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San Francisco: A Tale of Two Office Markets

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# **FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS**

## **WORKING PAPER SERIES**

**WORKING PAPER NO. 01-275**

**SAN FRANCISCO: A TALE OF TWO OFFICE MARKETS**

By

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# **San Francisco: A Tale of Two Office Markets**

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**Working Paper 01-275**

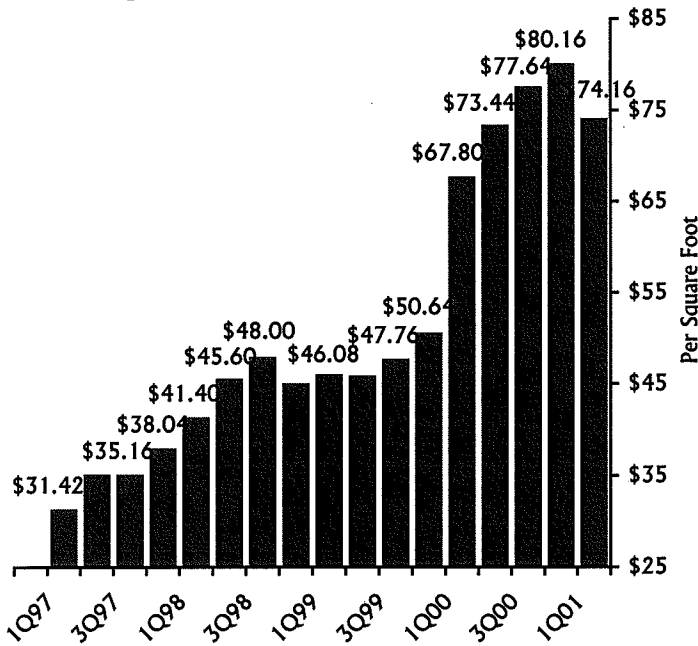
**March 2001**



As a whole, the San Francisco office market weakened during the first quarter of 2001, in tandem with rising Internet firm layoffs, a reduction in venture capital funding and a deceleration in broader technology sector growth. However, overall market data masks important distinctions between submarkets and between building classes. **San Francisco is a tale of two markets.**

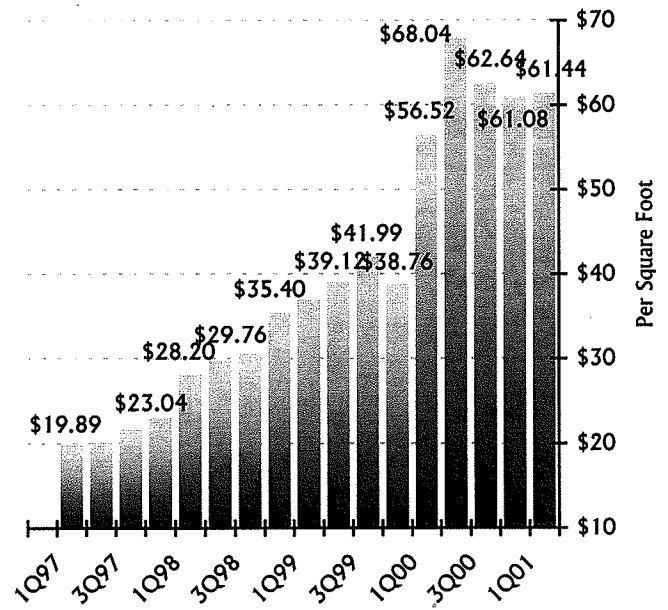
Class A rents in the Financial District slipped a comparatively modest 7.5 percent to \$74.16 per square foot during the first quarter of 2001, from \$80.16 per square foot in the fourth quarter of 2000, according to a compilation of lease activity tallied by Cushman & Wakefield (C&W). (Figure 1) Class A vacancy rates, including space available for sublet, have risen to 5.4 percent in the first quarter of 2001, from 2.1 percent in the fourth quarter of 2000. (Figure 3) Although vacancy rates for Class B CBD space climbed nearly eight percentage points to 13.8 percent in first three months of 2001 (from 6.1 percent at year-end 2000), rents actually increased 0.6 percent, to \$61.44 per square foot, from \$61.08 in the fourth quarter of 2000. (Figures 2, 4) This kind of counter-intuitive behavior is indicative of a market in transition and underscores the importance of perspective. Even after these first quarter declines, rents for both Class A and B space are up between 40 and 60 percent at the end of March 2001, from year-end 1999 levels of \$50.64 and \$38.76 per square foot, respectively.

**Figure 1: San Francisco CBD Class A Rents**



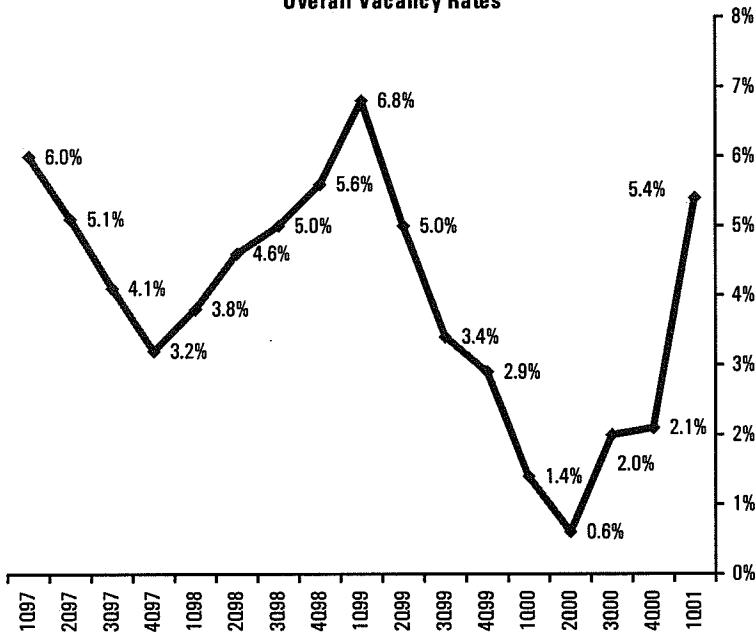
Source: Cushman & Wakefield

**Figure 2: San Francisco CBD Class B Rents**



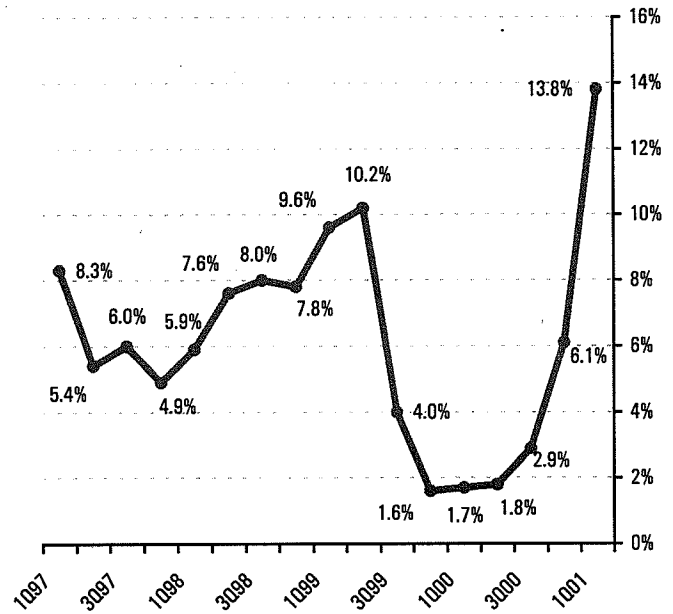
Source: Cushman & Wakefield

**Figure 3: San Francisco CBD Class A Overall Vacancy Rates**



Source: Cushman & Wakefield

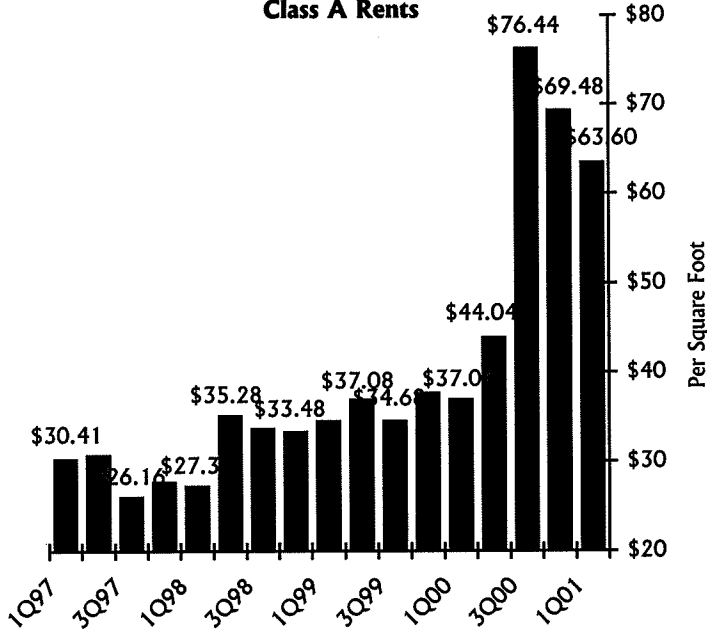
**Figure 4: San Francisco CBD Class B Overall Vacancy Rates**



Source: Cushman & Wakefield

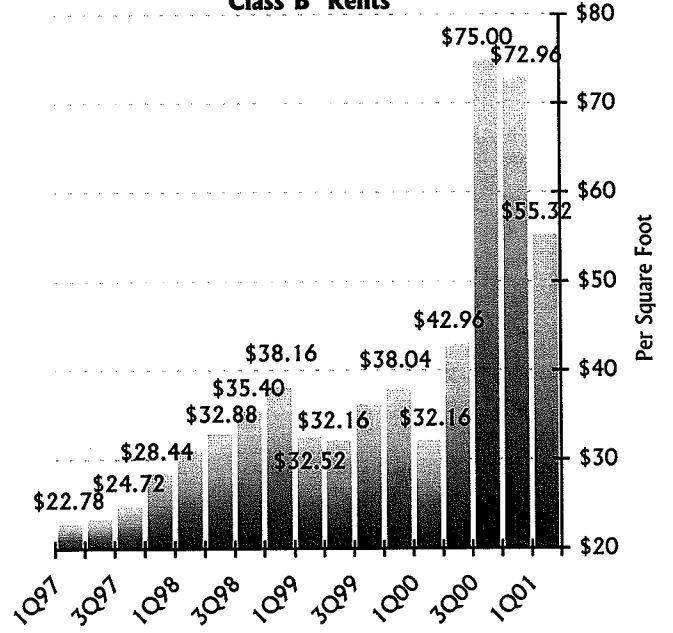
In the area south of Market Street (non-CBD) known as Multi-Media Gulch, Class A buildings have withstood the slump in demand and increase in supply better than Class B buildings. Class A rents declined 8.5 percent to \$63.60 per square foot in the first quarter of 2001, from \$69.48 per square foot at year-end 2000. (Figure 5) Although Class A vacancy rates, including space available for sublet, are now in the double digits (13.1 percent), the increase in vacancies was muted (4.5 percentage points) relative to the rise in Class B vacancy rates. (Figure 7) Multi-Media Gulch Class B vacancy rates increased more than 14 percentage points during the first three months of 2001, to a high 16.5 percent. (Figure 8) In this submarket, Class B rents responded more predictably to such a steep increase in vacancies, falling 24.2 percent to \$55.32 per square foot in the first quarter of 2001, from \$72.96 in the fourth quarter of 1999. (Figure 6) Again however, even after the rapid first quarter decline, rents are an average 45 percent higher in March 2001 than in December 1999. Class A rents in Multi-Media Gulch are nearly 70 percent above the \$37.80 per square foot quoted at year-end 1999.

**Figure 5: San Francisco Multi-Media Gulch  
Class A Rents**



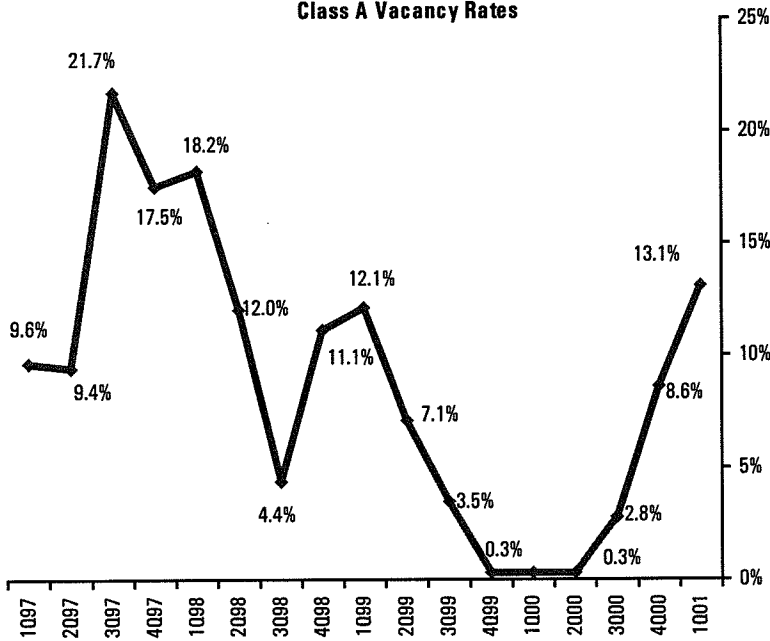
Source: Cushman & Wakefield

**Figure 6: San Francisco Multi-Media Gulch  
Class B Rents**



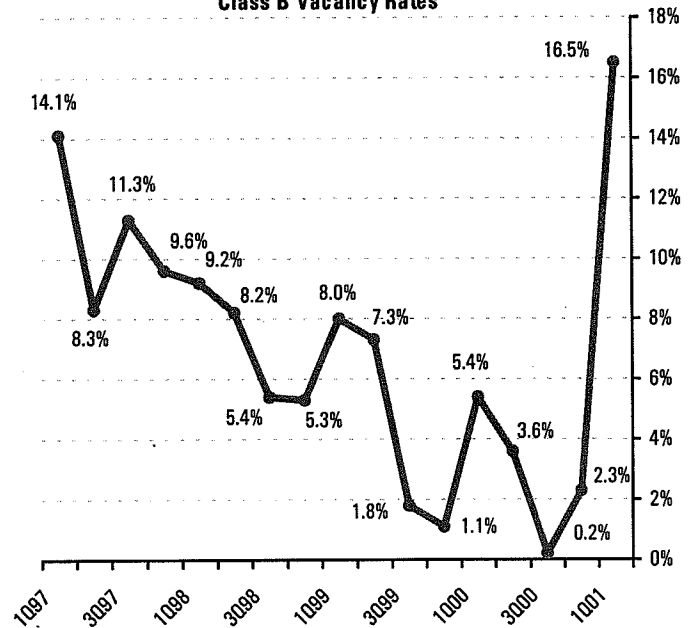
Source: Cushman & Wakefield

**Figure 7: San Francisco Multi-Media Gulch  
Class A Vacancy Rates**



Source: Cushman & Wakefield

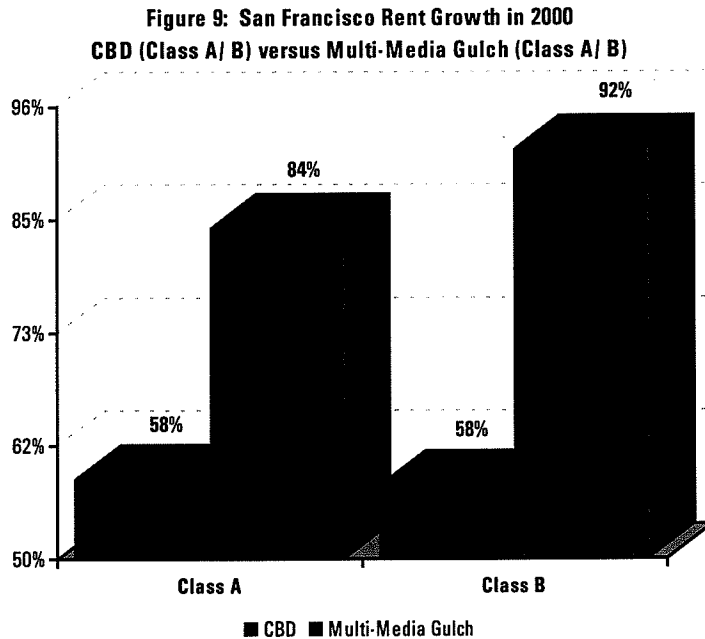
**Figure 8: San Francisco Multi-Media Gulch  
Class B Vacancy Rates**



Source: Cushman & Wakefield



The difference in the scale of rent decline is, in part, related to the disparity in the size of rent increases during 2000. Rental rates for both Class A and B buildings in Multi-Media Gulch nearly doubled in 12 months (and increased 75 percent in a single quarter), while rent growth in the Financial District averaged a still spectacular, but lower, 60 percent. (Figure 9)

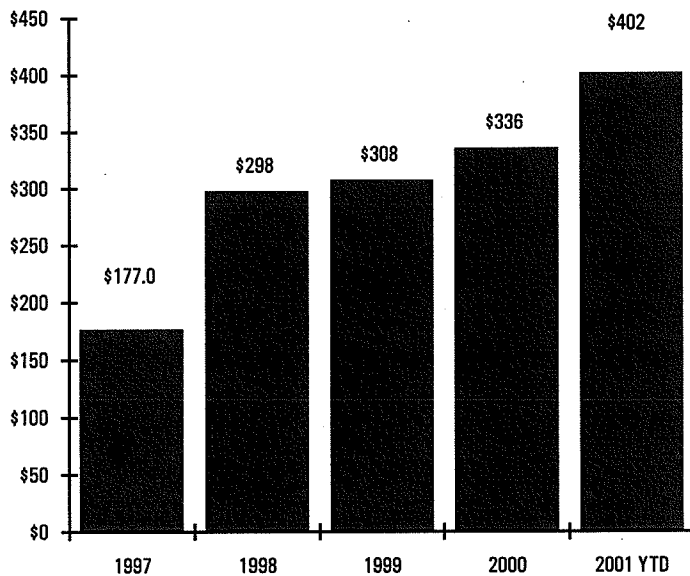


Source: Cushman & Wakefield

Although rents increased 60 to 90 percent in the 12 months ending in 2000, the rise in values during this period was more restrained. (Figure 10) The average price per square foot for Class A and Trophy buildings increased just 9.4 percent in 2000, following a mild 3.4 percent average increase in values in 1999. The reason for the smaller rise in sale prices is that in-place rents were substantially below market rents. In other words, during the last 15 months, rental rates have increased so rapidly that no more than 10 percent of leases actually rolled to market. The average Class A in-place rent in downtown San Francisco is \$42.94 per square foot in the first quarter of 2001, compared with an average “corrected” market rent of \$74.16 per square foot. The estimate for in-place rents is based on a C&W survey of 15 Class A buildings in the district north of Market Street (NOMA), representing 9.7 million square feet of office space. The overall vacancy rate, including space available for sublet, in these buildings is a low 2.4 percent. The top Class A buildings in Multi-Media Gulch (representing approximately two million square feet) have an equally low average in-place rent of \$38 per square foot but, including space available for sublet, have an average vacancy rate of 20.4. This disparity between contract and market rents (in either submarket) contained sales price inflation during the last several years by discouraging investors and lenders from underwriting

rents above \$55 per square foot. At the same time, sellers were satisfied with the return inherent in such a valuation (evidenced by a record number of trades in 2000). **As a result, rent declines will have a more minor impact on building values.** In fact, with cap rates approximately 300 basis points above commercial mortgage rates, Jeffrey Congdon, Executive Director at C&W, anticipates transaction volume in excess of five million square feet in 2001, an amount rivaling the banner year of 1998, which included the sale of the Embarcadero holdings. First quarter 2001 San Francisco is not only a tale of two submarkets, it is also the tale of the leasing versus the investment market. Despite overall rising vacancy rates, falling rents and weakening demand, San Francisco still represents an attractive investment market; rents in the \$50 to \$60 per square foot range enable investors to achieve an 8 to 10 percent return. (Table 1)

**Figure 10: Sales Class A and Trophy Properties:  
Average Price Per SF and Weighted Average Cap Rate**



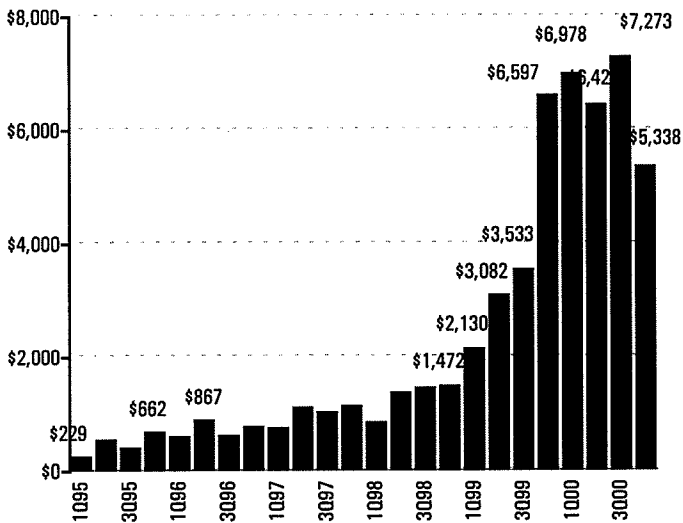
Source: Cushman & Wakefield

**TABLE 1: San Francisco CBD Class A Office Market—Effective Rent Necessary to Achieve 10%/ 8% Return**

	10% Return	8% Return
Estimated Ave. Sales Price Per Square Foot 2001	\$391.00	\$391.00
NOI Necessary to Achieve 10%/ 8% Return	\$39.10	\$31.28
Plus: Stabilized Vacancy (5%)	\$2.82	\$2.41
Plus: Expenses	\$10.00	\$10.00
Plus: Taxes	\$4.41	\$4.41
<b>Effective Rent Necessary to Achieve 10%/ 8% Return</b>	<b>\$56.33</b>	<b>\$48.10</b>
1Q00 Class A CBD Asking Rent	\$74.16	\$74.16
Increase in Class A Rents Necessary to Achieve 10%/ 8% Return	(\$17.83)	(\$26.06)
<b>Percentage Increase in Class A Rents Necessary to Achieve 10%/ 8% Return</b>	<b>(31.7%)</b>	<b>(54.2%)</b>

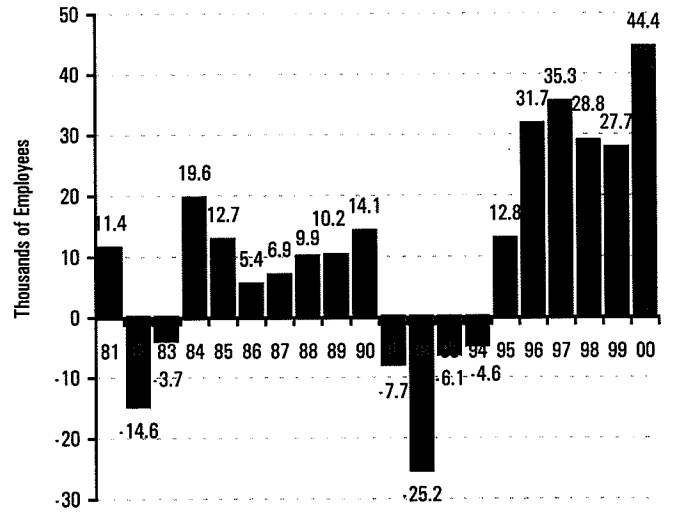
The rise and fall in San Francisco rents neatly corresponds with the growth and decline in Internet (and related high-tech and high-tech service) employment. The Bay Area received more than \$53 billion in venture money between 1996 and 2000, a record sum, and nearly 40 percent of the total amount of venture capital invested in the U.S. during the last four years. (Figure 11) San Francisco added an equally extraordinary (and unprecedented) number of jobs during this same period (nearly 170,000). (Figure 12) Risk capital contributed to this meteoric growth in employment and sponsored the seemingly insatiable demand for office space. In “The Tech Slowdown: Implications for the Bay Area Office Market” (FCREUE Working Paper No. 01-272), completed in fall 2000, the authors reviewed more than 500 lease transactions that occurred between 1999 and the first three quarters of 2000. From this examination, they concluded that 50 to 60 percent of all leases signed during this period were to high-risk Internet and Internet service firms.

**Figure 11: Amount Raised by Venture-Backed Firms--  
Bay Area, Millions \$**



Source: VentureOne  
RCG

**Figure 12: Absolute Growth in Total Employment--  
San Francisco, SA**

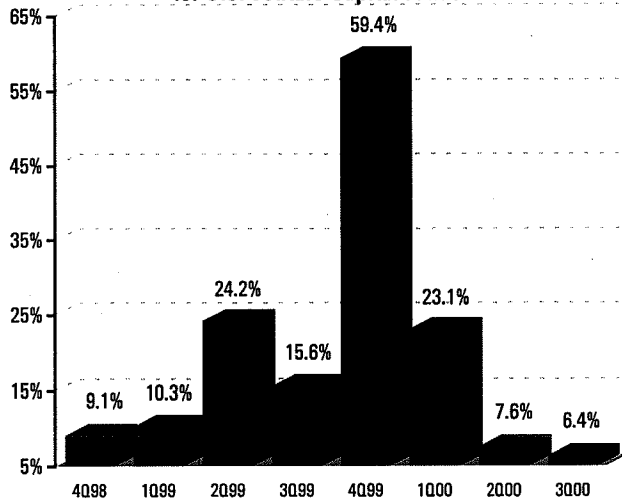


Source: Bureau of Labor Statistics,

However, as start-up firm earnings remain elusive and as the prospect for a successful IPO has diminished, venture capital returns have deteriorated and consequently, risk capital inflows have weakened. Quarterly returns for U.S. venture capital funds averaged just over six percent in the third quarter of 2000, compared with quarterly returns of nearly 60 percent nine months prior. (Figure 13) Not surprisingly, the amount of venture capital raised by start-up firms (nationally) fell 20 percent in the fourth quarter of 2000 (and decreased 27 percent in the Bay Area), the third consecutive quarterly decline in such funding. Without venture or public market support (and in many cases without a workable business model), Internet firms are collapsing. During the 12 months ending in February 2001, nearly 65,000 employees have been laid off from dot.com companies. (Figure 14) Telecom and more traditional technology firms have also found public and private capital difficult to obtain; forty-nine of the stocks in the NASDAQ 100 Index are California firms. Without financing, with steep stock price declines and with dwindling product demand, these sectors are reducing their overhead expense and laying off workers. Cisco, Nortel, Lucent, Worldcom, Intel, 3Com, Compaq, Motorola, among others, have announced combined job cuts of more than 83,000 workers during the last five months. Because the fortunes of the financial services sector are so closely tied to stock prices and

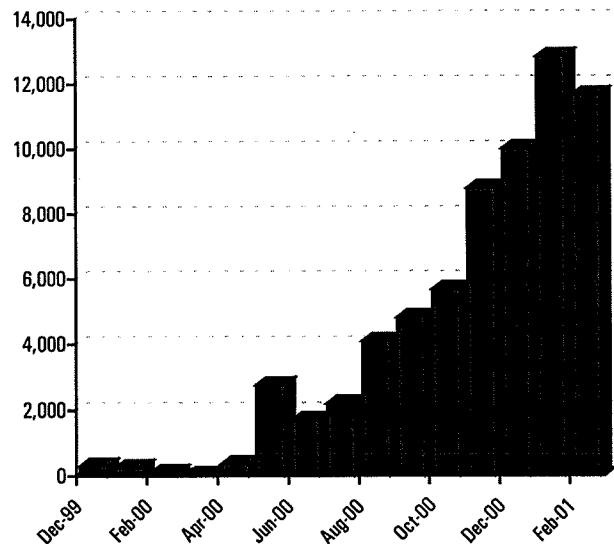
investor enthusiasm, the layoff domino will hit this sector next. **The combination of continued Internet dispersion, a reduction in the growth of high-tech and financial services firms and a slowing national economy will lower the rate of San Francisco office employment growth** (office employment in San Francisco has expanded at an average 4.4 percent rate between 1996 and 2000, compared with a 15-year average rate of 2.6 percent) **and further reduce demand for office space. In a recession San Francisco would experience negative employment growth; we believe the risk of recession is 70 percent.** On the other hand, in a still-tight labor market, layoffs and vacant space are not a one-to-one ratio. Furthermore, Lucas Films' Presidio project and University of San Francisco's growing bio-tech presence may generate some offsetting demand for space.

**Figure 13: Average Quarterly Returns for U.S. Venture Capital Funds**



Source: National Venture Capital Association

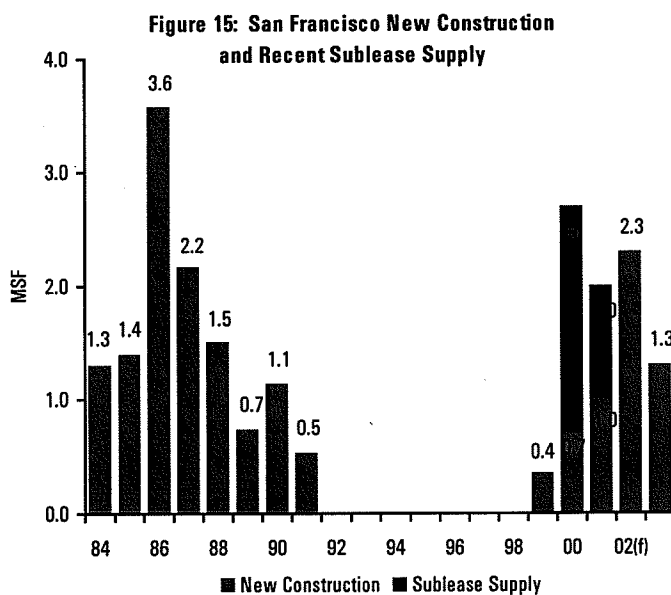
**Figure 14: Internet Layoffs**



Source: Challenger, Gray & Christmas

Although the rate of layoffs is increasing and consequently demand for office space is contracting, it is new supply (both in the form of new construction and sublease space) that may increase the severity of the downturn. As rents have risen dramatically above replacement levels, (estimated to average \$55 to \$60 per square foot in San Francisco), the pipeline of new supply has expanded. Approximately 4.6 million square feet of space is expected to be added between 2001 and 2003, and 1.4 million square feet of renovated space will re-enter the market in 2001 and 2002. (Figure 15) Another 7.6 million square feet are awaiting approval, illustrating the development community's ill-timed exuberance. A seven percent increase in total office stock (or a nine percent increase in total office supply) in three years is significant during a period of weak demand. However, several factors could soften the impact of such a large amount of new supply. Nearly 50 percent of the five million square feet under construction are pre-leased, the majority of these leases are to tenants that are

earnings-positive, with a history of stable revenue growth. In other words, 2.2 million square feet of new construction is spoken for with relative certainty. Second, a number of projects that have broken ground are currently on hold, pending signs of more stable demand (there may be fewer than 4.6 million square feet of new development added to office stock during the next three years). Third, as capital markets have turned more risk adverse, the credit environment has become more restrictive; many lenders will not support a project that is less than 50 percent pre-leased. Fourth, San Francisco has a strict regulatory code intended to limit development. Finally, 4.6 million square feet of new construction seems less remarkable when we consider that between 1992 and 1998, San Francisco added little to its office stock.



Source: Cushman & Wakefield

However, the primary contributor to the *current* rise in vacancies is a surge in the space available for sublet. In just five months, between the fourth quarter of 2000 and February 2001, approximately three million square feet of sublease space have been returned to the market. Internet and high-risk technology firms accounted for 77 percent of such space. Contrary to general perception, we found (after reviewing six million square feet of Internet leases) that about 57 percent of dot.com and start-up technology firms are located within the CBD; just under 40 percent are located in Multi-Media Gulch. Both submarkets have had an equal amount of sublease space (about one million square feet each) enter the market during the last five months. After accounting for this recent sublease activity, we estimate that dot.coms still inhabit about six million square feet of space, or nine percent of total office stock. However, a nine percent figure is slightly misleading because a large percentage of the space occupied by Internet, and related firms, is zoned for services, light industrial,

general business, or other uses, rather than for office, and therefore is not counted as part of the 66 million square feet of total San Francisco office stock. The increase in supply of non-office-zoned space explains, in part, the more significant slide in Class B rents and dramatic rise in Class B vacancies. **We expect that approximately 80 percent of dot.coms will die. The implication of such a widespread collapse is that there may be as much as four million square feet of additional web-occupied space (a high proportion of which may be in marginal buildings) that will be vacated during the next 12 months.**

Ultimately, the data describe the tale of (what will be) two distinct markets, two distinct market classes and two distinct market arenas (leasing and investment): overall rents will continue to decline and overall vacancy rates will continue to rise (into the low- to mid-teens) during the next two quarters, continuing the current momentum, but Class B space will be more affected than Class A space, and Class A Financial District properties will remain the most insulated from a severe correction, in terms of total rent decline, percentage of vacant space and price per square foot value. A rational drop in rents will improve the long-run health of the market by allowing normal tenant mobility at affordable occupancy costs.

