

| FEATURED ARTICLE

SILICON VALLEY

THE CENTER FOR INNOVATION AND ENTREPRENEURSHIP

BY DAVE SANDLIN, SIOR





Technology companies have fanned out into a handful of U.S. markets such as Seattle, Austin, and Raleigh, while big cities like New York and Los Angeles now have a solid tenant base made up of tech companies. Even so, there is still nothing like Silicon Valley when it comes to an economy driven by innovation and entrepreneurship.

According to Forbes 2017 World's Largest Tech Companies, eight of the top 10 are U.S.-based companies: Apple, Microsoft, Alphabet (Google's parent company), IBM, Intel, Cisco Systems, Oracle, and Facebook. Five of those are headquartered in Silicon Valley. As of late September, Apple, Google, and Facebook were the number 1, 2, and 4 most valuable companies in the U.S. by market capitalization, with values of \$806.1 billion, \$656.5 billion, and \$500 billion, respectively (as ranked by dogsofthedow.com).

San Jose is the 10th largest city in America with over one million people, while San Francisco is number 13 according to the 2014 U.S. Census. Since the recession ended, Silicon Valley and San Francisco combined have added some 700,000 net new jobs. The unemployment rate in San Jose fell to 3.0 percent in the second quarter, one of the lowest in the country for a major metro area.

Historically speaking, one-third of all venture capital raised in the United States is invested in San Francisco Bay Area companies, and by far, those companies are located in the 50-mile span that separates San Jose and San Francisco. During the first quarter this year, venture capital (VC) firms funded 113 startups with \$2.7 billion in capital. In the second quarter, VC's invested another \$3.6 billion in 119 deals.

It's against this backdrop that my fellow SIORs will understand current market conditions and trends in Silicon Valley commercial real estate.

The office and R&D markets started to turn positive in 2012. The recovery was slow at first, picked up the pace in 2014, and three-quarters into 2015 demand was setting records not seen since the dot.com era. Colliers International research (San Jose office) reported that during the first three quarters of 2015 net absorption of Silicon Valley office was 4.5 million square feet, or 8.3 percent more than 2014 and 2013 combined.

By mid-2016 our research department was tracking 8.2 million square feet of office space under construction with total potential development an astounding 60 million square feet! Meanwhile, R&D availability dipped to 9.3 percent – the lowest it had been since the first quarter of 2001.

In the four quarters from mid-2016 to mid-2017, net absorption of Silicon Valley office space was 3.94 million square feet.

By mid-2017 supply had caught up with demand. From the fourth quarter of 2013 through 2Q2017 developers have added more than 23 million square feet of new office inventory – from a former base of 64,187,305 square feet to the current 87,580,374 square feet. Total available office space is just under 12 percent.

We started 2017 with over 10 million square feet under construction, though leasing activity remained strong, with gross absorption of 7.6 million square feet for all product types (office, R&D, industrial – but not retail) in Silicon Valley in the second quarter.

All that construction activity has driven up costs for labor and material. By most estimates, costs have risen 10-15 percent a year for nearly five years now. At this rate, by 2020 when a lot of the



Google's San Jose campus will be on the other side of the freeway, just west of this portion of downtown San Jose.

projects currently underway are scheduled for completion, construction costs will have doubled since the beginning of the recovery.

In recent years, Google and Apple have dominated Silicon Valley's real estate market with each firm assembling more than 13 million square feet of leased and owned properties. Apple recently completed building its "spaceship" in Cupertino, so named for its circular construction with a massive interior courtyard. Officially called Apple Park and located at One Infinity Loop, the 2.8-million-square-foot building will eventually hold 13,000 employees. Staffers started moving in during August; the company expects to move in 500 people per week for the foreseeable future. The \$5 billion project is the fifth biggest construction project in world history.

Not to be outdone, Google's stealth work to establish a downtown San Jose presence became public knowledge in June

this year as the local business journal and San Jose's major daily newspaper started publishing stories about Google's plan to stitch together a 6-million-square-foot campus across the street from SAP Arena (where the NHL club San Jose Sharks play) and nearly adjacent to Diridon Station – where Caltrain brings commuters to and from San Francisco. Preliminary estimates are that the search giant will generate upward of 20,000 jobs in the downtown. If all this comes to pass, it will be a transformational event for San Jose.

Ironically, I was involved in the original transaction that set Google's San Jose play in motion.

At a holiday party in 2014, I met a long-time friend in the business and client who is on the development team for the regional Trammel Crow operation. He asked if a site near Diridon Station controlled by the Valley Transportation Authority (VTA) might become available to purchase. I immediately discouraged

him from pursuing that but said it could be possible to buy the entitled land owned by Adobe System next door to the VTA site. Adobe had bought this land years earlier and had it entitled for 1 million square feet of office space. Instead of building on that land, however, Adobe reconfigured every floor in the two buildings it already occupies in downtown San Jose and was able to increase its occupancy by 50 percent at its main headquarters. Thus, the site across from SAP Center became surplus property. Trammel Crow, with funding from Bentall Kennedy, closed on the Adobe site in September of 2015 (I represented the buyer). That speculative building (construction has yet to start) was the first downtown property tied up by a Google proxy when the Alphabet subsidiary began its quest for a San Jose campus over a year ago.

Major Silicon Valley trends include increased development density, the way parking structures are being designed, the impact from Title 24 and place-making in new office and R&D developments.

Twenty years ago it was typical for new projects to be designed with a Floor Area Ratio (FAR) of 0.5 to 1 – or building coverage to be approximately half of

a site. Those days are over. There's a new project starting in Santa Clara with an FAR closer to 2:1. In other words, a 240,000-square-foot building rising above a land area just under 120,000 square feet.

I'm working with a developer trying to get about 500,000 square feet entitled in Sunnyvale near a Caltrain station. The parking structure associated with the project is being designed in anticipation of autonomous driving, the evolution of Uber and Google car services, where the demand for parking could all but disappear in commercial office settings in 10 or 15 years. The parking structure is being designed with higher floor-to-floor ceiling heights and flat floors. In other words, to be converted to livable or workable space without needing to tear down the entire structure.

The cost to implement Title 24 building energy standards is having a significant impact on landlords with older properties and tenants that occupy them – depending on who pays. Title 24 is the California Energy Commission's new standards for commercial space and achieving energy savings. Every new lease triggers a Title 24 renovation requirement of new lighting (LED),

auto (on/off) lighting sensors and new electrical outlets to work with the new equipment, among other building infrastructure issues. It costs about \$25 per foot in tenant improvements to comply with Title 24, or upward of \$250,000 for a 100,000-square-foot lease.

Lastly, landlords aren't just building buildings anymore. They have to build places. Work environments have to accommodate collaboration – both intentional collaboration and "accidental" collaboration, like building extra-wide stairwells so people can have a conversation on the stairs without disrupting other colleagues from getting up or down the stairs. Place-making involves lots of on-site amenities, from outdoor benches and meeting areas to pizza ovens and places for food trucks to pull up and park. It's all driven by competition for talent. Today's office workers, engineers and designers don't want to just come to a place to work, they want to work somewhere with a sense of place. ▾

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