

MARKET REPORT

OFFICE

San Jose Metro Area

IPA INSTITUTIONAL
PROPERTY
ADVISORS

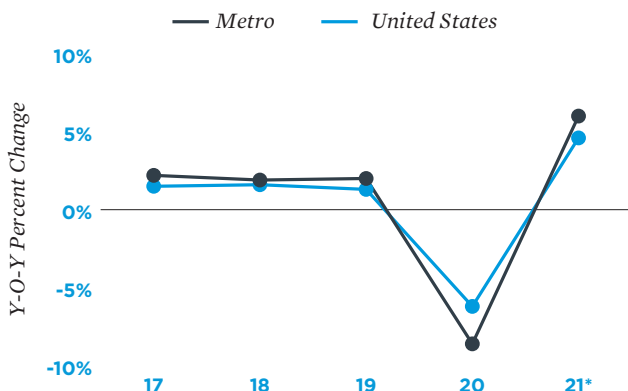
4Q/21

Tech Giants Remain Cautiously Optimistic; Investors Precede Office Tenants Back Into Market

Delay in reopening pauses office recovery. Both Google and Apple pushed back their windows for workers to come back to offices until early next year due to the delta variant. The return of these anchor tenants will likely precede smaller firms that rely on contracts with Big Tech. As a result, a wider reopening is unlikely to occur until the first few months of 2022. Nonetheless, both Google and Apple do plan to bring most of their employees back onto their campuses. Each company has a large real estate presence in the South Bay and both have reported in-person collaboration is paramount to the success of their operations. Therefore, the recovery in San Jose should outpace San Francisco, where the large tech firms have already committed to significant remote work options.

Construction to temporarily pressure fundamentals. Although most of the office space that is currently underway has leasing commitments, those buildings will compete with existing properties. The pace of development will reach the highest level since 2017, when more than 8 million square feet came online. The inclination of office users willing to reopen will determine the rate at which the supply overhang gets absorbed, though work-from-home and redistribution of jobs remains largely unknown. Most of the large tech companies have opened significant-size offices outside of the Bay Area, so at least some positions are unlikely to return to the market.

Employment Trends



* Forecast
Sources: BLS; CoStar Group, Inc.

Office 2021 Outlook



64,000

JOBS

will be created

EMPLOYMENT:

Employment is set to climb 6.0 percent this year as tech firms bring a significant portion of their staff back to offices. Traditional office employers will add 4.8 percent, or 18,500 workers, to their headcounts.



4,700,000

SQ. FT.

will be completed

CONSTRUCTION:

Development surges this year after construction was slowed during the downturn in 2020. Supply is on pace to increase by 3.8 percent in 2021, though most of the new space has pre-leasing commitments.



280

BASIS POINT

increase in vacancy

VACANCY:

A large jump in stock and mostly delayed reopening due to the delta variant will result in an increase in vacancy to 16.2 percent. Last year, the rate rose 350 basis points.



3.1%

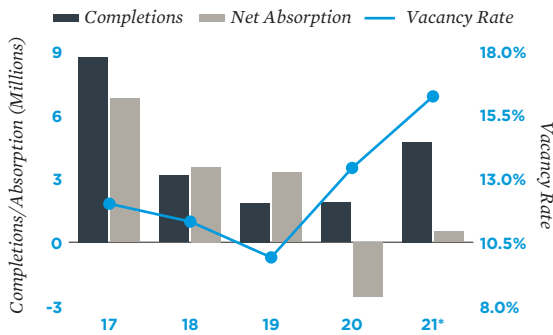
DECREASE

in asking rent

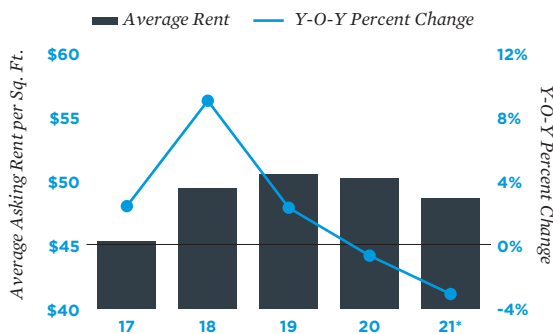
RENT:

In an effort to attract tenants, the average asking rent is projected to decline to \$48.64 per square foot this year. In 2020, operators pared 0.7 percent from the average asking rent.

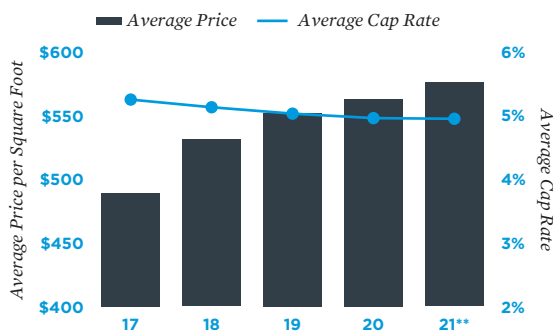
Supply and Demand



Rent Trends



Sales Trends



* Forecast ** Through 2Q
Sources: CoStar Group, Inc.; Real Capital Analytics

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2Q21 – 12-Month Period



CONSTRUCTION

2,218,000 sq. ft. completed

- Office supply increased 1.8 percent during the yearlong period that ended in June. Builders slowed the pace of development in the third quarter of last year before resuming construction.
- Approximately 8.2 million square feet of office space is underway, though more than 70 percent of that space has leasing commitments.



VACANCY

410 basis point increase in vacancy Y-O-Y

- Vacancy increased 80 basis points in this year's spring period as local tech companies reevaluated their space requirements. At midyear, vacancy was 15.1 percent.
- Class A vacancy rose 340 basis points in the last 12 months to 15.4 percent while Class B/C vacancy climbed 460 basis points.



RENT

0.8% increase in the average asking rent Y-O-Y

- In June, the average asking rent was \$51.41 per square foot, up modestly year over year. The increase can be attributed to an improvement in the quality of space available.
- Top-tier office rents were marketed at \$57.88 per square foot in the second quarter, up 7.5 percent annually.

Investment Highlights

- Investors returned to the market after pausing during the height of the downturn. In the third quarter of this year, the new record in office sales was established, including at least five deals valued over \$200 million. Buyers seeking discounted properties will be challenged to find those opportunities.
- Buyers never lost faith in the long-term health of the San Jose office market. During the 12-month period ending at midyear, the average price of an office property increased 3 percent to \$575 per square foot. Since Google owns a sizable share of the office inventory, particularly in Mountainview, investors have limited options.
- Few markets had a decrease in the average cap rate during the year-long period ending in June, but the South Bay is an exception. During that time, the average rate dipped 10 basis points to 4.9 percent. Little pressure on first-year returns are expected until more clarity on office reoccupation is available.