Kidder Mathews

Real Estate Market Review

NORTHERN CALIFORNIA | San Francisco County

2nd Quarter
2016

San Francisco Office

Market Summary

	Q2 2016	FORECAST
Absorption	↑	↓
Vacancy	↑	↑
Rental Rate	↓	↓
New Construction	↑	↑

Notable Leases Signed

Fitbit
215 Fremont
207,193 s.f. sublease

Lyft
185 Berry
110,654 s.f. sublease

Lyft
185 Berry
93,713 s.f. lease

Airware
343 Sansome
60,506 s.f. sublease

Notable Sales

140 New Montgomery
$284M or $962/s.f.

180 Montgomery
$185M or $608/s.f.

799 Market
$141.5M or $973/s.f.

The San Francisco office real estate market was buoyed by its technology giants in the second quarter of 2016, with 346,838 s.f. of positive net absorption stemming mainly from newly delivered, preleased buildings that were occupied in part by Twilio (375 Beale) and Splunk (270 Brannan). Citywide vacancies rose from 5.8% to 6.1%, as prospective sublessors left their spaces and portions of the new structures remained vacant amid phased move-ins by their future tenants. Leasing activity increased to 2,247,341 s.f. over 310 transactions, with two tech-sector firms, Fitbit and Lyft, accounting for 14% of the deal volume in a pair of sublease pacts. While the supply of available space in San Francisco is at its highest point in nine quarters, asking rental rates have proven resilient, leading companies to look eastward for more affordable opportunities. Leases worth over $100 per s.f. are still commonplace in both view space in trophy buildings and Class C creative spaces in coveted locations such as South Park. Meanwhile, San Francisco office structures remain some of the world's most prized commercial real estate assets, attracting record-breaking outlays from domestic and foreign investors alike.

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. Brown & Toland medical group was the most notable firm to move across the Bay Bridge this quarter, leaving its headquarters space at 153 Townsend for a 60,000 square-foot base at the Clorox Building in downtown Oakland, where it signed a lease last year.

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. At quarter's end, asking rents on many SOMA-submarket office spaces topped $72 per s.f., 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, as companies prioritize proximity to the city's tech giants and access to public transportation.

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Area Review

Sublease Space

There was 2,685,041 s.f. of available sublease space in San Francisco at quarter's end, the greatest volume on record since at least 2005. Subleases accounted for nearly 25% of the space on the market, also a record high, even after 761,008 s.f. was subleased this quarter. Subleasing activity can indicate a healthy, dynamic tech sector, rather than a contracting one, and the rapid turnarounds secured by the city's largest sublessors are a positive sign in that regard. However, as of the end of the quarter, seven of the 11 sublease listings in excess of 50,000 s.f. had been on the market for at least 90 days, potentially an indication of waning demand.

The longer subleases stay on the market, the likelier they are to become vacant, and there was 683,036 s.f. of vacant-available sublease space in San Francisco at the end of the second quarter, the most since 2009. More than 500,000 s.f. of the vacant-available subleases was in Class A properties, and 280,451 s.f. was in the North Financial District. The Philadelphia-based global lawfirm Morgan, Lewis & Bockius, which last year absorbed Bingham McCutchen LLP, has been unloading the latter's old offices nationwide and is seeking a subtenant for 76,779 s.f. at 3 Embarcadero. In the South Financial District, Bare Escentuals was marketing 79,678 s.f. at 71 Stevenson after announcing plans to relocate its headquarters to New York City.

Office Leasing

Direct asking rental rates for fully-serviced Class A spaces ranged from the mid-$60s per s.f. near the northern edge of the Financial District to the low-$100s on the upper floors of choice properties such as 4 Embarcadero Center. Class B direct lease price tags also varied across submarkets, from the low-$50s per s.f. at 220 Montgomery north of Market Street to the low-$80s at 501 2nd in Rincon/South Beach, both fully serviced. Class C assets showed the widest asking-rent spread, even within preferred submarkets; some desirable spaces in SOMA and Rincon/South Beach properties are available in the high-$50s per s.f., while South Park asks just blocks away continue to comfortably clear $100. Sublease discounts hinged on building class and submarket, but increased slightly from the first quarter. Coupled with the shorter terms and plug-'n'-play potential that subleases offer, the lower prices can make them more appealing to tenants than the direct options currently on the market.

Net absorption (the change in occupied space) was a positive 346,838 s.f. in the second quarter, bringing the year-to-date gain to 1,149,476 s.f. Three fully preleased building deliveries accounted for most of the positive absorption this quarter, as the Metropolitan Transportation Commission, Twilio, and other tenants occupied The MTC Building at 375 Beale, Splunk began a phased move into 270 Brannan, and Collective Health set up shop at 85 Bluxome. Hence, the Rincon/South Beach submarket, home to the former two, led the city with 430,490 s.f. of positive absorption over the past three months. The Financial District came out virtually even on balance, with 320,031 s.f. gained in the south and 325,249 s.f. lost in the north, tracking the southward shift in the city's center of gravity. Class A absorption was negative 85,060 s.f., the premium class's first period in the red since the third quarter of 2013, mainly as a result of move-outs by companies that are now seeking subtenants. Direct-leased Class A spaces saw a 59,172 s.f. growth in occupied space while an additional 174,232 s.f. of sublease space became vacant.

Investment

While there were only six investment sales this quarter, dollar volume increased to $673 million, and the average price per s.f. surged to $727.33, the highest quarterly mean ever recorded, albeit from a small sample of investments. The sale of 140 New Montgomery, a 295,000 s.f. Class A property that is home to Yelp's headquarters, from Wilson Meany to Pembroke Real Estate for $284 million ($962/s.f.), broke the city's previous per s.f. record. Shortly thereafter, 799 Market, a 142,900 s.f. Class B property, traded from Jamestown to ASB Real Estate Investments for $141.5 million ($973/s.f.). While those currently represent landmark transactions, several properties rumored to be on the market, including 505 Howard, 222 Second, and The Piers (Piers 1.5, 3 and 5 along the Embarcadero), could eclipse $1,000 per s.f. if they trade during the coming quarter. North of Market Street, the 304,000 s.f. Bank of the West Building (180 New Montgomery) traded from CBRE Global Investors to Sidra Capital for $185 million ($608/s.f.). CBRE bought the asset for $126.25 million just two-and-a-half years ago, turning a 46.5% profit.

Spotlight: Tencent and Chinese Investors' Growing Appetite

Amid lingering doubts about the health of China's economy, Chinese investors are increasingly eager to place their money into American assets. While commercial real estate, particularly in globally renowned cities such as San Francisco and New York, remains the primary arena of Chinese investment in the United States, there were signs this quarter that investors' appetite was both growing and widening.

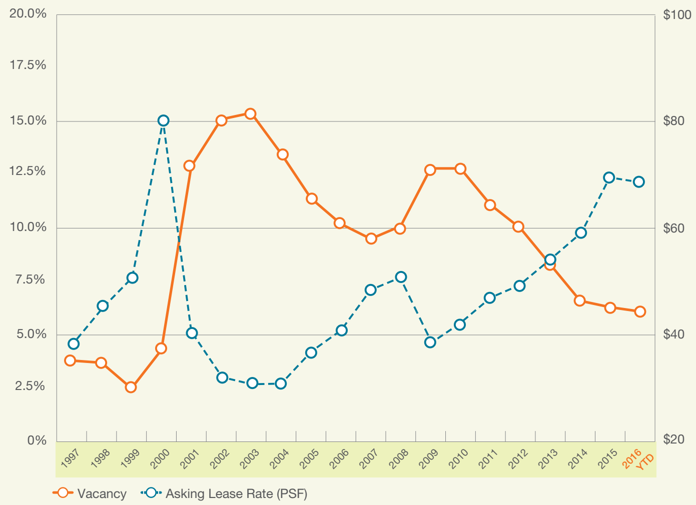
In June, the internet giant Tencent Holdings, which has a market capitalization of over $200 billion, greater than those of American tech giants such as IBM, Cisco Systems, and Oracle, spent $8.6 billion to acquire an 84.3% stake in the Finnish gaming firm Supercell, best known for "Clash of Clans." Headquartered in Helsinki, Supercell has notable ties to Asia, with offices in Beijing, Seoul, and Tokyo, but it also holds a 23,000 square-foot perch on the top floor of the Bank of America Center (555 California) in San Francisco. Mobile gaming is among the fastest-growing technology industries, with market researchers anticipating 20%-or-greater revenue increases to an estimated $37 billion in 2016, and Supercell holds one of its premium products.

With limited reliable investment opportunities across the Pacific, China's wealth-holders are diversifying their American portfolios, both geographically and across industries. Successful tech-sector companies with growth potential are a logical target for overseas investors, particularly if they offer Asian firms an opportunity to get closer to their American customers. As the center of the nation's tech industry, San Francisco is poised to stay near the top of the leaderboard among U.S. cities for inflow of Chinese money, which could reach $200 billion nationally by 2020.

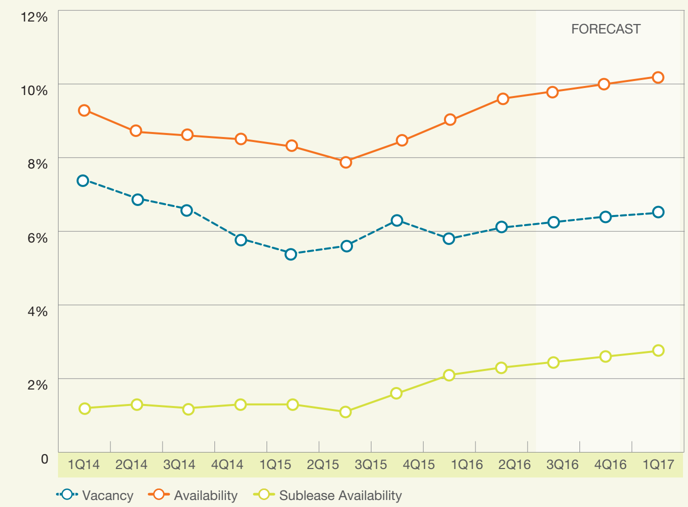
Macro-Economic Factors

Several noteworthy economic trends reached the San Francisco market this quarter. As the national labor force participation rate declined to 62.5%, the local economy saw its labor force drop by some 6,900 workers between March and May, and it was this labor-force contraction, rather than job growth, that trimmed the local unemployment rate to 2.8%. Following slower-than-expected employment gains, the Federal Reserve postponed its planned increase in the short-term interest rate, and many investors now believe the benchmark rate will remain at 0.5% until the fourth quarter. From a real-estate perspective, lower short-term interest rates can boost investment activity by improving buyers' projected cash-on-cash returns. San Francisco office assets are highly coveted by both domestic and foreign investors, and a delay in the Fed's interest-rate hikes could foretell an increase in property trading this summer. Finally, uncertainty surrounding the impact of "Brexit", Britain's decision to leave the European Union, is a macroeconomic event worth monitoring into the coming quarter.

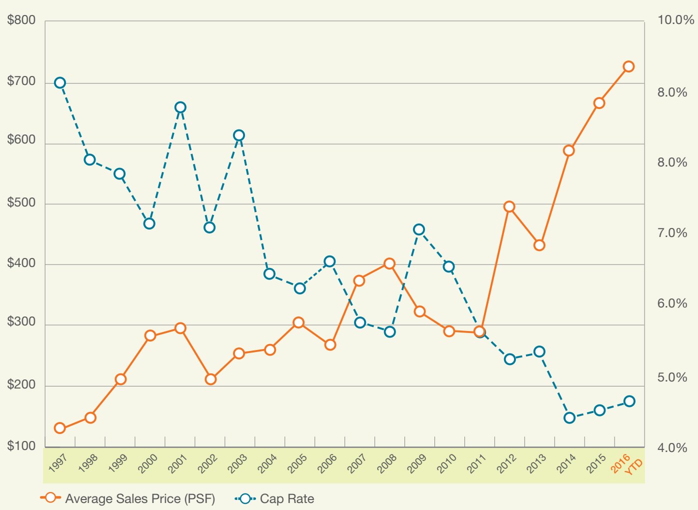
VACANCY VS ASKING LEASE RATE



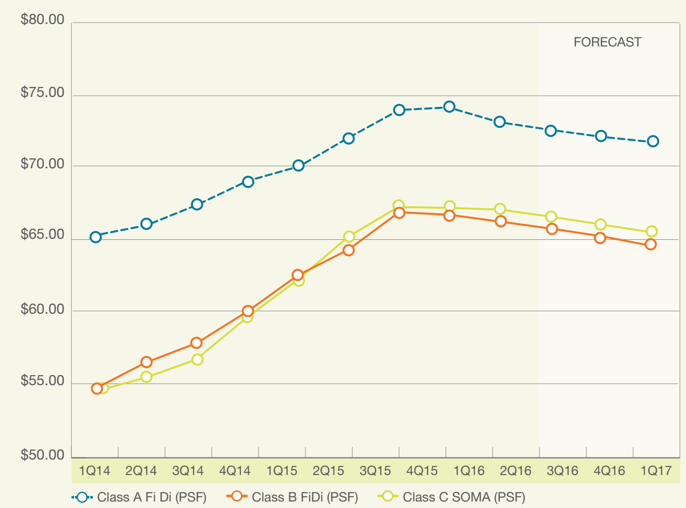
VACANCY VS AVAILABILITY



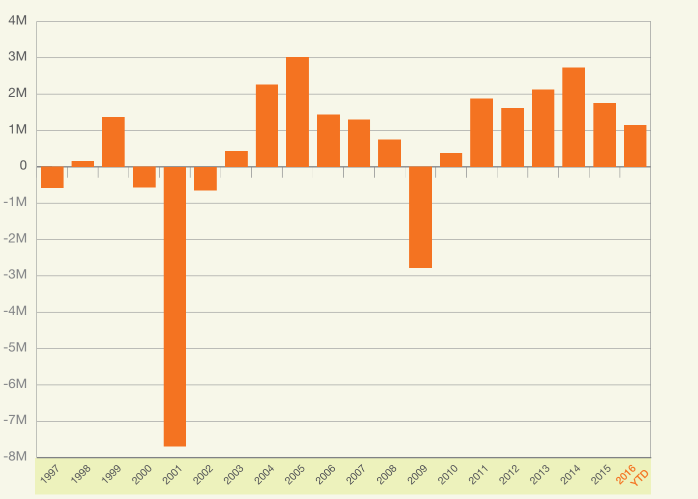
AVERAGE SALES PRICE & CAPITALIZATION RATES



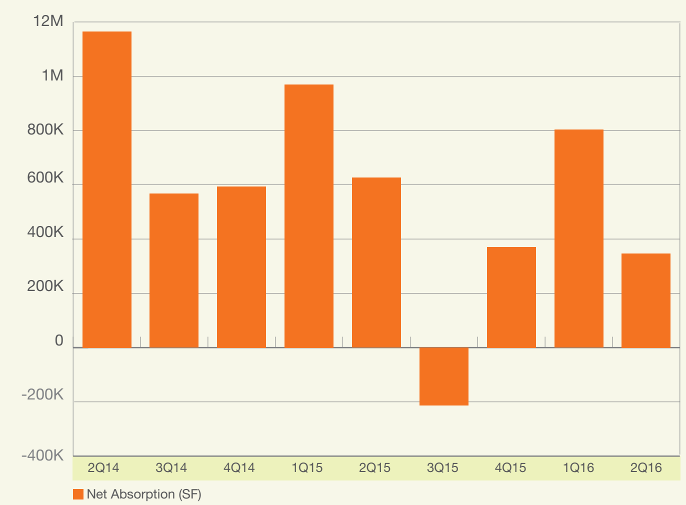
ASKING LEASE RATE



NET ABSORPTION - HISTORICAL



NET ABSORPTION - QUARTERLY



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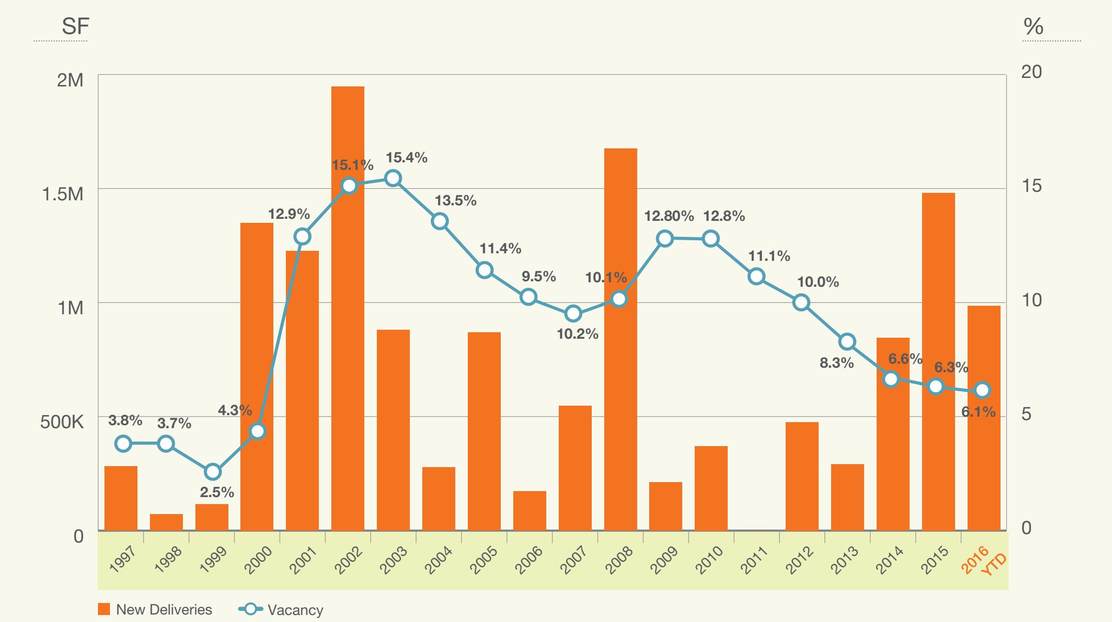
Market Breakdown

	2Q 2016	1Q 2016	2Q 2015	Annual % Change
Vacancy Rate	6.1%	5.8%	5.4%	12.96%
Availability Rate	9.6%	9.0%	8.3%	15.66%
Asking Lease Rate	$68.71	$70.33	$66.09	3.96%
Leased SF	2,247,341	2,159,819	2,683,469	-16.25%
Sold SF	878,843	829,190	468,944	87.41%
Net Absorption	346,838	802,538	625,759	N/A

HISTORICAL NEW CONSTRUCTION & VACANCY RATES



HISTORICAL SALES SF & MEDIAN SALE PRICE