MARKET REPORT

OFFICE

San Jose Metro Area

IPA INSTITUTIONAL PROPERTY ADVISORS

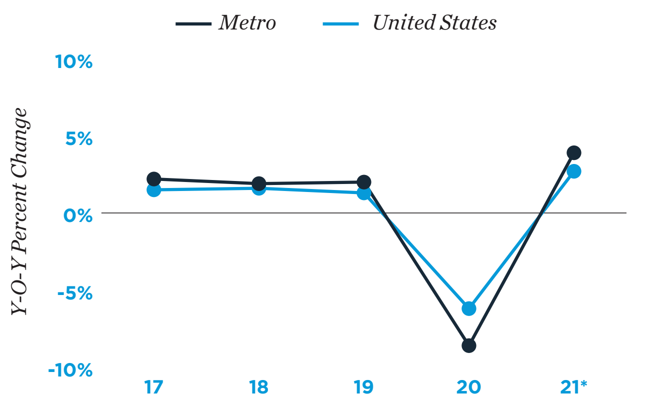
2Q/21

Groundwork for Brighter Office Outlook Emerges; Payoff Remains Several Quarters Away

White-collar jobs set foundation for broader recovery. Silicon Valley's tech companies retained a sizable share of their staffs during the health crisis, paving the way for hiring in secondary positions. Sectors that typically account for a large share of office demand were within 1 percent of pre-recession levels at the end of the first quarter. However, many of those firms will need to recall their employees after greenlighting dispersed working at the onset of the pandemic. Google and Apple are already in the process of bringing their staffs back to their large campuses, and contractors that support these companies will soon follow. Once the employment base is reestablished, leisure and hospitality positions will return.

Construction and Class C space demand weigh on office market. Although tech employees are expected to return of their offices this year, those workers will occupy already-leased space. Flex work schedules will also limit expansions as firms re-evaluate footprints. Overall, Class A vacancy is expected to remain relatively flat this year due to new construction and some downsizing despite being the most sought-after buildings. Class C space, meanwhile, has been particularly hard-hit by the pandemic. These office tenants were less likely to enjoy the large cash reserves of the tech giants and participate in industries that will take longer to return following a full reopening. As a result, some lower-tier office users will relinquish space as leases expire throughout the year.

Employment Trends



* Forecast

Sources: BLS; CoStar Group, Inc.

Office 2021 Outlook

41,900 JOBS
will be created

EMPLOYMENT:

Payrolls are expected to rise 3.9 percent this year, led by late-recovery sectors including leisure and hospitality. The metro will remain nearly 60,000 positions below the previous peak reached at the end of 2019.

4,102,000 SQ. FT.
will be completed

CONSTRUCTION:

Inventory is scheduled to jump 3.4 percent in 2021 as deliveries reach the highest level since 2017. With 7.5 million square feet under construction, hastened delivery schedules could increase construction further this year.

250 BASIS POINT
increase in vacancy

VACANCY:

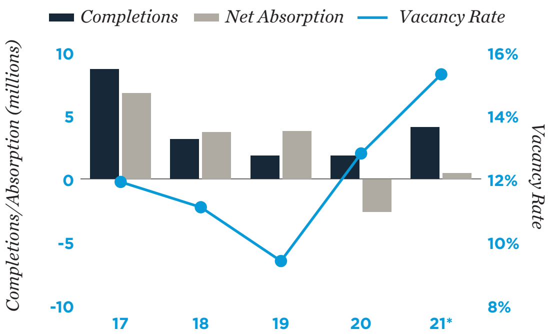
Soaring construction and soft demand for lower-tier space will push the marketwide vacancy rate up to 15.3 percent this year, the highest level since mid-2011.

2.3% DECREASE
in asking rent

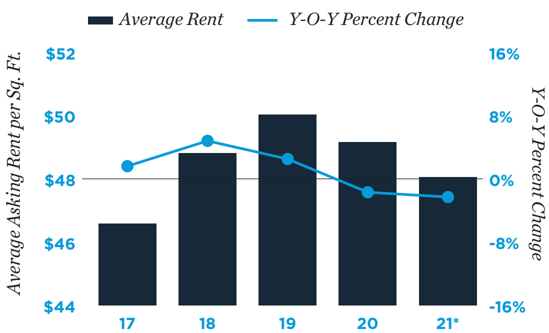
RENT:

Rising vacancy is going to encourage operators to increase tenant improvements and decrease asking rent to $48.05 per square foot. Class C rents are most at risk over the coming year due to slow leasing.

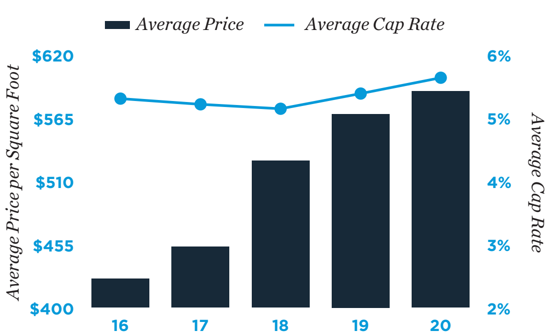
Supply and Demand



Rent Trends



Sales Trends



** Forecast*

Sources: CoStar Group, Inc.; Real Capital Analytics

IPA Office

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2020

CONSTRUCTION

1,840,000 square feet completed

- Builders expanded inventory by 1.5 percent in 2020 as deliveries were relatively consistent with the 2019 level.
- Approximately 7.5 million square feet of space is under construction in the South Bay, representing 6.1 percent of existing inventory. Nearly 80 percent of underway projects have leasing commitments.

VACANCY

340 basis point increase in vacancy Y-O-Y

- Many local companies did not fully renew leases in light of uncertainty surrounding the health crisis, lifting vacancy to 12.8 percent last year.
- Class A vacancy jumped 280 basis points to 12.5 percent, mostly attributable to new construction. The rate at Class B/C office buildings jumped 380 basis points to 13.0 percent as space was surrendered.

RENT

1.7% decrease in the average asking rent Y-O-Y

- The average asking rent declined to $49.16 per square foot due to a sharp decline in Class B/C rent, which fell 4.4 percent. Class A rent for available space increased 2.4 percent as new space came online.
- Average asking rent declined 1.3 percent in central business districts and 1.5 percent in suburban areas, indicative of widespread weakness.

Investment Highlights

- Transaction velocity declined by approximately 50 percent from 2019 to 2020 as the health crisis gave investors pause. More than 30 percent of deals transacted in the fourth quarter, whereas approximately 25 percent of sales were completed in the second and third quarters combined. The return of buyers at the end of last year has carried into 2021 as sales velocity in the first quarter was on par with the fourth quarter of 2020.
- The average price last year was $588 per square foot, up 3 percent from 2019. A reduction in the percentage of Class C sales, where uncertainty was most prevalent, resulted in the increase. Additionally, higher-quality properties changed hands last year.
- Overall, the average cap rate inched up 20 basis points to 5.6 percent in 2020. An increase in returns while interest rates remain extremely low is attracting buyers seeking higher spreads. Furthermore, early deals this year indicate that buyers remain active in the suburbs, including South San Jose, Los Gatos and Campbell.