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The Golden State of California's Office Market | January 2016

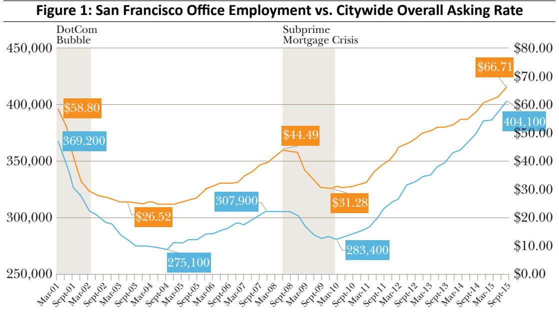
Recently there have been concerns in California of another tech crash like the state experienced in 2000. During that time, California's private sector lost 25% of its jobs—jobs that have only just been recovered. As a result, tech-focused real estate fundamentals followed suit. Fast forward fifteen years (Figure 1), and San Francisco office rents are finally above their 2000 peak and vacancy is at 5.5%.

California and tech are synonymous. The state accounts for almost one-fifth of the country's tech jobs. The industry has become so engrained into California's culture that entire markets and even cities are adapting to accommodate them. New, lively submarkets are being created, and an emphasis has been placed on more efficient and sustainable space. Real estate owners who have acknowledged this trend have seen rents rise, occupancies increase, and space being leased before it is even completed.

All Work, Live, and Play

Over the next 10 years, there is expected to be intense competition for talent, especially within STEM (science, technology, engineering, and math) jobs. According to the Deloitte Center for Financial Services, there will be surplus demand for over 23 million STEM workers in the US by 2025, making anyone with experience and education highly sought after. To fill positions with the talent required, companies will need to be located in areas preferred by the largest segment of the country's employment base: Millennials (the generation born between 1982 and 2004).

Figure 1: San Francisco Office Employment vs. Citywide Overall Asking Rate



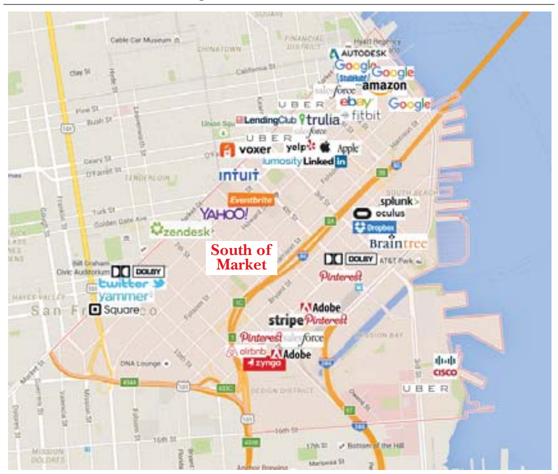
Source: Cushman & Wakefield, State of California Employment Development Department | Office of Employment for San Francisco and San Mateo Metropolitan Division. As of 9/30/2015.

As a "knowledge-based" economy, California is the ideal market for attracting STEM and millennial talent. According to the recruiting platform Jobvite, eight out of the top 10 universities for tech hiring are located within the state. Palo Alto, home to the number four school Stanford University, has traditionally been known as the "tech capital". The suburban nature of Palo Alto and the surrounding peninsula area has allowed companies to build huge campuses that cater to employees' needs during the work day. However, this leaves the typical millennial employees with the options of either living in an area that lacks the liveliness of the city or having a long commute time to and from work. As evidence of the difficulties a company can have if they are located in a less desirable area, Facebook (NASDAQ: FB) recently announced that it will be offering awards up to $15,000 for employees to move closer to its Menlo Park campus.

Accordingly, tech firms have been increasingly moving into San Francisco. Today, tech firms account for almost 60% of San Francisco's office leasing, and since 2010, over 2.5 million square feet of absorption can be attributed to Silicon Valley tech firms moving into the city. One of the San Francisco submarkets that has seen the most impact from this trend is "SoMa", or "South of Market Street". The area has gone through a period of rapid gentrification to become a hodgepodge of night clubs, apartments, lofts, warehouses, museums, and, now, office buildings filled with well-known tech companies (Figure 2). The culture and feel of the neighborhood have made the submarket one of the most desirable and unique places to live and work within San Francisco. Despite recent construction activity in the area, SoMa class A office vacancy is close to zero, and, not surprisingly, average rents in the submarket have increased 130% over the past five years.

Kilroy (NYSE: KRC) is one of several REITs taking advantage of the supply/demand imbalance by building new office space, most of which has been fully leased at rents above budget by completion. The company recently completed 333 Brannan Street, a $105 million, 180,000 square foot, 6-story office building in the middle of SoMa. The building offers a restaurant, ground floor retail, and a roof top deck. The property is conveniently located within walking distance of the CalTrain Station, BART, and AT&T Park, the home field of the San Francisco Giants baseball team. 333 Brannan opened 100% pre-leased to Dropbox, a private cloud storage tech company valued at approximately $10 billion in its most recent fundraising round. The economics of the lease far exceeded KRC's initial expectations and the company anticipates a double-digit return on cost from the project.

Figure 2: SoMa Tech Tenants



Source: Stamen Design, broker Kalin Kelly, and select tech tenants by Chilton Capital as of 12/28/2015

Out with the Old, In with the New

Tech companies are not only changing the neighborhoods they live in, but they are also having an impact on the layouts and structure of new real estate developments and renovations. Los Angeles, and more specifically Hollywood, has been able to attract numerous large companies due to the foresight of developers that have adapted to the changing demands of such companies and their employees.

Unlike San Francisco, L.A. is primarily home to digital media, entertainment, and content providers. Large open floor plates, spans of column-free space, high ceilings, close proximity to stage and production space, under-floor power and data options, as well as the opportunity to co-locate with other related companies are examples of ideal qualities for the media tech companies looking for space. The growth of tech media has driven the vacancy level of Class A space in Hollywood down to 5.1%, as compared to ~15% for the overall L.A. market. It can be argued the actual vacancy numbers are even lower than the headline statistics suggest due to space that is becoming functionally obsolete.

Hudson Pacific Properties (NYSE: HPP) is an office REIT that is helping meet the changing needs of the media tech companies. HPP is currently developing the $200 million Icon office tower at Sunset Bronson Studios in Hollywood. The 14-story, 323,000 square foot tower will have large, open floors of approximately 24,000 square feet and 14-foot ceilings allowing for the tenant to have multiple uses for the space. The Icon will be part of a 10.55-acre campus that includes the original Warner Brothers Studios and the site of the first talking film, *The Jazz Singer*. After Icon's completion, the campus will include more than 700,000 square feet of offices, sound stages, and other production-related facilities.

In August of 2015, Netflix (NASDAQ: NFLX) signed a lease for 200,000 square feet at Icon—the largest lease ever in Hollywood. This brought the previously speculative development to approximately 60% pre-leased. The building is expected to be completed late 2016 with Netflix moving in the following year. The CFO of Netflix, David Wells, described Icon as a "state-of-the-art facility that places Netflix squarely in the middle of Hollywood's creative culture to support our next stage of growth and content creation." He added, "The property's combination of office, stage, and production space provides an ideal setting." According to Victor Coleman, CEO of HPP, the company is in talks with several tenants for the remaining space at Icon as well as the adjacent 90,000 square feet of production space that is currently in predevelopment.

Sustainable Business Models for Millennials

Millennials' desire for sustainability has become a selling point for tech companies to stay competitive in the hiring market, especially in California. As a result, the tech industry has been a trailblazer for the real estate industry to build sustainable, or "green", buildings. Salesforce.com (NYSE: CRM), a software services company headquartered in San Francisco, is one of the leaders in this regard. In 2012, it became the first software company to commit to meeting LEED (Leadership in Energy and Environmental Design, a green building certification program) building standards for all large future build-outs. As a result, from 2013 to 2014 the percentage of CRM's office portfolio complying with LEED standards nearly doubled to 38%. In 2013, the company joined an initiative called the Building Health Challenge which explores the health and environmental effects of building materials. Google (NASDAQ: GOOG), Adobe (NASDAQ: ADBE), and DirecTV (owned by AT&T (NASDAQ: T)) are a few other prominent tech companies that have similar sustainable real estate focuses. With millennials projected to comprise 75% of the workforce by 2030, employers who want to stay competitive will need to imitate these companies to attract top talent.

Figure 3: Top 10 Greenest Cities

Highest percentage of green building square footage

Rank	Market	Square footage
1	Minneapolis	77.0%
2	**San Francisco**	**67.2%**
3	Chicago	62.1%
4	Houston	54.8%
5	Atlanta	54.1%
6	**Los Angeles**	**49.7%**
7	Denver	49.3%
8	Seattle	46.6%
9	Miami	46.0%
10	Washington, D.C.	42.2%

Source: CBRE as of 2014.

Salesforce has been significantly expanding its footprint in San Francisco, one of the "greenest" cities in the country according to CBRE in 2014 (Figure 3). In the past few years, the company has committed to 450,000 square feet at KRC's 350 Mission (100% of the building) and 714,000 square feet at Boston Properties' (NYSE: BXP) Salesforce Tower (50% of the building).

350 Mission is the first ground up development in San Francisco to earn LEED Platinum status, the highest and most rigorous level for the standard. The 450,000 square foot, 27-story building has open floor plates, high ceilings, and ample natural light. It is also directly across the street from the Transbay Transit Center, a new transportation hub that will provide 350 Mission's tenants easy access to the entire Bay Area. One of the building's more unique features is HVAC distribution under the floor allowing for zoned heating and cooling, an approach that uses only enough energy to regulate the temperature of space used by occupants. The building will also be capable of using 100% outside air for cooling, which will reduce mechanical refrigeration and carbon emissions. Overall, the building's design will cut energy costs by over one third.

Salesforce Tower will also be LEED Platinum and is located directly above the Transit Center. The 1,070-foot tower will feature a comprehensive water recycling system that will reduce consumption 30% below code inside the building and greater than 50% in outdoor landscaping. Salesforce Tower is currently under construction and due to open in 2017. Demand for the building has been so strong that Bob Pester, BXP's regional manager of the San Francisco office, forecasted on the 3Q15 earnings call that the building will be 100% pre-leased by completion.

Valuation versus Business Risk

Though Salesforce has been aggressively expanding its footprint, its revenues and cash position have been growing as well, according to recent financial filings. Unlike the 2000 tech bubble, the recent increase in rents and positive absorption for San Francisco office have mostly been attributed to well-funded technology companies. Salesforce was founded in 1999 and has been publicly traded since 2004. As of October 31, 2015, the company had $1.36 billion in cash on its balance sheet and consensus adjusted earnings of $508 million and $688 million in calendar years 2015 and 2016, respectively. However, a few "unicorns" (tech start-ups valued at $1 billion or more) have grabbed headlines recently, receiving devaluations from well-known mutual funds. Specifically, Snapchat, an ephemeral messaging company, and Dropbox, a cloud storage company, were devalued at Fidelity and Blackrock, which brought back visions of the 2000 tech bubble and the subsequent collapse.

Large valuation fluctuations in private companies can occur without fundamentals deteriorating given the lack of timely data and the rapid movements of publicly traded comparables. At Fidelity, the value of individual private companies held in mutual funds is valued regularly by a committee due to regulations for 40 Act Funds. Since the valuation of similar publicly traded companies declined in the third quarter, lower peer multiples contributed to downward pressure on valuations. It is also worth remembering that these are highly illiquid shares being held in a liquid mutual fund, and therefore the committees tend to err on the conservative side.

There is a difference between *valuation* risk and *business* risk. SnapChat is growing and gathering new users to its vanishing image and video sharing service. Most of the users are Millennials or Centennials (born after 2000), an enviable and fickle consumer base which caused the platform's value to rise rapidly. For a growing early stage company, this type of valuation reduction (between equity raises) means little, and is not indicative of a change in the underlying strength of the business. Therefore, businesses can still grow extremely quickly while having their valuations compress.

Despite recent headlines, our focus is on the public tech companies. For example, the top 10 publicly traded tech companies employ almost 15 times more people in the Bay Area (also includes minimal contribution from Seattle) than the top 20 unicorns, and they have accounted for 85% of the San Francisco region's occupancy growth over the past five years. In addition to garnering large market capitalizations and profits, the top 10 tech firms are also extremely financially sound, boasting $556 billion in cash on their balance sheets according to a presentation by Essex Property Trust (NYSE: ESS) as of November 6, 2015.

Chilton REIT Reaction

Because of the unicorn concern, as of December 16, 2015, REITs with San Francisco office exposure (BXP, KRC, ARE, HPP) underperformed the REIT index by an average of 262 bps (or 542 bps excluding BXP who has the lowest tech exposure of the four) following an October 19, 2015 WSJ story concerning declining tech valuations. However, we believe these concerns may be overblown. In contrast to the 2000 tech bubble, the supply and demand dynamics are much more favorable, and REITs with San Francisco exposure have been astute in minimizing balance sheet and development risk. For example, the four office REITs with the most exposure to San Francisco have average leverage (measured by debt/gross asset value) of 30% as of September 30, 2015, and the weighted average pre-leasing of their San Francisco office pipelines is 63%.

Riding the wave of tech hiring, demand in the San Francisco office market has far outpaced supply for the past 5 years, and the imbalance does not appear to be abating any time soon. According to CBRE as of 3Q 2015, there was still 4.9 million square feet of demand versus only 2.8 million square feet of available supply, including properties under construction. Obsolescence is accelerating due to floor plans and features not up to tenants' standards, and a city program called Prop M that limits the amount of office high-rise development to 875,000 square feet per year. Today, projects pending approval exceed available permits by a wide margin, which will preserve the supply and demand imbalance and should drive rents higher.

San Francisco is a large model of urbanization and the impact that millennials are having on real estate owners and developers. Our investment approach favors markets that have high barriers for new construction. Future regulations on energy consumption enacted by the state could result in further obsolescence of existing office space and enhance the investment merits of newer products, driving rents even higher than they are today. It is no wonder that Newmark Grubb Frank Knight, a top commercial real estate brokerage company, projects San Francisco to have the largest increase in rents for any city in the world over the next 5 years.

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RMS: 1753 (12.31.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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