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According to the *SF Business Times* (2/28/03), "Synthetic Leases Causing Real Problems: A change in accounting rules will shift hundreds of millions of dollars in previously hidden real estate costs onto local company books, and may lead to a flurry of corporate building purchases. Prompted by last year's accounting scandals at Enron and WorldCom, the Financial Accounting Standards Board is putting restrictions on so-called variable-interest or special-purpose entities. The new rules generally require companies to include such vehicles on their consolidated financial statements. Bay Area companies – among them Charles Schwab & Co., Genentech Inc., Chiron Corp., Sun Microsystems, Inc., Oracle Corp. and Inktomi Corp. – used such entities to purchase buildings and lease the space back to the business, often at below-market and rate costs, in a complex arrangement known as a synthetic lease. The real estate cost was kept off the books, but the companies could still depreciate the property for tax purposes. Now these companies face the choice of taking a hit on their financial statements, or finding the cash to unravel synthetic leases and purchase the buildings outright."

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Business Facilities (January 2003) listed the key risks/mistakes to avoid during a corporate site selection process:

1. Assuming the measures of success for someone else will be the same as yours;
2. A schedule that is either too short, where you react, rather than control the situation; or too long, where everyone loses focus;
3. If you cannot identify reduced costs and/or improved profit by at least 30 percent, inertia of the status quo will kill the project;
4. Inaccurate estimates of the number of employees you will retain and the associated costs;
5. How you handle shareholder's suggestions and manage the process may impact your career;
6. You are far more likely to lose friends and customers, than make new ones in the process (I'm not sure that I personally agree with this one);
7. The biggest risk facing you is that the decision will be made on where to place the project, before the what or why;

Others I might add – The greater the decision-committee, the more cumbersome and costly the project; strong commitment from the top is usually critical regardless of the savings or benefits; and planning is of high importance. But the most valuable opportunity to conserve time and money is in the front-end process. By not over-analyzing the project with "studies and re-studies," you can avoid making more costly decisions later to get back on schedule.

When do I expect the Bay Area office market to recover? For the past three years, ever since I got lucky and guessed in the August 1, 2002 OfficeTimes newsletter that the Bay Area office market reached its peak in March of 2000, my forecasts have been that it will take a lot longer then most folks expect to turn this office market around. It wouldn't surprise me if it takes until 2004, 2005 or perhaps later to really make serious dents in the estimated 90+ million square feet of currently available Bay Area office and R&D space I did a quick micro-test on two Bay Area submarkets! During the month of February 2003, just along the I-680 Corridor, 109,000 sf of office lease/

sublease were signed, but 215,000 sf of new available space from downsizing came on the market. In San Francisco, during the past two months there were more than 800,000 sf of office leases and LOI's reported, but multiple sources still report 17 million square feet of vacant office space. The *San Francisco Chronicle* (2/1/03) reported on a recent real estate forecast with the headlines, "S.F. facing long, slow recovery in office rentals." On February 14, 2003, the *San Francisco Business Times* stated, "Just when it seemed San Francisco's commercial real estate market had hit rock bottom, a new round of sublease space is threatening to drive rents further down and vacancy back up. Law firm Brobeck, Phleger & Harrison's failure, DHL's move to Florida and Citicorp's consolidation of acquisition Cal Fed Bank are expected to generate upwards of 300,000 square feet of new sublease space this quarter." Remember, corporate layoffs are very painful and costly, and it may take 6 to 18 months of sustained profitability before corporations begin rehiring. With 10 to 20 percent corporate "shadow" space (vacant but not on the market, often interdispursed within the existing facilities) this is usually where new hires will go first, further delaying the market office recovery. Here are a few recent headlines from the financial section: Cnet Networks Inc., owner of Internet sites such as Cnet.com and Zdnet.com posted its first profit in three years after firing hundreds of workers to reduce expenses … Merrill Lynch & Co. earned $603 million last quarter as CEO Stanley O'Neal cut expenses faster then revenues fell … Kodak costs to fire workers will total as much as $100 million this year … Job cuts helped Kodak rebound to a profit in the fourth quarter … Charles Schwab & Co. had a 2002 setback that included $183 million in changes to pay for 1,800 fourth-quarter layoffs and other cutbacks that management made to adjust for the continuing erosion in Schwab's business … Solectron, seeking a return to profitability, reported it will take up to $300 million in restructuring changes during the next several quarters to consolidate facilities and cut jobs in Europe and North America … Applied Materials will cut 2,000 jobs and expects the cuts and building consolidations to cost as much as $425 million during the next four quarters with about $120 million of that for severance … Based on these types of huge restructuring costs, I think even cautious expansion may be quite a ways down the road …

On the more positive side, James F. Smith, Society of Industrial and Office Realtors chief economist writing in *The SIOR Professional Report* winter issue 2003 states, "Commercial Real Estate Will Turn The Corner This Year. Low interest rates are doubly beneficial to commercial real estate. In the first instance, they help get the economy moving more rapidly, which spurs demand for properties. In the second place, they allow owners of commercial properties to refinance at a lower cost. This improves cash flow, sometimes dramatically. Demand for office space doesn't pick up until the economy is generating more than 150,000 net new payroll jobs every month. We should be there by June, which means that demand will improve in the second half of the year." I'm not sure I agree, but now we've both publicly stated our views so we will check back on this in July …

Deals and Rumors: In **Walnut Creek**, at 2850 Shadelands Drive, I represented Pacific Service Credit Union in a 24,000 sf lease extension; helped sublease BriteSmile 23,000 sf at 2625 Shadelands Drive; Chicago Title is rumored to be subleasing 19,000 sf at 1277 Treat Blvd.; Danz is reportedly leasing 27,000 sf at the PMI building at the PH BART Station; and Golden Eagle Insurance is out looking for 15 to 20,000 sf in the Walnut Creek region. In **Concord**, Matson Intermodal leased 9,800 at 1855 Gateway Blvd. and Meritage Homes leased 12,000 sf at Sutter Square. In **Brentwood**, California Pacific Federal Credit Union leased 12,096 sf at the Sand Hill Business Center. In **Dublin**, I represented Valent U.S.A. in a long-term lease extension of 42,000 sf of laboratory space at 6560 Trinity, Long Beach Mortgage is supposedly leasing 27,000 sf at Koll Dublin and E-loan might be out looking for 30,000 sf of expansion space. In **Pleasanton**, GoBeam sublet 18,000 sf at 5050 Hopyard, H&R Block leased 18,000 sf at 4256 Hacienda and Silicon Valley College was recently out looking for 40 to 50,000 sf in the Pleasanton region. In **Fairfield**, State Fund is rumored to have leased 42,000 sf at Green Valley and MV Transportation leased 11,000 sf at 360 Campus Lane. In **Oakland**, 555 City Center signed up Matson Navigation Co. for 52,000 sf, Federal Public Defenders Office for 13,000 sf, Meyers Nave for 29,000 sf, and Laughlin, Falbo, Levy and Moresi leased 16,000 sf. At 1333 Broadway, Kelling Northcross & Norbriga took 12,000 sf. In **San Leandro,** Levine & Fricke expanded by 11,000 sf at 6615 San Leandro St., and Alameda County signed a 50,000 sf lease at Creekside Plaza for a to-be-built next phase. In **Emeryville's** Watergate Towers, McGraw Hill sublet 22,000 sf from Siebel Systems. In **San Francisco**, Brown & Toland Medical Group leased 40,000 sf at 160 King St.; Kaufman & Logan took 10,000 sf at 100 Spear St.; Morgan Lewis may have signed a LOI for 100,000 sf; at One Market St., where Simpson Gumpertiz & Heger leased 27,000 sf; UCSF leased 50,000 at 185 Berry St. as well as leasing 66,000 at 2300 Harrison St.; the Academy of Sciences is rumored to be almost signed at 875 Howard St. for 153,000 sf (nothing fishy about that deal …); U.S. Bankcorp is taking 49,000 sf at One Bush St.; Jacobs & Assoc. leased 13,000 sf at 465 Calif. St.; AOL Time Warner took 16,000 sf at Two Embarcadero; Wells Fargo leased 35,000 sf at One Front St.; American Reinsurance is leasing 18,000 also at One Front St.; URS Corp. has a commitment for 20,000 sf at 600 Montgomery St.; GSA leased 12,000 sf at 801 Montgomery St.; Think Equity will be taking 11,000 sf at 475 Sansome St.; OpenTV Corp. reportedly signed for 60,000 sf at 275 Sacramento; Salesforce.com is reportedly out for 80 to 100,000 sf, and San Francisco Convention & Visitors Bureau leased 18,000 sf at 201 Third St.; Lucas finally broke ground for its 850,000 sf office campus in The Presidio; and finally, Gavin Newson for Mayor leased 15,000 sf at 1625 Van Ness St.

People have asked me that if the office vacancy rate is so high, demand so low and sublease space an intense competition to many landlords, how come we haven't seen more office foreclosures or even a partial re-experience of what happened to us in the late 1980's and early 1990's when waves and waves of office buildings were foreclosed? There are several office foreclosures currently underway, including a South of Market 60,000 square foot building at 680 Second St., and as of last month, Tishman Speyer Properties had reportedly defaulted on a $160 million mortgage on its 769,000 sf at 555/575 Market St., San Francisco, but there are a number of reasons why history will not be repeating itself this time: 1) Most office building owners are not as highly leveraged as was the case in the last downturn, and many investors such as many of the REITS and institutional investors have no leverage. 2) The commercial refinance market at sub-6 percent makes semi-leased buildings still cash-flow even if not at high occupancy rates. 3) Alternative investments such as the stock market, money markets and bonds are to many not very attractive and in fact has greatly heightened the demand for leased office buildings where recent Class A offerings have attracted 25+ buyer offers per listing. 4) Owner-users are seeking small and medium vacant office buildings, taking advantage of low commercial interest rates to lock in their destinies rather than undergo the next inevitable rental increase cycle. "The level of nonperforming commercial real estate loans and the pipeline of future problems remained stable in the fourth quarter," Joe Morford, an analyst with RBC Capital Markets in San Francisco, said, in the *San Francisco Business Times* (3/21/03) citing FDIC call reports and discussions with bankers. "There's always a lag in problem loans surfacing, but it should be manageable." In the *National Real Estate Investor*, January 2003, "This is not to say that delinquencies won't rise. Commercial delinquencies typically lag a national recession by six to nine months, as corporate tenants lay off workers, unload office space and, in the worst cases, proceed into bankruptcy reorganization. Disciplined lending in the late 1990s and exceptionally low interest rates have prevented the kind of wide-spread collapse that occurred during the previous recession of the last 1980s."

If you're a major office tenant, don't take it for granted your landlord has filed a property tax appeal in regions where rents have experienced dramatic drops. As reported in the *Silicon Valley Biz Ink* (2/12/03), "With rents falling and entire corporate campuses sitting empty, it has become imperative that building owners reduce their property tax liabilities. Some counties have started doing this proactively, but many still wait for owners to appeal a tax assessment. For example, if you own a 200,000-square-foot building and your lease rates have dropped by 50 percent or more – or you can't even secure a tenant – the building's ability to earn revenue drops dramatically. As a result, some owners could be eligible for a reduction of up to 50 percent in property taxes, based on the revised valuation of a near-empty building." However, if the building is fully leased to credit tenants paying dot-boom high rental rates, this tax situation may not be as applicable, but it still might be worth a preliminary evaluation. Of course, on the other side, at least here in California, there is a state bill in legislation which would allow more frequent reassessment upward on commercial buildings and shift a larger portion of the state's property tax burden on commercial properties. What, we need one more barrier to California job retention on top of our high housing costs, our long commute in many areas, and compared to a number of states, higher state income tax, higher sales tax and energy costs? Hey, beautiful weather, incredible scenery and tons of lifestyle amenities can only go so far!

Corporate Real Estate Leader, January 2003, had an interesting overview authored by Randy White, of the office and industrial market in China. China has a GNP for 2002 of 7 percent, trade is growing by nearly 20-percent annually, and is the No. 1 destination of foreign direct investment, surpassing the United States in September 2002. Office lease terms are usually 2-3 years, space efficiencies range from 60-80 percent and Beijing has annual rents of $40/sf for Class A and half this for secondary markets.

What have recent press releases said about our current job situation? The headlines for the business section in the *Contra Costa Times* (3/1/03), "East Bay Gains Jobs, State Says." But on the same day in the *Tri-Valley Herald*, "Bay Area Jobless Rates Up" with a quote from Steve Levy, an economist at the Palo Alto Center for the Continuing Study of the California Economy, "We are not in any kind of recovery in the Bay Area. Period." The difference was that according to *The Contra Costa Times*, the East Bay added 11,000 jobs in 2002, but the rest of the Bay Area lost 50,000 jobs. To further instill confidence in government statistics, also on March 1, 2003 in the *SF Chronicle*, "State Squares Job Loss Numbers with Reality," official state data grossly underestimated job losses in the San Jose and San Francisco metropolitan areas, evidence that the crash of the technology sector has hit the region mostly harder than previously calculated. "Clearly, things have been much worse than we previously believed," said Paul Fassinger, research director for ABAG." Then in case you think it's just California numbers that are suspect, *The Los Angeles Times* (March 8, 2003) stated "U.S. payrolls unexpectedly plunged last month by 308,000 jobs, the most since the immediate after month of the 2001 terrorist attacks, the Bureau of Labor Statistics said Friday. The job loss was so much greater than anybody had predicted that economists were left scrambling for an explanation."

National Real Estate Investor (February 2003), states, "Occupancy may be down and sales prices high in many property types, but pension funds have big plans for buying commercial real estate in 2003." The funds have allocated $14 billion to the U.S. real estate equity market this year.

What's it cost to unravel a high-tech office lease done during the dotcom boom? Cable & Wireless will pony up around $20 million to terminate its 158,000 square foot lease at 55 Second St., in San Francisco. Handspring will pay Mozart Development $61.2 million in cash plus $5 million in various debt payments to back out of a $350 million, 12 year lease for 310,000 sf in downtown Sunnyvale. Softwaremaker Niku Corp. paid $7.6 million in termination fees, $8.8 million in security deposits and stock warrants for 14.45 million shares to cancel a 15-year 76,000 sf lease in Redwood City.

According to a number of recent reports and articles by the major commercial brokerage companies, San Francisco office rents have fallen to 1992 levels when adjusted for inflation, which is a greater drop than the level which existed right before the dotcom boom. However, at the same time building expenses have risen fairly dramatically, with a ballpark cost now at $14 to 15/sf, which means net returns are down even further. In Santa Clara, with 60 million feet, vacant rents are expected to drop by another 5 to 15 percent.

Anthony Downs, one of the most accurate real estate gurus, stated in *The National Real Estate Investor* (February 2003): "Unfortunately, I do not believe conditions in commercial property markets will recover in 2003, although they probably will not worsen either. Even if the pace of economic growth increases in 2003, demand for office and industrial space will not expand much because so many firms already have excess space. Therefore, vacancy rates – especially in high-tech markets – will remain high throughout 2003."

One of the main reasons San Francisco companies flocked to Oakland, Walnut Creek and Pleasanton back in the 1980s was due to the lower East Bay office rents. However, with San Francisco rents so low today why aren't firms heading back? One of the other main reasons they relocated in the first place was to be closer to management and staff residences, to be able to access future housing sectors (i.e. East Contra Costa, Solano, San Joaquin) and to escape the significantly higher City of San Francisco business tax structure (who do you think pays for those 27,000 city/county employees?). That is why a handful of firms in the legal and transportation industry are still relocating eastward out of SF, and during the past 20-years almost no company has migrated back …

More economic overviews … According to the *S.F. Chronicle* (3/13/03), "Economy to stay stalled … The economy is expected to trudge along with little growth in the coming months and into next year, according to economists at UCLA." Along with this comes the triple whammy affecting government in many shapes and forms. Retail spending is down so there are less retail revenues. Income is down and less people are working so again, less tax revenue. For the commercial property sector, values are down substantially in many areas and as properties are reassessed, property tax revenue is expected to drop. As a local example, the Oakland Kaiser Center, which has a $133 million tax roll valuation, just sold for $100 million, and it can be expected the $1.4 million in annual property taxes will be slashed, resulting in less tax revenue. Our federal government is in deficit spending, the State of California is only short by 30 to 35 billion dollars and we have various counties and cities reporting shortfalls (San Francisco alone has a $200 to 300 million negative short fall). What will result from this? An expected 10,000 California teachers will get potential lay-off notices, and government entities of all types are expected to downsize at some point in order to meet reduced tax revenues. In a recent survey by the Public Policy Institute of California, 71 percent of Californians said they expect bad times financially in the coming year, compared to the 47 percent who said that in a similar survey one year ago. Today, 60 percent of Californians believe their region of the state is in an economic recession.

Sending office work to foreign countries is a trend that will continue to increase in corporate popularity. According to *San Francisco Business Times* (3/7/03), "Charles Schwab Corp. is jumping on the corporate bandwagon of outsourcing tech work to India to cut costs and boost efficiency. Using workers in India allows software code to be written around the clock as Indians work on projects while their counterparts sleep. And the cost savings are significant, with tech workers in America easily earning five times the salary and benefits paid to a tech worker in India." *Silicon Valley Biz Link* (2/21/03), "Oracle to farm out software jobs to India … Despite the large number of unemployed technology workers in Silicon Valley, Oracle Corp., the world's largest enterprise software company, plans to hire about 2,000 lower paid software developers in India during the next couple of years; Oracle's growing employee base in India and China is part of an accelerating trend creating technology jobs outside the United States to save money. Forester Research, Inc. estimates $136 billion in U.S. wages – or about 3.3 million jobs in software, product development, back-office accounting and call center support – will move offshore to India, Malaysia, China, Russia and the Philippines in the next 15 years." Let's see, at 200 sf per employee, that works out to 660,000,000 square feet of office space we won't be needing in the good 'ole United States … Reported in the *Contra Costa Times* (1/26/03), "From health claims to credit-card applications, American's personal data are increasingly traveling the globe through a vast, little-seen network of people and computers. Thanks to telecommunications and computer networks, companies such as Dallas-based ACS can handle routine paperwork for American businesses far outside U.S. borders – slashing their costs and fueling the growth of a young industry known as business process outsourcing." Countries mentioned in this article include the Philippines, India, Spain, Czech Republic, Mexico, Ireland, South Africa, Guatemala and Ghana.

Our son, Jordan, turns 6 next month on May 26, which is coincidentally the birthday of my wife, Lisa, as well. In February, Jordan went skiing for a week in Taos, New Mexico, one of the great ski resorts in the country. He took group lessons all day for six days, but usually was the only one in his class and by the end of the week had progressed from Level 4 to a Level 7 skier (there are 10 levels). It's a trip to see your little 5 year old zip down black diamond expert runs, but then again they don't have as far to fall as we grown-ups. It was also with mixed feelings that I watched Jordan wash his hands, and for the first time in his life, not need a stepstool to reach the faucet. Growing up and letting go … We've joined mainstream suburban parenthood, and Jordan just started T-ball which has turned out to be one of the best parts of the week for both dad and son. I'm an assistant coach and I couldn't understand when other dads told me how awesome it is to do this until actually being able to experience it first-hand. To view Jordan's recent adventures just click www.officetimes.com/JordanApril03Page.htm Well, spring was just a week ago, Iraq is so near yet so far, and I hope you all survived successfully this past winter. Please feel free to call me regarding any aspect of the commercial real estate market, and until the next officetimes.com newsletter, take care!

Sincerely,

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