Commercial Real Estate is on Fire, What Will be Hot and Where for 2014

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First of all, thank you so much for allowing me to share my thoughts and predictions regarding our amazing and very fascinating commercial real estate market.

I am going to start with the Big Picture of the Greater Bay Area and touch on most of the aspects of commercial real estate, the investment arena, including apartment house sale trends, triple net industrial, shopping center sales and of course, office buildings.

I'll talk about major industrial trends, mostly here in the East Bay, the Bay Area retail scene, the impact of the exploding e-commerce on brick and mortar, seven residential and retail developments, either new under construction in Walnut Creek or soon to break ground, and then go over what is causing portions of our Bay Area office market to be sizzling hot, while other submarkets are decidedly not hot; I'll segue at this point into a short discussion of what the new and hottest trends are in workplace design. Please feel free interrupt me any time you want, and if you disagree with anything I am saying, great, bring it on!

Also, there will be plenty of time at the end of my presentation for questions and answers and there will be a handout with links to just about every chart, report and development that I reference, so those of you who are interested can download to your heart's content.

So, what's happening with commercial real estate investments? Well, if you take your money down to your local bank, they might charge you interest just to store

your dough for you. Banks are still paying almost no interest, bonds and CD's returns are miniscule, yet there are trillions of dollars out there in investment land looking for a place to invest.

Kevin Van Voorhis with Colliers has been selling major shopping centers and office buildings for more than 33 years. The cap rate, which is how we price investment property, is the net operating income divided by the price, and for Prime Class A apartment and commercial properties, can be as low as 4-5%. Lesser quality properties with potential tenant turnover in less desirable locations might be 6 to 8% or higher. Grocery anchored centers are currently in the 5 to 6% range. A recent case in point is the new Pleasanton Safeway project on Bernal by the fairgrounds, which just sold to Invesco for 5% a cap on $3.75/ sq. ft. NNN rents.

Kevin's theory on cap rates and interest rate volatility – Cap rates over time follow interest rates. If interest rates go up, we can expect that cap rates will too.

If interest rates go up, investors have other investment vehicles to put their money in. Buyers who leverage, i.e., make a loan to purchase property; will face higher payments if interest rates go up. If an owner is holding on thinking his or her rents are going up and therefore the value of the property will go up, yes, but if interest rates go up 1%, rents will have to go up 20% just to maintain the same value. Using a 5% cap rate example.

Apartment houses are the hottest investments right now as apartment rents are still going up, it is fairly easy to keep them full and there is lots of financing available – 4.5% for 10 years as a ballpark. Mom and pop units take 30% down, cap rates range from Walnut Creek at 4 to 4.5%, Concord at 6% and Antioch at 7%.

Almost no one wants to sell today because then what would they do with their money?

One research group, RealFacts, reported that out of 28 major metro markets for apartment houses, #1 was San Francisco, #2 is the Oakland / Contra Costa region and #3 is San Jose.

For the industrial outlook, I'd like to give credit to Todd Severson, who for decades has specialized along the I-880 corridor.

One of the reasons I love giving speeches like this one is that it gives me an opportunity to learn outside my box of office building product, as everything has an impact on everything else.

The industrial market is tightening everywhere, and on the I-880 corridor, the vacancy rate is about 6%. There are basically two kinds of industrial product, buildings 25 to 30 years or older, with ceiling heights of 16 to 20 foot clearance, lower capacity sprinkler systems, truck docks on only one side of the building and roof support columns inside the building that can get in the way of workflow and minimize storage capacity. Then there is the Class A industrial product, with 32 foot or higher clearance height so you can rack up, FRS sprinkler ratings, which again lets you stack stuff higher, fewer interior columns so you have greater efficiency, and cross docks - I had a physician who was always grumpy, but what cross docks means is truck loading docks on opposite sides of the building so trucks pull up on one end, you do whatever your business is and then you load the product on trucks at the other end.

It goes without saying, the older building might work for smaller mom and pops, but they are becoming increasingly obsolete and in the future may be tear-down opportunities. New industrial developments, like a 275,000 square foot project Panattoni is building in Fremont, another 300,000 square footer in Fremont McShane is doing, a 575,000 square foot building for at most two tenants, being built spec in Newark (and one rumor is Amazon's new grocery concept may be leasing the entire building). In Richmond, there is a 600,000 square foot spec building going up and other spec developments in Solano County.

Amazon built two million feet of new warehouse space out in Tracy. Their Fresh Grocery Concept which debuted in Seattle; not sure what impact this will have on our grocery world. I know Amazon is working on a huge fleet of delivery drones, so you can order tomatoes and milk in the morning and find it on your doorstep or roof when you get home. At the Port of Oakland Goodman Birtcher has a 375,000 square foot project, Shell Complete.

The bread and butter industrial tenant is a 30 to 60,000 square foot user, but there are an increasing number of 100,000 square foot users coming into the market.

An interesting phenomenon – because of our Bay Area traffic issues, national tenants may want to pay a lot more to be closer to the market than out in the cheaper valley, or up in Solano. Two hour commute traffic can make a huge difference. For the I-680 and East Bay region, vacancy rates are also down below 8%, back to 2007 levels. Out in East Contra Costa, smaller owner-user buildings which sold as high as $200 a square foot back in 2006 – before the market crashed – our guys have been selling these at a fraction of that price, and now almost all product has been sold and developers are beginning to think about new construction.

I read a recent report titled 2013 Global Logistics, Trends, and Their Impact on Industrial Real Estate – Key markets will be based on population growth, and here in the Bay Area we have another million folks headed our way. Look for where the demographic trends are likely to emerge in 10 year segments and plan accordingly. Supply chains will continue to be complex. New manufacturing in North America is coming back strong. Globalization in all industries is likely to continue, but with a US component now!

And growth in E-Commerce will lead the retail and logistics industries to re-define Distribution Center Networks.

Bay Area Retail – Jim McMasters is the guru of retail development and leasing for Colliers International and he was kind enough to let me share his thoughts with you.

For the most part around the Greater Bay Area there is still a lot of retail downsizing. There is NOT a lot of new construction. The guy I sit next to specializes in shopping center leasing, and he told me he just signed a retail store lease out in Brentwood for $0.78 a square foot, NNN, which five years ago would have been at $1.78/sf NNN, so you can see the trend in the outlying hardest hit regions like East Contra Costa, Solano and Stockton/Tracy. After the Great Recession hit in 2007 we had several years of huge vacancies, downsizing, and rent restructuring. I'll be giving out gift cards to circuit City, and Borders Books if you need a memory jog.

Back to Jim's comments, retail rents for the most part are creeping up slowly, although in some subregions like Downtown Walnut Creek there have been rent spikes up to $5 and $6 a square foot, triple-net, due to Broadway Plaza knocking down 40 stores.

Out in Livermore the Factory Outlet Center with its first 600,000 square feet full has already pre-leased the next phase of 200,000 square feet.

There are some retailers who have had less impact from e-commerce. Last week I tried to use the Internet to order a hot fudge sundae and what a mess that was... Chain stores are slow to expand, larger stores like Best Buy are downsizing, and the retail growth is with mom and pops who don't have the credit but make up for it in enthusiasm and sweat. The Dollar Tree and Dollar General are also still expanding.

For the Bay Area we don't have a lot of vacant land for new retail construction so when it happens look for redevelopment and reuse.

Let's spend just a few moments on what's happening with our local Walnut Creek residential and retail developments.

On South California Boulevard where the new Charles Schwab offices are will be high-end condos over 20,000 square feet of new retail, called Centre Place with two spaces for restaurants.

In the Ross Stores center across the street where First Tuesday is temporarily parked will be a 20,000 square foot retail space once this center is reconfigured.

Off Boulevard Way on Saranap they will be building 233 units for sale or for rent over 18,000 square feet of retail, and they have several boutique grocery stores looking as well as a health club.

Down in Shadelands the new Safeway project still getting approvals will have a new 55,000 square foot Safeway Store, possibly a 40,000 square foot fitness facility and lots of retail. The old Safeway across the street will be a Whole Foods store.

At 1500 Newell across the street from Kaiser where they tore down that ugly office building will be 49 units, three stories of residential over 35,000 square feet of new retail.

At 1500 North California where California Café use to be will be 141 new apartments, 4 story, over 18,000 square feet of new retail, with rents estimated in the $4 to $6 a square foot NNN range.

Diablo Valley College, DVC Plaza, where Kmart used to be will be a complete teardown and rumors say this will be a new Target and Home Depot.

And last but definitely not least, Broadway Plaza, which just got its final approvals, has given notice to 40 tenants to be out by the end of this week. They are going to demolish 200,000 square feet of store space and replace it with 500,000 square feet, and most of this new space scheduled for 2015 delivery is already preleased. Gucci, Faragomo, Louis Viton, Michael Kors, Brooks Brothers, Hugo Bass, Tesla Motors Showroom, Coach, Microsoft and more, and space for two large restaurants. I've heard Roys and Tommy Bahamas have been poking

around, but who knows. The new retail will also front on South Broadway across from Vic Stewarts.

All these projects can be downloaded from the links on the handout I will give you shortly.

Let me digress for a few moments about design changes. I wrote an article for the Contra Costa Bar Association Magazine titled *Major Trends in Urban & Suburban Law Firm Office Space Design*, which you can download from the link in the handout. Here are a few summarized highlights: Heavy wood and dark colors are out; light, steel, white, glass and transparency are in. Senior partners might be in their 60's or even 90's; new associates are in their 20's and Twitterized and do research on their iPads or other mobile devices. The younger generation has different life parameters and would rather have a smaller or shared private office, or in some cases, no private office if this means they get more balanced family and personal time, because less overhead means more income to them. Some firms are taking large window offices and putting 3 or 4 associates in one office and they love it. Flexible conference rooms, casual meeting areas, conference tables on wheels that convert for training, disappearing law libraries, lunchrooms that are wired and allow meetings.

Collaboration is way up, teaming with flexibility, mobility, and getting more workforce in a smaller footprint.

Gensler just published a very interesting report titled "Design Forecast 2014 Top Trends Shaping Design" and I would like to touch upon several of their insights. The old school of office design had most of the executives in private offices, the clerical and assistants in workstations, and once in a while you would meet up with your colleagues in one of the conference rooms. Today it is all about mobility and collaboration. With the internet and Cloud you can work practically anyplace, and we are doing so much more in shifting teams and groups of co-workers. On the other side of this, we still need to be focused and so the

challenge is mitigating all the distraction that comes with collaboration to allow quiet focus time when it is needed.

Tech workers in San Francisco may sit at long benches with their laptops and headphones on, and I've heard it is totally inappropriate if you want to meet with a co-worker to tap them on the shoulder – No Way, they are in their zone listening to music or whatever allows them to be extremely focused even though other workers are sitting just a few feet away from either side of them, instead you text the person you want to meet, and when they are able to respond off you go to the nearest conference room.

When Google Glasses first came out a year or so ago I made a partially whimsical prediction that at some future point we might be able to do away with the long benches and laptops entirely and just have rows of workers sitting in chairs doing their work on Google Glasses, Think of the office density we could get – Scary.

So we need balance between increased collaboration. Conference calls, virtual meetings, casual meetings – one new angle is Gensler has furniture designed to enhance those interactions but also to calm down the social noise of distractions.

I mentioned in a recent blog, and I blog frequently on office trends, the Big Ass Fan Company who leased 80,000 square feet of office space with just one private office. Fifteen meeting rooms, but just one private office.

Gensler also reported that professional service firms are growing, but within smaller footprints. Shared open and team-based workspaces. Libraries, records and administrative staff are all getting downsized and virtualized.

Gensler also talked about trend changes in office building design. In Pre-Great Recession days floor plates might have been 25,000 square feet, while today they might be up to 60,000 square feet. The square foot per person ratio was 250 to 350 square feet and now this is 150 to 250 square feet. Of course with Google Glasses we could get it down to 50 square feet and if we had employees just

stand all day, what, five feet. Just joking and it sounds like George Orwell 1984 or something sinister. Pre-Great Recession there was 10% chance of unplanned encounters and the new designs 90% of unplanned encounters, old school had 8 or 9 foot ceilings, new school 9 to 12 feet and they could vary. Lastly, old school had offices located in central business districts or in the suburbs, but now what is hot is mixed use, urban, near public transportation.

Office layout design out here in the suburbs, for the most part, is old school. Attorneys and CPA's still insist on their own private offices, but I heard of a recent e company in Pleasanton that put in 170 benching stations. Emeryville and Oakland are a lot more hip to new ideas, open plans instead of private offices, more but smaller conference rooms.

What's happening in the Green Environmental Building Friendly sector? Lots – New buildings will be way more energy efficient, and we have a new generation of ZNE buildings, that's zero net energy, that are just hitting the market kind of like the first battery / gas hybrid vehicles did. These office buildings produce as much energy as they use through solar and wind generation and energy management vampire systems which shut down non-essentials at night. As technology continues to get more sophisticated, expect to see exterior solar paint and panels that convert the sunlight into grid energy, small wind turbines incredibly efficient at harnessing power, and more and more Zero Net and even Positive Net buildings in the future.

So what is happening with the Bay Area Office Market? We hit bottom in the East Bay about three years ago, however I will explain in a bit why we are far from opening champagne bottles to celebrate. Silicon Valley, the Peninsula and especially San Francisco are sizzling hot. Tech, tech and more tech. Just during the past year alone over 700,000 square feet of Silicon Valley companies have set up offices in San Francisco ranging from tiny start-ups to giants like Cisco and LinkedIn. Fleets of buses take tech workers in their Wi-Fi deluxe rolling offices from Santa Clara to San Francisco and other fleets take the San Francisco

residents to Silicon Valley. Google is working on their own ferry boat system. Why is San Francisco so hot? This is the internet Gold Rush, and 20 and 30 year old wiz bangs are flocking in from all over the US and the world to be part of this. Three million feet of new office building construction is underway San Francisco office brokers predicting that in 2014 regarding rental rates, "All hell is going to break out." Class A buildings are ripping out ceiling grids and pulling up carpet to get their space funky and techy. Workers sit with their laptops at long benches, their bicycles securely stored in locked bike rooms, showers and lockers in their suite, free catered lunches and dinners provided the their employers, and with crazy office density ratios, waiting lines for restrooms. On-site exercise facilities, fitness instructors and physicians brought into the office, whatever bells and whistles needed to keep these techies happy, and after work they bike, BART, and Muni to their San Francisco pad to take in and enjoy all that San Francisco living has to offer.

So my title of today's presentation is 'What Is Hot, What Is Not' and like Charles Dickens' Tale of Two Cities, San Francisco is hot, the 680 Corridor is not. Oakland and Emeryville are a bit trendier, with Oakland Class A vacancy at 14% and annual $35 dollar rents. Tri-Valley Pleasanton Class A vacancy about 12%, with Class A rent around $2.40 – $2.60 a month. The I-680 vacancy went down over the past three years from 17% vacant to 16% vacant, whoopee and that is why no champagne – Downtown Walnut Creek Class A 13%, yet just three miles away out in Shadelands a 35% vacancy factor. Some downtown Walnut Creek landlords have been spiking the rents anyway, and I have urged all my clients to start working on lease renewals 18 to 24 months before their lease is up. 1333 N. Cal just raised their rates to $4 a square foot, but these are exceptions to the I-680 Corridor. SF/Peninsula/East Bay Deals

San Francisco 2013 Major Office Deals

Google expansion	372,000
Stubhub expansion	140,000
Neustar	138,000
Visa	111,000
Illumina	97,000
Esurance	91,000
Uber	88,000

Silicon Valley 2013 Major Office Deals

Google:	
Mountain View	500,000
Sunnyvale	232,000
Mountain View	168,000
Netflix:	
Los Gatos	242,000
Nivida:	
Santa Clara	200,000

East Bay 2013 Major Office Deals

Art.com	**Watergate**	**72,000 sf**
Oakland Unified	**1000 Broadway**	**52,000 sf**
Farmers Insurance	**Rosewood**	**50,000 sf**
Genworth	**Swift**	**48,000 sf**
AT&T Center	**1.8 million sold**	**900k going to Texas**

What happened is our growth drivers, the industry that filled our office space back in 2005 and 2006 were mortgage companies, residential developers, title companies, banks, and subprime lenders. The Countrywides of yesterday are gone and unfortunately, here in the East Bay we have had no industries or growth service groups to replace them. Yes, we have WorkDay and General Electric, but no Google, Twitter, Instrgram, Facebook, LinkedIn and on and on. We have CPA and law and financial planners, and they are cautious, conservative and thus we are seeing little new hiring.

I'd like to quote the January 25th San Ramon Valley Times "The Bay Area added more than 11,000 jobs in December, led by a big surge in Santa Clara County and the San Francisco – San Mateo – Marin region that drove these two regions to five year highs. The East Bay, however, lost jobs in December as that region continued to lag the robust gains in the South Bay and San Francisco metro area. The contrast is striking. The South Bay and the San Francisco metro area are the major job engines for the entire state, while the East Bay is one of the weakest."

Don't forget as well that back in the 1980's and 90's our region was a wonderful place for back office operations to relocate to. Insurance, accounting functions, we have a stable workforce and low rents, but for the past 10-15 years these functions coming out of San Francisco have skipped right over Walnut Creek and

Concord, in fact they flew past the entire US and are now relocating to the Philippines, Indonesia, India and elsewhere. But wait.

FIRE and ICE - Traditional office markets can be predominantly FIRE, Finance, Insurance and Real Estate, which is what the I-680 Corridor and a lot of American cities and towns were back before the 2007 Great Recession Cliff of Doom, when tens of thousands of mortgage companies, banks, as well as real estate development and sales, title companies and the like, literally fell over the Cliff of Doom and disappeared forever. At least in my region, there is little sight of any return other than a few cautiously expanding residential developers. Banks have shrunk, been acquired, and moved their back offices to India and elsewhere. ICE, which can stand for Innovation, Creativity and Entrepreneurship, is symbolized by the Googles, LinkedIns, Salesforces, Twitters and Facebooks of the world. "Several years ago, Colliers coined the term "ICEE" to describe metropolitan areas with large concentrations of Intellectual Capital, Energy and/or Education industries. During the current recovery, office markets in these metros have been outperforming those which depended on the more traditional drivers of office absorptions -- the finance, insurance and real estate or "FIRE" industries -- and are poised for continued growth."

So San Francisco versus Walnut Creek. Where do young, tech-savy adventurers want to work? We will be getting thousands of them living here and commuting into the City as rents keep sky-rocketing for San Francisco apartments and maybe one day as these youngsters mature get married and think about raising a family and the techie becomes his or her company CFO-who knows in 10 or 20 years we may have an entirely new migration pattern that will lead to jobs in Contra Costa.

In conclusion, if you or your clients are thinking of selling your commercial property any time in the next few years, current market conditions make "now" the "Perfect Storm" time to sell. Super-high buyer demand, still plenty of

financing at relatively low rates, but rates have gone up a percentage point already – otherwise hold on for the long haul.

If you rent office space, hire an exclusive tenant rep broker, depending on your size, but if you are 2,500 square feet or larger, at least a full year before lease expiration, start getting guidance 18 to 24 months prior. There's no downside and you will regret it if you don't position yourself correctly.

We have three huge space opportunities: the former Bank of America Concord facility that Swift bought, the 900,000 square foot AT&T vacancy in San Ramon and another 800,000 square foot vacancy at Rosewood in Pleasanton.

New Industrial development is coming back, and e-commerce 'I want it now' mentality is putting goods closer to where their customers live. Retail in key areas like Downtown Walnut Creek is super hot, while the outlying burbs still struggle to survive. The drought notwithstanding, we live in a very special place here along the I-680 corridor. Sure, our market isn't necessarily on fire, but we are out of the Great Recession and into a slow but steady recovery.

At this time I would like to open this up for questions and answers.

Here is the handout with all of the links that I've referred to.

But Wait,

What makes a healthy office market? When vacancy rates begin to dip below 10 percent, construction cranes show up to alleviate future space scarcity, and when rates hover higher than 20 percent, the Grim Reaper of Foreclosure waves his evil staff over underwater over leveraged properties. With the East Bay vacancy rate around 10 to 16 percent, are we healthy or unhealthy? Most corporate executives would much rather pay more rent in a robust rising economy as compared with getting bargain-basement rents in a layoff-laden depressed business environment. Who cares if your office costs are low if your business is losing money? So I define a healthy office market as one where there is sufficient supply

for almost all size and types of office users, where both tenants and landlords are making tons of money, and when companies can expand and not worry about forced relocation due to lack of expansion space. So both San Francisco and Walnut Creek are healthy, as are many of our nation's cities and towns.