a recent Silicon Valley purchase by the San Francisco office of **Rockpoint Group LLC** and the sale of a vacant ADT Security Systems building to a Texas investor, but he maintains interest in the market has not so much dissipated as been tempered by reality.

"We've seen a tremendous increase in rents, and as a result, the investment market for office and R&D has really been pretty frothy. There's been institutional money pouring into the market at silly rates trying to chase the rent appreciation. Things are settling back to a more realistic perspective," he said.

According to Dan Fasulo, managing director, research for New York-based **Real Capital Analytics**, many market participants have been expecting significant price corrections in markets across the country.

"We've definitely seen some of that," he said. "But while we've seen rising cap rates in secondary and tertiary markets, we've not seen a softening in primary markets like the Bay Area. The Bay Area is awfully resilient in the face of higher debt costs."

According to Fasulo, the region's overall ability to hold the line on pricing speaks to investors' confidence in the market due to underlying constraints on development.

"The Bay Area is relatively supply constrained on the commercial side. The commercial market has not been overbuilt like the residential market, and there are a lot of factors in place to prevent that from happening," he said, citing strict zoning and environmental laws, community activism, high land costs and geographic limitations as primary constraints to over-development.

But while prices have stayed high, Hallgrimson reports recent transactions indicate they are beginning to slip as investors begin to see the writing on the wall. Even if some buyers remain willing to offer top dollar, the reluctance of lenders to come through at the highest price points is prompting sellers to drop prices or accept lower offers that seem more likely to go through.

As an example, Hallgrimson points to the sale of 900-910 Hamilton Ave. in Campbell, which is currently in escrow. He says the 175,000-square-foot, two-building property, which is about two-thirds vacant, was offered at $400 per square foot, a rate brokers considered too high. But where they expected it to sell at about $370 a square foot, he said the deal ultimately came in at only $350 per square foot.

Conversely, San Francisco-based **Shorenstein Properties LLC** recently paid $85 million, or $761 per square foot, for a 111,653-square-foot building at 601 California Ave. in Palo Alto's Stanford Research Park. A long-term lease by lawyers **Wilson, Sonsini, Goodrich and Rosati** for the entire two-building property partly accounted for the value placed by the buyer, but the high price nonetheless forcefully demonstrates the market's continuing desirability.

Making its first foray into Silicon Valley, Houston-based **Lionstone Group** paid a lesser but still-aggressive $510-a-square-foot price for a 181,000-square-foot property at 1801-1891 Page Mill Road in Palo Alto. And a joint venture of Boston's **Harvest Properties LLC** and Atlanta's **Invesco Ltd.** paid Houston-based Hines a solid $450 per square foot for the fully leased, 400,000-square-foot Parkside Towers in Foster City.

By contrast, Philadelphia's **BPG Properties Ltd.** picked up the 600,000-square-foot Park Center Plaza in San Jose for only $282 per square foot. However, the nine-building complex, which includes 62,000 square feet of retail and restaurant space, is 26 percent vacant and needs an estimated $10 million in capital improvements to bring it up to current standards.

Leasing Outlook Shifts

From a leasing standpoint, certainly, the market appears solid. According to Grubb & Ellis, the Bay Area, minus San Francisco, experienced 3.4 million square feet of positive absorption last year. The activity dropped the vacancy level 190 basis points to just over 11 percent. Rents climbed to about $43 per square foot for Class A and $33 per square foot for Class B, with submarket averages ranging from $56 per square foot for Class A on the San Francisco Peninsula to $24.77 per square foot for Class B in the East Bay. Silicon Valley rents fell in the middle.

This year's performance appears unlikely to match last year's, however, with tenants hesitating to pay escalating rates and whenever possible waiting to see if they might drop back a bit. According to Grubb & Ellis, more than 3 million square feet of new spec product is in or scheduled for construction, but Erich Sengelmann, managing director of the East Palo Alto office of **Jones Lang LaSalle**, said little of that space has been leased. In fact, he adds, few tenants have even shown serious interest.

"Our clients are monitoring the situation and seeing what develops. They're not ready to commit if they don't absolutely have to," he said.

Grubb & Ellis research indicates the hesitation has only partly to do with waiting for rent trends to become clear. The brokerage reports tenants are equally uncertain about the impact of a potential general economic downturn on their businesses and the willingness of capital sources to provide money for expansion.

"A lot of people are predicting leasing will decline," said Hallgrimson. "But it's too early to tell if this year will lose leasing velocity. We don't have enough data or active requirements to make a viable prediction yet. A lot of people are just starting to get themselves organized regarding their plans for 2008. It's going to take a few more weeks for a clear pattern to begin to emerge."

Grubb & Ellis forecasts a strong year for the Peninsula due to the growing power of the life science industry. The market's 12.4 percent vacancy level failed to hold rents in check, largely because much of the vacant space fails to meet the needs of life-science tenants.

The brokerage says the high rents recent Silicon Valley buyers need to cover their debt are scaring off tenants there, but a shortage of Class B alternatives may force them from the sidelines. Sengelmann says landlords, for their part, are more willing to adjust their expectations downward to get leases signed.

"For good tenants, I think landlords are coming to the table with much greater alacrity to make deals. They realize it's better to have tenants than not have tenants even if the rents don't meet pro forma," he said.

At the same time, Grubb & Ellis suggests some Silicon Valley and Peninsula tenants may instead shift to Oakland and the East Bay, where rents are anywhere from 15 percent to 40 percent cheaper already. The 12.5 percent vacancy rate gives the submarket some room for play before pressures might begin pushing rents significantly higher.

Given the market's continuing strength, Hallgrimson says it's hardly surprising buyers are still out scouting deals. He reported his office just fielded 14 offers on a three-building portfolio, and said other brokers he has talked to have had similar experiences.

"I don't think investment volume will be as high in 2008, but there are still be deals to be had," he said.

He added, however, that the composition of the buyer pool is changing, with the credit crunch winnowing out buyers that were highly leveraged with Wall Street money. Fasulo said private equity funds and institutional investors made 65 percent of the region's commercial property purchases in 2007, up from less than 50 percent in 2006. He expects the percentage to grow further this year.

"The depth of the capital looking to buy Bay Area commercial property is incredible," he said. "When one group retracts, there's another group right behind them ready to fill the void. While sales may slow, you've got to remember it's slowing in comparison to several record-breaking years. I think you'll still see a sizable volume of deals in the coming year."

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