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THE SAN FRANCISCO OFFICE MARKET: ADJUSTING TO A RECESSIONARY MARKET

By

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Amanda Bishop

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Introduction

The San Francisco metropolitan area experienced unprecedented job growth in the late 1990s and 2000, adding more than 170,000 jobs in six years. Hundreds of Internet start-ups, heavily financed by venture capital money, were launched in the city, and traditional firms such as law, advertising and financial companies expanded to meet the needs of the growing technology sector. The explosive job growth dramatically increased demand for commercial office space.

Internet firms flocked to the city's South of Market area, a former industrial location, where they set up offices in converted warehouses. The young executives of these firms were seeking low cost, edgy space different from their parents' generations of high-rise space. Rent in the area, christened the Multimedia Gulch, reached $66.24 per square foot in 2000, an 80 percent increase over 1999. Demand for downtown high-rises was also frenzied, and Class A rental rates climbed 71 percent to $80.16 per square foot in 2000. The spread between South of Market and high-rise rent did not reflect asset quality.

Vacancy became almost non-existent as tenants gobbled up much more space than they needed in anticipation of future growth. Bidding wars for space ensued, and San Francisco surpassed New York to become the most expensive city for commercial office space in the country. To meet the strong demand in San Francisco, many developers launched new projects creating construction activity not seen since the mid-80s in San Francisco.

But the market has shifted dramatically in just one year. In 2001, the San Francisco area lost nearly 50,000 jobs and will likely lose another 10,000 to 15,000 in 2002. Most Internet start-ups have gone out of business leaving huge chunks of space behind. Traditional firms, which built up their business in response to the technology boom, have also flooded the market with sublease space as they now downsize.

Downtown vacancy has gone from 2.9 percent at the end of 2000 to 16 percent at the end of 2001. About 12.1 million square feet of space is available in San Francisco. Average asking rent for Class A space is $40.08, down by 50 percent from the end of 2000.

In the last six months alone, some landlords have lowered their rent by as much as $10 per square foot, putting rents at 1997 - 1998 levels.

However, the real estate market is again showing signs of life. After standing virtually still for most of 2001, leasing is slowly starting to pick up. Many tenants who earlier postponed space decisions are now actively looking in the market, and many landlords are anxious to do deals. Effective rents have fallen to the $35- to $55-range for Class A space, and tenant improvement dollars of between $12 to $45 per square foot are being offered. Brokers who suffered a miserable 2001 are also keen to do deals and some landlords have fattened their commissions since last year. The San Francisco commercial real estate still has a long road ahead to recovery, but the market's engine is now churning, and the office market is pulling itself out of last year's slump.

<u>Leasing demand</u>

Prospective tenants are currently looking for about two million square feet of space in San Francisco. Most of these tenants are companies that already have a presence in San Francisco and are "playing musical chairs." Most have leases expiring within the next year or two and are exploring their options. Ten to 15 percent of all tenants have leases expiring in 2002, that means between 4.5 and 6.5 million square feet of downtown space is up for renewal this year.

We expect renewals to make up a significant portion of leasing in 2002. Less than 10 percent of all leasing activity in 2000 was renewals, but they made up about one-fifth of all leasing activity in 2001. More renewal activity will take place in six to 12 months.

Few large corporations are looking for additional space. Most deals are in the 2,000- to 10,000-square-foot range. Although there has been some movement from Class B to Class A space, this is not yet a pronounced trend. As Class A rents decline further and the gap between B and A rents narrows, we expect more such movement.

The level of leasing activity in San Francisco is welcome after a period of stagnation, however it will not be enough to quickly turn the market around. During 1999 and 2000, companies leased much more space than they needed in anticipation of rapid expansion. Based on an average of 200 square feet per worker, employment figures suggest absorption in 1999 and 2000 combined should have been 3.5 million square feet. In reality, firms absorbed 7.4 million square feet, meaning there was "overleasing" of 3.9 million square feet in 1999 and 2000. Due to this "overleasing," San Francisco experienced negative absorption of 4.8 million square feet in 2001 and backfilling this space will take two to four years.

In addition to existing vacant space on the market, 1.7 million square feet of office space are under construction downtown and are expected to be complete by the end of the year. Large projects that have yet to announce tenants and are set for completion this

San Francisco Construction Deliveries (75,000 square feet and greater)

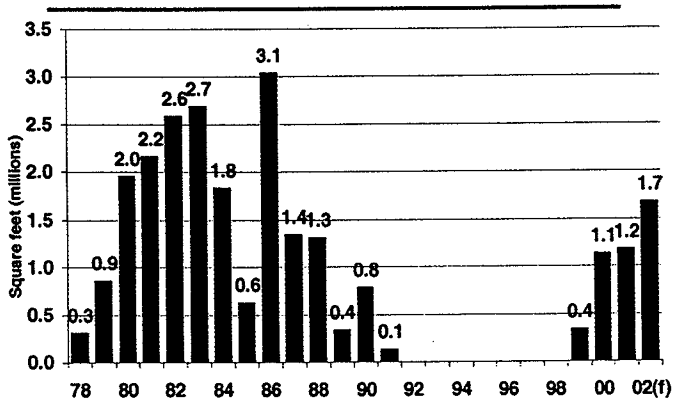
Building Address	Developer	Rentable Office Area	Square Feet Pre-Leased	Percent Pre-Leased
2001 Deliveries				
250 Embarcadero	The GAP/ Wilson	540,000	540,000	100.00%
123 Townsend	TMG Partners	129,040	129,040	100.00%
***Pier 1**	AMB Property/ Port of SF	98,000	98,000	100.00%
215 Fremont	Charles Schwab/ Beacon Capital	265,000	265,000	100.00%
	Total 2001	**1,032,040**	**1,032,040**	**100.00%**
2002 Delivery				
350 Rhode Island	SKS Investments	260,000	-0-	0.00%
55 Second	Myers/Cousins	373,500	346,538	92.78%
***Ferry Building**	Wilson/ Equity Office	170,000	-0-	0.00%
560 Mission	Hines/CalPERS	665,000	415,000	62.41%
Foundry Square- Phse I Bldg 2	Wilson/ Equity Office	490,000	-0-	0.00%
Mission Bay Blk 28 Bldg 1	Catellus	283,000	283,000	100.00%
160 King / 155 Townsend	Rosenberg Hood	165,000	66,000	33.94%
	Total 2002	**2,406,500**	**1,110,538**	**41.30%**
2003 Delivery				
Foundry Square Phase 3 Bldg 4	Wilson/ Equity Office	225,000	225,000	100.00%
	Total 2003	**225,000**	**225,000**	**100.00%**

* denotes renovation

Sources: RCG, Whitney Cressman Ltd, Cushman & Wakefield year include a 490,000-square-foot phase of south financial district project Foundry Square and the renovation of the 175,000 square foot Ferry Building. As more space comes on the market, tenants will have even greater bargaining powers.

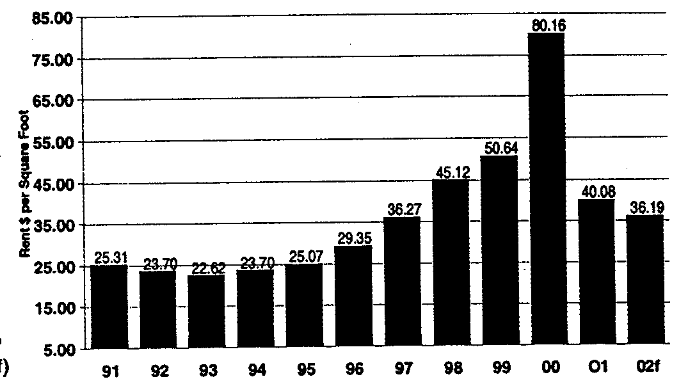
In general, real estate professionals describe tenants as "unfocused" and "skittish" -- they are reluctant to sign leases. Many are waiting until just a few months before their leases expire to commit to space either because they feel rents will drop further, or they are unsure, due to an uncertain business climate, how much space they will need.

New Office Deliveries
San Francisco - Downtown



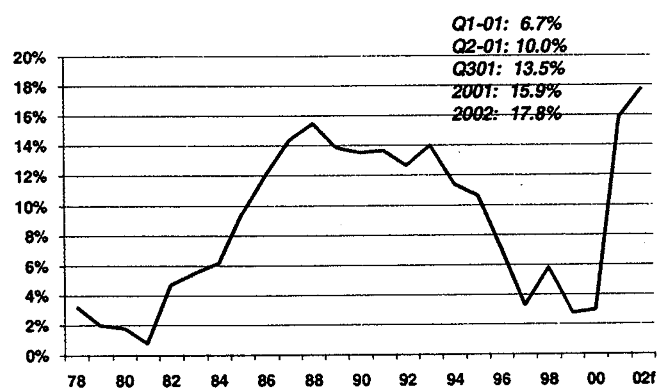
Source: Cushman & Wakefield, RCG

Rent Level
San Francisco - Downtown



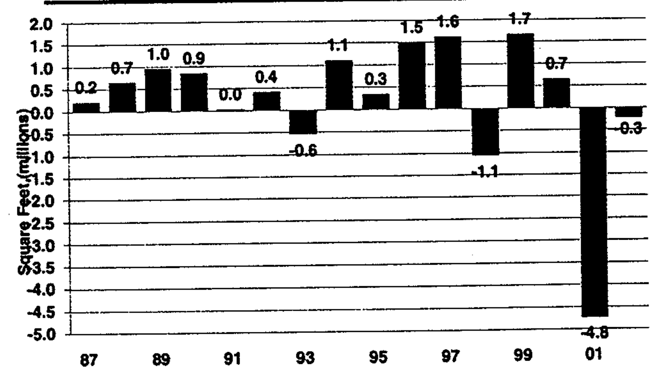
Source: Cushman & Wakefield, RCG

Vacancy Rate
San Francisco - Downtown



Source: Cushman & Wakefield, RCG

Net Absorption
San Francisco - Downtown



Source: Cushman & Wakefield, RCG

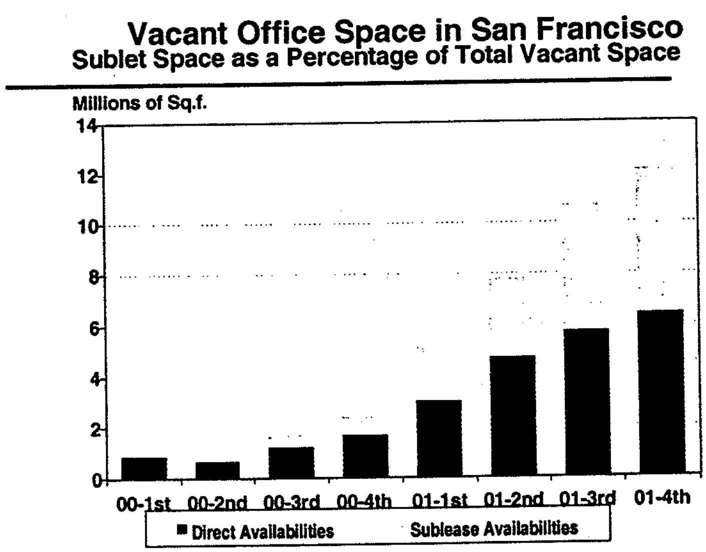
Sublease space

There is more than 5.7 million square feet of available sublease space in San Francisco or 46 percent of all space on the market. Sublease space as a percentage of total vacant space has increased dramatically over the last two years (See chart). J.P. Morgan H & Q, The Gap, Charles Schwab and NBCi are offering the some of the largest blocks of sublease space. These tenants have high credit ratings and continue to pay rent.

Space offered by companies rather than landlords is slow to move for two reasons. First, much of the space is for shorter terms and tenants now want to lock in longer terms. Second, some of the companies offering space are technology firms on shaky financial ground, and companies needing space are wary to sign leases with them. Despite slow leasing of sublease space, many tenants with such space continue to pay rent allowing landlords to maintain yields.

Although most tenants are opting to lease space from landlords, they are using sublease space as leverage for obtaining lower rents. Sublease space is priced artificially low because companies with such space are often eager to "stop the bleeding" on their balance sheet rather than hold out for a market rate deal.

Companies interested in sublease space will often negotiate with the landlord to terminate the existing tenant and sign a deal directly with them. Landlords are sometimes willing to trade a credit worthy tenant for a tenant that looks headed toward bankruptcy, even if the new tenant will pay lower rent.



Source Cushman & Wakefield, RCG

Landlord response

Landlords are responding in a variety of ways to slow demand and increased competition. The most common response is lowering rent and increasing incentives. Effective rents have dropped to the mid-$30s per square foot for Class A downtown space, with the highest quality space renting for between $45 and $60 per square foot. In the former Multimedia Gulch, vacancy has surpassed 25 percent. Class B and C space in this area can be leased for effective rent between $15 and $25 per square foot, whereas Class A space might cost as much as $40 per square foot. The array of rents in the area reflects the variety of space, which ranges from hastily converted warehouses, to expensive renovations and new buildings. Current rates represent drops of more than 50 percent from their 2000 peaks.

Free rent is also returning to San Francisco for the first time since the last recession, although only a minority of landlords is offering it. In most cases, this is not a true discount because the tenant trades off several months of free rent for a higher overall rate.

Increased tenant improvement dollars are another trend. On average, landlords are giving $30 to $40 per square in tenant improvement dollars, more than three times the amount offered during the height of the boom. To fill new or difficult to lease space, or to gain a much sought after tenant, landlords are offering improvement dollars as high as $50 to $60 per square foot. On the other hand, landlords with top tier, finished-out space might offer as little as $10 per square foot.

In addition to lowering costs for tenants, landlords are also increasing fees to procuring brokers. Commissions have gone up from $5 per square foot at this time last year to $7 per square foot for five-year deals and from $7 to $10 for 10-year deals. One well-known landlord is offering $10 per square foot on five-year deals for selected buildings.

Landlords are also aggressively pursuing renewals. Landlords are offering tenants such incentives as taking back space they don't need in exchange for longer leases. Commissions to procuring brokers for renewals have also gone up to as high as $5 per square foot. During the boom, commissions of higher than $2.50 per square foot for renewals were not common.

Although landlords are lowering rates, most are still making excellent returns on their buildings. Much of San Francisco's Class A space is held by strong landlords, that is to say mainly institutional investors who bought the buildings prior to the latest boom. Such landlords have the luxury of waiting until rents stabilize and are not forced to lower prices to sign leases. The holders of the city's premier office buildings are in the best position to negotiate. There are fewer options available for tenants desiring Class A space directly from the landlord since such space is only 10 percent vacant.

While tenants should try to lock-in today's rates for longer, landlords should focus on signing short term deals of five years to be well positioned when the market recovers.

Investment Sales

Lenders and equity players are for the most part staying on the sidelines in San Francisco. The year 2000 was a record year for investment sales with many buyers hoping to take advantage of historically high rates to increase yields. However, in 2001 the market dramatically reversed course. Last year, many properties went in and out of contract or were pulled from the market. Office investment activity amounted to just $436.3 million in 2001 compared to $2.5 billion in 2000, according to Cushman & Wakefield. Because of sluggish leasing and a wide range of rental rates, values are difficult to determine. There is wide gap between the price sellers want for their properties and what buyers are willing to pay, therefore many owners are taking advantage of lower interest rates to refinance their properties rather than sell them.

Groups looking to buy are finding that lenders have tightened requirements. Lenders are typically offering only a 55 to 60 percent loan to value and are also using market rents to determine values. In 2000, lenders were offering as much as 75 percent loan to value. Lenders see current demand as weak and are therefore not giving credit for above market rents. They are also looking carefully at a building's actual vacancy and potential vacancy, as are credit rating agencies.

Although some national players are hesitant to invest in San Francisco due to the dot-com fallout, equity investors, who are flush with cash, are interested in select properties.

Well-located buildings with little rent rollover and credit worthy tenants would receive multiple bids, but few are on the market. By contrast, single tenant buildings, those with short-term lease rollover, or those with poor credit tenants are not favored.

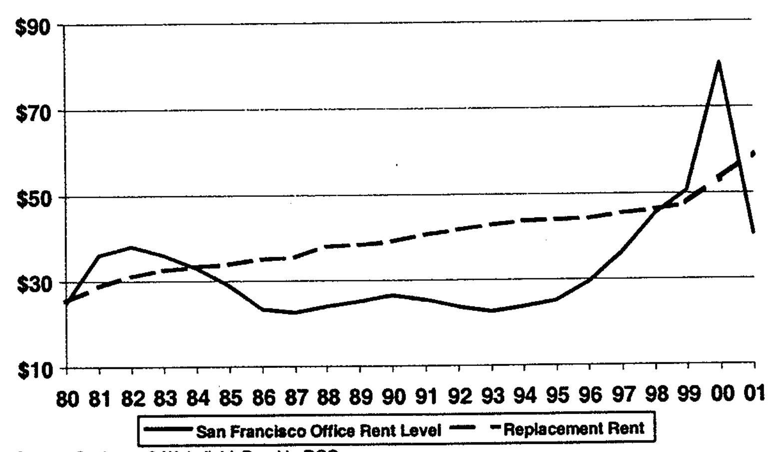
For the most part, San Francisco landlords appear well positioned to withstand the downturn because many buildings are under leveraged, interest rates are down and many companies looking to sublease are still paying rent. A few ambitious real estate companies purchased properties in San Francisco at the height of the market for prices as high as $400 per square foot. Some hoped to capture peak rents but missed the market. Such owners must be well capitalized to weather the storm.

Still, commercial real estate owners in San Francisco are in a better situation than in the last recession due to lender restraint. In general, lenders underwrote loans at rents below $55 per square foot. Compared to extreme rental rate appreciation in 2000, office building sales prices increased a moderate 9.4 percent in 2000 following a 3.4 percent increase in 1999.

The majority of owners have lower debt levels and thus smaller payments. They are able to lower rental rates and still make satisfactory yields.

Sales activity should pick up toward the end of the year when some owners may be forced to drop prices and sell. Also, some buyers will pay up rather than wait for sellers to substantially lower prices. In addition, some opportunity investors are looking to exit the market and that will result in a slight increase in sales volume.

San Francisco
Replacement Cost Vs. Rent



Source :Cushman & Wakefield, Boeckh, RCG

Drivers for recovery

Because of sparse leasing activity, there is no one industry or development that appears poised to led the real estate market to recovery. However, some positive trends are emerging. San Francisco rental rates are now on par with rates in Oakland. East Bay companies, some of whom were driven out of San Francisco during the boom years, are started to tour San Francisco office buildings. Also, a significant lease for a giant film studio signed by Lucas Arts at San Francisco's Presidio last year has the potential to bring more film related industries to the city. Another positive sign for the city is the launch of the University of California at San Francisco's biotechnology campus at Mission Bay, which has drawn the interest of the biotech community. A number of biotechnology companies from the East Bay and Peninsula are considering offices in San Francisco. By some estimates, there is close to 500,000 square feet of biotech demand in the market.

While the biotechnology industry is small now, it is expected to grown and become increasingly significant. However, we feel the biotechnology should not now be looked at as the savior of San Francisco's real estate market. The industry is currently too small to make a significant impact on office leasing.

We feel the long-term outlook for San Francisco is positive. The economy is diverse and supply is more restricted than other areas of the country due to stringent development controls and limited land supply. The area's mild climate and reputation as a tourist destination are also considered a draw for companies considering relocating their businesses. The sharp drop in rents in 2001 has made San Francisco more affordable than many other large U.S. cities.

Because of a weak market, there will be virtually no development between 2003 and 2005. Replacement rent, the rental rate required to justify to new construction taking into account construction and land costs, leasing commissions and tenant inducements, was below actual rent during the boom. For example in 2000, average actual rent in San Francisco was $80.16 while replacement rent was estimated at $53.05. This encouraged many developers to launch projects. However, actual rents had fallen by a half by the end of 2001 to $40.08 with replacement cost rent still in the high $40s to low $50s per square foot. The drop in rents and high construction and land costs caused many developers to postpone building. As the recession lengthens, land and construction costs will fall, causing a decline in replacement rent. As the market turns, actual rent will jump and new office construction will once again be justified. This will likely occur by mid-decade.

The excess from San Francisco's technology boom and bust will take a while to burn off. An economic recovery in San Francisco will probably not occur until 2003, although 2002 will probably be a bottoming year.

Further increases in vacancy and declines in rent are likely this year before the market bottoms and starts down the path to recovery. Many companies that laid off employees in the last year are only utilizing between 50 and 80 percent of their space and will not be expanding immediately after the economy reverses course.