GREI (Global Real Estate Investor Club)
Dynasty Restaurant, 10123 N. Wolfe Road, Cupertino
Saturday, December 6, 2014
Speak 10:30 for 60 min
Contact: Carl Yeung 510-501-2248 yeung.carl@gmail.com

Lawrence E. Stone, Assessor

We have emerged fully 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 property type.

APARTMENTS

The Silicon Valley apartment market is on fire! Vacancies have declined and rents have risen. In San Jose, the average rent for a two-bedroom apartment is $2,300 a month. The apartment occupancy for Silicon Valley stands in excess of 96%. There's been nearly six years of strong and steady performance for the multi-family sector.

An article earlier this year in Multifamily Executive Magazine listed San Jose as the number one apartment "boomtown" in the U.S., which has raised some concern about potential overbuilding in Silicon Valley. Rents have climbed so fast that concern for affordability has come into play.

Since the end of 2012, 10,000 new apartment units have been approved, are under construction or have been completed in San Jose alone, and another 5,000 units in the South Bay. Apartment demand is directly related to job growth, and we are leading the nation in job growth.

Unemployment dropped to 5.2% in the region, lower than the state at 7.3% and the nation. The South Bay non-farm employment base grew by 2.3% from July 2013 to July 2014—an increase of 22,000 jobs, surpassing peak pre-recession employment levels by 6%.

Sales of high-tech products increased 30% in 2013, and smart phones and tablets accounted for 43% of all tech sales. During the same period, however, PC sales declined 11%.

The two largest apartment rental groups are Baby Boomers and Millennials. Each generation has its own unique lifestyle, habits and demands.

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. So many don't consider homeownership as an investment that automatically appreciates in value.

No age group was more deeply impacted by the recession than the Millennials.

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.

It's called the 24-hour community, 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, collaboration and the convenience of public transportation are high on the preference list of younger folks.

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.

SINGLE FAMILY

The single family market was slow to recover out of the recession, but has really caught fire. The combination of overbuilding and easy money, created a perfect storm that dragged an already weak U.S. economy into its greatest recession since the Great Depression. In Silicon Valley, values declined during the recession by as much as 60% in some geographic areas. Condominiums and townhouses were especially hard hit.

A prime cause of the financial meltdown in 2007-08 was subprime, low-down-payment mortgage lending to marginally qualified borrowers who defaulted when the housing market collapsed, sticking financial institutions with securities full of junk loans.

Fast-forward to today. The median price of single family homes in Santa Clara County increased 9 percent from September 2013 to September 2014, and 17 percent a year earlier. Condominiums, which were hardest hit during the downturn, increased 12 percent during the same period and 20 percent a year earlier.

For-sale inventory is down, so there's too much money chasing too few homes. The Mercury News reported last Sunday that a 1,100-square-foot, 2-bedroom, 1-bath home in Cupertino sold for 1.4 million dollars.

Multiple offers with sales above the asking price, however, are declining, reflecting a more normal residential market. The foreclosure crisis is behind us.

However, there are wide differences by geographic area. South County, Gilroy, and Morgan Hill were hit hard during the recession. Property values in Gilroy are up 24% and Morgan Hill up 19% as of January 1, 2014, leading all cities in Santa Clara County. Lots of expensive homes are being purchased by newly wealthy high-tech workers and oversees buyers, particularly from Asia.

The single family housing market has been impacted by all-cash buyers. Foreign investors are playing an expanding role in the residential market, including single family homes, condos and even apartments.

The Chinese are investing heavily in residential real estate in California. Some of it is "flight capital" from Latin America and Europe where investors are looking for increased safety.

There is a latent risk when investors, rather than individual home buyers, purchase residential property. Investors need an exit strategy, and they tend to move out of an investment about the same time. That can have an unsettling effect on the residential marketplace in the future.

The one predictable indicator for single-family residential property in Silicon Valley is schools. Neighborhoods with excellent schools experienced fewer declines in market value during the recession. These same neighborhoods are experiencing greater increases in market value during the recovery.

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 10 new office buildings on that same 10-mile drive. Mountain View, Sunnyvale, Santa Clara and north San Jose have experienced significant office leasing activity during 2011, 2012, 2013 and into 2014.

The Silicon Valley Business Journal reported that Silicon Valley posted 14 consecutive quarters of positive office leasing activity, the longest stretch since the "dot-com boom."

In the final half of 2014, Silicon Valley recorded net absorbtion of 1.3 million square feet of office space, and one million square feet of new office construction. Silicon Valley had the third-highest increase in office rents, trailing only San Francisco and New York. The fundamental question is: Has the office market out-priced itself?

Historically, the office market activity is far more robust in north Santa Clara County than in San Jose. Tech companies are reporting record profits, and Silicon Valley is the most productive region on the planet.

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 2013, the average space a company needed for each employee declined sharply, from approximately 225 square feet to just 150 square feet, and that trend is expected to continue.

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

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 contact and collaboration.

WAREHOUSE AND INDUSTRIAL SPACE

I'm bullish on the industrial market. Vacancy countywide is a modest 4.6%. The industrial market was also not overbuilt during the period leading up to the Great Recession.

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 in 2016, is also having an impact on the location of warehouses and factories. The expanded canal will allow easier access to ports in New Orleans, Miami and Houston, which could negatively affect West Coast ports.

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.

According to the latest numbers from the U.S. Bureau of Economic Analysis, the California economy has grown at 16.5% over the last ten years, and 4.3 percentage points of that growth can be attributed directly to California manufacturing. Looked at another way, more than one-quarter of the state's economic growth in the past decade has been due to this one industry.

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 October San Jose Hotel Occupancy Report, covering 14 hotels, shows occupancy at 81 percent, and occupancy of the 7 downtown hotels was 85.5 percent.

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.

Hopefully, as the economy continues to recover, and corporate travel budgets increase, the hotel industry will benefit from increased demand. However, technology (video and teleconferencing), is providing a viable alternative to expensive and often unproductive travel.

On the consumer side, lower levels of discretionary spending will have a moderating effect, particularly on high-end, expensive hotels.

RETAIL SECTOR

The one sector that has been slow to recover is the retail sector. 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 upon 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 6% of all retail sales, while 50% 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 has recently opened its first retail store in Manhattan.

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.

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

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 posted $1.3 billion in online sales in 2013, and they project half of their total sales in 2014 will be generated online.

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. Many retailers are offering smaller store prototypes. Wal-Mart is testing much smaller convenience-sized stores.

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.

It truly has become survival of the fittest as the name-brand retailers like Circuit City, Mervyns, Blockbuster, K-Mart, Border's Books, Loehmann's and Linens 'N Things continue to disappear. Sears, JC Penney, Staples, Office Depot and Radio Shack are closing hundreds of stores, and Best Buy is reported to be in financial trouble. What's this world coming to… even Hooters has closed some restaurants.

Excess Space reported that 2,600 retail stores closed in 2013, and the company projects 6,000 more will close this year. These do not include bankruptcies.

Retail sales exploded as homeowners used second mortgages to take equity from their homes and purchase consumer goods and services. Well, tightened lending requirements and the experience of the collapse of the residential real estate market has cooled that game.

CONCLUSION

Led by the stock market in which the Dow Jones has gone from 6,500 to ________ yesterday, the national economy has stabilized, and Silicon Valley is a national leader for this recovery.

The NASDAQ increased 53 percent since January 1, 2013, and office and R & D rents in Silicon Valley generally follow the NASDAQ.

Silicon Valley registered 15,000 patents, and immediately following a new record for exports set in 2013, California's exporters again posted strong growth numbers in September, according to Beacon Economics' analysis of foreign trade data reeased by the U.S. Commerce Department. The state's merchandise export trade in September increased 4.6% from exports recorded in September 2013. The exports of manufactured goods rose by 5.1% over the previous year.

Venture capitalists invested $8 billion in the South Bay last year, and two-thirds of all VC investments went to software companies. Our region accounted for 42 percent of venture dollars invested in the world between April and June of this year—the most invested since 2000.

Again, this raises the question whether the Bay Area is in the midst of another venture investment bubble. Silicon Valley had 20 IPO's in 2013, and more Silicon Valley companies are proceeding with IPO offerings this year, which is an excellent indicator that Silicon Valley has a big role in the solid recovery.

So, I believe we have risen from the depths of the bottom of the worst economic decline in my lifetime.

While the general outlook is positive, there are significant areas of concern. The wildcards for 2015 include:

A. Continued dysfunction and gridlock in Washington, D.C. and, to a lesser extent, in Sacramento.
B. Sequester continues to be a cloud hovering over the U.S. economy.
C. Interest rates: Some economists believe we are sitting on an interest rate timebomb. Now that the Fed has stopped purchasing $40 billion in bonds per month, interest rates are expected to increase gradually, and cap rates usually follow.
D. IP theft costs the U.S. economy $300 billion and 1.2 million jobs last year. Many believe Target is just the beginning of electronic penetration by "hackers" in committing cyber-crimes.
E. 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.
F. Federal fiscal and monetary policies and political chaos can cause the U.S. economy to once again spin out of control.
G. And in California, the drought can have major consequences for our economy.

QUIZ TO DISPEL SOME MYTHS

How many of you have heard the claim that California is in decline? That California is:

A. Unfriendly to business.
B. Has high taxes.
C. Over-regulates business.
D. Business are leaving the state for Texas, Arizona, etc.

All nonsense.

- California is the 8th fastest-growing economy.
- California added 340,000 jobs last year (the same as Texas).
- California constantly outpaces the U.S. in economic growth, and is leading the nation's economic recovery.
- Jobs lost during the recession have been completely restored.
- While California does have some of the highest business tax rates, what businesses actually pay in taxes is a little bit above the middle of the 50 states.
- California property taxes are among the lowest of states that have property taxes.

- Joint Venture Silicon Valley tracks businesses leaving California annually. Joint Venture reports there is no evidence that California is losing companies or jobs to Texas or anywhere else.

How many of you have heard the claim that the federal debt is killing the national economy?

Again, nonsense:
- The federal debt is actually declining dramatically, from $1 trillion dollars to $400 billion.
- During Ronald Reagan's presidency, the federal debt was 4% of the GDP.
- Today it is 2% of the GDP.
- TARP bailout of the banking system, Congress budgeted $750 billion. $573 billion spent invested or loaned. U.S. $25 billion profit.