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With 31.8M square feet in the pipeline, developers build on spec

Silicon Valley / San Jose Business Journal - by [Sharon Simonson](#)

Even as Silicon Valley companies rein in their leasing habits, the region's office developers continue to pursue new construction, including speculative buildings.

The latest is Cupertino-based **Sobrato Development** Cos., which announced April 10 that it plans to go forward with a 172,000-square-foot building adjacent to its complex on Julian Street in downtown San Jose. The company is also moving dirt on Lawson Lane in Santa Clara, where it is putting up 150,000 square feet of speculative workplace space.

Sobrato's projects would add to the stream of South Bay offices under development or being planned, according to a new report from brokerage NAI BT Commercial. That study finds that developers and a handful of companies, such as **Network Appliance** Inc. and **Cadence Design Systems**, are pursuing construction of 31.8 million square feet of new work space from Menlo Park to Morgan Hill. Most plans are in San Jose (17.6 million square feet), Santa Clara (5.7 million square feet), Sunnyvale (3.9 million square feet) and Cupertino (1.2 million square feet).

Although those projects are still in the pipeline, more than 2 million square feet of space was completed during the first quarter of 2008 and 3.4 million more is in progress, according to NAI BT.

No developer, however, has announced leases for any speculative office property, and the demand for property over 100,000 square feet has slowed considerably from a year ago.

Cost is one big reason.

Typically, landlords deliver a new building to a tenant in "cold shell" condition, with an additional investment needed to make it usable. Marketplace estimates range from about \$80 a square foot to \$175 a square foot for tenant-improvement costs, though some landlords pay part of the expense.

Beyond that, the rent on new buildings is higher. Colliers International broker Jim Beeger says historically the spread between rents for new construction and newer existing buildings is about 20 percent. The spread today is more than twice that.

"I don't know a lot of tenants that would pay that premium," he says.

Sobrato Vice President Michael Field says his company is relying on its "competitive advantages," such as local management able to make decisions quickly, and buildings of exceptional quality and in strong locations. Sobrato has done well in the last 12 months, leasing 1.2 million square feet, Field says.

"The market does not have to be on fire for speculative development to make sense," he says. "You just have to have faith in the long-term reliability of the Silicon Valley market."

It's also difficult to lease unfinished buildings, says Gregory M. Davies, a vice president at Santa Clara brokerage CPS Corfac International.

"It seems premature to be calling for panic," he adds.

Davies acknowledges that times are as uncertain, but it's too early to tell where the market is heading.

"Everyone is unsure if this is going to be a blip, whether we will get back to the growth we've seen in the last two years or it's a recession," Davies says.

Silicon Valley is no stranger to overbuilding, despite a reputation as a difficult place to get new development approved. Newport Beach real-estate investment consultant Green Street Advisors published a report in late 2002 about the Bay Area's office development rate over the previous eight years -- covering the run-up to the dot-com boom, the peak between 1999 and 2000 and the nose dive in 2001.

In that go-around, it's widely accepted that tenants who had signed expansive leases for new space, including brand names such as **Cisco Systems** Inc., took the brunt of the pain. To a degree, the valley's commercial real estate sector still has not fully rebounded since then.

Although office markets in the most desirable locations such as Palo Alto, Mountain View and Cupertino boast vacancy rates well below 10 percent, vacancy rates for the valley's most plentiful workplace products -- research and development buildings -- remain stubbornly high, at 16 percent, NAI BT reports.

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