Kidder Mathews

Real Estate Market Review

NORTHERN CALIFORNIA | San Francisco County

1st Quarter **2016**

San Francisco Office

Market Trends

	Trends
Absorption	↑
Vacancy	↓
Rental Rate	↑
New Construction	↔

Notable Lease Transactions

Airbnb
150,000 s.f. | 999 Brannan

Quantcast
±95,000 s.f. | 795 Folsom

Twilio
91,823 s.f. | 375 Beale

WeWork
72,963 s.f. | 600 California

Notable Sales Transactions

580 California | $220M or $690/s.f.

530-550 Kearny | $103.7M or $526/s.f.

995 Market | $62M or $679/s.f.

The San Francisco office real estate market sent mixed signals in the first quarter of 2016, with 433,868 square feet of positive net absorption masking a continued slump in leasing activity. The city-wide vacancy rate returned to 5.7%, after a brief jump to 6.5% last quarter, as tenants of buildings delivered in late 2015 began occupying their new spaces. While the supply of available space in San Francisco is at its highest point in the past eight quarters, non-tech-sector companies are increasingly looking to the East Bay and Peninsula for more affordable opportunities, with markets such as downtown Oakland tightening substantially as a result. Leasing activity was quiet, with 293 transactions totaling approximately 1.75 million square feet, down 21% from the fourth quarter of 2015. Nonetheless, demand continues to fuel soaring rental rates, particularly in sought-after submarkets such as the South Financial District and SOMA, where asking rents are up about 13% year-over-year. Leases worth over $100 per square foot remain commonplace in both view space in trophy buildings and Class C creative spaces in coveted locations such as South Park.

Market Drivers

Technology Sector. Technology companies continue to steer the San Francisco office market. The abundance of "unicorns" and more mature, established firms has, in recent quarters, priced many non-tech tenants out of the city. Vacancies have generally held in the mid-5.0% range since early 2015, nearly four percentage points lower than they were before the 2008 recession.

One possible indicator of the technology sector's influence is the demand for Class B and C office space, particularly in renovated industrial buildings, which offer the exposed ceilings, large floor plates, and open floor plans that creative and technology firms desire. Hence, the demand for Class B and C SOMA space, relative to Class A Financial District high-rise offerings, can serve as a proxy for the prominence of the technology sector. At quarter's end, asking rents on many SOMA-submarket offices space topped $75 per square foot, while most middle-floor Class A offerings in the North Financial District were in the mid-to-high $60s.

The tech sector is also behind the southward shift in the "center of gravity" of the San Francisco office market. Companies are increasingly prioritizing being near the city's tech giants and within steps of BART and Muni—features geared toward the young workers they aim to attract to gain a competitive edge in the industry. At quarter's end, Class B spaces on 2nd Street were listed in the mid-$70s per square foot, while landlords near the Financial District-Jackson Square border—even at landmark buildings such as the Transamerica Pyramid—were seen dipping into the low-to-mid-$60s retain existing tenants and maintain their occupancy levels.

With tech winners expanding and struggling startups downsizing, there were 2.3 million square feet of available sublease space in San Francisco at quarter's end—up a full million square feet

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over the past six months and the most in any quarter since 2009. While many large subleases were quickly gobbled up by growing tech firms, about half of the 20 largest listings had been on the market for over 90 days. Charles Schwab was the city's largest sublessor at the end of the quarter, with approximately 300,000 square feet available at 215 Fremont, Dropbox, which is subleasing about 200,000 square feet at 185 Berry, was rumored to have secured Stripe as a subtenant for roughly one-half of the space and to be nearing a deal with Lyft for the remainder. Subleasing activity can indicate a healthy, dynamic tech sector, rather than a contracting one, but coupled with signs of tighter venture-capital funding, it is a trend worth monitoring.

Office Leasing

Direct asking rental rates for fully-serviced Class A spaces ranged from the mid-$60s per square foot in the northern fringes of the Financial District to the low-$100s on the upper floors of choice properties such as 555 Mission and 4 Embarcadero Center. Class B direct lease price tags also varied across submarkets, from the low-$50s per square foot at 500 Washington in Jackson Square to $80 per square foot at 501 2nd in Rincon/South Beach, both fully serviced. Class C assets showed the widest asking-rent spread, even within preferred submarkets; upper-floor space in 425 2nd in Rincon/South Beach was listed in the low-$50s per square foot, while South Park (just 1 block away) asks continue to comfortably clear $100. Sublease discounts hinged on building class and submarket, but averaged approximately 15% off comparable direct lease offerings. A 13th-floor sublease in 2 Embarcadero was listed at $78 per square foot, a small dip from direct asking rates in the complex, while a fifth-floor space at 417 Montgomery was on the market for $45 per square foot, well below the direct price tags in proximate North Financial District properties.

Net absorption (the change in occupied space) was a positive 433,868 square feet in the first quarter, up from positive 94,612 square feet in the third quarter. Individual submarkets were a mixed bag, most starkly in the Financial District, where Market Street split a positive 413,101 square feet of net absorption to the south and negative 158,771 square feet to the north. Gains were largely concentrated in the South Financial District and Rincon/South Beach (+271,511 square feet) submarkets. While net absorption for direct leases was a positive 533,595 square feet, sublease space recorded its fourth straight quarter of negative net absorption, shedding 99,727 square feet. Several sublease offerings in excess of 40,000 square feet remain on the market, so sublease absorption may return to the black in the coming quarters. However, with leasing activity at its slowest pace since the third quarter of 2009, net absorption as a whole could slip later this year.

Investment

Investment activity perked up at the end of the fourth quarter and into the first, with dollar volume since mid-December totaling $1.15 billion and cap rates holding at an average of 4.4%. Two North Financial District high-rises traded in the past three months: 580 California, from Prudential to JP Morgan, for $220 million or $690 per square foot, and 550 Kearny, from Brickman Associates to Madison International Realty, which bought a 90% stake for $103.7 million, or $526 per square foot. In the Mid-Market area, the David Hewes Building at 995 Market Street—a 91,308 square foot Class B asset—traded from Long Market Property Partners to Bridgetown Holdings for $62 million, or $679 per square foot. Finally, 140 New Montgomery was rumored to be near a sale for what would be a record-high price tag of $975 per square foot, a potential landmark deal that we will continue to track.

Short-Term Interest Rates

After raising the short-term interest rate by 0.25 percentage points in December, the first hike in the critical rate since 2006, the Federal Reserve announced in March that it would keep the federal funds rate at 0.375% for the coming quarter. Uncertainty about the economic slowdown in China and Europe contributed to the decision, but economists expect the Fed to resume increasing borrowing costs in June. Job growth in the United States was robust against both the December increase in the short-term interest rate and the rocky sledding abroad, affirming the Federal Reserve's expectations of the economic recovery. Still, economists now project only two (2) more rate hikes before the end of the calendar year, rather than the four (4) anticipated last December.

**Figures and information for this report look only at office buildings larger than 5,000 s.f. and were obtained using 3/15/2016 as the cutoff date for the 1st Quarter. Source: CoStar Data*

SPOTLIGHT: Major Zynga

As concerns about the health of the tech sector loom, the fall of one of San Francisco's giants is a cautionary tale. Back in 2010, when the late-2000s recession gave way to the ongoing tech boom, Zynga struck what then was the city's largest lease deal in half a decade, a 270,000 s.f. grab at 650 Townsend. The social-gaming firm's apparent expansion plans served as a harbinger for the rapid tech-sector growth to come, and in 2012, Zynga bought the entire 670,000 s.f. complex, 650 Townsend and 699 8th, that housed its headquarters. Not long after, signs of trouble began to emerge.

By the end of 2012, the partnership with Facebook that fueled Zynga's surge was no more, and the buzz from its 2011 IPO had waned. A year later, the company acknowledged it could not fill its Showplace Square headquarters, subleasing 101,000 square feet to Practice Fusion while laying off some 500 employees. Finally, earlier this quarter, Zynga confirmed that 650 Townsend and 699 8th were for sale, with the company seeking a purchase-leaseback deal for some of the space. While Zynga is expected to turn a sizable profit when it secures a buyer, its workforce has dwindled from 3,500 to 2,300.

From a real-estate perspective, Zynga has come full circle: It will soon return to leasing a fraction of its building after a few years of big dreams that never materialized. As the gap between the tech sector's winners and losers widens, Zynga is a reminder of how steep the downslope can be.

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