

High Tech May Be a Good Source for Future Office Demand

In the short term, technology companies struggle to raise venture capital and expect more employees to work from home

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Technology companies may be poised for growth over the long term, but brokers have yet to see much expansion in local markets throughout California.

Research suggests that employment at high-tech and biotechnology firms may increase more rapidly than other types of office tenants. Venture capital investment in those firms is on the rise, but it is still down from last year, limiting growth in the short term.

According to research by real estate economist Jeff Myers of Boston-based PPR, a CoStar Group Inc. company, financial firms will regain many of the jobs lost during the next five years, but high-tech companies will drive urban office demand in San Francisco, Seattle and Portland, Ore. High tech is expected to fully recover by the end of 2011 and have a workforce 7 percent larger in 2013 than at its peak before the recession.

However, technology companies likely are to choose low- and mid-rise Class B and Class C space instead of high-end, high-rise office buildings vacated by law firms and financial businesses, for various reasons including a preference for more creative space, an aversion to high-priced real estate and a general lack of funds. As a result, Myers reported that submarkets such as San Francisco's South of Market area should benefit.

His research focused on Seattle, San Francisco and Portland because those cities have above-average concentrations of technology companies, but high tech should boost employment in other cities.

"One of the things we're finding across the country is that [high tech] is one of the areas we think can be good source of growth for office markets," Myers said. "It's not going to fall as far and it should recover strong. The jobs in five years will outnumber the number of jobs that you had entering the recession."

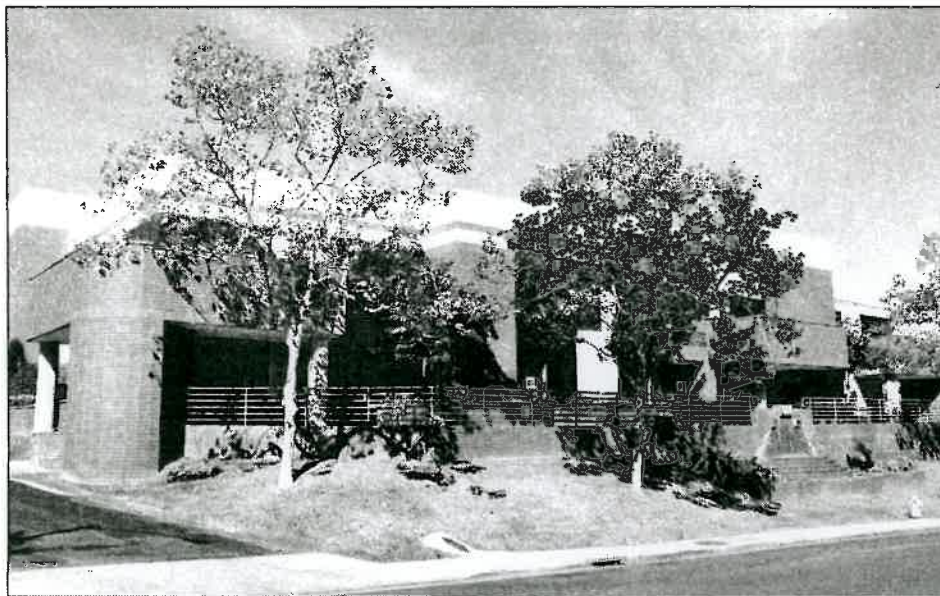
In his review of San Francisco and the Silicon Valley, he said manufacturers such as computer chip producers are seeing heavier job losses than other high-tech sectors, such as computer programming and data processing, which are more likely to drive office growth than manufacturing.

Bill Nork, senior vice president and manager in the Emeryville office of Cornish & Carey Commercial, said there was increased tenant activity in the Bay Area during the second half of 2009 as federal funds to stimulate the economy filtered out to companies involved in alternative energy in the East Bay, Berkeley and Emeryville.

The number of high-tech tenants looking for space, though still small, is increasing. The Lawrence Berkeley National Laboratory run by the University of California was looking for a 78,000-square-foot space and another 15,000-square-foot site in the fourth quarter.

On the other end of the spectrum, Nork said there were at least three and up to five high-tech start-up companies looking for 3,000 to 5,000 square feet and some life science start-ups with new funding that are looking for space.

"In the fourth quarter [of 2008] everybody freaked out because they didn't know what was going to happen," he said. "Then in the first two



High-tech defense contractor L-3 Communications signed an \$8.8 million lease renewal for 123,442 square feet of office and research-and-development space at Metropolitan Life Insurance Co.'s 10770 Wateridge Circle in San Diego last year.

quarters of [2009], they were stunned. Now, people are seeing good deals and they're stepping up to lease space."

Corporations such as Apple are showing a profit and banks are beginning to make business loans again, so it appears that the Bay Area is starting to see the start of improving market fundamentals, or at least a bottoming out.

"We were seeing tenants renew for 12 or 14 months," Nork said. "Now rates are going down enough that they're saying, 'We may be smaller, but we're not going anywhere, so we're locking in rates now.' We're seeing leases for five years."

Fast Growers in California

Deloitte LLP's 2009 Technology Fast 500 list recognized the fastest-growing technology companies in the United States. Woodland Hills-based ReachLocal, an online advertising company, topped the list with \$146.7 million in fiscal year 2008 revenue and a five-year growth rate of 146,050 percent. Eight of the top 10 companies are headquartered in California; 134 of the 500 are in the state.

Other than some large, iconic companies such as Google and Hewlett-Packard, the preponderance of high-tech firms on the West Coast are startup businesses, said Mark Jensen, managing partner in Venture Capital Services for Deloitte LLP.

"In a downturn, when companies are watching their spending, those companies get hit harder and sooner than bigger companies," Jensen said.

East Coast companies tend to be bigger and older, but one-third of the technology companies on Deloitte's Fast 500 list were on the West Coast, with a large concentration in the San Francisco Bay Area.

"In my view, it will remain that way," Jensen said. "I don't think the data suggests companies are leaving California; the numbers are just not as robust."

The state is at the center of significant technology innovation and companies in California attract a large share of venture capital investment. The state attracted more than 40 percent of the U.S. venture capital investment from 1999 through 2007, according to the Milken Institute.

"The biggest reason Silicon Valley exists is the talent there that likes living here," Jensen said. "Tech companies will always go where the talent is."

Keeping Costs Down

Venture capital firms generally tell the companies that they've funded that they need to keep their spending down, including real estate expenses.

"A lot of earlier-stage companies did heed that advice and slow down a bit," Jensen said. "I kind of like a good downturn. Real estate rents decline, people pay more attention to the startups, they can find less expensive space and get more flexibility from landlords."

Gerald Porter, chairman of tenant representation firm Cresa Partners in Los Angeles, said he would be skeptical of any indications that leasing activity is increasing among high-tech tenants for anything more than relocations and consolidations.

"Most of our large national clients, including high-tech companies such as Oracle and EMC, are looking to optimize their portfolios and are dealing with low utilization in their existing space, mostly due to a more mobile workforce," Porter said.

He said it is not unusual for larger corporations to have only 40 percent of their office workers utilize the companies' existing space, so they are revisiting workplace strategies to increase opportunities for employees to work from home or share work spaces.

Working from home and hoteling have become more appealing than they were 10 years ago because senior managers want to reduce real estate costs and take advantage of technology that makes mobile work viable, while business unit managers are more inclined to withstand change in favor of reducing overall costs.

Dave Odmark, a broker at San Diego-based Cassidy Turley BRE Commercial, said leasing by biotechnology tenants in San Diego was subdued in 2009 and isn't expected to improve soon.

"There just isn't enough absorption to put a dent in the biotech real estate vacancy," Odmark said. "Vacancy is close to an all-time high and I

don't think it will get any better. I think it will remain flat at best."

There has been growth among some specialized segments of biotechnology. For example, San Diego officials are trying to establish the region as a hub for the research and production of biofuels made from algae. Unfortunately, Odmark said those kinds of tenants might not be interested in leasing biotech space that's already on the market or rumored to be hitting the market as larger pharmaceutical companies give back space.

"There's been existing space on the market for two or three years and there's zero development unless it's a build-to-suit," he said. "I think some developers will convert biotech space back to flex space because there's just not enough tenants in the market. There's some good activity, but we've got a ways to go to fill the vacant space."

Odmark said rising employment and continued increases in venture capital funding are needed to boost the life science sector.

Venture capitalists invested \$5 billion in U.S. technology companies in fourth-quarter 2009, nearly equal to the \$5.1 billion invested in the third quarter but down from \$5.9 billion in fourth-quarter 2009 and \$8 billion for the same period in 2007, according to the MoneyTree Report from PricewaterhouseCoopers LLP and the National Venture Capital Association, based on data from Thomson Reuters.

In California, venture capitalists invested \$2.5 billion in fourth-quarter 2009, which was \$344 million less than in the third quarter and \$67 million less than fourth-quarter 2008. By region, \$1.9 billion was invested in the Silicon Valley in the fourth quarter of last year, followed by \$300 million in San Diego, \$288 million in Los Angeles and Orange County and \$3 million in Sacramento.

Some defense and high-tech companies are growing and leasing space in central San Diego, but it's taking a while to finalize deals, according to Jeb Bakke, senior vice president at CB Richard Ellis in San Diego.

Bakke said there seem to be more larger tenants — 20,000 square feet and above — looking for offices than smaller businesses. Hitachi, Raytheon, MedImpact, Mitchell International and Northrop Grumman were among the companies with requirements for new space in the fourth quarter.

"There is some musical chairs, which means that they're just looking at their other alternatives in the market, many times to effectuate a better renewal with their landlords," Bakke said.

Landlords are working to renew existing tenants because doing so even at less favorable terms is better than waiting for another company that could fill the tenant's space.

"There are some tenants that are looking to grow," Bakke said. "I don't know that there's an overwhelming trend."

Then again, some requests that tenants and their brokers have sent out to the market as they look for new facilities have indicated a need for expansion space.

"Usually when you call the broker or tenant and explore that with them they say it's a real concern for them," Bakke said. "I don't know if it's just optimism or if they're going to grow when the economy grows again."

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