Title
Strong California Economy Transforms The Office Sector

Permalink
https://escholarship.org/uc/item/2wr267df

Authors
Kroll, Cynthia
Howe, David

Publication Date
2000-09-01
Strong California Economy Transforms the Office Sector

Introduction

The California economy continues to outpace the nation, bringing employment growth to metropolitan areas throughout the state. With much of the growth spurred by “new economy” sectors such as multimedia and dot-com enterprises, this growth is increasing demand for office and industrial space, everywhere from the fringes of central city financial districts to more distant suburbs. Many of the state’s office markets have begun the 21st century with vacancy rates at record low levels and rents at record highs. An important question is whether this prosperity will continue, and if so, will the inflated prices remain. A related question is whether the transformation of the tenant base that has occurred in many of these markets will make permanent changes to the office landscape or will disappear in the next downturn.

Economic Strength is Widely Spread

California employment grew at an average annual rate of 3.2% over the first half of 2000. This was almost one percentage point over the US average of 2.3%, and 0.4 percentage points over California’s annual rate of growth in 1999, as shown in Figure 1. As in earlier years, services employment accounted for the bulk of jobs added to the state’s economy in the past year. Of the 440,000 jobs added (net) in the past year, 180,000 were in services, and half of the growth in services jobs was in business services.1 Real estate related sectors have also fared well in this continued expansion, with construction employment growing by an annual rate of 8.8% in the first half of the year (adding 57,000 jobs over the previous year), real estate services employment growing by 4.5% (8,700 jobs), and employment in retail sales of building materials up by 5.8%.

Throughout the state, the largest metropolitan areas show continued strength. Employment grew most quickly in suburban MSAs. The Riverside/San Bernardino area grew at an annual rate of 5.3% in the first half of the year, and the Vallejo-Fairfield-Napa MSA grew at 4.9%. While many of the large coastal MSAs grew at a slower than average pace, even the slowest growing (San Jose) expanded at a moderate rate of 2.1%, a recovery from an annual rate of 0.5% in 1999. Los Angeles, the largest MSA in the state, grew by an annual rate of 2.2%, and was the largest producer of net new jobs for the state, with an increase of almost 88,000 jobs from a year ago. (See Figure 2.)

Income and Wealth Continue Strong Growth

Growth in personal income has accelerated in California in 2000.

---

1 Business services include services ranging from personnel supply to advertising to computer and data processing. This latter category encompasses 24% of California’s business services employment and 1/3 of growth in business services in the first half of 2000.
Before adjusting for inflation, income rose at an annual rate of 7.5% in 1999, compared to 6.7% in 1998 and 6.2% in 1997. In 2000, income growth appears to be accelerating further. California Department of Finance quarterly estimates show nominal personal income in California growing at a 14.4% annualized rate in 1st quarter 2000 and at 10.5% in 2nd quarter 2000. Inflation rose to 3.7% in the 12 months preceding June 2000, compared with 3.2% during the June 1998 to June 1999 period. Price increases eroded the gains in growth in 1999 compared to 1998, but have not been so high as to bring real growth in 2000 back to 1998 and 1999 levels.

For California’s high-tech sectors, company values have risen even faster than income. The Pacific Technology Index reported by the Pacific Stock Exchange increased by 86% between October 1998 and October 1999, and by 65% between October 1999 and September 2000.

**Tight Labor Markets Characterize Much of the State**

California’s large MSAs have among the tightest labor markets in the country. Statewide, the unemployment rate, at 5.2% in June (not seasonally adjusted), remains a percentage point above the US rate of 4.2%. For many of the state’s large coastal areas, the rate of unemployment is significantly below the US average. The San Jose MSA had the lowest unemployment rate of all of California’s large MSAs, at 2.2% (down from 3.3% in 1999), as shown in Figure 3. The San Francisco and Orange County MSAs, at 2.4% and 2.8%, were also well below the US average, as were Oakland (3.2%) and San Diego (3.3%). Unemployment rates in Sacramento (4.4%), Los Angeles (5.3%) and Riverside/San Bernardino (5.6%) are above the US level, but remain quite moderate. Employee availability is so low in many San Francisco Bay Area counties in 2000 that employment growth may be difficult to sustain. In contrast, a more available labor force may be contributing to the strength of job growth in suburban California markets such as the Riverside/San Bernardino and Vallejo/Fairfield/Napa MSAs, as firms in San Francisco, San Jose and Orange County MSAs look for other sources of labor.

**The New Economy Reshapes Office Demand**

The major office-using employment sectors in California are finance, insurance and real estate (usually abbreviated as FIRE), business services, legal services, and engineering and management firms. Data is available from California’s Employment Development Department on all
four sectors for California, and on all but legal services for most of the state’s largest MSAs. Of these four sectors, business services is both the fastest growing and largest job producer. Employment dropped in both FIRE and legal services for several years during the past decade, and both the San Francisco and Oakland MSAs continue to lose FIRE employment in 2000, as shown in Figure 4. Business services growth accounts for over 100% of all office-type employment growth in the San Francisco and Oakland MSAs (because of job losses in finance, insurance and real estate) and for at least 85% of office tenant growth in the San Jose MSA. In contrast, other traditional office sectors, such as FIRE, play a significant role in tenant base growth in southern California office markets, although business services are the largest and fastest growing tenants in those markets as well. Computer and data processing, which accounts for almost one-fourth of business service jobs, is among the fastest growing segments of business services, expanding at an annual growth rate of 14.6% in 1999 and 11.4% in the first half of 2000. Strong employment growth in business services and the increasing importance of the high tech/computer based component of office-type employment is contributing to a resurgence and reshaping of office demand throughout the state.

New Records Set in the Office Market: Bay Area Vacancies Scraping Bottom

The office market is experiencing its strongest position since the early 1980s, in terms of vacancies and rent increases, with the core of strength in the San Francisco Bay Area. With the expansion built on the explosive growth of “new economy” multimedia and dot-com firms, questions are inevitable on the sustainability of current levels of demand and the long-term viability of newly emerging activity centers.

Average office vacancy in California has dropped from 10.3% in 1998 to 8.4% in 1999, and to 7.5% in 1st quarter 2000. The greatest drops can be seen in the San Francisco Bay Area markets, as shown in Figure 5. Over a 15-month period, office vacancies dropped from 8% to 1.3% in San Francisco (based on Cushman and Wakefield data), from 5.7% to 0.3% in San Mateo County, just south of San Francisco (CB Richard Ellis data), and from 6.3% to 1.7% in Silicon Valley (Grubb & Ellis data). A spillover in unmet demand brought vacancies down even more sharply in the Oakland/East Bay Shore market, with vacancies dropping from 13.2% in 4th quarter 1998 to 4.0% in 2nd quarter 2000, according to Cushman.
and Wakefield data.\(^2\) CB Richard Ellis data show the I-680 corridor, in the central East Bay, experiencing continued low vacancy rates, moving from 4% in 1998 to 3.6% in 1\(^{st}\) quarter 2000.

Southern California markets are also experiencing vacancy decreases, but the area has not returned to the tight conditions of the early 1980s, and vacancy rates remain well above the Bay Area market. On average, southern California vacancies were 11.6% in 1\(^{st}\) quarter 2000, compared to 2% in the San Francisco Bay Area. Grubb & Ellis data shows vacancies dropping in many southern California markets, with vacancy rates going from 14.9% (4\(^{th}\) quarter 1998) to 13% (1\(^{st}\) quarter 2000) for the large Los Angeles market, and from 21.2% to 16.7% in the Riverside/San Bernardino “Inland Empire,” as shown in Figure 6. At 9.5% in 1\(^{st}\) quarter 2000, Orange County rates were up from their 8.5% level in 4\(^{th}\) quarter 1998, but down from 10.1% in 4\(^{th}\) quarter 1999. CB Richard Ellis data show San Diego vacancies down in the last two quarters as well, dropping from 10% in 4\(^{th}\) quarter 1998 to 8.3% a year later, and to 7.4% in 1\(^{st}\) quarter 2000.

**Shifts in Supply of Office Space Address Growing Demand**

Data from commercial brokers on new space added to the market suggest that an estimated 16 million square feet of newly constructed space were added to California’s office stock in the past year. (Stock figures for leased office space change not only from new construction but also as buildings move into or out of the base because of changing occupancy type, demolition, or renovation.) Southern California had the largest share of the growth in office space, but the San Francisco Bay Area new construction is large relative to the existing base. Recent office building permit activity suggests that the San Francisco Bay Area could match southern California in new office construction over the next two years.

Adjusting for inflation, California office building permit activity for 1999 was 45% below permit levels in 1989, a decade earlier, and about 3% below 1998 levels. For southern California, office building permits have remained well below the levels of the late 1980s, as shown in Figure 7. The inflation-adjusted value of southern California office permits in

---

\(^2\)Cushman and Wakefield have redone their building inventory for the Oakland area during 2000, making the comparison with earlier periods less consistent than in other markets. Nevertheless, the drops suggested by the comparison here are consistent with other broker reports and trade journal discussions of the transformation Oakland is currently undergoing.
1999 was only 37% of the 1989 level, and 15% above the 1998 permit level. The San Francisco Bay Area, in contrast, had a 1999 office permit level almost 60% above 1989 building permit levels, but 22% below 1998 permit levels. While southern California dominated office building activity in the last half of the 1980s and the first half of the 1990s, San Francisco Bay Area office permit levels have come close to or exceeded southern California levels since 1995. This trend is continuing in 2000. For the first half of the year, Bay Area office permits were 10% above those for all of southern California. This interregional shift suggests a role reversal for the two regions as compared to the late 1980s. Office development was much more restrained in northern California in the second half of the 1980s than in southern California, contributing to the speed at which vacancy rates dropped in the San Francisco Bay Area over the past 15 months. With vacancies remaining above 10% in many of southern California’s major markets, building activity now appears to be more restrained in that region of the state. In the San Francisco Bay Area, permit numbers should be interpreted in light of two significant factors. First, the permit category for new office construction does not include other types of nonresidential space that have been converted to office space during this period. Second, 80% of the increase in Bay Area office permits in 2000 are from the City of San Francisco, which faces an upcoming vote on growth limits.

Despite the increased construction activity, especially in the San Francisco Bay Area, there is no immediate risk of overbuilding. For the past decade, with the exception of 1998, building levels have lagged absorption rates, as shown in Figure 8. Even the relatively high construction levels of the past two years remain well below new construction at the end of the 1980s. Longer-term risks are discussed at the end of this article in the Outlook section.

**Rents and Lease Terms Reflect Changing Demand Base**

Falling vacancies throughout the state have contributed to rent increases ranging from moderate in Sacramento to astronomical in parts of the San Francisco Bay Area. CB Richard Ellis reports a rental rate increase of approximately 5% in Sacramento office markets from 4th quarter 1998 to 4th quarter 1999, with an additional 3% rise in 2nd quarter 2000. Grubb & Ellis and CB Richard Ellis data show rent increases of between 7% and 12% in southern California markets. According to data from Cushman and Wakefield and CB Richard Ellis, rents in San Francisco and San Mateo rose by about 15% and 25% respectively during 1999. In the 1st quarter of 2000, rents rose another 25% in San Francisco and 50% in San Mateo. Class A asking rents in San Francisco now exceed New York City class A levels, according to Grubb and Ellis national figures. Silicon Valley rents are beginning to challenge San Francisco rent levels. The change occurred very quickly over the first half of 2000. According to figures from CB Richard Ellis, Silicon Valley Class A rents rose by 26% between 4th quarter 1999 and 1st quarter 2000, and again by 26% in 2nd quarter 2000, reaching an average of over $6/sq. ft. monthly. Even in the Oakland market, Cushman and Wakefield reports average asking rents of $37/sq. ft. annually for Class A CBD buildings, and $54/sq. ft. for Non-CBD space—a range that would have been high for San Francisco a few years ago.

The changing balance of supply and demand has also led to significant shifts in the structure of office leases. Questionnaire responses by brokers in the state’s major markets show that landlords are offering far fewer incentives to attract tenants, and instead are demanding much more in the way of security for new leases. The degree of this shift varies by

---

1 FCREUE annually sends questionnaires to representative brokers in the major office markets in California. As much as possible, the same offices are contacted each year, to build a consistent long-term series.
market area. Free rental periods have all but disappeared, except in Sacramento, where they are being used less frequently than in the recent past. Letters of credit and six-month tenant deposits are de rigueur in San Francisco and increasing throughout northern California, including the Sacramento area. In San Diego, letters of credit are required for some, but not all leases, and six-month deposits are rare, while in Orange County, both letters of credit and warrants are now used somewhat less frequently than in 1998. Landlords take advantage of warrant opportunities with some leases throughout the state. For most Bay Area markets, lease lengths have become shorter (with five-year leases becoming more frequent than ten-year leases over the past year). In other parts of the state, lease lengths remain unchanged, with both five and ten-year leases used.

Broker responses suggest that tenant improvement allowances have shifted less than might have been expected in the current leasing climate. Tenant improvement (TI) allowances in newly constructed space have increased somewhat in Silicon Valley. In downtown San Francisco, allowances remain among the highest in the state, at about $35/sq. ft. for newly constructed space. For second-generation space, improvement allowances typically declined in northern California, the exception being the I-680 corridor where allowances increased for both types of space. In Los Angeles, improvement allowances for both types of space increased, while in Orange County, TI allowances increased for new space and held steady for second-generation space.

New Economy Firms Drive the Growth in Demand

The rapidly tightening office market is explained by both the overall robustness of the economy, as described earlier, and by the transformation of certain sectors of the economy. Broker responses confirm that high tech sectors are playing a major role in the pressure for office space, particularly in the San Francisco Bay Area. All of the northern California markets report an increasing share of tenants in dot-com and other high-tech sectors. Multi-media firms are of growing importance in San Francisco and neighboring markets, as well as in Sacramento. For the most part, traditional office sectors such as FIRE and legal firms are unchanged or of reduced importance to these market areas. The growth in tenants shows a slightly different pattern in southern California, with multimedia firms playing a stronger role than dot-coms in the Los Angeles market, and many traditional tenants are continuing to compete with new economy firms as demand grows in the Orange County and San Diego markets.

According to broker responses, many of the new tenants in the San Francisco Bay Area market are in start-up firms. In the city of San Francisco, these firms are the primary source of growth in new demand, while growth of existing firms is also a significant source of tenants for Silicon Valley and the San Mateo market, and expansion of firms from other market areas influences the I-680 corridor market. In southern California, all three sources of growth are important to the expanding tenant base. The Sacramento Area reports growth coming primarily from startups and movers from other areas, rather than from local expansion.

The heavy mix of high tech firms and start-ups in California’s office market has helped to shape the lease rates and lease agreements being reached currently. Firms in early stages of growth, focused on expansion rather than a profitable operation, have proven to be much less price sensitive in looking for space than are the traditional office tenants. From the landlord’s point of view, many have found it prudent to try to profit from their tenant’s prosperity through negotiating warrants as part of the lease agreement while at the same time protecting their portfolio from the uncertain future of these firms through letters of credit and large deposits. The preference of these firms for a few prime sites is also reshaping regional markets. The Oakland CBD, for example, now looks very attractive to firms priced out of the San Francisco market.

Outlook

The high rents and low vacancy levels evident in the California office market raise questions about the impacts of current conditions on future economic growth and the sustainability of current levels of rent and vacancies. At one extreme are risks of firm displacement. High rents and lack of available space are already leading some firms to seek space outside of their preferred locations, either in nearby California markets or out of state. At the other extreme, shakeouts in the emerging multi-media and dot-com industries combined with expanding permit activity could lead to rent decreases or rising vacancies, particularly in the San Francisco Bay Area.

The risk of displacement is real. Firms without the benefit of venture capital funding are finding it difficult to compete with dot-com and multimedia firms in many California office markets. If rent increases prove to be long term rather than a short-term

---

4 Response was incomplete in this portion of our survey for the Oakland market area. However, business press reports also suggest that the exploding demand in this market is primarily due to dot-com and other high tech companies seeking available space, rather than to spillover of other tenant types to a less expensive market.
Figure 9
Office Market Regional Risk Matrix

<table>
<thead>
<tr>
<th>Market Area</th>
<th>Vacancies</th>
<th>Rents</th>
<th>Excess Planned Construction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt;15%</td>
<td>&gt;25%</td>
<td>Increasing 1998-99</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>0.5</td>
<td>0.6</td>
<td></td>
</tr>
<tr>
<td>Orange</td>
<td>✓</td>
<td>1.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Inland Empire</td>
<td>0.8</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>San Diego</td>
<td>0.7</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>San Francisco</td>
<td>0.4</td>
<td>0.4</td>
<td></td>
</tr>
<tr>
<td>San Mateo</td>
<td>0.8</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>San Jose</td>
<td>0.5</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Oakland</td>
<td>0.5</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>I-680 Corridor</td>
<td>✓</td>
<td>0.4</td>
<td>2.1</td>
</tr>
<tr>
<td>Marin</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Sacramento</td>
<td>✓</td>
<td>✓</td>
<td>0.7</td>
</tr>
</tbody>
</table>

* These ratios may be too high because EDD employment growth figures (the denominator) have a lag in incorporating data from new firms and because of pent-up demand where vacancies are low.

Source: FCREUE estimates.

spike, businesses reliant on the local customer base will look for nearby solutions (less desirable locations, smaller spaces), but those serving a broader market would be more inclined to relocate. The risk could be heightened if further restrictive measures on office construction are passed by voters in San Francisco this November.

The risk of overbuilding is less immediate, but should not be discounted in the longer term. Figure 9 summarizes some of the overbuilding risk factors facing the different regional markets. This year, the chart is almost blank — all of California’s office markets show few overbuilding risk factors. The few markets that have one or two significant factors also have significant mitigating factors.

In southern California’s Inland Empire, where vacancies topped 16% in 1st quarter 2000, vacancies are nonetheless falling, fueled by growth in office employment that is upwards of 8%. In regions where vacancies rose during 1999, they nonetheless remained in the 3-10% range during 1st quarter 2000, and all regions had lower vacancies in 2nd quarter 2000 than they did in 4th quarter 1998. Rents are growing faster than inflation in all market areas.

Brokers report almost 20 million square feet of space under construction in the first half of 2000. This is higher than 1999, but appears compatible with existing net absorption levels during the first half of the year. An exception to that rule is Orange County, where space added (close to four million square feet) is 20% above the annualized net absorption level. By way of comparison, average net absorption was about one-third of that in the 1995-1998 period, while during Orange County’s 1980-89 boom, average net absorption topped the 2000 estimate at 5.5 million square feet.

The ratio of projected growth in office stock* to the recent rate of growth in office employment is another measure of potential supply excess or shortage. This ratio exceeds one (showing potential excess space being added) in San Diego, San Mateo and along the I-680 corridor. In San Diego, this may lead to somewhat higher vacancies, although annualized net absorption during the first two quarters of the year exceeded projected growth in office stock. For the San Mateo market and possibly for the I-680 corridor, it is likely that the repressed employment growth reflects lags in measuring employment from new startups (and in the case of San Mateo, the inability to locate space in San Mateo), rather than any fundamental mismatch of supply and demand for space. In addition, vacancies are very low in these two markets, suggesting possible pent-up demand. Orange County, with a construction/absorption ratio of 1.2 and an office stock growth/employment growth ratio of one, can likely absorb current construction, but concern could arise if this rate of construction continues for several years.

Also of long-term concern is whether employment growth in the new economy is sustainable at current rates. As of this summer, dot-com business failures remained below the average for old-economy startups, as reported in The Economist, suggesting that most of the dot-com shakeout is ahead of us. Under these circumstances, the prevalence of six-month deposits and mandatory letters of credit is perhaps unsurprising.

Employment losses in dot-com and high-tech sectors could significantly drop occupancy in the state’s strongest office markets. The very low vacancy rates in the California office markets most at risk leaves some leeway should this occur. The Fisher Center is currently engaged in a study

* Roughly estimated as projected new construction as a percent of existing stock.
that includes both a survey of corporate real estate responses to current rents and vacancies, and an analysis of alternative futures of the dot-com sector in the region.

The greatest risk to the current office market is on the rent side. Even if they maintain a low failure rate, as firms move from a venture-capital fostered growth phase to operations focused on profit margins, they will become much more sensitive to space costs. Investors in new construction should take into account the likelihood that current rent levels are unsustainable, and that the heavily landlord-favored lease conditions could change quickly with a maturing or a downturn in the fortunes of California’s new economy companies.

Cynthia A. Kroll
David Howe

Our annual update on California’s office market could not occur without help from major commercial brokerage firms throughout the state. This year, CB Richard Ellis provided data for Sacramento, San Diego and the I-680 corridor; Cushman and Wakefield provided data for San Francisco and Oakland; Grubb & Ellis provided data for Los Angeles, Orange, the Inland Empire and Silicon Valley; and Orion Partners provided data for Marin. We also used CB Richard Ellis and Grubb & Ellis Web sites to supplement information for other areas.

How To Order:
Working papers may be ordered prepaid at the prices indicated, plus applicable tax. (Sales tax: Alameda County - 8 1/4%; California Bart area - 8%; other areas in California - 7 1/2%; out of state - 0. Checks should be made payable to Regents of the University of California. Mail payment and orders to:

Institute of Business & Economic Research
FCREUE Publications
F502 Haas School of Business MC#1922
Berkeley, CA 94720-1922

Recent Publications

00-270 Cynthia A. Kroll. “Expanding Economic Development Resources with the World Wide Web: The Case of CEDAR.” February 2000. ($5.00)


