Marcus & Millichap

Office Research Market Report

Second Half 2016

Oakland Metro Area

Affordability and Organic Business Growth Propel Oakland Office Market

Occupancy and rents reach record highs amid explosion of tenant demand. The Oakland office market is poised for another year of robust growth as a strong local economy and relative space affordability encourage corporate expansion and relocation. Soaring office prices in other parts of the Bay Area have left many firms eyeing Oakland as a lower-cost alternative. Several prominent tech companies have already made the trip across the Bay Bridge, headlined by Uber's announcement last year to relocate its corporate headquarters here. Many workers already live in the East Bay and commute to San Francisco and San Jose, easing relocation pains. However, not all growth is simply the product of San Francisco overflow. Firms that already have a presence in the metro and homegrown startups are expanding. A severe lack of office construction amid the flurry of demand has sent vacancy spiraling. The metrowide vacancy rate is down 580 basis points in the past five years and is dropping. Businesses are penning leases for all types of space with vacancy improvements occurring in nearly every submarket and across all property classes. Overwhelming tightness has resulted in robust rent growth with lease rates expected to top the pre-recession peak by more than 18 percent this year.

Out-of-town investors look to capitalize on Oakland office boom. Easy access to financing coupled with sound property fundamentals will fuel demand for Oakland office investments. The risk of being outpositioned is low as the high cost of construction and a lack of affordable land will keep office development somewhat subdued. These factors together with low borrowing rates have spurred investor bullishness. The majority of buyers are located in California, although out-of-state money is becoming a more prominent force. Overall, deal volume is surging and prices are rising, placing downward pressure on cap rates. The average first-year return compressed to the low- to mid-6 percent range with properties in downtown Oakland commanding a 100-basis-point premium. Out-of-market institutional groups will often target these larger, more expensive assets in the urban core.

2016 Annual Office Forecast

3.0% increase in total employment

Employment:

Following a job gain of 2.8 percent in 2015, the Oakland workforce will grow another 3.0 percent this year through the addition of 33,000 positions. Office-using employment will grow 2.1 percent during the same period.

319,000 sq. ft. will be completed

Construction:

Office development will start to pick up after years of inactivity. Builders will complete 319,000 square feet of space in 2016, nearly tripling the delivery total last year.

70 basis point decrease in vacancy

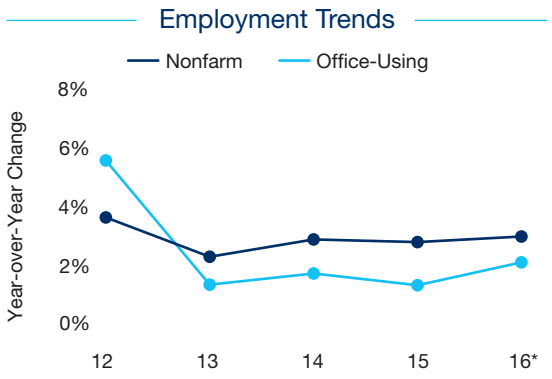
Vacancy:

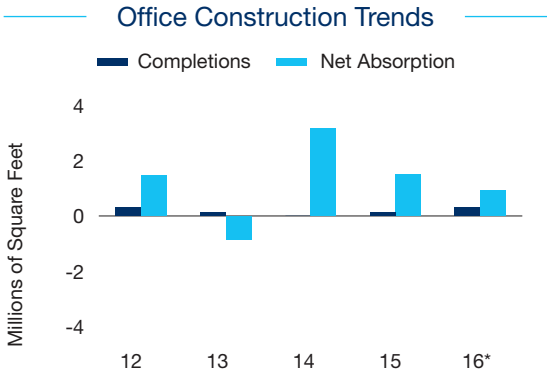
Positive net absorption of nearly 920,000 square feet will drive the metrowide vacancy rate down 70 basis points this year to 10.6 percent. In 2015, the metro recorded a vacancy contraction of 140 basis points.

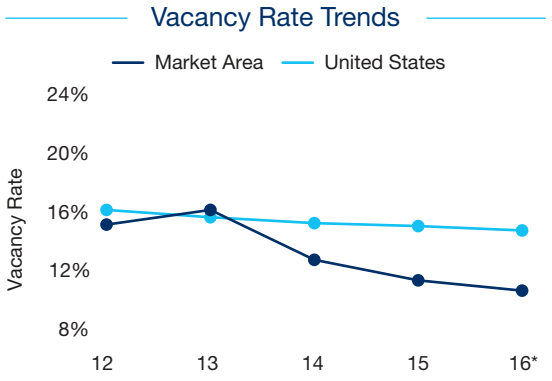
9.2% increase in asking rents

Rents:

Further market tightening and a lack of office development will sustain the rapid rise in rents this year. The average asking rent will advance 9.2 percent in 2016, reaching $31.17 per square foot. A rent gain of 9.0 percent was posted last year.







* Forecast

Economy

- Oakland organizations hired 22,400 workers through the first seven months of the year, representing an expansion 2.0 percent. On a year-over-year basis this equates to workforce gain of 2.9 percent.
- Building firms are padding payrolls as construction projects commence throughout the East Bay. In the last 12 months ending in the second quarter, the construction sector registered employment growth of 7.4 percent on nearly 4,600 new hires. The education and health services sector also performed well, adding more than 6,300 positions during the same period.
- Sitting at 4.3 percent in June, the Oakland unemployment rate is well below the national average and at the lowest point since 2000.

Outlook: Following a job gain of 30,000 workers in 2015, the local workforce will expand 3.0 percent this year through the addition of 33,000 employees. Office-using employment will jump 2.1 percent.

Construction

- After no deliveries between mid-2013 and late 2015, office development has picked up. In the last four quarters ending at midyear, the market received more than 178,000 square feet of office space.
- Completions were dominated by 740 Heinz Avenue. The 110,000-square-foot office project is designed as a flex-use, life science research and development building. Located in the Aquatic Park Center in Berkeley, the development was far and away the most significant East Bay office project in the past 12 months and was finalized in September of 2015.
- There is approximately 483,000 square feet of office space under construction with completion dates stretching through 2017. Locations where development is underway include Emeryville, San Leandro East of 880 and the Hacienda Business Park.

Outlook: Completions will total approximately 319,000 square feet in 2016, more office development than the last three years combined. In 2015, builders brought more than 110,000 square feet to market.

Vacancy

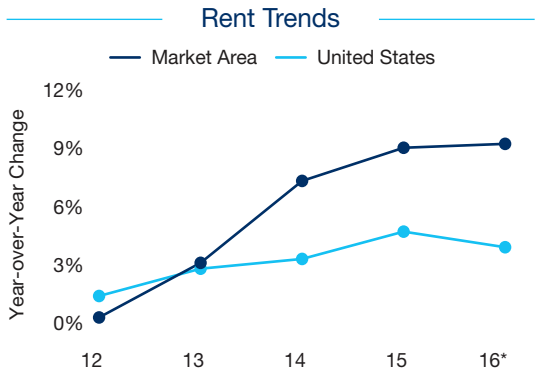
- Net absorption in excess of 1 million square feet enabled a vacancy contraction of 90 basis points in the past four quarters, reaching 11.2 percent at midyear. In the prior annual period, vacancy plummeted 260 basis points.
- The vacancy rate in the Class A segment dropped 90 basis points in the past year to 11.5 percent in June. During the same time frame, the Class B and C market saw rates fall 100 basis points to 11 percent.
- Three East Bay submarkets boast single-digit vacancy. The city of Oakland area is the tightest of these with a vacancy rate of 8.1 percent in the second quarter, down 110 basis points from year-earlier levels. Conversely, 880 Corridor is the least occupied submarket with vacancy at 14.7 percent.

Outlook: Overwhelming demand of Oakland office space will persist in 2016 with vacancy poised to fall 70 basis points to 10.6 percent. A vacancy decline of 140 basis points was recorded last year.

Rents

- The average rent for East Bay office space surged 11.9 percent in the last 12 months, the strongest four quarters of rent growth on record. Marketed space averaged $30.50 per square foot as of June. During the same time span a year earlier, rents climbed 8.1 percent.
- Class A space experienced a sharp run up in rents. The average asking rent in the Class A sector jumped 17.9 percent year over year, reaching more than $40 per square foot in June. Class B and C offices saw rents advance 8.5 percent to $26.32 per square foot.
- The tight Oakland City submarket commands the highest rents, charging $36.77 per square foot for marketed space in the second quarter, up significantly from a year earlier. The Highway 4 and 880 Corridor submarkets offer the most affordable space with average asking rents at $18.75 per square foot and $21.73 per square foot, respectively.

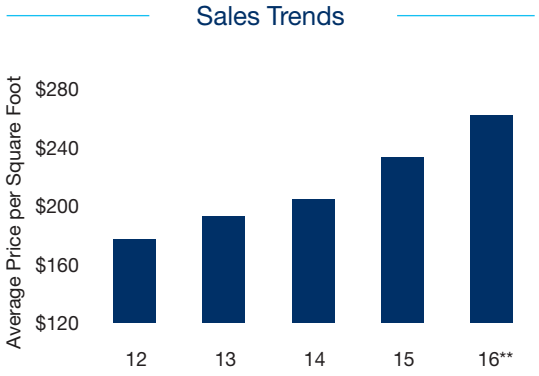
Outlook: Following a 9.0 percent increase in 2015, the average asking rent in the East Bay will rise another 9.2 percent this year to $31.17 per square foot.



Sales Trends**

- Transaction velocity jumped more than 50 percent in the last 12 months led by a tripling of deal volume in the city of Oakland. In the prior 12-month period, trading was flat, showing no increase or decrease.
- Intense demand for East Bay offices is igniting price appreciation. Following a double-digit increase in 2015, the average price jumped another 18.3 percent in the last 12 months to more than $260 per square foot in June.
- The rapid rise in pricing has pushed the average cap rate down 50 basis points in the past year, reaching the low- to mid-6 percent range. First-year returns still remain a solid 50 basis points above pre-recession levels.

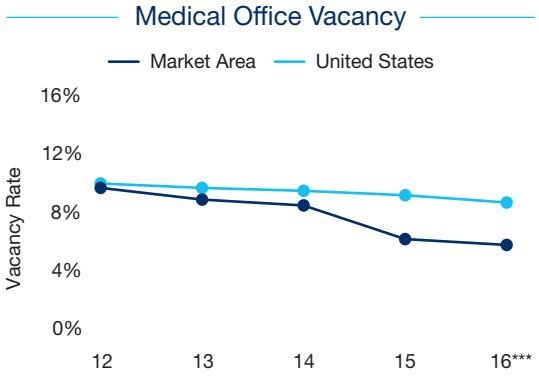
Outlook: The flood of capital searching for a home in the East Bay office market shows no signs of slowing. As companies and residents alike flee exorbitant rents in San Francisco and San Jose, the demand for Oakland office space will continue its upward trajectory.



Medical Office***

- Medical office construction has been scarce in the past few years. One medical office project was completed thus far in 2016. EcoVive West is a 10,000-square-foot environmentally sustainable medical office development in Lafayette.
- The lack of substantial development amid healthy demand has pushed vacancy down 200 basis points in the last four quarters to 5.7 percent in June. The metrowide vacancy rate is at the lowest level since early 2005.
- As of the second quarter, the average asking rent for East Bay medical office properties is $26.29 per square foot. Although current rent levels are down from a year ago, the leasing up of expensive Class A space amid a static inventory is likely the reason rents for marketed space have fallen.

Outlook: Ultra-tight vacancy rates and the stability offered by medical tenants have bolstered demand for medical office assets. Deal volume has greatly accelerated in the past year and prices have taken off. In the last 12 months, the average price crossed the $300 per square foot threshold.



* Forecast
** Trailing 12-month period through 2Q16
*** 2Q16
Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The 10-year U.S. Treasury has been trading lower, closing below 1.7 percent, since the Federal Reserve decided to leave the federal funds rate unchanged in September. Policymakers left the door open for a rate increase before the end of December and proposed how interest rates could rise over the coming years. The S&P 500 Index and other U.S. equity indexes continue to hover around all-time highs.
- The Federal Open Market Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities and rolling over maturing Treasury securities at auction. It anticipates doing this until normalization of the level of the federal funds rate is well underway. The committee anticipates holding longer-term securities at sizable levels should help maintain accommodative financial conditions.
- Interest rate volatility has moved over to the commercial loan markets and 10-year fixed-rate loans are now pricing between 3.9 and 4.4 percent. Loan to values range from 60 to 75 percent for commercial properties depending on location, as underwriters remain competitive in an effort to do business. Floating-rate bridge loans for stabilized assets will require LTVs of 70 percent and price with a spread between 275 and 425 basis points over Libor, while repositioning will be underwritten at 80 percent LTV with a 375- to 475-basis-point spread.
- A Federal Reserve survey of lenders indicates that commercial real estate loan standards tightened in the second quarter. Debt providers are likely seeking to balance risk exposure to commercial real estate and take a more conservative lending approach while the current cycle matures, rather than expressing a bearish outlook on commercial property. Some of the greatest tightening occurred for construction loans, a trend that may potentially prevent some early-stage developments from advancing and ultimately minimize the upward pressure of new supply on vacancy rates.

Local Highlights

- Wells Fargo has recently announced plans to take new space in Concord. The international banking giant will occupy 282,000 square feet of office space at Swift Plaza, a business center off Galindo Street and Clayton Road. Wells Fargo is consolidating its East Bay operations at the site, vacating an 81,000-square-foot office in Oakland.
- The largest office project under construction is EmeryStation West, an infill laboratory/office tower located just north of the Emeryville Amtrak Station. Upon completion in 2017, the 260,000-square-foot development will replace two existing surface parking lots and will offer ground-floor space for transit, retail and/or office uses.
- The broader Oakland metro is benefiting from improving demographic metrics. The levels of population growth and household formation exceed the national rate as people flock to the East Bay for job opportunities and housing affordability. The total population will expand 1.1 percent in 2016 with the cohort of 20- to 34-year-olds growing 1.4 percent. Additionally, the median household income is approximately 48 percent higher than the national level with East Bay residents taking home an average of $84,850 annually.