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"Silicon Valley's Booming Real Estate Market: The Assessor's Assessment"

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We are well into the fourth year of recovery from the greatest economic downturn since the Great Depression, so I'd like to give you a brief update of the very robust recovery we continue to experience in Silicon Valley, including the current status of each commercial property type.

APARTMENTS

The Silicon Valley apartment market is on fire! Vacancies have declined and rents increased 11.5% in 2015. Business Journal real estate reporter Nathan Donato-Weinstein wrote that San Jose apartment rents have risen over 45% in the past four years. In the metropolitan San Jose area, the average monthly rent for a one-bedroom apartment hit $2,381 in the third quarter of 2015. The apartment occupancy for Silicon Valley stands at 97.6%. There's been nearly six years of strong and steady performance for the multi-family sector.

Multifamily Executive Magazine listed San Jose as the number one apartment "boomtown" in the U.S. Long-term rents depend on incomes, and incomes in Silicon Valley continue to rise rapidly. The annual median income in Santa Clara County is $115,013. The outlook for 2016 is that apartment rents will stabilize.

With tech giants like Google, Apple, and LinkedIn continuing to project significant increases in jobs, Chris Thornberg of Beacon Economics concludes the apartment market is still desperately undersupplied.

My appraisal staff advised me that as of January 1, 2016, 14,996 apartment units were completed, under construction or permitted in the previous 24 months in Santa Clara County.

Apartment demand is directly related to job growth, and we continue to lead the nation in job growth, albeit at a slower pace in 2016. Joint Venture Silicon Valley's 2015 Annual Index reported that Silicon Valley added 58,000 jobs in 2014, following 44,000 jobs in 2013. I'm looking forward to Joint Venture's annual job growth numbers for 2015.

Santa Clara County has had 60 consecutive months of job gains, reaching a 5.1% rate of growth, a full 1% better than San Francisco, surpassing peak pre-recession employment levels. California job growth was 2.6% compared to 1.9% in the United States.

However, we are on an island here in Silicon Valley. The sea around us is not so favorable. The FED reports that a strong labor market nationally is not generating higher wages or inflation, and consumer prices are running from flat to moderate.

Unemployment dropped to 3.9% in Santa Clara County, the fourth consecutive month below 4%, lower than the state at 5.7% and the nation at 5%.

Sales of tablets and smart phones grew by 8% in 2015, following a 10% increase in 2014, and 30% in 2013. Unit prices of tablets and smart phones continue to decline. Tablets and smart phones and mobile PC's accounted for 58% of global tech sales in 2015. Industry experts expect sales of laptops and tablets to fall 8% and 3%, respectively.

PC sales have been declining for the last four years, down 10.4% in 2015, which is hurting chipmakers like Intel, and the other companies that make PC components.

Apple is projecting a 30% drop in iPhone and tablet sales in the first half of 2016. Consumer response to the Apple watch has been modest, at best.

What's emerging in consumer electronics? Drones, virtual reality headsets and home automation gadgets are projected to increase by 18% this year. Further out: Self-driving automobiles.

The long-term future of the job market is somewhat clouded as more Baby Boomers are leaving the labor force, than Millennials (born after 1980) are entering the labor force. Many of our younger generations (e.g., Gen. X and Gen. Y, Millennials) no longer believe that homeownership is an essential component of the American dream.

First, they saw trillions of dollars of homeowner equity evaporate during the collapse of the housing market, during the recession. So many don't consider homeownership as an investment that automatically appreciates in value.

Second, college graduation often comes with as much as six-figure student debt, which makes qualifying for a home loan more problematic for first-time home buyers.

The Millennials are changing the marketplace for housing. More and more, they prefer urban city living and compact development, in sharp contrast with the historical pattern in America since World War II.

Sixty-six percent of Millennials chose place over job. Where you want to live is more important than the job you select.

Individuals under 30 are projected to form 20 million new households over the next 10 years, a majority of which will be rented. Home ownership fell for the ninth straight year in 2015.

Home ownership is at its lowest rate since 1967, falling from 64.5% last year to 63.4% in the second quarter of 2015.

It's called the 24-hour city, a work-live-play lifestyle, including a desire to live in an area in close proximity to where one works, dines, shops and entertains.

Short commutes—preferably walking or cycling to work—a vibrant location close to shopping and entertainment, common amenities like fitness facilities and the convenience of public transportation are high on the preference list of younger folks.

Millennials are driving less, evidenced by a declining numbers of driver license applications submitted by younger people.

Only 44% of Millennials obtained a driver license within 12 months of the minimum age, and 28% hadn't received a driver license by age 18.

Finally, Gen X, Gen Y and the Millennials are much more mobile. They can do the same work in New York, London, San Francisco, or Singapore, and maybe all four. So why get tied down with a mortgage?

Older people believe that renting is throwing your money away. An increasing number of young people believe that owning is throwing your freedom away.

OFFICE/R&D

I go to Sacramento regularly. During the recession, I would drive the 237 corridor between Highway 85 and Highway 880 to Milpitas on my way to Sacramento, and literally "see through" a half-dozen Class A office buildings.

The landscaping was completed, parking lots striped, but the buildings were vacant; shells built for companies that never expanded or worse, buildings constructed on speculation. Today, all those buildings are leased, usually with major credit tenants.

Recently, I counted 14 new office buildings on that same 10-mile drive. Mountain View, Sunnyvale, Santa Clara and north San Jose have experienced significant office leasing activity from 2011 to today.

A Collier's International Commercial Real Estate Brokerage report states that Class A office rents increased 18.3 percent in 2015, and R&D rents were up 22.8 percent. Office vacancy in Silicon Valley has declined from 25 percent in 2009, to 8.9 percent last year, and R&D vacancies stood at 7.3 percent at the end of the third quarter, both the lowest since 2001.

Google executed the largest tenant lease in history, leasing 1.9 million square feet. Silicon Valley had the third-highest increase in office rents, trailing only San Francisco and New York.

The fundamental question is: Is the technology sector becoming overvalued, evidenced by an office market that has outpriced itself? There are 6 million square feet of office space under construction in Silicon Valley, and that number may go up to 47 million based on proposed developments.

Office obsolescence is impacting the market as the single-story concrete tilt-ups constructed in the 1960's and 70's, are being demolished in favor of larger, more modern, denser buildings.

Employee densification, designed to improve efficiency and lower the cost per employee, is having an impact on office leasing. Putting more employees in less space has become a trend.

Between 2010 and 2015, the average space a company needed for each employee declined sharply, from approximately 225 square feet to just 138 square feet.

Office tenants are downsizing their space requirements at the same time they are increasing their employee head count. Think of the impact this has on parking and traffic planning.

Tech companies want open floor plans with fewer cubicles and offices. This is called a "collision environment," promoting direct collaboration between employees. Tech managers believe productivity increases when people interact directly more often.

Marissa Mayer, the CEO of Yahoo, eliminated almost all telecommuting when she became the CEO, to encourage more employee contact and collaboration.

Employee collaboration is easier with larger floor plates. There is a 95% chance of employees coming into contact with each other when they work on the same floor. That declines to 5% when they work on different floors, even at the same company.

In Silicon Valley, land is the most expensive component. Larger floor plates means more land, increasing the development costs dramatically. In addition, construction costs have increased 6% to 10% in the last couple of years.

Construction costs vary wildly. Fuel costs have declined, reducing transportation costs. However, costs of construction materials are up, and because there are so many projects under construction, skilled labor is scarce, which increases construction labor costs.

WAREHOUSE AND INDUSTRIAL SPACE

I'm bullish on the industrial/warehouse market. Vacancy countywide is a modest 2.6% for warehouse and 3.2% for industrial. Industrial rents climbed 16.8 percent last year.

U.S. manufacturing is experiencing a modest resurgence, due to narrowing international labor cost differentials, declining energy costs compared to our leading competitors in Germany, France, Japan, and the U.K., concerns over the piracy of intellectual property in Asia, and better oversight and control of projects and products in the U.S. It's called "reshoring" of manufacturing back to the U.S.

Dozens of companies are moving back to the U.S. because the economics are shifting. Labor costs in China are increasing at 15 to 20 percent per year. The manufacturing process is becoming more and more automated with robots, requiring fewer humans.

More and more products require customization, and customized products are good for U.S. manufacturing. In the tech world, there is also a belief that separating the design function from the manufacturing function can be problematic.
U.S. companies that manufacture overseas want to reduce the long supply chain across the ocean. The widening of the Panama Canal, scheduled for completion this year, is also having an impact on the location of warehouses and factories.

As the U.S. retreats from being the world's policeman, the world is becoming more disorderly. The manufacturing supply chain can be threatened by increased unrest in the world. The need to have manufacturing closer to the demand is a natural outcome.

Will the U.S. become an industrial powerhouse again? No! Lower costs alone won't entirely restore the erosion created by American companies that have left the U.S. to manufacture overseas.

Online commerce is one of the strongest drivers of industrial demand. As retailers continue to offer fast shipment, often next-day delivery, strategically located distribution centers are essential.

HOSPITALITY AND LODGING INDUSTRY
The hotel industry has always been the most sensitive to economic fluctuations, so it is no surprise that it suffered the most during the recession.

The trend is very positive. The San Jose Hotel Occupancy Report, covering 13 hotels, shows occupancy increased from 58.5 percent in 2010 to 75.5 percent in 2015. Hotel operating profits are up across America with Houston, L.A., Miami, Boston and San Francisco leading the way.

The expansion and renovation of the San Jose Convention Center is having a positive impact on the local hotel market.

The hotel industry has benefited from the strong economy and increased corporate travel budgets. However, technology (video, teleconferencing and webinars), is providing a viable alternative to expensive and often unproductive travel.

RETAIL SECTOR
The one sector that was slow to recover is retail. The retail sector was terribly overbuilt. During the "dot-com boom," there was a glut of strip malls and power centers built to accommodate what turned out to be the absolute peak of the consumer market.

It was built on the framework of the old model, that people would walk in the front door of a storefront and shop.

The increasing prevalence of online shopping vs. traditional brick-and-mortar stores, all point in the same direction: Online sales are growing at more than twice the rate of in-store sales, and that trend is accelerating.

Nevertheless, online transactions still represent only 14 percent of all retail sales, while 60% of U.S. consumers shopped online at least once last year.
A few years ago many real estate experts were forecasting that online sales were going to heavily circumvent brick-and-mortar stores.
Many consumers, however (more women than men), want to stroll into a retail store, enjoy the experience and have the opportunity to select the actual item they are purchasing.
Proof: Amazon opened its first retail store in Manhattan.

For other shoppers, however, the internet is the place to go to conduct research, read reviews or compare products, before going to a store to seal the deal.

It's really a competition between physical and digital platforms. Brick-and-mortar retailers are beginning to aggressively respond to the practice of "showrooming," where shoppers go to a store to see, touch and experience a product, then purchase the product online at a discount, often without paying sales tax.

Many traditional retailers are beginning to embrace and invest in "showrooming" technology, providing store-specific smartphone apps, installing scanners that track inventory, same-day delivery, offering product information, and in-store demonstrations that online retailers can't provide.

Many traditional retailers have active websites and mobile apps. It's called multi-channeling. Nordstrom, Macy's, and Ann Taylor are far ahead of the curve. Nordstrom's online sales increased 24 percent in the second quarter of 2015, accounting for nearly 20 percent of the retailer's total revenue during the first half of the year.
Nordstrom plans to invest $3.9 billion over the next five years to increase online sales.

Some retailers are reducing their store footprint in exchange for operating more distribution warehouses closer to consumers. Excess Space Solutions Company projects that retailers are expected to downsize their storefront space by 40 to 50 percent over the next dozen years.

To counter the move by traditional retailers into the online market, some online retailers are shipping their products for free to try on at home before buying. A customer's credit card is not charged until the customer doesn't return the item within a specific time limit, usually ten days.

The decline of the middle class is having a profound effect on retailers. Deep-discount retailers (Dollar Store) are doing extraordinarily well.
High-end retailers are also doing well. Mid-level retailers, however, are struggling, consistent with the decline in America's middle class. Conversely, Asia's middle class is growing.

It truly has become survival of the fittest as the name-brand retailers like Circuit City, Mervyns, Blockbuster, Borders Books, Loehmann's and Linens 'N Things continue to disappear. Wal-Mart is closing 150 stores in the U.S., including one on Monterey Road in San Jose.

Radio Shack declared bankruptcy last year. Sears, JC Penney, Staples, and Office Depot are closing hundreds of stores, and Best Buy is reported to be in financial trouble.

What's this world coming to… even Hooters and Frederick's of Hollywood have closed some restaurants and stores.

In the second quarter of 2015, 1,500 establishments were closed. 1,260 of them were retailers and restaurants. These include McDonald's, Walgreens, The Gap, Pier 1 Imports and Rite Aid.

Holiday sales increased 2.1%, the lowest level in 6 years. Millennials are impacting retail sales. They are spending less on things and more on the experience.

CONCLUSION

Led by the stock market in which the Dow Jones has gone from 6,500 in March 2009, to 15,767 yesterday, Silicon Valley continues to be a national leader for the U.S. economy.

Tech stocks outpaced the broader stock market during 2015, fueled by a relentless appetite by consumers for cutting-edge software, hardware, and mobile devices.

The NASDAQ increased 44% since January 1, 2013, but only 5.7% in 2015. Nevertheless, the NASDAQ outperformed the Dow Jones
(-2.2%) and the S&P 500 (-0.7%). Office and R & D rents in Silicon Valley generally follow the NASDAQ.

Stock market analysts believe that the major indexes (Dow Jones Industrial, NASDAQ and S&P 500) will experience a period of significant market volatility in 2016.

2015 was the year that Apple passed Chevron in total market value, and Google is closing the gap with Apple.

Silicon Valley registered 16,975 patents in 2014.

During 2015, venture capitalists invested $27.3 billion in Bay Area companies, a 7.6% increase over 2014, and the most since 2000.

During the third quarter alone, Bay Area companies received 27.1 percent of total global venture capital dollars invested, with more than $1.9 billion invested in 35 deals.

Two-thirds of all VC investments went to software companies. During the fourth quarter of 2015, however, venture capital investments dropped 40.2%, reflecting concerns about technology valuations, and questions of whether the Bay Area is in the midst of another venture investment bubble.

Silicon Valley had 23 IPO's in 2014, but that number dropped sharply in 2015. The Los Angeles Times reported that IPO and venture capital funding in general declined 62% in 2015.

So, we have risen from the depths of the bottom of the worst economic decline in my lifetime.
While the general outlook continues to be positive, there are significant areas of concern. The wildcards for 2016 include:

A. Continued dysfunction and gridlock in Washington, D.C.
B. A major study in 2013 estimated that intellectual property (IP) theft costs the U.S. economy $320 billion and 1.2 million jobs annually. You can't have innovation without the protection of ideas.
C. Cyber-crimes have increased dramatically. A Washington think tank estimated the annual cost of cybercrime and economic espionage to the world economy at more than $445 billion – or almost one percent of global income.) Target was just the

beginning of consumer awareness of electronic penetration by "hackers" in committing cyber-crimes. Hackers are from China, Romania, U.S., Bulgaria and Russia.

Top targets are U.S. aerospace and defense, energy, finance, software, legal and media/entertainment (think Sony, and North Korea).

D. The income/wealth gap continues to widen. The median income in Silicon Valley actually declined in recent years, at the same time the local economy was surging.
E. Wages are beginning to increase slowly, which will boost the economy.
F. Federal fiscal and monetary policies and political chaos can cause the U.S. economy to spin out of control.
G. The most serious problem facing California and the country is our decaying infrastructure: roads, bridges, schools, ports, transit, water treatment facilities and distribution systems.
H. Globally: China, European Zone, Russia, Japan, Brazil, Greece and Spain are a mess economically, and further deterioration could have a catastrophic impact on a strong U.S. economy.
I. One very serious problem that confronts us is immigration reform:
    - The U.S. issues approximately 400,000 permanent visas annually
    - 4.4 million immigrants are waiting for green cards
    - 200,000 Chinese students educated in the U.S. went back home in 2012 (up from 50,000 in 2008) and they will compete with U.S. businesses
    - One-third of all new businesses created in the U.S. were founded by immigrants
    - Two-thirds of patents awarded to employees of QualComm, Merek, GE, Cisco and Siemens were immigrants
    - 36% of all patents awarded in Silicon Valley were to foreign-born individuals
    - Ten percent of all U.S. workers are employed by immigrants
J. The world is interdependent and volatile, both politically and economically