

INVESTMENT FORECAST

OFFICE

San Jose Metro Area

IPA

INSTITUTIONAL
PROPERTY
ADVISORS

2020

Owner-User Developments Lead Wave of Deliveries; Vacancy Tightening as Tech Firms Expand

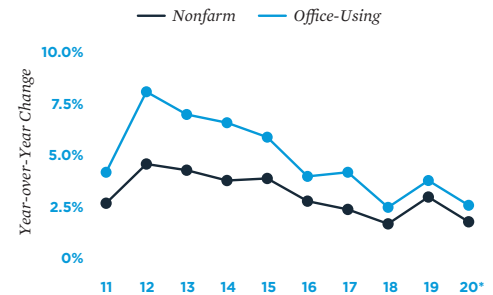
Silicon Valley overcomes construction surge as vacancy returns to cyclical low. The surge in development in 2017 pushed office vacancy over 13 percent, but strong demand supported a 230-basis-point drop in available space over the past two years and further tightening is anticipated in 2020. On the face, the sheer volume of office space underway is sufficient to raise concerns of a potential supply overhang in the coming year. However, the largest projects tend to be owner-user buildings, including two Google properties that account for approximately 25 percent of the space underway. Adobe and LinkedIn also spearhead large developments, which is generating pre-leasing levels close to 80 percent. On the demand side, tech firms remain committed to the area despite elevated costs for labor and real estate. Most of the large tech companies have sizable cash reserves, providing a healthy backbone for the market during this mature economic cycle.

Lower-tier assets draw investor attention. Since 2018, the average cap rate has remained stable at 5.1 percent, though prices have jumped significantly due to rapidly improving net operating income. While the market appears homogeneous, modest trends emerge below the surface. Buyers are acquiring 50 percent larger Class C assets than two years ago as leasing concerns have abated in the wake of the latest round of speculative construction. Furthermore, the average vacancy in newly acquired properties has declined in both the Class B and C segments. Although some of the decrease can be attributed to the limited availability of value-add deals, other factors contribute to the change. Namely, investors are more bullish on the future of the market and eagerly purchase properties with below-market rents that can be repositioned as existing leases expire. Much of the demand for Class C space will be derived from firms that support the tech giants.

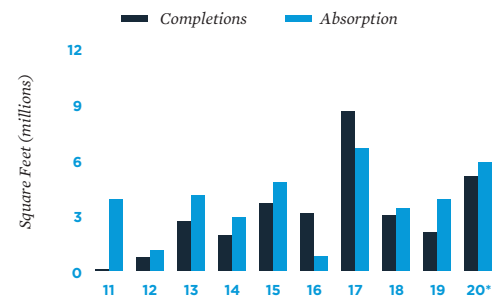
2020 Market Forecast

- Employment** up 1.7%
Nearly half of the 20,000 new jobs anticipated for this year are in office-using sectors, which will expand 2.5 percent.
- Construction** 5.1 million sq. ft.
Builders will lift inventory 4.2 percent this year, though strong pre-leasing minimizes the potential impact of supply additions.
- Vacancy** down 100 bps
Vacancy retreats to 8.7 percent by year end, surpassing a previous cyclical low from the end of 2015.
- Rent** up 3.3%
The average asking rent regains some traction and reaches \$53.73 per square foot in 2020. Last year, the asking rent improved 0.7 percent in the South Bay.
- Investment**
Most of the upside potential in the market may lie with properties that have tenant rosters secured under medium-term leases. Operators with impending rollovers have proved to be reluctant sellers due to improving fundamentals.

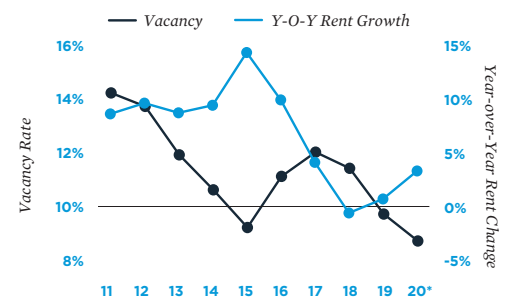
Employment Trends



Office Supply and Demand



Vacancy and Rent Trends



* Forecast

Sources: CoStar Group, Inc.; Real Capital Analytics

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Metro-level employment, vacancy and asking rents are year-end figures and are based on the most up-to-date information available as of December 2020. Asking rent is based on the full-service marketed rental rate. Average prices and cap rates are a function of the age, class and geographic area of the properties trading and therefore may not be representative of the market as a whole. Sales data includes transactions valued at \$1,000,000 and greater unless otherwise noted. Forecasts for employment and office data are made during the fourth quarter and represent estimates of future performance. No representation, warranty or guaranty, express or implied may be made as to the accuracy or reliability of the information contained herein. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.