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## Corporate Office Perspectives

December 1, 2002 ISSUE: 136

I had the numbers double-checked, and no matter which way they were counted, as of this month the overall Bay Area office/R & D vacancy is in excess of 84 million square feet, with 50 million feet in the Silicon Valley, 15 million feet in San Francisco, and the rest on the Peninsula and the East Bay. Only an opinion, but there may be an additional 8 to 15 million square feet of "shadow space," which is vacant office/R & D space either not readily subleaseable or not officially on the market. Again, just an opinion, but in most submarkets, we have yet to hit bottom. For the office market recovery to firmly take hold, companies have to have sustained profitability for several or more quarters. Initial new hires will first absorb the already-leased or owned "shadow space" before corporations begin to impact market vacancies. Thus, it may still take 12 to18 months following sustained corporate profitability before we begin to see declining vacancy in the office/R & D sectors.

As reported in *National Real Estate Investor* (November 2002), "Respondents to a BOMA Survey conducted in March listed what additional security measures they planned to add to their buildings this year: 1.) Install security cameras or upgrade the existing security camera systems 2.) Update and expand emergency planning and evacuation procedures 3.) Increase the number of security personnel 4.) Implement identity card systems for tenants and vendors 5.) Implement or expand key-card access systems 6.) Ban exemptions to security requirements 7.) Eliminate loading-dock parking and after-hours deliveries 8.) Expand security training for all property employees 9.) Restrict access to certain building areas 10.) Implement new security procedures for mail center areas."

Centralized, computerized call centers of property management firms utilize multiple technologies, such as e-mail, pagers, cell phones, PDA's, and the Internet to weave the various players together - tenants, managers, building engineers and vendors (*PikeNet* 10/17/02). This results in reduced customer complaints, much quicker response times, and lower management costs due to harnessing technology and consolidating multiple operations centers.

"I-680 Corridor leasing looks like another record low year with an estimated 600-700,000 sf projected for net absorption…A far cry from the 2.5-3.5 million square feet we used to do. Company downsizing helped contribute to these gruesome figures…" This was from the December, 1991 newsletter. And in the February, 2000 issue, in a rare flash of premonition, "The Bay Area office market is still on fire. When will the bubble burst, or is this significant e-revolution going to continue its course?" In the April 1, 1991 newsletter, "According to a new study commissioned by NAIOP and funded by Price Waterhouse, "America's Future Office Needs: Preparing for the Year 2000," 50% of <u>all</u> office space ever built in the U.S. came on-stream in the 1980's. Half of the country's major cities have more than a 10-year supply of vacant office space." Sometimes the more things change the more they stay the same… now we're nervous about just "staying alive until 2005," or maybe "Landlords can't wait for 2008"...

There's nothing fishy about the San Francisco office market. Two landlords are currently competing for the Steinhart Aquarium's need for 100,000 square feet to house 175 exhibition tanks, 400,000 gallons of water, and millions of dead insects while it rebuilds its Golden Gate Park facility. Their first choice appears to be a former dot-com office building …

*Editor:*

**Jeffrey S. Weil**,
MCR.h, CCIM, SIOR
Senior Vice President

1850 Mt. Diablo Blvd.
Suite 200
Walnut Creek, CA 94596

Phone: 925.279.5590
Fax: 925.279.0450
jweil@colliersparrish.com
**www.officetimes.com**

During the past five years many new corporate real estate software programs hit the market, offering to expedite, automate, streamline, overhaul or just tweak various parts of the corporate real estate process. A number of these programs actually delivered as promised, but unfortunately, the dotbomb/e-commerce meltdown of the past two years has seen the demise of many of these once-promising companies. What has begun to arise from the shadows are the established, well-capitalized business software companies such as Oracle and Quicken who have entered the corporate real estate software industry with aggressive staying power and an existing business customer base. That's not to say niche independents can't become successful, but if you're a CFO about to authorize a significant investment in web-based CRE systems, which vendor-type will you lean toward?

*Deals and Rumors:* Starting with **Oakland**, Public Health Institute and Carol Williams Advertising each leased 24,000 sf at 555 City Center, and ACFRA took 15,000 sf at 475 14th St. Next door in **Emeryville**, Alden Computer leased 15,000 sf at 6001 Shellmound St.; Nanomix took 13,000 sf at EmeryStation, and Kaiser Permanente is rumored to be taking 60,000 sf at The Hollis Business Center. In **Berkeley**, Fresenius Medical Care leased 10,000 sf at 2895 Seventh St. for a dialysis clinic. Up in **Richmond**, Berkeley Process Control leased 21,000 sf at 4120-4140 Lakeside Drive, and Design Veronique took 30,000 sf at 999 Marina Way South. In **San Francisco**, Wells Fargo is rumored to be taking 120,000 sf at One Front St.; Stone & Youngberg leased 35,000 sf at the Ferry Building, where Coblentz, Patch, Duffy & Bass is reportedly close to signing for 65,000 sf; The State Compensation Fund plans to build a 267,000 sf expansion of its 1275 Market St. headquarters; Nexant, Inc. leased 35,000 sf at 101 Second St.; EDAW took 36,000 sf at 150 Chestnut St.; KNTV television signed for 25,000 sf at 848 Battery St.; Friedkin Realty Group leased 15,000 sf at 44 Montgomery St.; Cullan Associates is rumored to be looking for 40 to 50,000 sf, and Genstar Capital leased 12,000 sf at Embarcadero Center Four. In **Pleasanton,** Option One signed for 18,000 sf at Hacienda Lakes; Olympic Funding took 11,000 sf at 7139 Koll Center, and up in **San Ramon,** John Muir Hospital sublet 12,000 sf at Bishop Ranch 11. In **Danville,** Brookfield Homes leased 12,000 sf on La Gonda. In **Walnut Creek**, Massachusetts Mutual Life is relocating to 16,000 sf at 2121 N. California, where Parsons Engineering just signed for 10,000 sf. Also in **Walnut Creek,** WildPackets sublet 25,000 at 1340 Treat Blvd., and in **Concord**, Round Table Pizza leased 19,000 sf at 1320 Willow Pass Rd. for its headquarters.

A chart in the *Silicon Valley Biz Link* (11/8/02), illustrated the Bay Area work force by area as follows: East Bay 32%; San Francisco 27%; San Jose 27%; Sonoma 7% and Solano 7%.

I've attended a number of recent corporate real estate seminars on CRE cost reduction, and one trend that is still going strong is overseas call center operations. The first wave was getting call centers out of U.S. urban centers to less expensive suburban or rural communities, but multiple testimonials rave about cost savings and the quality of output in setting up call centers in India or the Philippines. The overseas workers are trained to speak fluent English with a Texan or Arkansas drawl, and work for a fraction of their U.S. counterpart salary. Of course, with new advances in intelligent voice computing it may only be a question of time before this entire process is fully automated and computerized. (Did my computer call yours last week about that order?) In the *Contra Costa Times* (10/25/02), "Slowdown Sends Tech Jobs Overseas," it used to be engineering jobs were sent overseas during boom times due to worker shortages and high wages. Now the reverse is true. "The economic slowdown is speeding up the export of jobs, experts say. As executives face smaller budgets and more pressure for profits, they find it much cheaper to send work to contractors overseas. More U.S. companies are following Silicon Valley's lead by shifting engineering and other technology-related jobs to places such as China, Ireland, India and the Philippines to cut costs." Hey, how are we going to fill all our vacant office space if you do that? "About 200 of the Fortune 500 companies now ship software work overseas. Fortune 1000 companies are quickly following. Forrester Research estimates that corporate budgets for offshore software outsourcing will probably more than double by 2004… A software engineer fresh from college in India might earn $5,000 a year, compared with about $50,000 in the United States."

During the past 12 months we have seen operating expenses shoot up in a number of office submarkets. The main culprits include utility spikes from 2001 projected forward, with increases of 20 to 30 percent or more. Property insurance has increased 200 to 400 percent, especially for trophy properties, which have had the most difficulty procuring "reasonably" priced terrorism insurance. The Federal terrorism insurance legislation working its way through Congress will, at some point, partially alleviate this, but the trickle-down might take several years. Security measures in general brought to the forefront after 9/11 have had a dramatic increase on operating expenses. Suburban office projects have hired on-site security staff, and high-rises have beefed up security measures to where, in some instances, it feels like you're trying to board an airplane. I've also heard that some institutional long-term investors are taking advantage of the slow office market to renovate existing projects, and whether it is the landlord's nickel or the tenant's increased operating expense should be defined in the fine print of your lease.

Corporations contemplating long-term locational considerations often wonder where their future workforce will reside. In San Ramon/Danville, the Dougherty Valley project will add 11,000 homes to the current base of 13,000, which will add another 30 to 40,000 residents. According to the *San Francisco Business Times* (October 25, 2002)… "to put the size of the 11,000-home Dougherty Valley project in perspective, 8,100 new housing permits were filed for the entire East Bay in 2002." I've previously

Jeffrey S. Weil, MCR.h, CCIM, SIOR, Senior Vice President ◆ Colliers International
1850 Mt. Diablo Blvd. ◆ Suite 200 ◆ Walnut Creek, CA 94596 ◆ Ph. 925.279.5590 ◆ Fax 925.279.0450
jweil@colliersparrish.com ◆ **www.officetimes.com**

reported on the Mountain House and Lathrop projects in San Joaquin County, which combined will house 70,000 residents. Also recently announced was a 5,000 home development in Southern Antioch, representing another 15 to 20,000 future residents. Good thing our freeway and public transit infrastructure is already in place! (It can't even handle what's currently built. I can just picture the new Stephen King terror-novel "Bay Area Transportation Devours Its Residents." R-rated for sure …)

In a recent CoreNet Global (the merger of Nacore and IDRC) survey reported in *The Wall St. Journal* (11/20/02), "54 percent of 105 companies nationwide that responded plan to reduce the amount of office space they occupy in the next six months. Of those companies that plan to occupy less space, nearly half reported that so-called shadow space - space that is no longer needed or being held for future use made up more than 10 percent of their portfolios. 'Clearly, companies are continuing to downsize,' says Matthew Cullen, a General Motors corporate executive and CoreNet's chairman."

I've been a proud member of SIOR (Society of Industrial & Office Realtors) for the past 16 years, and for the past 10 years have sat on the Northern California Executive Board. There are 2,100 SIOR designees in 450 cities in 25 countries, with an average per member dollar volume of $25.7 million, an average 1.2 million square feet leased or sold per member last year, and as a group the Society closed 68,422 transactions last year.

You know it is interesting times when a one-million square foot office/manufacturing/warehouse building goes on the market for a total sale price of $1.00. The facility is owned by Bayer Diagnostics and is in Elkhart, Indiana. Its estimated value is $12 million, but maintenance and security costs exceed $6.5 million annually, so with the average selling time for this type of property of two to five years, a quick sale might be the ticket. I wonder what the commission is if they sell if for a buck… (okay, here's your nickel, thanks for the terrific job!). And if you think $1.00 is too pricey, the 300,000 square foot Abbott Laboratories Building in North Carolina is being offered "At No Cost" to a qualified buyer!

If you're a corporate real estate professional faced with having to sublease excess space and this hasn't been a normal task in the past, you might want to check out "Tips and Ideas for the Sublandlord" at the bottom of the home page of **www.officetimes.com**. Curious about the costs and nuances of Plug & Play? "Plug & Play Office Space Phenomenon" might be useful, also on **www.officetimes.com**. For back issues of the OfficeTimes Newsletter, now in its 22nd year of publication, yep, **www.officetimes.com**!

According to *National Real Estate Investor* (November 2002), net leasing is taking 15 to 30 percent longer to complete than in the past, investors are having to review 50 percent more net lease candidates to complete the same number of deals it closed before the credit scandals of the past year arose, and as James Cate, a managing principal at Newark Capital Group stated, "Due to the surprise demise of a long list of corporations in the last year, credit scrutiny is more sophisticated than at any other time in the history of the net lease industry." Gary Ralston, president of Commercial Net Lease Realty, an equity REIT with a $1 billion portfolio of freestanding, net lease retail properties in 14 states, believes the industry is poised for significant growth as net lease providers plot to capture business from the troubled synthetic lease sector. Existing synthetic lease structures throughout the commercial real estate industry are valued between $100 billion and $120 billion, according to Ralston. "I'm not saying that we're going to see $100 billion of new net lease transactions suddenly," he says, "I think we could see $5 or $6 billion fairly quickly, which could effectively double the annual volume of net lease."

According to an article in the *California Real Estate Journal*, (October 28, 2002) titled "Office Buyers Ignore Vacancies," "The news coming out of the commercial real estate market is bleak: Office vacancy rates are rising, and rents are softening in many cities. Yet the market for buying office buildings is on fire…. Why the disconnect? If you look below the surface, buyers are focusing mainly on isolated buildings that still have very low vacancy rates. And compared with the stock and bond markets, real estate's immediate return of 7 percent to 10 percent look pretty good to many buyers right now, especially with interest rates at 40-year lows. But the huge flow of capital into commercial office properties amid the weak environment has some analysts raising a yellow flag." "I think there is a bubble in the commercial real estate market," Peter F. Korpacz, a director at Pricewaterhouse Coopers said. An interesting companion article directly below this was titled, "U.S. Office Vacancy Rate Increased to Almost 16 Percent in Third Quarter." "The fact that office markets - after dropping sharply in 2001 - are still sliding is worrisome to office-building owners, who are fighting over a dwindling number of tenants." "The recovery from this sustained period of negative demand is not just over the horizon," said Lloyd Lynford, Reis's (the New York research firm that performed the survey) chief executive officer.

California came up with a sneaky method of collecting hundreds of millions of dollars almost immediately. Check with your CPA, but the new law effective 1/1/03 has escrow companies or buyers withholding 3 1/3 percent of the sales price for non-principal residential property in excess of $100,000, applies to both residents and non-residents, and 1031 exchanges are excluded. More information is available at the Franchise Tax Board web site, www.ftb.ca.gov or by calling FTB at (888)792-4900.

JJeffrey S. Weil, MCR.h, CCIM, SIOR, Senior Vice President ◆ Colliers International
1850 Mt. Diablo Blvd. ◆ Suite 200 ◆ Walnut Creek, CA 94596 ◆ Ph. 925.279.5590 ◆ Fax 925.279.0450
jweil@colliersparrish.com ◆ **www.officetimes.com**

Landlords who make it difficult for tenants trying to sublease excess space may find this attitude coming back to haunt them. For example, not agreeing to a reasonable attornment and acknowledge whereby if the tenant defaults the landlord is still obligated to honor the sublease terms and conditions of the subtenant (please check with your attorney for legal definitions) may make it very difficult to sublease to a much-stronger credit subtenant. If you make it too tough to sublet, the space may just sit there until it eventually becomes the landlords' problem at the end of the lease term. The landlord has an opportunity by approving a sublease to use the tenant's furniture and equipment, or basic tenant leasehold write down to get a new occupancy for the building. In almost all cases, the cost of sublease commissions, tenant improvements and downtime for TI construction are borne by the tenant trying to dispose of the space. I've also heard landlords complain that the deep-discounted sublease rate is not really "market," but the last time I checked the market sets the market, not the landlord or the tenant. Being unreasonably tough may also send a message to new tenants about what they might face in the future if they ever need to dispose of their office space.

Jordan Thomas Weil turned 5-1/2 last week on November 26, and is just getting into the youth sports scene. He is taking soccer before kindergarten classes start, and on weekends he has been on an indoor hockey team. My real fear came when my wife announced Jordan was taking chess classes as I barely know how to move the pieces. To our surprise he loves the game and is constantly asking me to play, so now I'm practicing on the computer just so I can keep up with my 5-year old son! Photographs from some of his recent adventures during the past few months can be seen at http://www.officetimes.com/ JordanDecember02.htm, and next week we are off to Michigan and Toronto to visit relatives before the crazy holiday rush. Have a safe, warm holiday season, and I'm sure you share my gratitude for how blessed we are in so many ways. Smell the roses, taste the snowflakes, and let those around you know how much you care for them!

Sincerely,

Jeffrey S. Weil, MCR.h, CCIM, SIOR
Senior Vice President

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Jeffrey S. Weil, MCR.h, CCIM, SIOR
Senior Vice President
1850 Mt. Diablo Blvd., Suite 200
Walnut Creek, CA 94596

# Newsletter

**December 2002**

effrey S. Weil, MCR.h, CCIM, SIOR, Senior Vice President ◆ Colliers International
1850 Mt. Diablo Blvd. ◆ Suite 200 ◆ Walnut Creek, CA 94596 ◆ Ph. 925.279.5590 ◆ Fax 925.279.0450
**www.officetimes.com** ◆ jweil@colliersparrish.com