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Americas Research

San Francisco Peninsula Class A Office / R&D Insight Q4 2009

Economy

The San Francisco Peninsula is heavily tenanted by stalwart technology and biotechnology companies that have more successfully endured the recession than any other region in the Bay Area. The only major layoff announcement during the fourth quarter spawned from Redwood City based Electronic Arts, who cut 1,500 employees globally. However, at the same time, rival video game developer Activision expanded their local footprint, opening a new studio with room to accommodate approximately 100 new employees. Although the resulting overall net employment growth is negative, it is positive to see corporate expansion considering the current economic environment.

Countywide unemployment remains 4.0 percent below the State average at 8.5 percent and has dropped by 50 basis points in the last three months. The AMEX Biotechnology Index and all other major high-tech indexes were up by over 45 percent at year-end, providing further optimism for Peninsula-based companies and the real estate market moving into 2010.

Market Conditions

The bulk of large-block R&D leasing opportunities remain concentrated in newly constructed, shell space in South San Francisco. The potential for this space to be leased stems from growth in the life sciences sector, which was timid during 2009 as a result economic uncertainty and merger & acquisitions. However, available second generation lab space is relatively tight and the bulk of spaces are subleases, spread out geographically throughout the North and Mid-Peninsula. the queue of Form S-1's being drafted and slated to be filed with the SEC by prominent Bay Area law firms are rapidly increasing and biotechnology was the top venture funded industry in the US for the first time on record, which correlate positively for future space requirements.

Office fundamentals are beginning to show signs of stabilization and the markets' active tenant requirements have the potential to absorb large blocks of high-quality space in 2010. These pending transactions could also shift leverage in certain high-demand submarkets to landlords as space availabilities diminish.

With the likelihood of slow to no job growth during the outset of recovery, it's quite possible that net absorption during 2010 will remain flat as a result of lateral relocations which occurred on several occasions in 2009. Additionally, with the limited possibility of tenant in-migration from the Silicon Valley, San Francisco or the East Bay, organic growth from the Peninsula's existing tenant base will dictate the rate of recovery. In fact, a larger threat is the possibility of continued out-migration as was the case for biotechnology company Nektar who relocated their global HQ from San Carlos to San Francisco's emerging life science hub Mission Bay.

Outlook

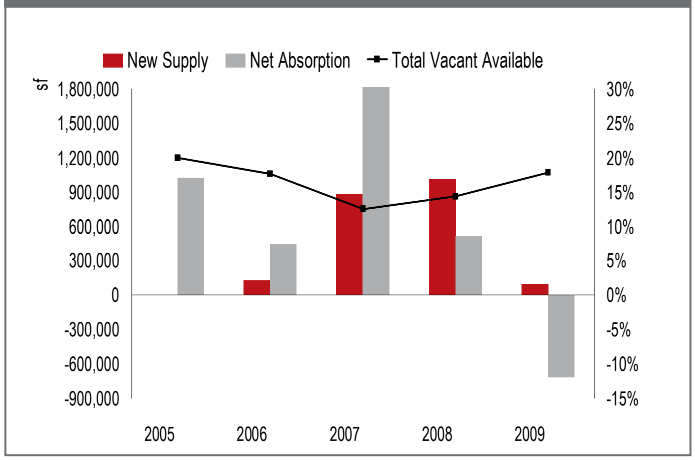
There's high probability that leasing activity will significantly increase in 2010 given the markets active tenant requirements. This is good news for landlords who have been steadily cutting asking rates since the fourth quarter of 2008. Expect rents to start to stabilize and potentially even increase in select submarkets should vacancies approach single digits.

Key market indicators*

	Indicator	Value	12-month forecast
Supply	Supply (Office) Supply (R&D)	19,384,246 sf 4,830,568 sf	
Supply	Total available rate (Office) Total available rate (R&D)	25.3% 21.8%	
Supply	Under construction (% preleased)	84K (100%)	
Demand	Q-O-Q leasing activity % change (Office & R&D)	-0.0%	
Demand	4Q09 net absorption (Office) 4Q09 net absorption (R&D)	13,628 sf -42,883 sf	
Pricing	Direct office asking rent (FSG) Direct R&D asking rent (NNN)	$2.97 FSG $2.93NNN	
Pricing	Sublease office asking rent (FSG) Sublease R&D asking rent (NNN)	$2.17 FSG $2.58 NNN	

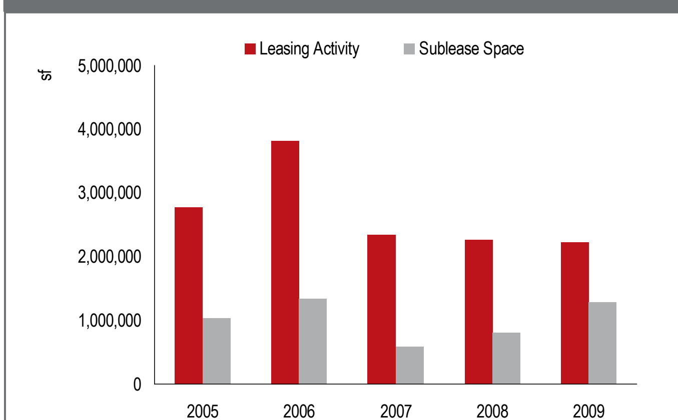
* Class A Office & R&D

Net new supply, net absorption and total availability*



* Combined Class A Office & R&D

Leasing activity vs. sublease available space



Sublease space includes vacant and available space

* Combined Class A Office & R&D

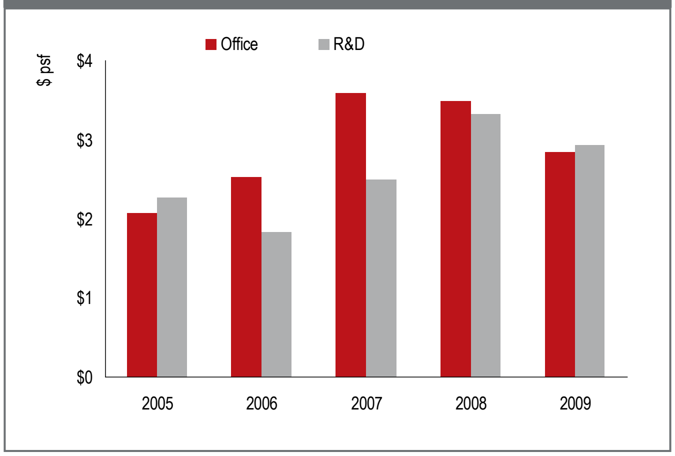
Tenant perspective

Although vacancy ticked upward in 2009, little additional strain was placed on the Peninsula by way of new large-block availabilities. Franklin Templeton and Oracle were the placed the largest blocks of space on the market, but they have since been leased or rescinded (as was the case of Oracle who may be stockpiling space for the recently approved Sun acquisition). Tenants are expected to maintain their position of leverage during negotiations as landlords are eager to keep occupancy levels as high as possible in their portfolios knowing that competition is fierce. Select submarkets are likely to begin recovering in 2010 given active tenant requirements, but at the expense of others. This could present a challenge to location sensitive companies with upcoming expiries in 2010 and beyond.

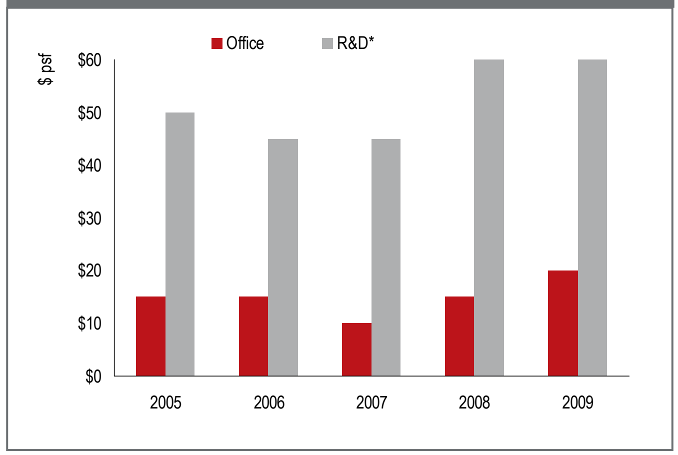
Landlord perspective

Aggressive and motivated is the best way to describe Peninsula landlords moving into 2010. Although an overall market recovery still seems distant, some signs of stability are emerging. The mid-to-large block segment has a manageable level of availabilities and they are spread out geographically enough that location sensitive companies with impending requirements could funnel into a short-listed number of options. That being said, as tenants begin relocating / consolidating they are leaving second generation alternatives behind. Furthermore, tenants are not over subscribing to space, which if holds course, has the possibility to keep market fundamentals flat, in spite of an uptick in leasing activity.

Class A asking rents

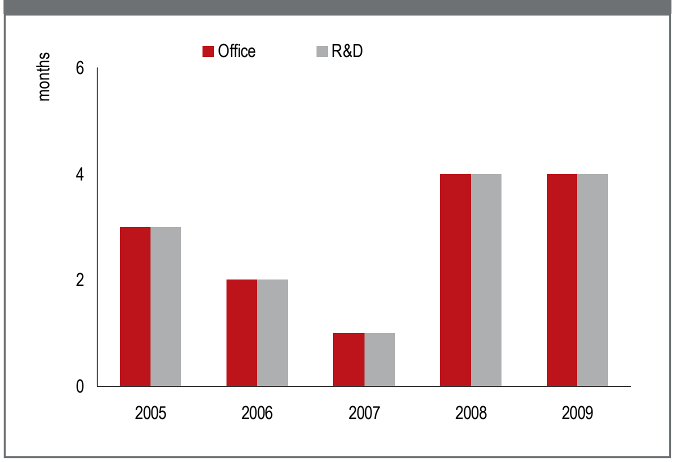


Class A tenant improvement allowance

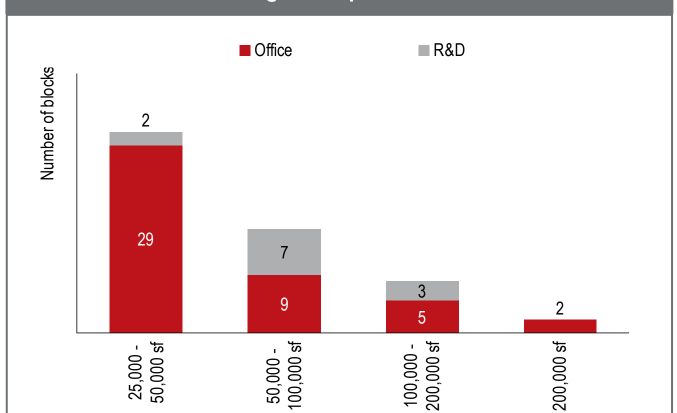


* The quoted R&D TI Allowance is a benchmark on 2nd generation wet lab/life science space. Allowances can vary significantly higher or lower based on the laboratory users needs and if existing improvements can be utilized

Class A free rent

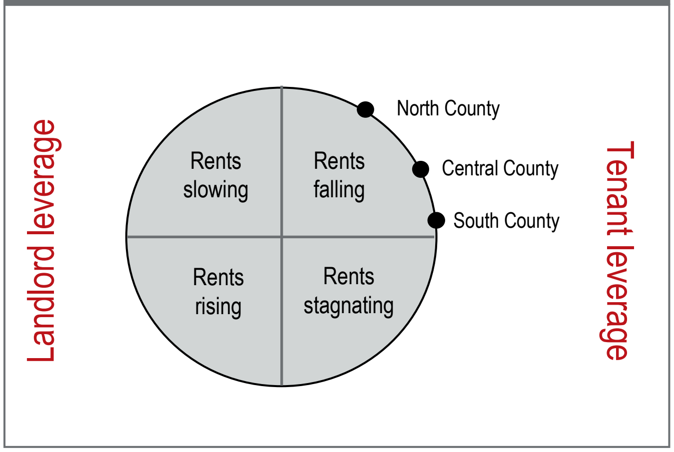


Class A blocks of contiguous space

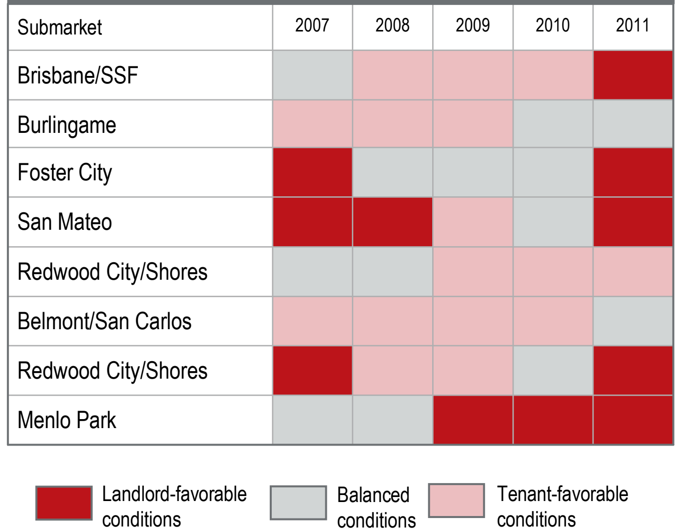


Based on available space per building. Existing buildings only.

Property clock – current market conditions



Submarket leverage – market history and forecast



Completed Class A lease transactions

Tenant	Address	Submarket	sf	Type
Success Factors	1500 Fashion Island Boulevard	Foster City	42,422	Renewal
Adchemy	1001 East Hillsdale Boulevard	Foster City	44,103	New
Sledgehammer Games (Activision)	1001 East Hillsdale Boulevard	Foster City	22,000	New
Regus	1001 Bayhill Drive	San Bruno	24,756	Renewal
Third Pillar Systems	577 Airport Drive	Burlingame	18,061	New

Completed Class A sale transactions

Address	Submarket	Buyer/Seller	SF	$PSF
No sale transactions > $10 million were completed in the fourth quarter				

Class A Under Construction

Address	Submarket	Developer / Anchor Tenant	SF	Delivery Date
200 Oyster Point Boulevard	South San Francisco	Chamberlain Associates / Elan Pharmaceuticals	84,000	Q1 2010

San Francisco Peninsula methodology: Inventory includes all Class A office properties > 10,000 square feet, excluding all condo, medical and government owned buildings, and owner occupied buildings

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