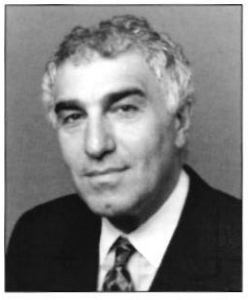
FOCUS ON RESEARCH

Technology Plays a Heavy Market Role

by Raymond G. Torto, CRE



Every other word today is technology, or at least that is the way it seems. But although technology is 90 percent of the "buzz," it is a far smaller portion of key measures of economic strength. Nevertheless, the buzz is dramatically affecting markets both stock and real estate.

Some recent calculations by the Federal Reserve Bank of San Francisco show that the tech industry is not as dominant in the economy as it is in the stock market. In terms of balance sheet assets, tech companies controlled 9 percent of total assets in 2000 compared to 6 percent in 1990. In terms of sales or employment the numbers are just as weak. The tech companies account for 7 percent of total employment and 10 percent of sales based on a study of publicly-traded, nonfinancial companies.

On the other hand, when looking at the stock market, tech companies play a heavier role. The San Francisco Fed found that tech stocks made up 36 percent of the market capitalization in March 2000 as compared to only 7 percent 10 years ago. And when it comes to profits, in an independent study, an analyst at Merrill Lynch, estimated that technology companies accounted for 17 percent of the profits of all companies in the S & P's 500 stock index over the last year. Dramatically, these same companies account for 27 percent of the coming year's estimated profit growth.

Bottom line: the tech companies are a small part of the economy, but big players and a heavy influence in the stock market.

TECH AND REAL ESTATE

The same is true today in the office real market. Tech is a small part of the market but big players in today's market measures. This dichotomy is leading us to see record levels of net absorption of space that are not consistent with the underlying fundamentals of office space demand.

More precisely, net absorption in the second quarter was 45 million square feet—a record quarterly level. In fact, the previous record was first quarter 2000 and prior to that it was in fourth quarter 1999. Put another way, the pace over the last three-quarters has been blistering and accelerating! How can this pace of net absorption be explained?

One thesis is that today's office market is reflective of the current boom in venture capital in technology companies. If markets are showing strong absorption without sustainable fundamentals, the explanation is simply "phantom absorption" or maybe we should call it "VC absorption"! Newly formed companies sign leases with letters of credit with the expectation of growing into the space by hiring employees from other firms. Landlords get high rents for short leases and for taking some risk.

Surveys show that in the first quarter of 2000, a record amount of venture

capital (VC) dollars were invested into entrepreneurial endeavors. The number of companies receiving funding was up 94 percent and the average funding per company increased 105 percent. Technology based companies received 93 percent of the total funding. These companies were service companies, application companies and business to business companies, all users of office space.

These companies expect to grow into their space and we would expect that many would fail after an exciting ride. While every VC-financed company needs to rent space, the venture capitalists know that only a few will make it. A year or so from now, we will be watching the sublease market for early signs of this.

Some of the underlying statistics on this phenomenon show that both office and industrial vacancy rates declined significantly in the second quarter of 2000, reflecting an element of "phantom" or "VC" absorption.

Industrial vacancy rates fell by 40 basis points in the second quarter and office vacancy rates fell 90 basis points. The industrial market is at 6.7 percent vacancy and the office market is down to 8 percent from 8.9 percent last quarter. Downtown rates are 6.7 percent and suburban rates are 8.8 percent. Third quarter reports equal second quarter.

Vacancy Rates	**2000.2**	**2000.1**	**1999.2**
Office Downtown	6.70%	7.30%	8.90%
Office Suburban	8.80%	9.80%	10.10%
Industrial	6.70%	7.10%	7.50%

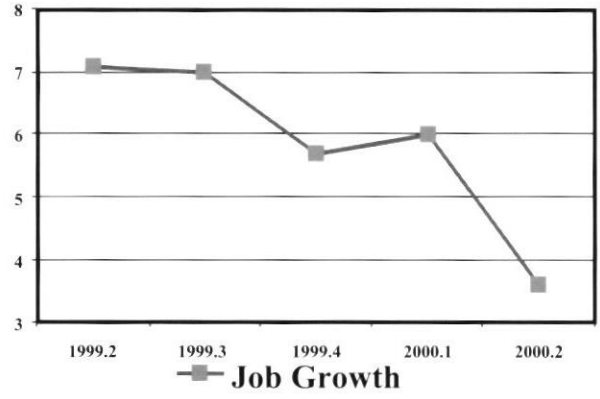
The office market's results are particularly strong and unexpected.

Traditional economic analysis of office real estate markets focuses on the number and growth in office related jobs as the underlying impetus to office net absorption. Historically, the analysis shows that stronger job growth leads to stronger net absorption. However, the basic economic fundamentals today show slowing job growth across the nation.

Overall job growth has been declining since 1998. In that year job growth for those occupations that occupy office space was 5.9 percent. In 1999 the growth rate fell to 5.1 percent and through 2000 to 4.4 percent. These are very healthy growth rates, compared to total job growth in the economy, but these fundamentals do not support the recent experience with net absorption.

Torto Wheaton Research looked behind the office employment growth rates to identify the growth in dot.com jobs or technical jobs. Here again, we find very healthy growth rates, but rates that are declining over time. Technical job growth was about 7 percent in early 1999 and has declined to under 4 percent on an annualized basis for the second quarter of 2000. The numbers are plotted in *Figure 1*. Of course, it makes perfect sense that job growth is slowing; there is a labor shortage.

Figure 1



There is one other consideration when looking at the relationship between job growth and net absorption. This relationship, research shows, holds strongly except when rents are high and rising.

Generally, when space is expensive, tenants economize and try to use less space per employee. Today's market is just such a period — high and rising rents. So how does one explain a strong and accelerating pace for net absorption when renting is expensive? It is all due to the "buzz!"

Beware of the "buzz." It does not last. REI25

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