2Q23

South Peninsula Office Market Overview

Market Observations

Economy

- The region's labor market remained historically strong amid shifting macroeconomic conditions. May's 3.1% unemployment rate was lower than the 4.3% 10-year historical average.
- Year-over-year, job gains have been most pronounced in the leisure/hospitality industry, which is still making up for lost ground during the pandemic. Leisure/hospitality led all sectors in job gains during the past 12 months.
- Technology firms are continuing to adjust labor needs. Locally, employment growth across office-occupying sectors decreased due to of tech-sector layoffs, but total employment remains near historical highs.

Leasing Market Fundamentals

- Absorption in the second quarter of 2023 totaled negative 1.3 million SF. This is the fifth consecutive quarter of occupancy losses. Major tenants continue to shed large blocks of space as they consolidate their operations. Year to date, there has been 1.9 million SF of net occupancy losses.
- The construction pipeline remains low by historical standards, with just ± 488,000 SF underway. There was one completion this quarter, Intuit's 179,000 SF headquarters expansion, indicating continued interest in the region from tech despite uncertainty.
- The vacancy rate increased year-over-year to 18.1% while rents continued to fall as large block sublease space continues to enter the market. Asking lease rates held steady quarter-over-quarter at $6.24/SF but are down 2.2% year-over-year.

Major Transactions

- This quarter, Google put up over 900,000 SF of sublet space on the market spread across three buildings in Mountain View (±562,000 SF) and three buildings in Redwood City (345,000 SF). Despite being one of the first advocates for "return-to-office" policies, its real estate footprint has decreased dramatically this quarter.
- In the same period, Google additionally renewed 411,000 SF at its three-building campus at 1900-2000 Charleston Ave. While Google may be shedding space abroad, its commitment to their hometown of Mountain View remains strong.
- Meta additionally put up 269,000 SF of space up for sublease in Menlo Park as it consolidates operations following three waves of layoffs since 2022.

Outlook

- Rising interest rates and the accompanying investment pullback has caused uncertainty among occupiers that is unlikely to abate in the immediate future.
- Despite an increase in mandatory return-to-work policies, vacancy in the office sector will continue to rise as major tech tenants give up space, reversing the "land banking" strategy that was widespread during the pre-pandemic era.
- After a small bump in 2022, when economic optimism was high, rents have slowly begun to fall as supply increases and demand remains at depressed levels.

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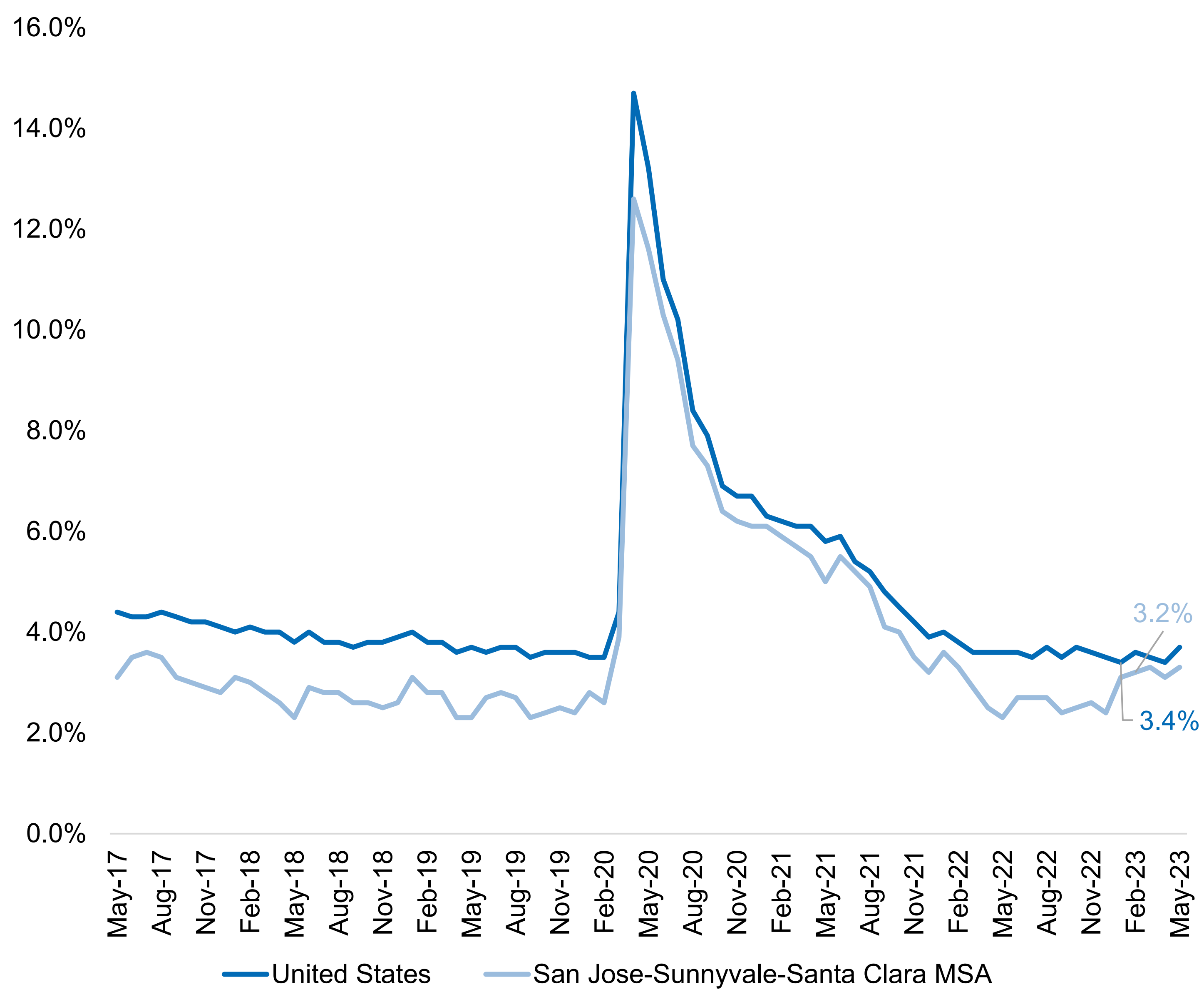
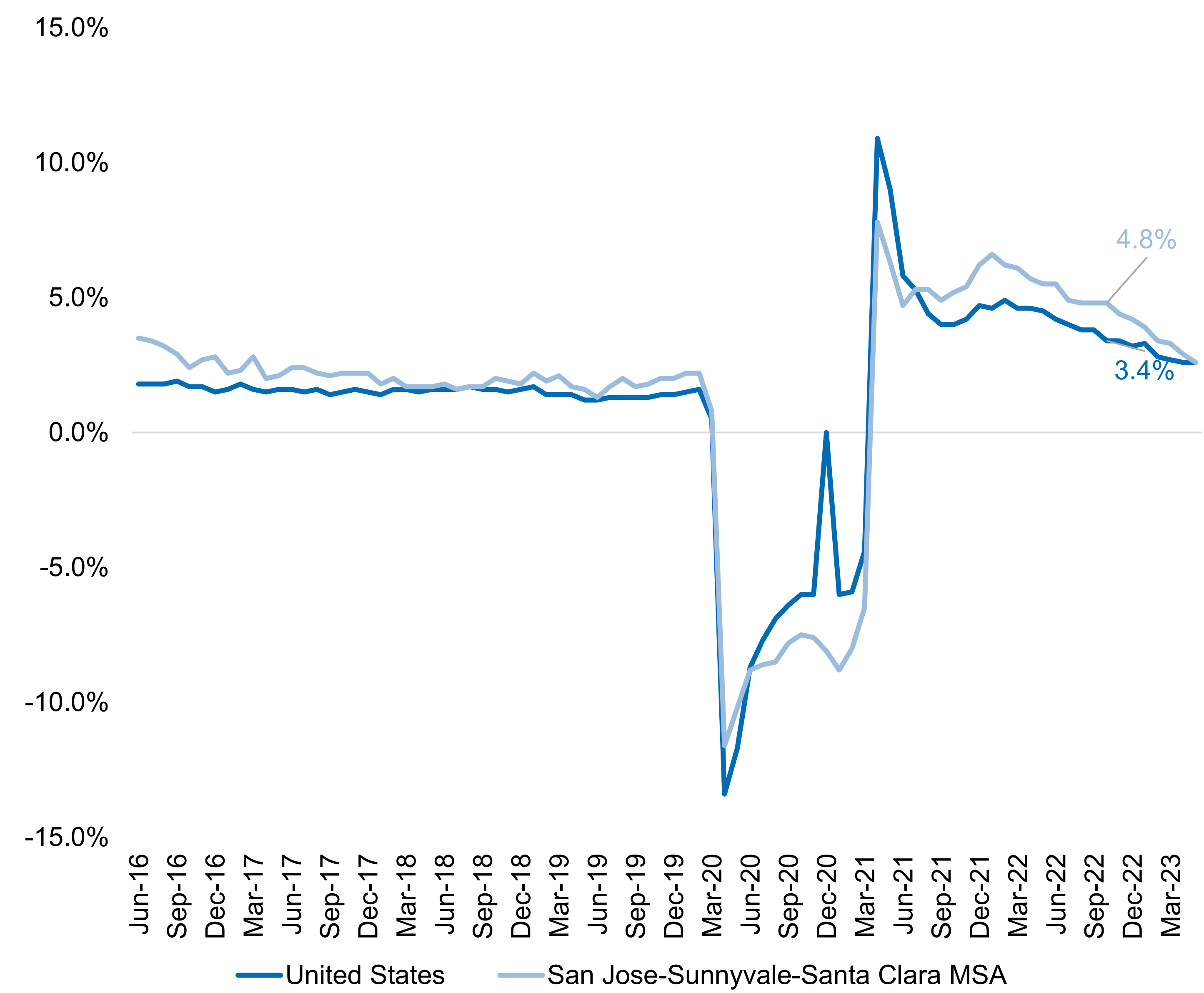
Metro Employment Trends Signal a Slowing Economy

While the Valley's labor market remains on solid footing and on par with pre-pandemic conditions, cracks are beginning to show amid persistently high inflation and increasing interest rates. Several waves of tech layoffs have caused unemployment to rise, though this level may remain stable should the national economy recover.

Unemployment Rate, Seasonally Adjusted



Nonfarm Payroll Employment, Non-Seasonally Adjusted, 12-Month % Change

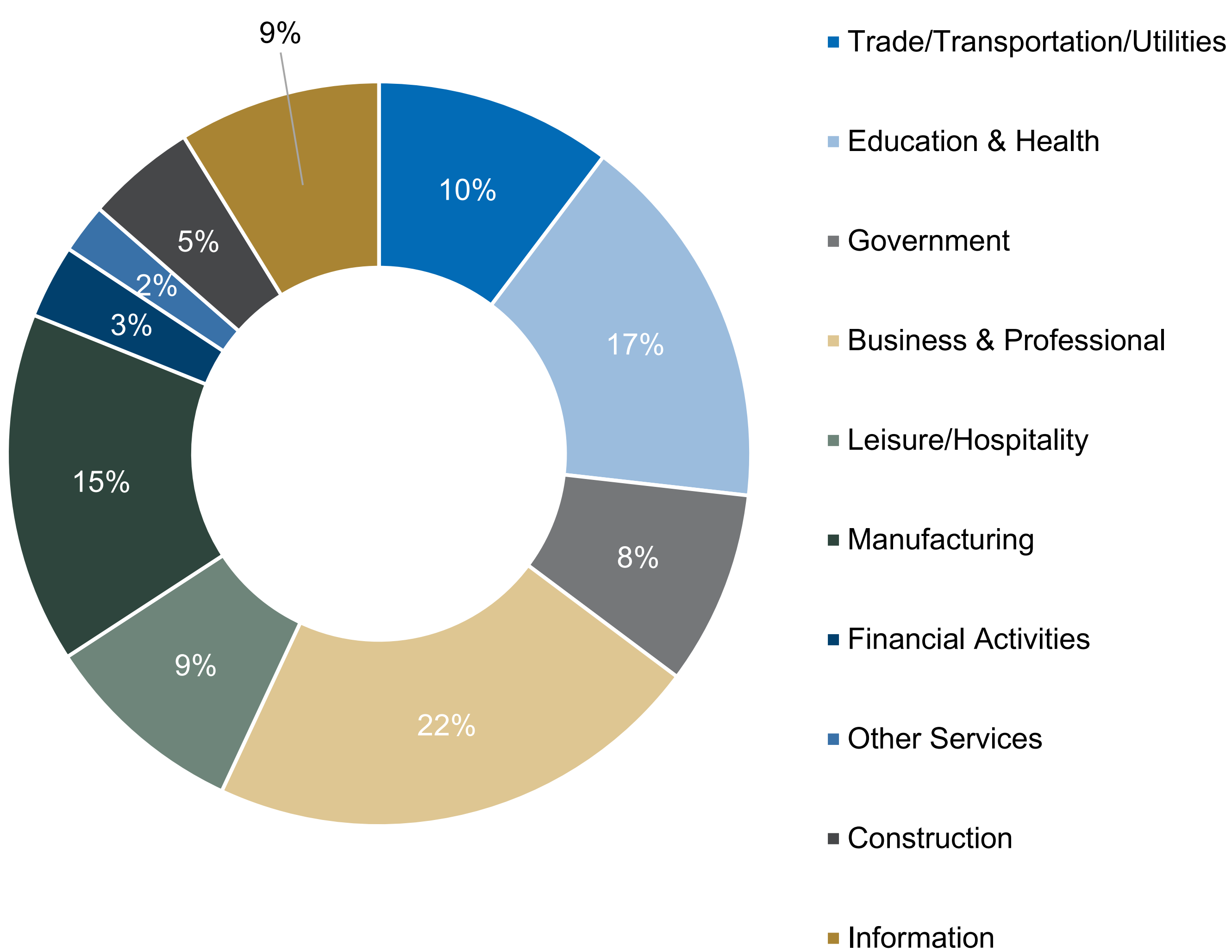


Source: U.S. Bureau of Labor Statistics, San Jose-Sunnyvale-Santa Clara MSA

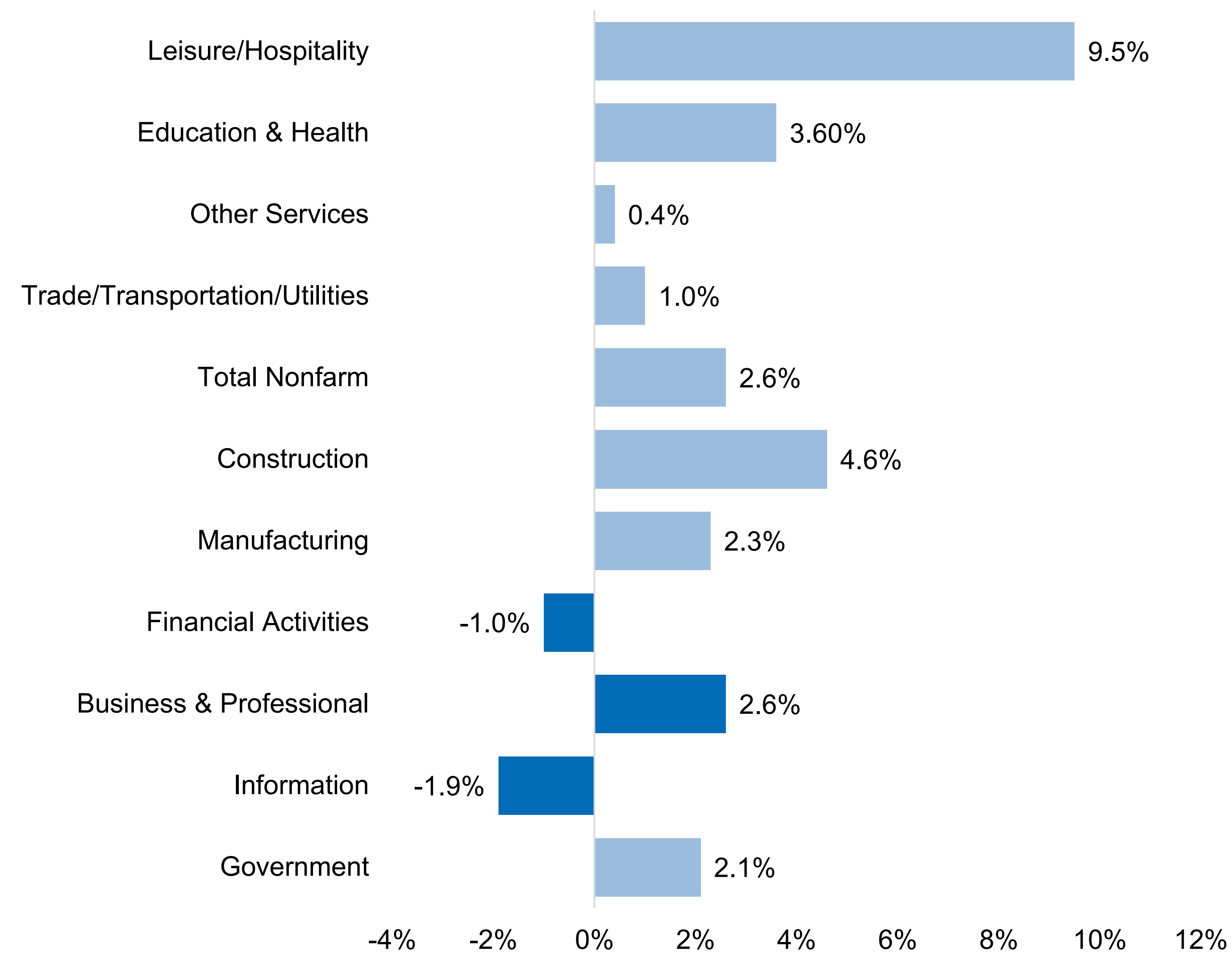
Job Growth Driven in Large Part by Services Still Making up for Pandemic Losses

The leisure/hospitality sector led all industries in regional annual job growth, underlining an industry still grappling with making up for pandemic losses amid a greater shift in spending from goods in favor of services. Most recent job numbers saw a decrease in office-occupying industries but remain at historically high levels.

Employment by Industry, May 2023



Employment Growth by Industry, 12-Month % Change, May 2023

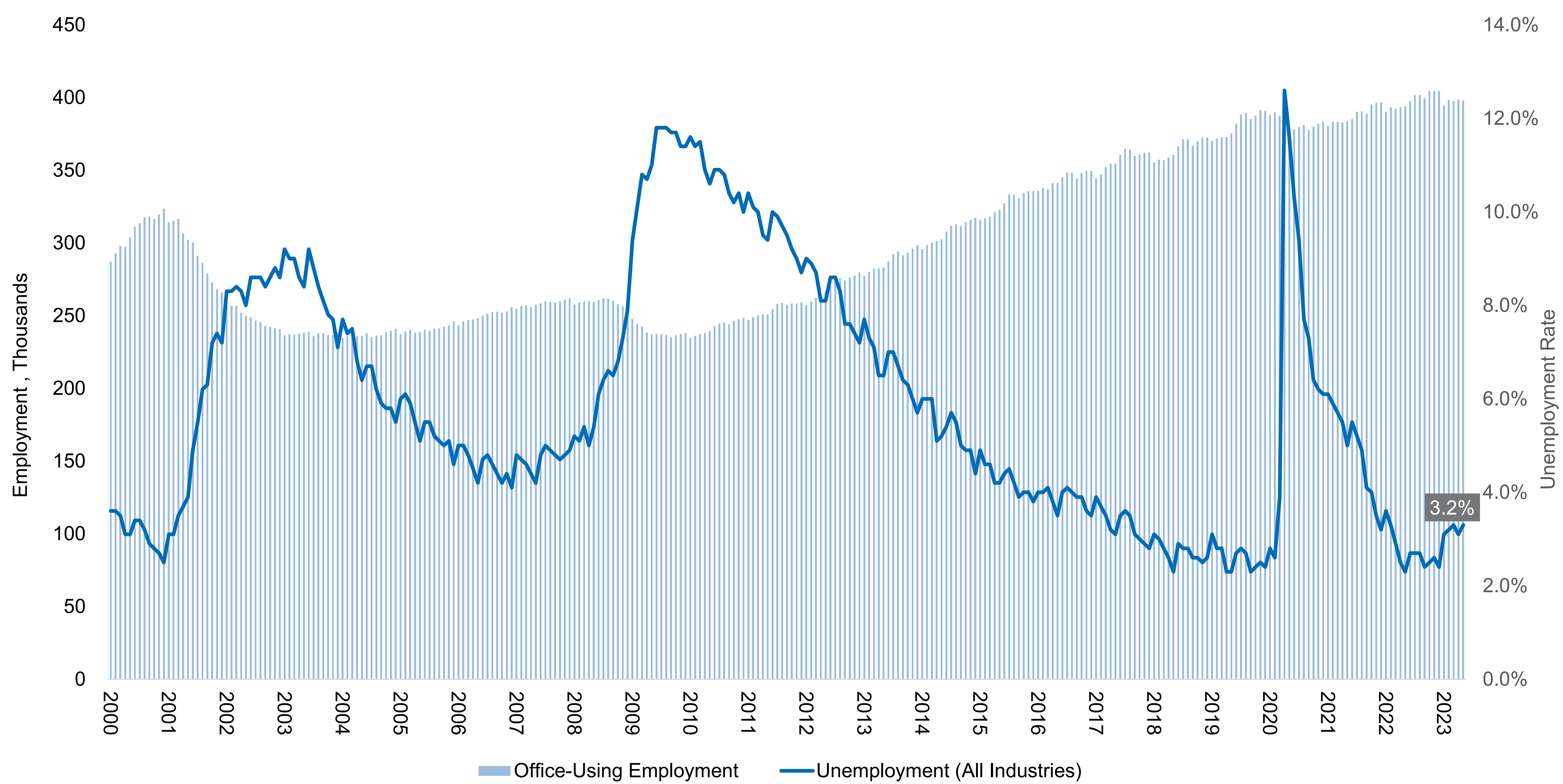


Source: U.S. Bureau of Labor Statistics, San Jose-Sunnyvale-Santa Clara MSA

Overall Office-Using Employment Has Rebounded

The number of office jobs has rebounded to pre-pandemic levels. While there has been a slight bump in unemployment due to tech sector pullbacks, the unemployment rate remains near-historic lows. Given the dynamic nature of the Bay Area, it’s likely that these jobs will be recouped in the future should economic conditions stabilize.

Office-Using Employment* and Unemployment Across All Industries



Source: U.S. Bureau of Labor Statistics, San Jose-Santa Clara-Sunnyvale
Note: May 2023 data is preliminary.
*Office-using employment includes employment in the following industry sectors: Professional & Business Services, Financial Activities and Information.

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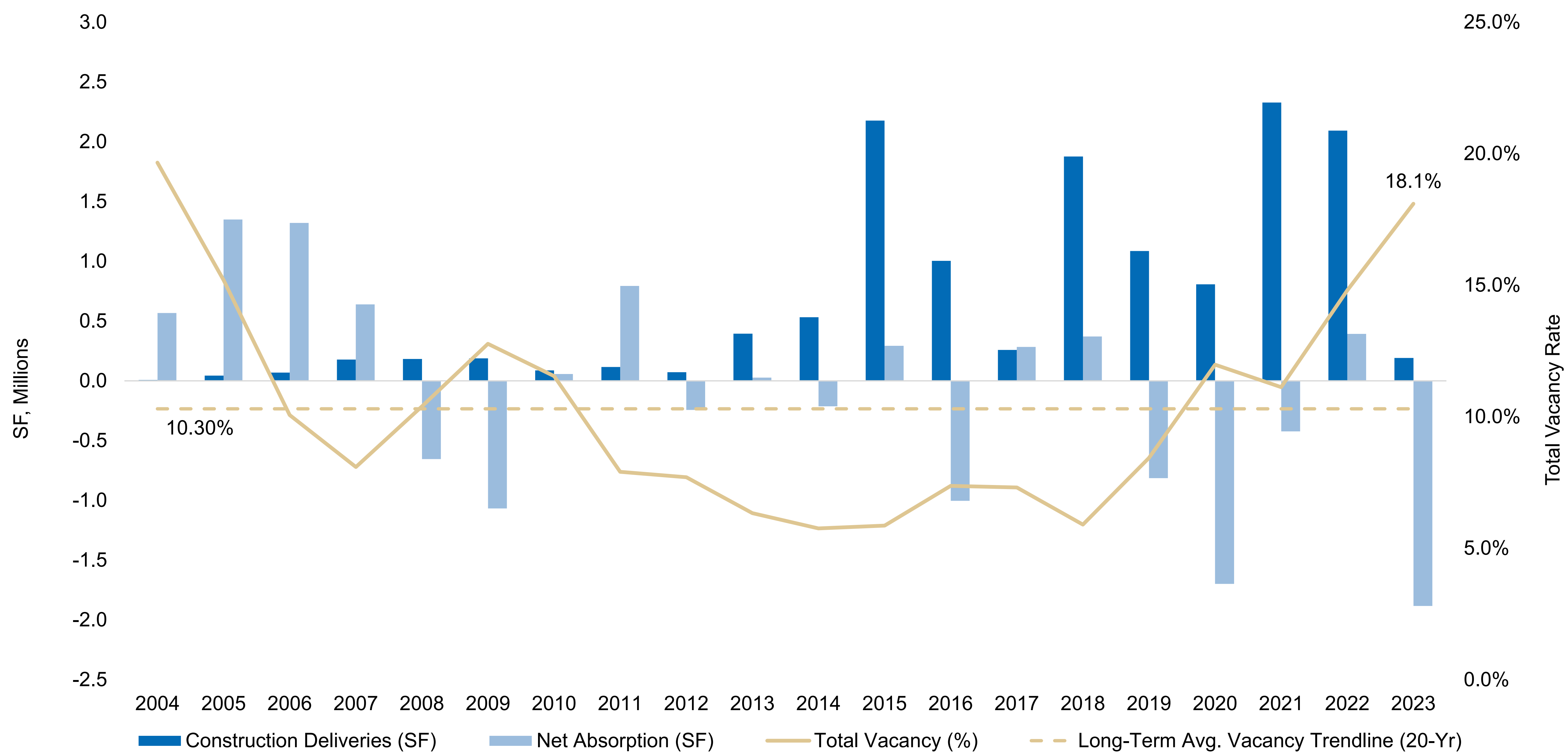
Leasing Market Fundamentals

Vacancy Rises as Construction Deliveries Outpace Net Absorption

The vacancy rate rose to 18.1% quarter over quarter from 15.2% in the first quarter of 2023. The market is recalibrating,and vacancy expected to continue to rise over the next few quarters as the economy slows and construction deliveries outpace demand, reversing the trend of the last two years.

Historical Construction Deliveries, Net Absorption, and Vacancy

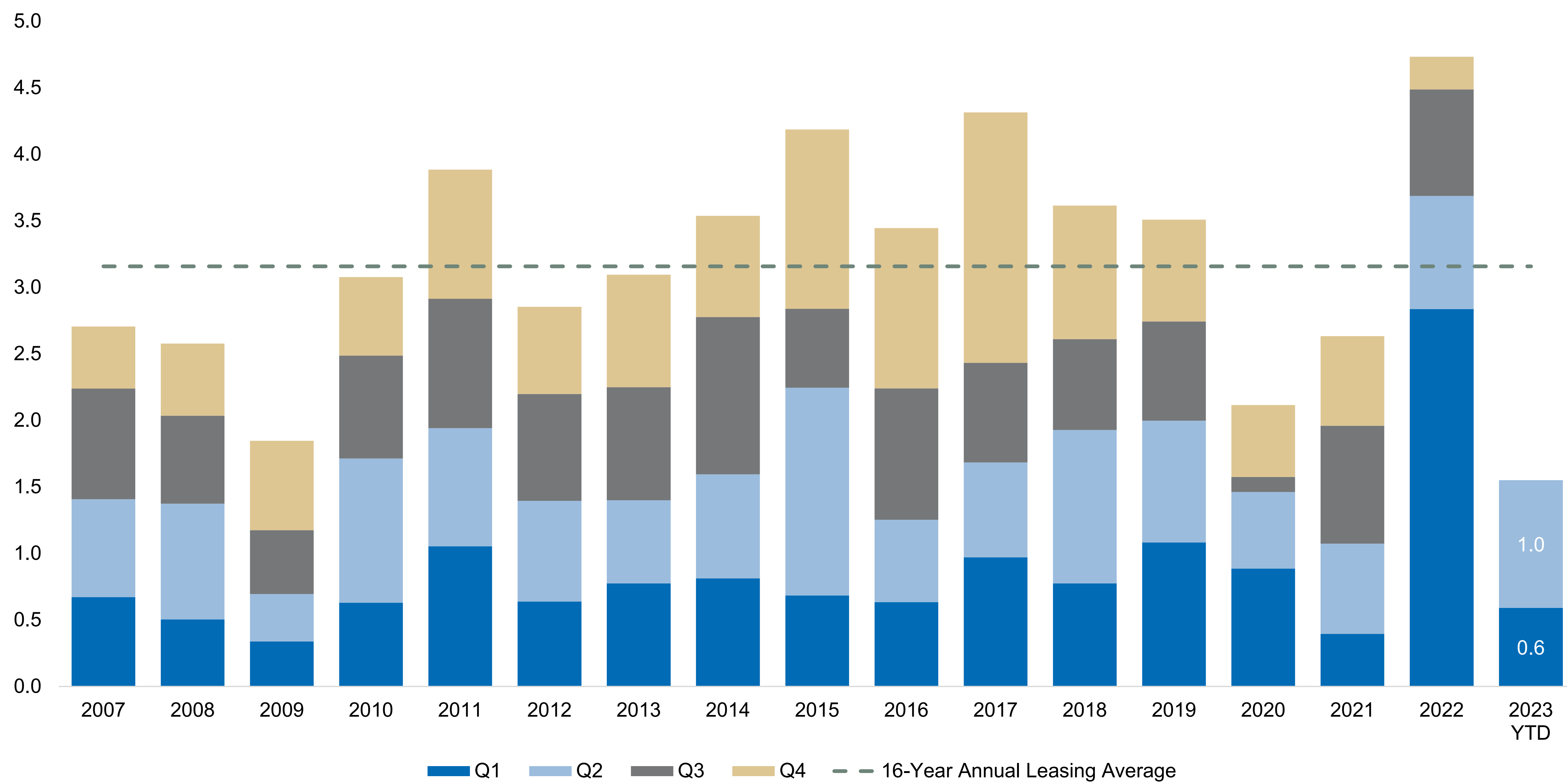


Source: Newmark Research

Leasing Activity Pace Has Slowed

Diminished demand for large-block space, a growing trend towards smaller offices, a cloudy economic outlook, and a higher cost of capital have caused many companies to pause and assess their real estate needs. These are all factors that have reduced leasing activity in the current year.

Total Leasing Activity (msf)

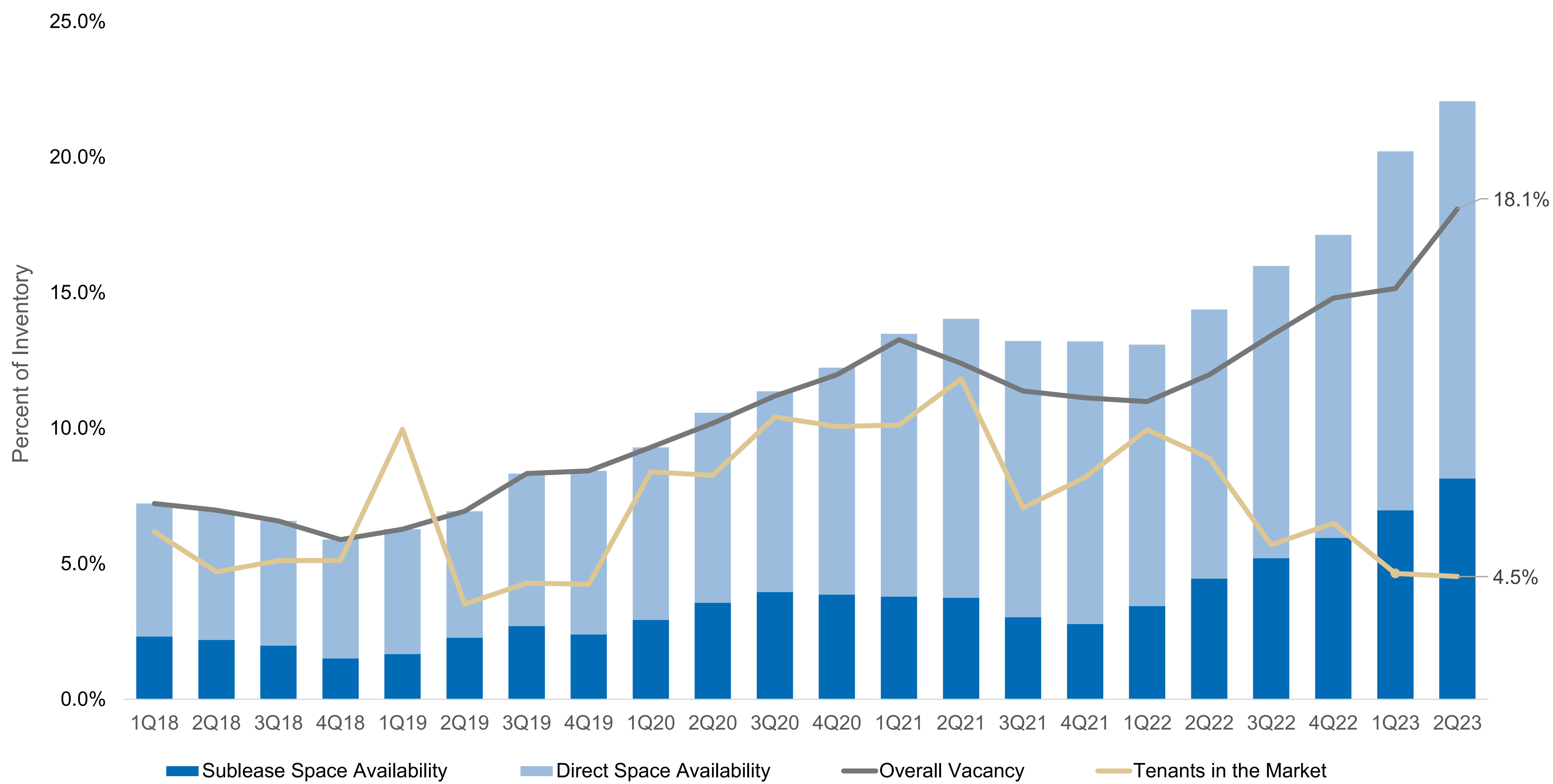


Source: Newmark Research, CoStar

Availability Continues to Increase While Tenant Demand Drops

In the years leading to the pandemic, many tech companies leased space based on future employment growth as a hedge against diminishing supply and increasing rents. This trend has now begun to reverse, and more sublease space is anticipated to become available as tech contracts and reevaluates their needs.

Available Space and Tenant Demand as Percent of Overall Market

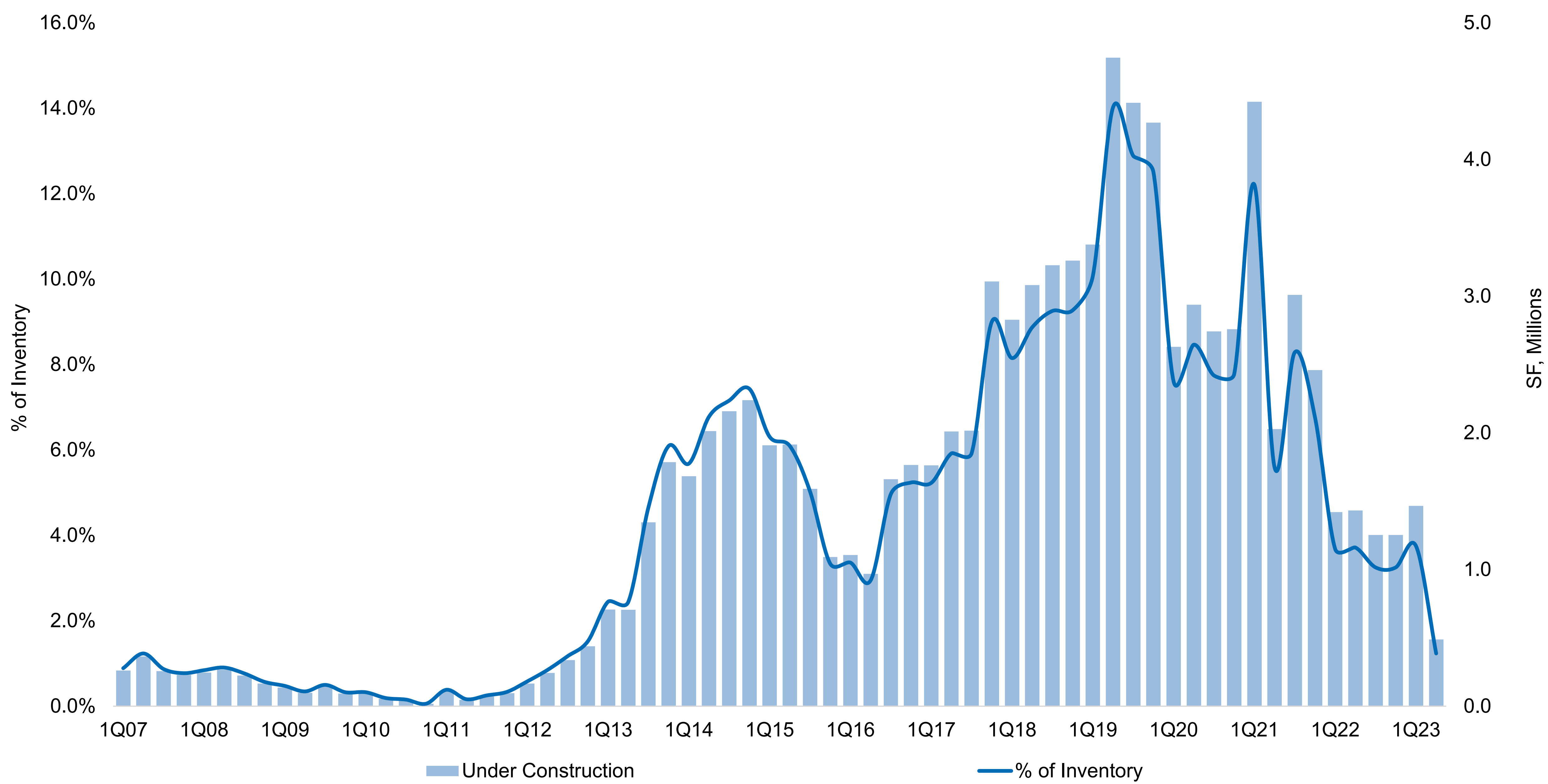


Source: Newmark Research

Construction Slows as Projects Are Put On Hold

Although tech companies continue to deliver owner-user build-to-suits, the office construction pipeline remains at historically low levels due to investor pullback, with many projects on hold until economic conditions improve.

Office Under Construction and % of Inventory

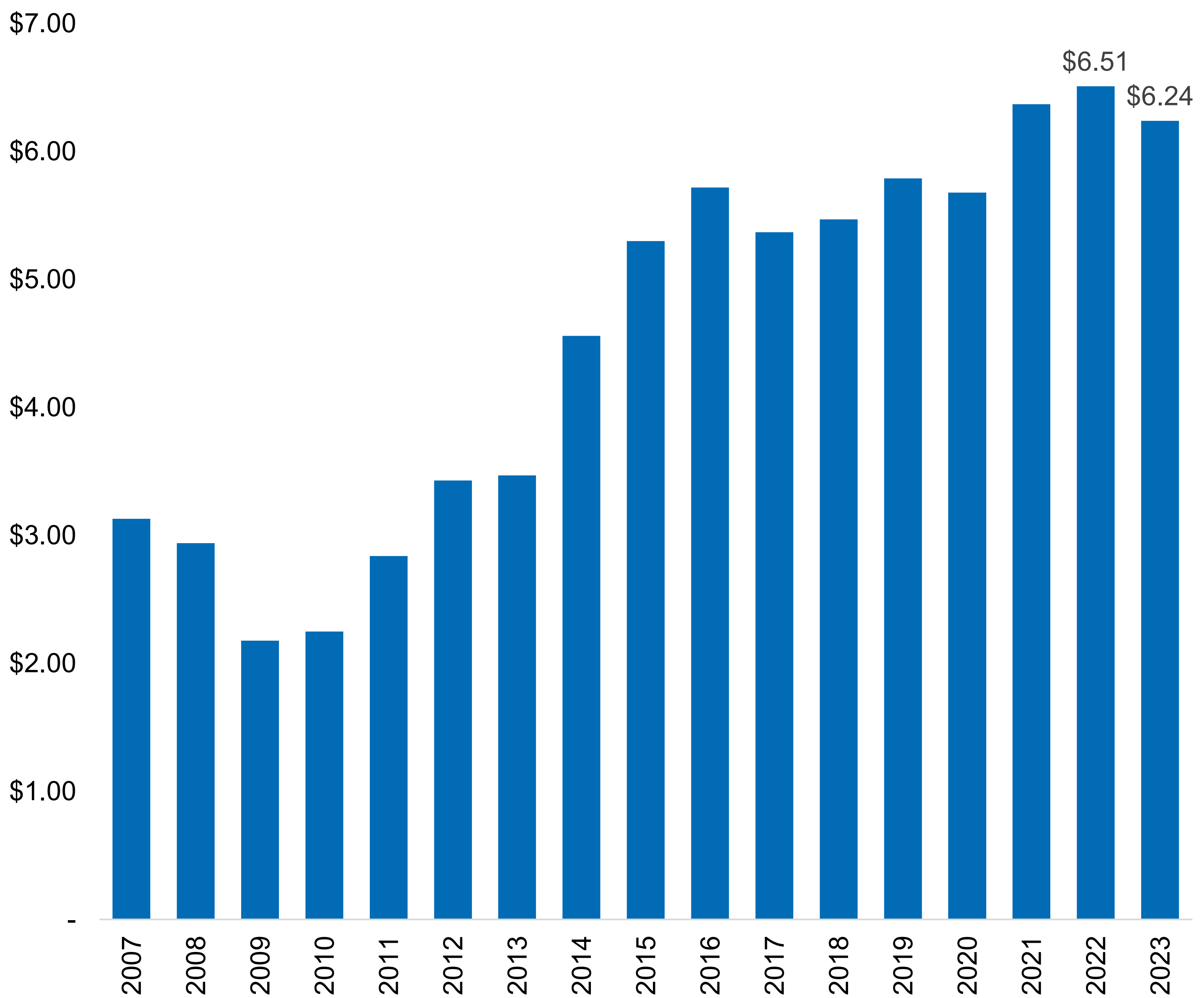


Source: Newmark Research, CoStar

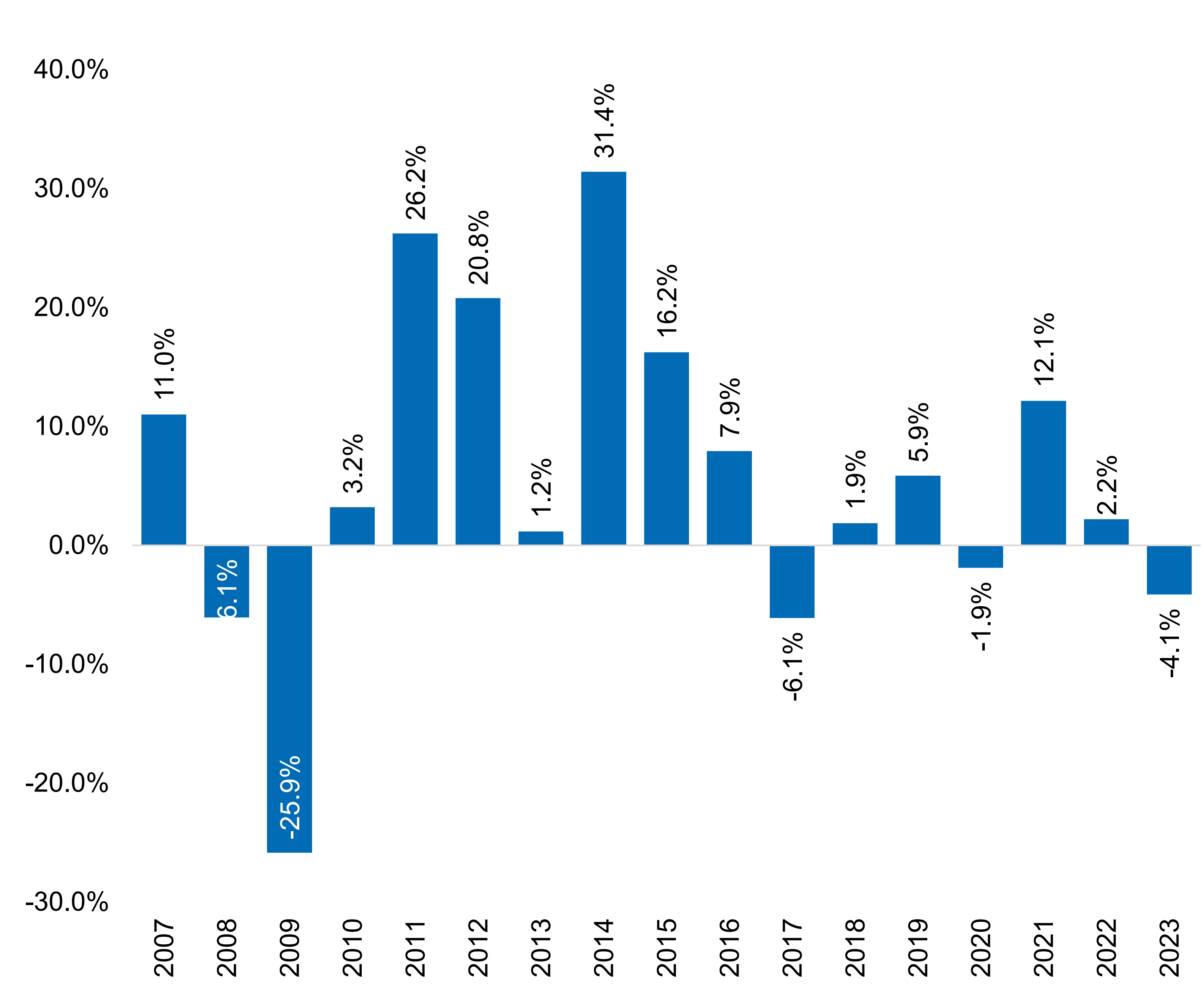
Rents Begin to Fall

Overall asking rates fell slightly this quarter to $6.24/SF, a 2.2% decrease year-over-year. In the same period, Class A rents have fallen 4.0% due to tech tenants shedding their Class A office space. As supply continues to rise, rents are expected to fall in step.

Office Average Asking Rent, $/SF, NNN



Year-over-Year Asking Rent Growth Rate

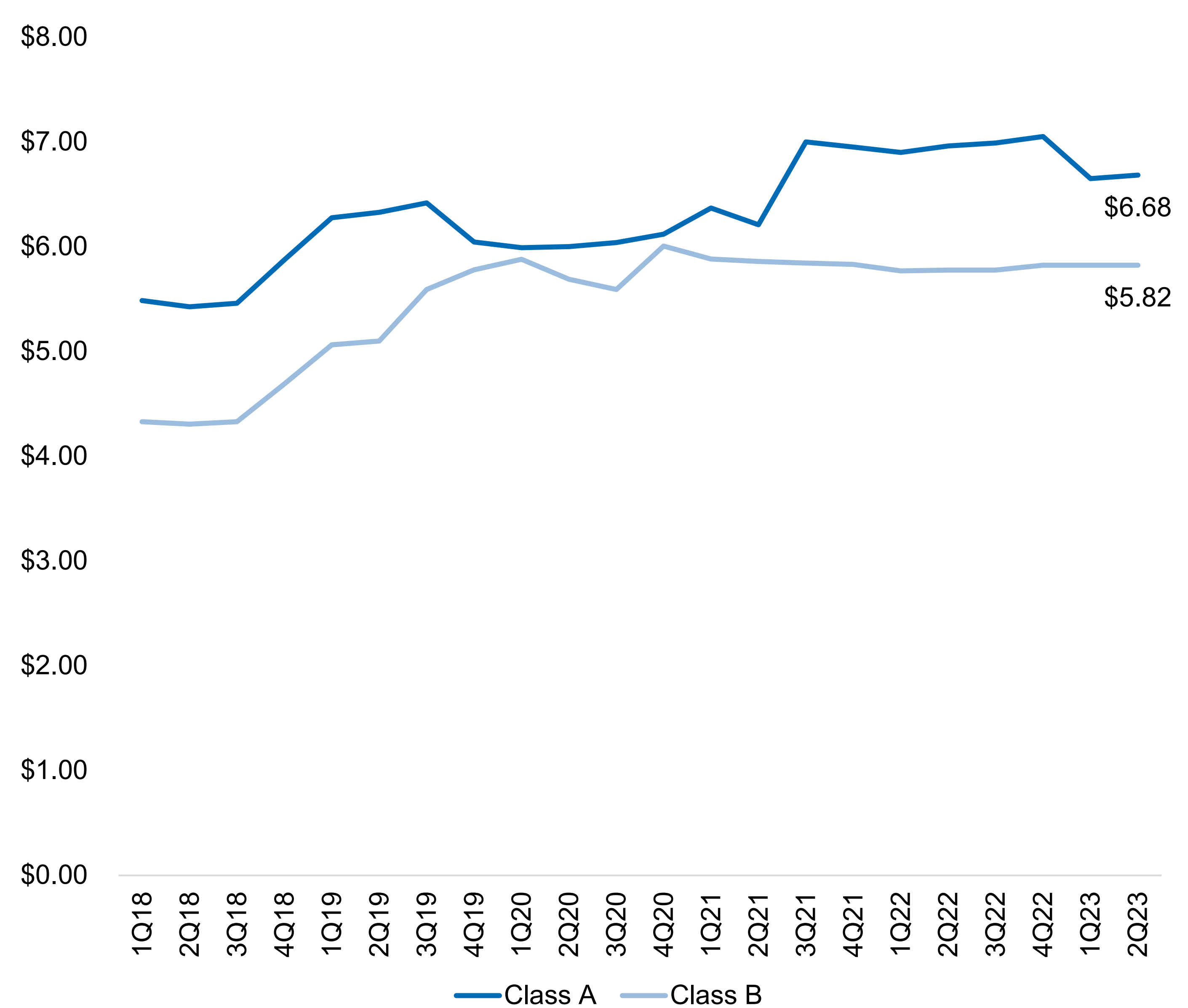


Source: Newmark Research, CoStar

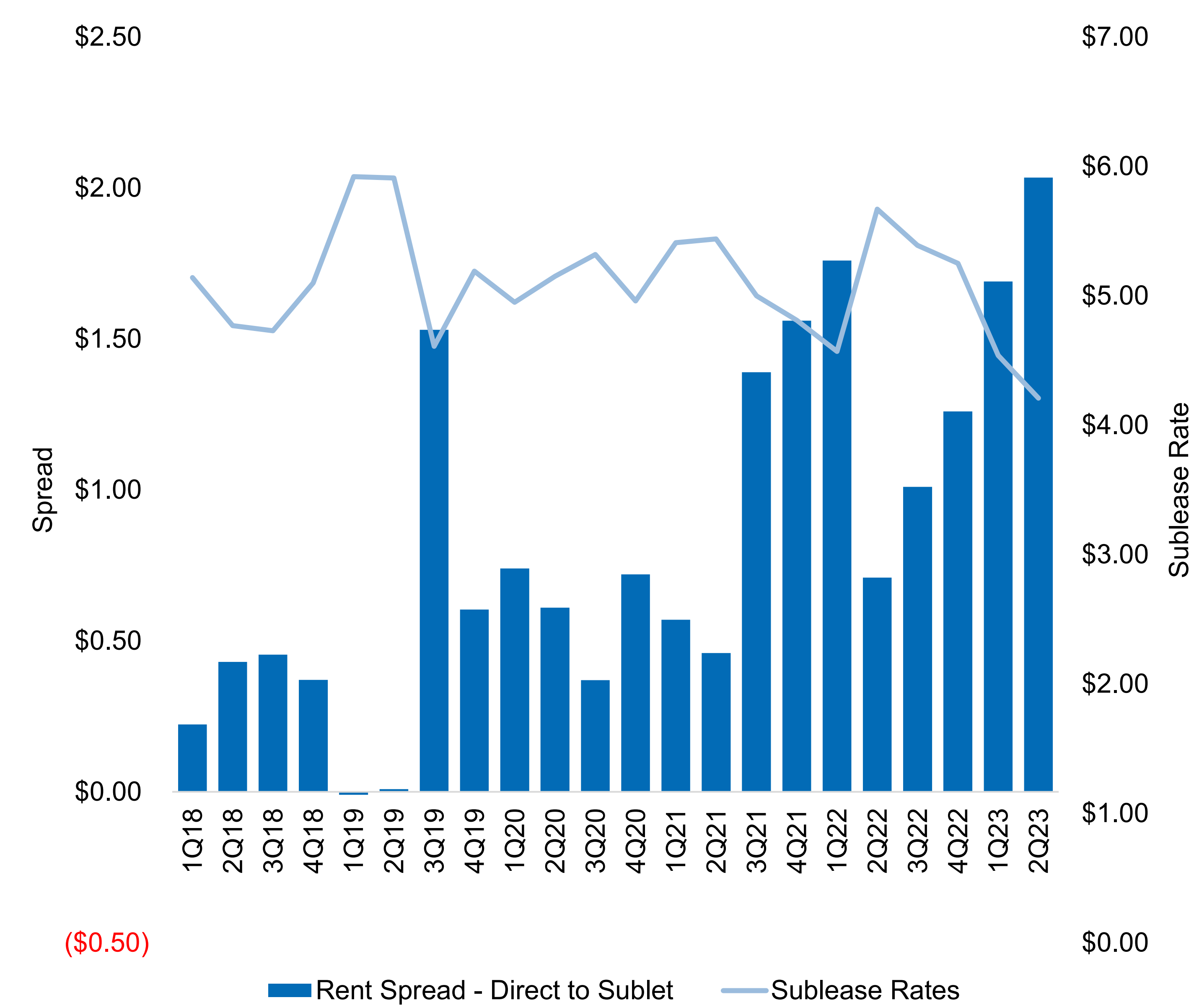
Asking Rents Remain High but Falling

Given the sharp increase in availability in the past years, the correction of lease rates in the South Peninsula market seems overdue. Historically, landlords have resisted asking rate adjustments in favor of concessions; however, that no longer seems to be the case going forward, and landlords have begun to bend on rates. Future rent adjustments are likely until the economy begins to recover.

Class A and Class B Asking Rents



Sublease Rates



Source: Newmark Research, CoStar

Leasing Activity Slows

Aside from Google's large renewal in Mountain View, leasing activity remains at a historically low level as tenants reassess their real estate needs, especially in the South Peninsula market which has historically commanded higher rents than the surrounding areas.

Notable 2Q23 Lease Transactions

Tenant	Building(s)	Submarket	Type	Square Feet
Google	1900-2000 Charleston Road	Mountain View - Shoreline	Lease Renewal	411,227
Lease renewal. Google renewed in 3 buildings (1900, 1950, and 2000 Charleston Rd) totaling 411,277 SF.				
Coinbase	391 San Antonio Road	Mountain View - El Camino Corridor	Sublease	40,000
Sublease. Sublessor: WeWork. Space was formerly leased to Meta on a coworking basis, but the entire sublet space is now being marketed as a traditional sublease.				
Ropes & Gray	525 University Avenue	Palo Alto – Downtown	Direct Lease	21,304
New lease. Ropes & Gray returns to their former space at 525 University after they left in 2008.				
Gunderson Dettmer	550 Allerton Street	Redwood City - Downtown	Direct Lease	14,886
New lease. This space was vacated by Chan-Zuckerberg Initiative, which moved to a newer building at 1180 Main Street, also in Downtown Redwood City.				
Foley, Lardner, Weissburg, & Aronson	525 University Avenue	Palo Alto – Downtown	Direct Lease	14,885
New lease. Despite tech pullback in the overall region, downtown areas remain popular among legal and professional service firms.				

Source: Newmark Research

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