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STRATEGIC INSIGHT

Why Invest in Global Real Estate Securities?

By Lee Menifee
Director

Question: How can you gain exposure to institutional property in nineteen countries across four continents?

Answer: There are more and more international commingled funds out there, making it possible for institutional investors to begin increasing their offshore property holdings. As demonstrated in the *Investment Research Quarterly* article, "Should Investors Cross Borders?"[1], direct investments in international property markets provide competitive returns to the U.S., plus valuable diversification benefits.

Wait, what's that? You want to gain exposure to international real estate…tomorrow? And you want liquidity *plus* current income? And the ability to quickly shift allocations to different regions?

In that case, **Answer:** Global real estate securities.

The Global Real Estate Securities Market Is Expanding

Global real estate securities have grown substantially since 1990. As shown in **Exhibit 1,** the free float market capitalization of the EPRA/NAREIT Index[2] has grown from $130 billion in 1990 to $415 billion as of September 2004. This growth has taken place in two main periods. The hyper growth period from 1993 to 1998 was fueled by booming IPO activity. This was followed by a contraction

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[1] Second quarter 2003 (volume 8, issue 2)

[2] The EPRA/NAREIT Index is jointly owned by the European Public Real Estate Association (EPRA), the National Association of Real Estate Investment Trusts (NAREIT), and Euronext Indices. The Index is structured to track trends of institutional-grade real estate stocks in North America, Europe and Asia, including companies that own, develop and trade income-producing commercial property. It does not track the performance of real estate services companies including those primarily engaged in services such as property management, financing, or of holding companies.

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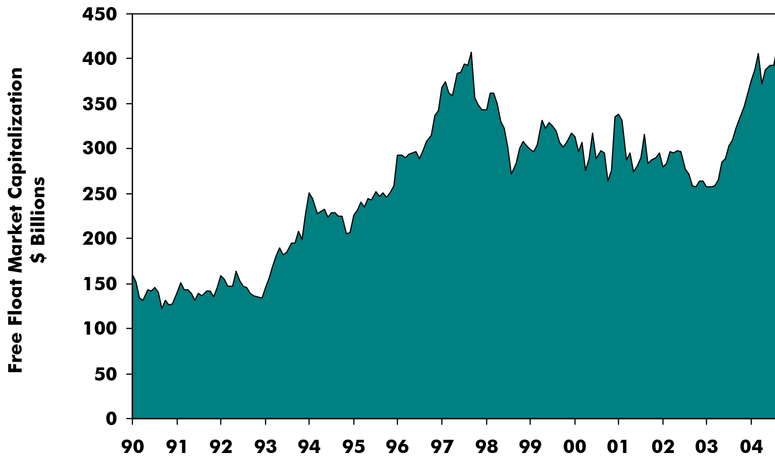
Exhibit 1
Real Estate Securities Market Capitalization Has Boomed



Source: EPRA/NAREIT Global Property Index

sparked in part by the Asian currency crisis. During the period since 2002, strong price appreciation combined with new offerings has caused the value of global securities to soar by over $150 billion.

The higher market capitalization of the global real estate securities market is substantially increasing liquidity. Until recently, in many countries, real estate securities were such a small component of their local stock markets, and so thinly traded that investors were reluctant to commit substantial capital to them. As their market capitalization has increased, so has institutional investors' willingness to take meaningful positions in them.

The U.S. is the largest real estate securities market in the world, as illustrated in **Exhibit 2**, with a 53% share of the EPRA/NAREIT Index. Asia/Pacific countries comprise 25% of the Index, led by Japan (9%) and Australia (8%), European countries account for 20% of the total, led by the United Kingdom (10%). Real estate investment trusts (REITs) and similar tax-efficient entities account for approximately three-quarters of the 250 companies in the Index.

Global Real Estate Securities Improve Risk-Adjusted Returns

Global real estate securities improve portfolio performance in three interrelated ways:

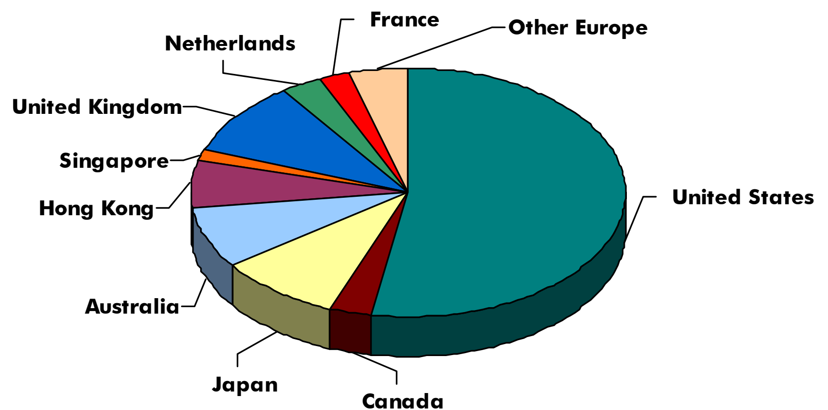
1) Returns are competitive with other asset classes.

Publicly-traded real estate operating companies as measured by the UBS Global Property Investors Index[3] have outperformed global stocks and government bonds, providing double-digit returns over one-, three-, five- and ten-year periods, as shown in **Exhibit 3**. Real estate securities have been among the strongest performing asset classes over the past year not just in the U.S., but also in the United Kingdom, Hong Kong and Japan.

2) Real estate securities reduce portfolio risk.

Real estate securities differ from most other equities in an important way: a substantial proportion of their total return is derived from dividend income. The high income component is the reason global real estate securities returns are less volatile than other equities[4], as shown in **Exhibit 4.** Income yields are generally above 5%, and historically higher in some countries including the U.S. The combination of high income and the potential for appreciation provide real estate securities with a risk profile higher than bonds but lower than other equities.

Exhibit 2
Nearly Half of Real Estate Securities Are Outside the U.S.

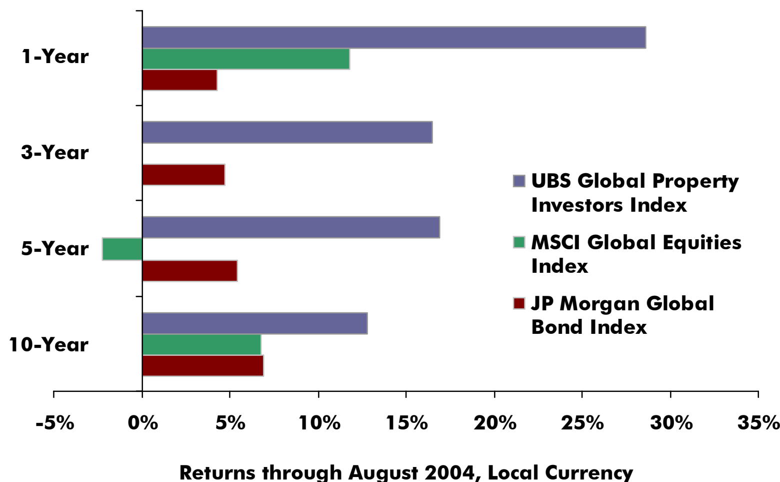


Source: EPRA/NAREIT Global Property Index

[3] The UBS Global Property Investors Index measures the performance of companies that derive their revenue primarily from rental income, i.e., excluding developers and contractors. The companies in the Index are a subset of those in the EPRA/NAREIT Index.

[4] Global real estate securities' lower standard deviation versus global stock indices makes real estate securities rare among subsets of the global stock market, since volatility is generally higher for industry-specific sectors.

Exhibit 3
Global Real Estate Securities Returns Have Been Attractive



Source: UBS; Morgan Stanley; JP Morgan

Global Real Estate Securities Provide Significant Advantages vs. Local Securities

The concept of global investing in real estate securities is relatively new; until the last decade, most investors chose to focus on property securities in their home markets due to the perceived risk, unfamiliarity, and lack of appropriate international investment vehicles. But a variety of factors have caused investors to cross borders, especially the availability of higher income yields. Currency and other perceived risks of international equities have historically deterred some investors[5], but the opportunity to invest in higher yielding securities outside their borders is becoming easier and more accepted.

Attractive yields are not the only reason investors are increasingly comfortable with global securities. There are three significant additional advantages to accessing global real estate markets:

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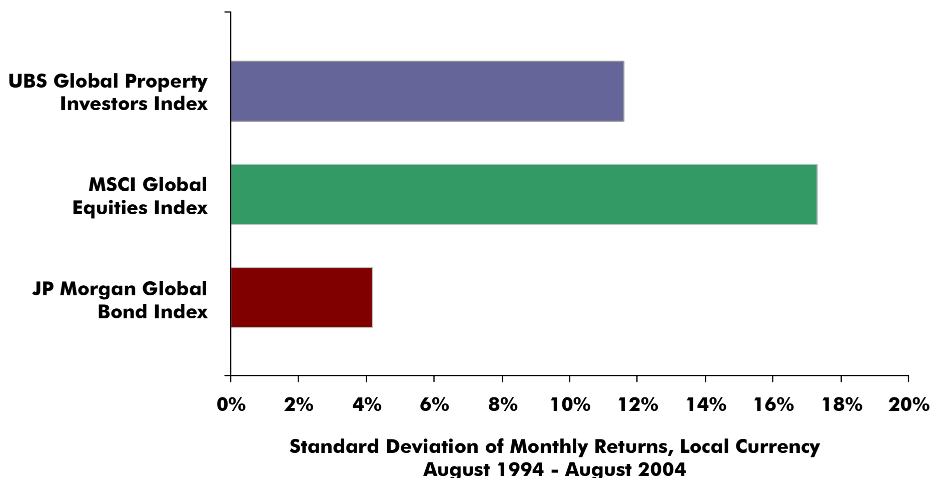
3) Real estate securities provide valuable portfolio diversification.

Modern portfolio theory demonstrates that the optimum portfolio is comprised of assets that have low correlations with one another. Global real estate securities behave differently than other stocks and bonds, and the correlations have fallen substantially since the mid-1990s, as shown in **Exhibit 5**. Because they have a low correlation with those other asset classes, real estate securities provide positive diversification benefits.

Total returns from global real estate securities have been favorable over the past decade. Notably, a substantial component of that total return was provided by dividend income that generated a steady stream of cash to investors, thereby reducing volatility. Portfolio diversification is greatly enhanced with the addition of global real estate securities.

Exhibit 4
Global Real Estate Securities Are Less Volatile than Stocks



Source: UBS; Morgan Stanley; JP Morgan; CBRE Investors calculations

[5] A globally diversified portfolio is less exposed to currency risk than investments in a single country or region, since by definition a drop in one currency is accompanied by a rise in another.

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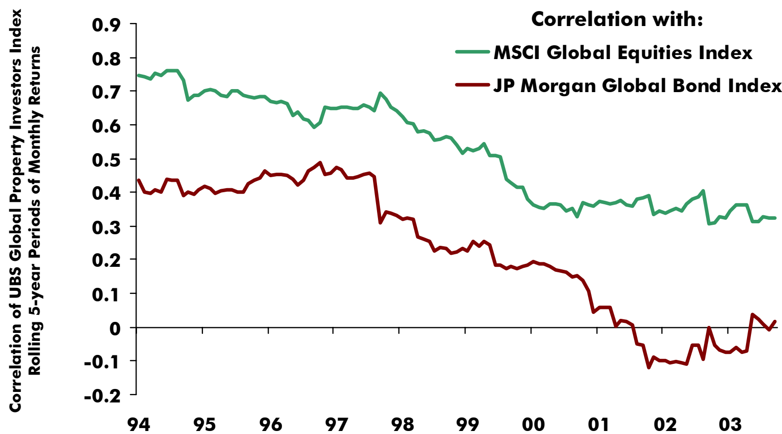
Exhibit 5
Global Real Estate Securities Are Becoming Less Correlated with Stocks and Bonds



Source: CBRE Investors calculations

1) Global real estate securities provide better diversification than individual regions and countries.

Real estate securities in individual countries and regions tend to provide similar total returns over the long-term, but perform differently over shorter periods. For example, correlations between real estate securities returns in the four largest markets – the United States, United Kingdom, Japan and Australia – were low since 1990, as shown in **Exhibit 6.** It's also true that even within regions, real estate securities act differently: the correlation between securities in Japan and Australia was only 0.09 over the period. Asynchronous regional trends mean that correlation between regions is low. And low correlations increase the diversification benefits of a globally diversified portfolio of real estate securities.

2) The expansion of REIT legislation to new countries is enhancing short-term returns.

Legislation to create public REITs and similar tax-efficient entities is expanding to new countries. This is important because in general, real estate securities' returns have historically been higher in countries with REIT structures. Higher returns are due in part to REITs' tax-efficient structures that allow them to pass more income on to investors than taxable operating companies. In 1994 there were three countries with well established REIT structures: the United States (legislation passed in 1961), Australia (1971) and the Netherlands (1972). These countries with mature REIT structures produced returns of 14.5%, 15.3%, and 10.8%, respectively, since 1994.

Public REIT structures recently have been established in Japan, Hong Kong, Singapore, Taiwan, South Korea and France. Proposals to create REITs are under consideration in other countries including the United Kingdom, Germany, Italy and Spain. Assuming these proposals result in new legislation, all of the G-7 countries and most of the Eurozone, representing almost 80% of the world's economy, will have REITs in place.

3) Increasing transparency is making more countries attractive to institutional investors.

The REIT structure is advantageous for investors because it allows for tax-free income distributions. But REITs also have a benefit that is not as widely acknowledged, but arguably more important: they increase transparency because their operations are subject to public scrutiny. REITs are generally required to disclose not just income and earnings, but also to report transactions and property performance measures including average occupancy levels. They must also disclose conflicts of interest and establish corporate governance standards.

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Exhibit 6
Correlations Between Regional Real Estate Securities Markets Are Low

	United Kingdom	United States	Japan	Australia
United Kingdom	1.00			
United States	0.48	1.00		
Japan	0.66	0.45	1.00	
Australia	0.39	0.31	0.10	1.00

Correlation of Local Currency Returns, 1990-2003

Source: CBRE Investors calculations

MARKET SPOTLIGHT EAST

NYC Post 9/11: Expectations versus Reality

By Jane Dorrel
Senior Director

It's been over three years now since the devastation of September 11th at the World Trade Center. The office and hotel markets have come a long way since that tragic day. But the course was never that clear, and "conventional wisdom" wasn't always so wise. How has our thinking about the New York market changed over the course of the past three years? What did we in the real estate industry get right, and what did we get wrong?

Immediately Following September 11th

Office Market

Situation In the days following the disaster, pundits pondered what impact the destruction of over 20 million square feet of office space would have on the local real estate market. Where would these workers – estimated at 50,000 to 100,000 – go? Was there enough vacant space in the market to accommodate them all?

Expectations* While it was commonly thought that some firms would move to the suburbs, at least temporarily, the market vacancy was expected to *fall* as displaced companies signed new leases elsewhere in the city. There was talk about how anyone who tried to raise rental rates in the short term would be a pariah, but that in the longer-run there would be upward pressure on rents due to the forces of supply and demand. There were a few lone voices predicting a mass exodus from the city. Acquisition activity was expected to be "the lowest in our lifetime" in the fourth quarter.

Reality Oh, how wrong the pundits were. Despite the removal of over 21 million square feet of office space, Manhattan's vacancy rose from 5.1% at the end of second quarter 2001 to 7.1% at the end of the third quarter. Net absorption totaled *negative* 27 million square feet of space. This was due to the incredible amount of sublease space that suddenly came on the market. Space became available as dot-coms and other marginal companies closed their doors. In addition, established profitable companies that had been warehousing space for future growth, put that space on the market. Many companies simply consolidated, squeezing the displaced workers from the WTC in with their employees at other locations. Finally, the suburbs provided another alternative. Major corporations – such as Morgan Stanley, Lehman Brothers and American Express – leased space in Northern New Jersey and Westchester County within days of the attack. This rapid rise in vacancy caused effective rents to fall 6.2% in the third quarter alone.

What Went Wrong? There was a terrible misreading of the underutilized and stockpiled shadow space that was available in the market. Conventional wisdom failed to recognize that while the overall supply of space was reduced, the pillars supporting demand for that space were crumbling.

Hotel Market

Situation On September 11, the World Trade Center Marriott (819 rooms) was destroyed and the nearby Financial Center Marriott (504 rooms) and the Millennium Hilton (561 rooms) were severely damaged. Besides the physical destruction of some hotel rooms, other hotels were temporarily taken off the market and leased as office space.

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*In this article, "expectations" are based on a variety of sources including Economy.com, Torto Wheaton Research, real estate brokerage companies, hotel consulting groups, Korpacz, Real Capital Analytics, FDIC, newspaper articles, and other miscellaneous sources. The forecasts are representative of consensus opinion at the time.

continued from page 5

Expectations There was an immediate downturn in tourism and business convention business, especially due to the absence of air travel. Major hotel researchers predicted that occupancy for the year would be down by 11-12% (2001 vs 2000), room rates would fall (anywhere between 5 and 14%) and revenue per available room (RevPAR) would decline a jaw-dropping 18-25%. General assumptions were that demand would recover slowly due to the weak economy and the fear of flying.

Reality The occupancy rate only fell by 8.7% (to a respectable level of 75.3% for the year) and room rates declined 9.3%. RevPAR for the year was down 18.7%, in line with predictions. Many hotels helped accommodate displaced residents, offering cheaper weekly rates. This maintained occupancy but lowered room rates.

What Went Wrong? In general, it appears that occupancy was bolstered by offering even lower prices than predicted. But, all-in-all, RevPAR expectations were quite close to the short-term reality.

One Year Later- Fall 2002

Office Market

Situation Office vacancies continued to climb and effective rents continued to fall in the first half of 2002, despite some positive absorption. Buildings that had been damaged, but not destroyed, were being added back into the inventory along with some new buildings that were under construction at the time of the attacks. However, a bear stock market increased capital flows into real estate, especially into downtown markets. Office sales activity in Manhattan accounted for 37% of all downtown transactions nationwide in the first half of the year. Cap rates actually fell and values increased.

Expectations Vacancies were expected to reach the high-8% range at year-end 2002 and peak near 9% in 2003. In 2003, the New York metro area employment was projected to turn the corner and increase by 29,000 jobs. Office demand was forecasted to rebound to 3.5 million square feet in 2003, and rent growth was projected to be only slightly negative in 2003. Manhattan's high barrier to entry and its historic strong performance were expected to continue to make New York City an attractive market for investors.

Reality Absorption did rebound somewhat in 2003, but did not reach the heights that were projected. With the completion of another 3.0 million square feet of space, vacancies hovered in the 9.0-9.6% range all year, above expectations. Rents, however, were the real disappointment. After falling by 4% in 2002, they plunged a horrendous 20% in 2003. The poor economy was having a major impact on the Manhattan office market. Major corporations – such as AT&T, AOL/Time Warner, and major banks – were having mass layoffs and Wall Street was hemorrhaging jobs. Instead of employment increasing by 29,000 jobs it *declined* by almost 53,000 jobs (a difference of 82,000!). Despite poor fundamentals, the dollar value of Manhattan's office sales was the highest in the nation in 2003, although there was little increase over 2002 levels. The average cap rate fell significantly in the second half of the year.

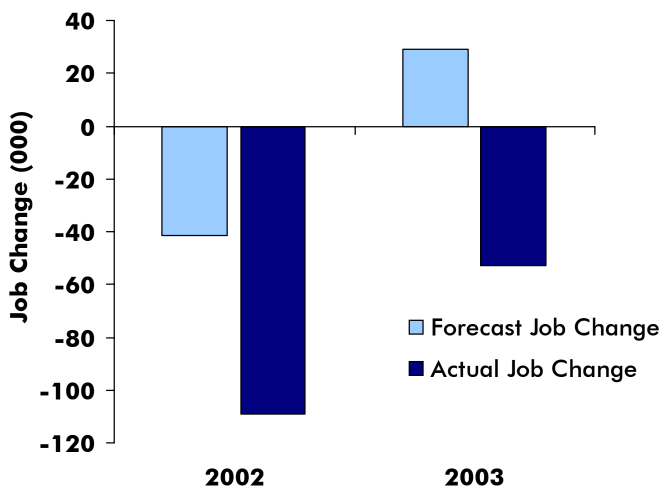
What Went Wrong? The economy continued to be rocked by fears of an impending war with Iraq, the SARS outbreak, Enron and other corporate governance scandals on Wall Street.

Hotel Market

Situation Demand for hotel rooms remained weak in the first half of 2002, and the second quarter occupancy reached 77.7%, the lowest for that quarter in the past four years. The average room rate was 10% below the previous year. As a result, RevPAR declined almost 12% from second quarter 2001 to second quarter 2002.

Expectations Popular expectations were that the market would see a significant turnaround in 2003 due to strong convention business and a small gain in leisure travel. Predictions were that occupancy would increase by almost 300 basis points and room rates would climb 7% in the year.

New York's Employment Failed to Catch Fire



Note: Forecasts made in the fall of the previous year.

Source: Economy.com; CB Richard Ellis Investors

Reality From second quarter 2002 through second quarter 2003, the Manhattan hotel market continued to suffer. The addition of 820 new hotel rooms and continued weak demand kept occupancy below the previous year in every quarter except the fourth quarter of 2002. The average room rate and RevPAR both fell approximately 7%. In the second half of 2003, however, conditions began to pick up. Demand in the fourth quarter was almost back to 2000 levels, the average room rate increased 3.7% over 2002, and RevPAR rose by 6.3%. For the year as a whole, 2003 saw a slight gain in occupancy, but a continued decline in room rates. RevPAR declined 1.3% for the year.

What Went Wrong? The projected turnaround in convention business and leisure travel arrived in 2003, but just a little later than most had expected. Trepidation about a war with Iraq and the outbreak of SARS dampened travel everywhere.

Two Years Later- Fall 2003

Office Market

Situation As of fall 2003, the economy continued to be constrained by a lagging Wall Street and the city's worst fiscal conditions since the 1970s. Office absorption was negative for the first half of 2003, and vacancies were above 9%. But there were some signs of an impending turnaround. Investment activity continued to be very strong.

Expectations Employment was projected to increase 0.8% in 2004. It was expected that absorption would be negative in 2003 and would be only an anemic 1.3 million square feet in 2004. Vacancy was projected to spike above 10% by year-end 2004, and rents were expected to be slightly positive in 2004. Investment demand was expected to remain hot.

Reality From second quarter 2003 through second quarter 2004, total employment increased 0.6%, the first gain since 2000. As a result, office absorption was kick-started in the second half of 2003 and continued to be healthy in the first half of 2004. In these four quarters, the market absorbed a total of 7.3 million square feet of office space, the highest demand since mid-1999 to mid-2000, and the second highest in the country. The Manhattan vacancy rate ended the second quarter of 2004 at 8.6%, significantly below expectations. Asking rents are beginning to increase and effective rents are stabilizing. An influx of capital continues to drive down the cap rate for office properties in Manhattan. In the first nine months of 2004, the average cap rate was 7.2% and the average price was $299 per square foot. This was based on a large volume of sales, which increased 51% over the same period in 2003.

What Went Wrong? Or should I say, what went right? The New York City economy gained almost 25,000 jobs from mid-2003 to mid-2004. Most of these jobs were in the Professional & Business Services, Education & Health, and Leisure & Hospitality sectors. At the same time, the national economy began to show serious improvement. Brisk leasing by some large and mid-size firms drove strong absorption in the last three quarters.

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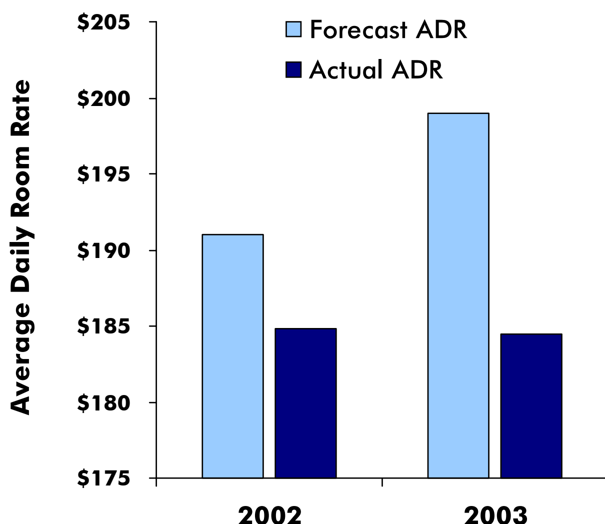
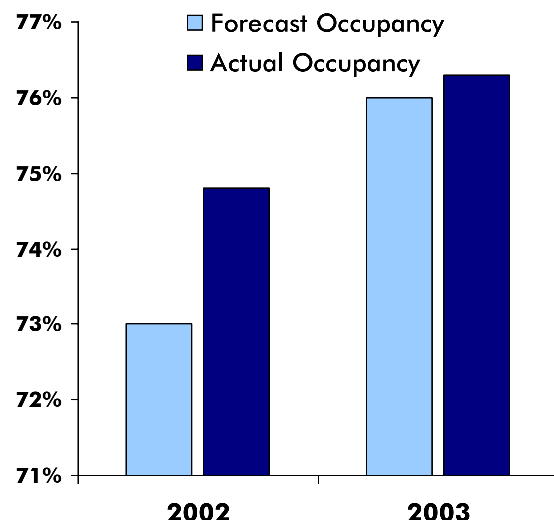
Low Hotel Room Rates...



...Helped Keep Occupancies Up



Note: Forecasts made in the fall of the previous year.

Source: PricewaterhouseCoopers; CB Richard Ellis Investors

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Hotel Market

Situation The Manhattan hotel market was strengthening in the fall of 2003. By fourth quarter, the occupancy rate was back above 80% and the $223 average room rate was the highest it had been since year-end 2000. It was conventional wisdom that a hotel recovery was definitely underway.

Expectations Business demand was expected to increase. In 2004, it was projected that occupancy improvement would slow as hotels pushed for more rent growth. RevPAR was expected to increase about 7% during the year.

Reality From mid-year 2003 through mid-year 2004, Manhattan hotels experienced a significant improvement in their occupancy levels (up 620 basis points) and a 12% increase in average room rate. As a result, RevPAR surged by a whopping 21% mid-year to mid-year.

What Went Wrong? The rebound in hotel room demand (beginning third quarter 2003) was under-estimated. At the same time, the total stock of hotel rooms actually declined. A number of hotels have closed in order to be converted into luxury condominiums. This classic mismatched supply/demand relationship drove the occupancy rate and room rates up rapidly. The Manhattan hotel market is back.

Lessons Learned – The Economy Is King

In the office market, demand was more important than supply. Conventional wisdom missed the office downturn since it gave more credence to the lowered physical supply than to the severe dampening affect that the disaster had on demand.

Hotel demand, however, *can* be stimulated by lower room rates, at least in a market like New York City. In particular, demand shifted from one hotel segment to another, as hotel guests traded up to top-line luxury hotels for the same price as upscale ones. This movement was facilitated by the distribution of unsold inventory on web-based third party discount sites such as Priceline and Hotels.com.

The view that the office and hotel markets would rapidly rebound proved to be illusory, as did the doomsayers' prediction that there would be a mass exodus from the city. Unforeseen was the huge inflow of capital which would drive robust investment activity.

The road to recovery was not always smooth nor the course always clear, but after three hard years, Manhattan is finally back. New York City's office and hotel markets are once again national leaders. ■

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Beyond legally required reporting, investors demand more open communication than private real estate companies usually provide. And indirectly, the REIT structure provides added market transparency because investor interest increases demand for accurate tracking of supply/demand fundamentals.

The introduction of REITs has made available information that simply wasn't accessible prior to their introduction in many countries. For example, the creation of the J-REIT structure in Japan has spurred new indices including the STBRI J-REIT Index[6], which reports dividend yields and price appreciation by sector comparable to the NAREIT Index in the United States.

Local Market Knowledge Is Essential to a Global Real Estate Securities Strategy

Equity market performance metrics are fairly uniform across countries, but the tracking of property market trends that drive the performance of real estate securities' underlying assets varies substantially. High quality, publicly available data is only available in a few countries. Especially in Asia, but also in many places in Europe, construction, tenant demand, occupancy and rent growth data are closely held by local companies. Local experts who use a combination of proprietary data, in-house analysis and anecdotal evidence, understand their markets far better than do outsiders.

Real estate supply/demand fundamentals are not easily tracked from afar, making an on-the-ground presence essential to successfully capitalize on emerging trends affecting real estate securities. Accurate and timely observations of local conditions can be used to forecast earnings and other valuation metrics of securities, which can be used to make prudent investment decisions.

Why Invest in Global Real Estate Securities?

Real estate securities provide immediate exposure to the $5 trillion global institutional property market. They provide competitive returns, high income yields and reduce portfolio risk. The addition of global real estate securities enhances the risk-adjusted returns of a mixed-asset portfolio. Securities are publicly traded, so investors can quickly gain exposure to those geographic regions and real estate sectors that possess the right combination of favorable market conditions and attractive valuation levels. On-the-ground knowledge of local market trends, and global real estate securities expertise, is essential to identify these opportunities. ■

[6] The Sumitomo Trust & Banking Co., Ltd. Research Institute's J-REIT Index.

MARKET SPOTLIGHT WEST

The Bay Area Bounce Back

By Shubhra Jha
Associate

The first sign I had that the Bay Area was on a comeback trail was not a jobs report, or the sharp improvement in office and industrial space conditions in the area, or the stupendous success of the Google IPO, or even excellent third quarter earnings report from tech giants IBM, Intel, EBay and Apple. It was the thickness of WIRED, the magazine I read religiously every month. I have subscribed to WIRED since March 1998 and it went from a 204 page read to a tome of 432 pages (December 1999) before falling to a dismal 132 pages (August 2002) at its nadir. As it slowly attracts more advertising dollars, the magazine now has crept up to 230 pages (November 2004). It may be symptomatic of the area's crawl back from the cavernous depths that it has endured for nearly four years.

Rational Exuberance?

In the late 1990s, nothing could go wrong in the Bay Area (San Francisco, San Jose and Oakland). The region was the world capital of the "New Economy." New businesses were sprouting everywhere – all one needed was an idea and venture capitalists would fund it. The IPO market was hot and billionaires were being made at an unprecedented rate. Financial and business services were booming, while hotels and restaurants were packed. The economy peaked in Y2K frenzy.

By Spring 2000, the NASDAQ started its collapse. The Internet and high-tech boom went into reverse. Soon, the tech-wreck took on a life of its own as the "new economy" imploded and job losses mounted. The Bay Area was declared dead.

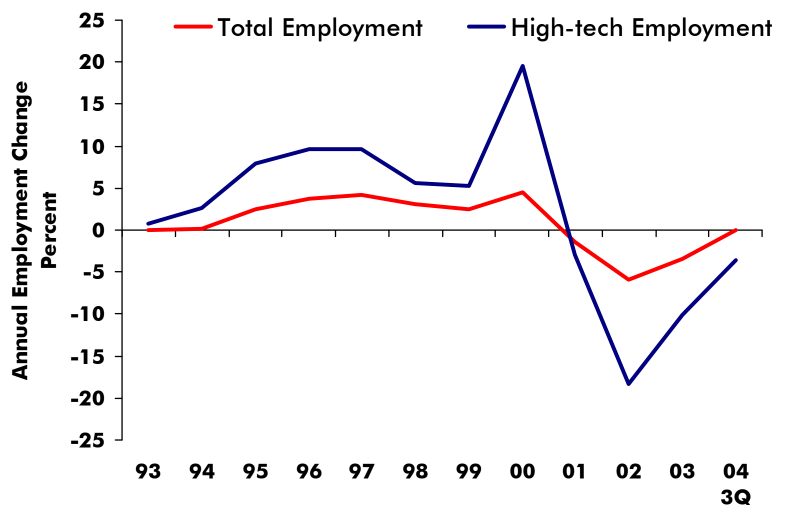
Written off multiple times in the past as dead, the Bay Area has managed to resurrect itself and reclaim its status time and again as the high-tech capital of the world. The entrepreneurial and innovative spirit that the region fosters has helped spawn new "killer-apps" that keep it at the cutting edge of technology.

Today, signs of the turnaround are all around, but with a difference. Instead of the "irrational exuberance" that characterized much of the boom of the late 1990s, there is an effort to almost underplay any new "big" ideas or treat them with a big dose of skepticism. This time, there is no talk of the "paradigm shift" or the "the business cycle as we know it is dead." The region is showing signs of life, but a full-scale recovery still has a long way to go.

Help Wanted (Finally!)

Job losses in the Bay Area, particularly in the high-tech sector, were unmatched anywhere else in the United States. From 2001 through 2003, total employment declines averaged 3.5% annually, a loss of nearly 325,000 jobs over the three-year period. When compared to the national average for the same period (negative 0.5% annually), this was catastrophic.

Bay Area Job Growth Is Beginning to Turn Positive



Source: Economy.com; CBRE Investors

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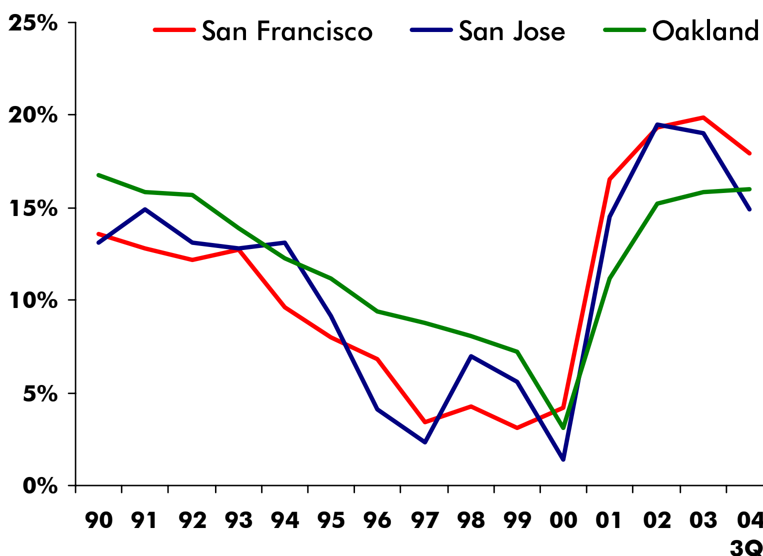
The story is more telling looking at high-tech employment. From 1995 through 2000, job growth in the high-tech sector averaged an astounding 9.6% annually in the Bay Area. After the bubble burst in early 2000, the fall averaged a sobering *negative* 10.4% annually from 2001 through 2003. No other metro area in the nation came close to this freefall. Added to the news of continued layoffs was news of structural adjustments – particularly offshoring to China and India. A lot of these jobs will never come back to the Bay Area, as companies struggle to maintain profitability while keeping labor costs down.

In 2004, there is reason to celebrate, albeit cautiously. The pace of job losses has slowed down considerably. In fact, preliminary estimates at the end of third quarter 2004 indicate that the region has added approximately 1,900 jobs, a 0.2% gain from a year ago. In contrast, at the end of fourth quarter 2003, year-over-year job losses had totaled nearly 93,000 or a 3.2% decline from a year ago. Individual MSAs are performing differently within the Bay Area. As of September 2004, Oakland (employment growth of +0.6% since September 2003) and San Francisco (+0.3%) have seen job gains from a year ago, while San Jose (-0.9%) still has some catching up to do. Even though the job gains are miniscule, it is an improvement nonetheless.

Bay Area Office Vacancy Rates Are Improving



Source: CBRE Torto Wheaton Research

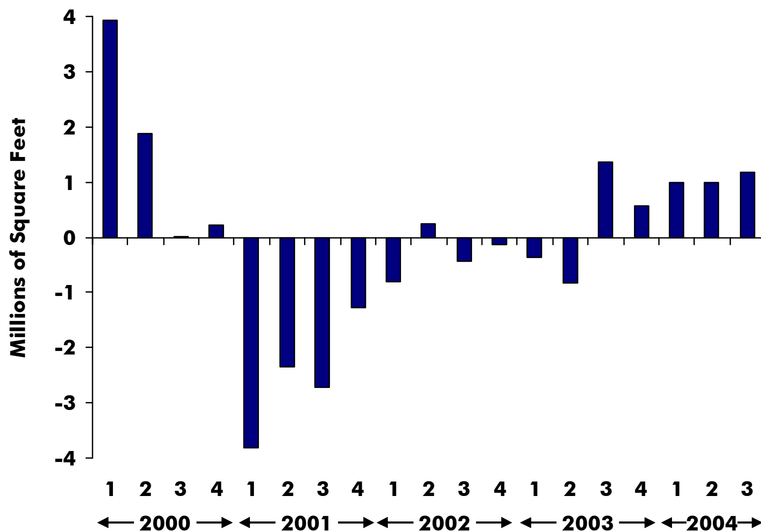
Office Demand Turnaround

The San Jose and San Francisco office markets were effectively fully leased at the end of second quarter 2000, with vacancy rates of 0.7% and 1.7%, respectively. But landlords were bracing for the worst, as the stock market bubble had begun to burst and signs of a meltdown were on the horizon. Over the following three years, vacancies surpassed 20%, in both San Francisco and San Jose. Oakland's office vacancy followed a similar trajectory, climbing from 2.6% in second quarter 2000 to 16.7% in second quarter 2003.

The turnaround has been decidedly dramatic. Since second quarter 2003 vacancies have fallen nearly 600 basis points in San Jose and 290 basis points in San Francisco. This marks five consecutive quarters of falling vacancy rates for San Jose and San Francisco, though Oakland has had a more volatile pattern. The spectacular decline in vacancies have been due to virtually no construction and strong absorption, particularly in San Jose and San Francisco. Collectively, the three office markets have absorbed more than five million square feet in the past five quarters.

The rapid improvement in office market conditions can in large part be explained by the resumption of job growth and by firms' anticipation of future expansion. However, a large component of this decline in vacancy rate can also be attributed to sublet space that has been taken off-market. Tenants holding large amounts of sublease space are getting closer to lease expirations and facing stiff competition from low-priced directly vacant space, and thus are more likely to stop marketing the space. This space will remain a factor as leases expire in the near future. Despite the presence of this "shadow space," vacancies are expected to continue to decline with no construction in the pipeline and continued strong job growth. As the business investment cycle gains traction both here and abroad, demand for the Bay Area's products and ideas will rise.

Bay Area Office Net Absorption Has Been Positive for Five Consecutive Quarters



Source: CBRE Torto Wheaton Research

Lower occupancy costs make the area extremely attractive to companies looking to hire and expand. Rents have fallen by staggering amounts in the past three years and are unlikely to see any immediate upswing until excess space gets absorbed. Although stabilizing, rents will not return to their 2000 levels over the next five years.

VCs Venture Back

Not everyone will see the return of Venture Capital (VC) firms as good news in the region. They were held responsible for much of the excessive euphoria of the Internet boom. Though the venture capital firms never really went away, funding took a deep dip after 2000.

At its peak in 2000, the Bay Area garnered nearly $35 billion in VC funding, capturing 33.7% of the national outlay. Over the following three years, funding fell dramatically each year (averaging approximately 40% annually), though the extent of the slide has diminished. The Money Tree survey at the end of third quarter 2004 shows an increase of 23% in funding flowing into the region over the same period in 2003. The Bay Area's share of the total national pie has also increased to 34.7% after falling to 30% for the year 2001. This signals a renewed interest in the area's viability as a growth leader in new technological initiatives, and means that any uptick in the national funding activity will disproportionately benefit the Bay Area.

Another interesting aspect of the survey speaks volumes about the mentality shift of venture capital firms. In the second quarter of 2000, Later Stage companies* captured approximately 19% of all VC funding in the area. Four years later, the percentage has jumped to nearly 34%, indicating that VC firms are betting on "sure things" rather than ideas without solid business plans behind them. This is a good sign for the Bay Area as it ushers in a time of more sustainable growth, rather than a proliferation of ultra-risky ventures with high failure rates.

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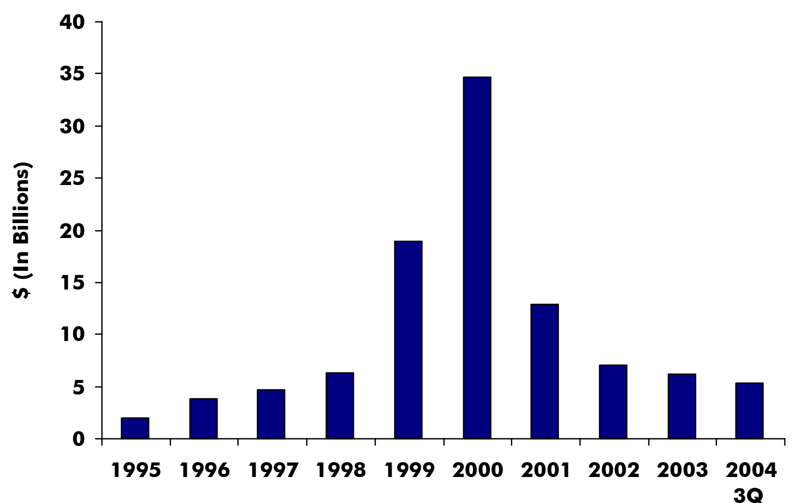
Is Venture Capital Funding in the Bay Area Crawling Back?



Source: Money Tree Survey (PricewaterhouseCoopers/Venture Economics/ National Venture Capital Association)

* Later stage companies are more established or mature companies whose products or services are widely available. They generate on-going revenue and usually have positive cash flow.

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The Recovery Is in the "Start Up" Stage

That recovery is inevitable was never in doubt, despite what the doomsayers had to say. Given the Bay Area's tenacious ability to bounce back, it was a foregone conclusion. What makes the region unique is its human capital and thousands of high-tech companies that have invested in R&D facilities. There is a spirit of innovation and entrepreneurship that is hard to replicate. If anything, the recent downturn only made the region leaner and more efficient as it trimmed costs for labor and space.

Yet virtually no one believes that the boom of the 1990s is likely to be repeated any time soon. The hubris of those days has been replaced by a more cautious optimism. Besides quantitative signs such as office vacancy rates, employment and venture capital funding, there are qualitative signs that indicate that the recovery is underway, but patchy. Restaurants show signs of activity though freeway traffic remains light. Job postings on Monster.com, Yahoo and Craigslist.com are rising though scores of office campuses are still dark.

So does all of this add up to a recovery or is it more like a mirage? It is too early to tell if the first steps to recovery are real or illusionary. Things are looking up but it would be premature to say that the Bay Area is back and the next boom is just around the corner. The decline in the economic growth of the areas was so spectacular that any positive news can only be viewed as a glimmer of hope for the beleaguered region. Given the extent of job losses in the past three years it will be a long road to recovery.

Though I do not have a crystal ball to predict when the Bay Area will ride high again and how big the next boom is going to be – I will be closely watching the number of pages that WIRED has every month. And it looks like the current issue has surpassed March 1998. So it looks like we are well on our way to recovery! ■

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