

# San Francisco Office

## Market Forecast

Trends

Absorption	↑
Vacancy	↓
Class A FiDi Rental Rate	↔
Under Construction	↑

## Notable 2016 Leases

- Charles Schwab**  
211 Main | 394,704 s.f. (Renewal)

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- Fitbit**  
215 Fremont | 315,000 s.f. (Sublease)

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- Twitch**  
350 Bush | 236,942 s.f. (Direct)

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- Lyft**  
185 Berry | 204,367 s.f. (Direct and Sublease)

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- Adobe**  
100 Hooper | 190,000 s.f. (Direct)

## Notable 2016 Sales

- Blackstone**  
Market Center (555-575 Market) | 752,738 s.f.  
Purchased for \$510M or \$678/s.f.

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- Paramount Group**  
One Front | 651,000 s.f.  
Purchased for \$490.2M or \$753/s.f.

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- American Realty Advisors**  
505 Howard | 291,032 s.f.  
Purchased for \$332M or \$1,141/s.f.

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- Pembroke Real Estate**  
140 New Montgomery | 295,177 s.f.  
Purchased for \$284M or \$962/s.f.

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- Invesco**  
The Piers (Piers 1, 3, 5) | 80,994 s.f.  
Purchased for \$103M or \$1,272/s.f.

The San Francisco office real estate market was as dynamic as ever in the fourth quarter of 2016, as tech-sector giants traded space and investors continued to bet big on some of the city's most coveted assets. This quarter's 49,732 square feet of positive net absorption pared the vacancy rate down to 6.2%, and several large move-ins anticipated in the first half of 2017 portend a return to sub-6.0% vacancy in the coming quarters. Asking rents ticked down slightly from the third quarter—to averages of \$72.98 for Class A Financial District space, \$66.19 for Class B offerings, and \$66.93 for creative Class C product South of Market—but have held firm since the beginning of 2016 and are likely to remain robust against an impending increase in supply. In a welcome development for the diversity of the local economy, financial sector firms led by Charles Schwab renewed their commitments to the city, joining rapidly growing technology companies to drive 2,000,357 square feet of leasing activity. With multiple large tenants still in the market, such as Amazon and Slack, the new year is likely to bring lower vacancies and steady rental rates, reaffirming the appeal of San Francisco office assets to U.S. and foreign investors.

### Technology Sector

Technology companies remain the heartbeat of San Francisco office real estate, accounting for the bulk of the city's tenant activity and providing a window into the health of the local economy. Larger, established firms continued to buoy the market during the fourth quarter, which featured several noteworthy expansions amid rocky sledding for startups and at least one of the city's giants.

San Jose-based Adobe made the quarter's biggest move, grabbing a total of 190,000 square feet in two transactions at 100 Hooper, a Kilroy development in Showplace Square that is set for delivery in January 2018. The newly delivered building at 500 Pine Street will be home to Blend Labs, a data-driven lending platform provider currently on the 25th floor of 100 Montgomery, which is building out a 56,741-square-foot space for occupancy in April.

Several other growing technology firms found expansion homes on the sublease market, backfilling spaces vacated by tech-sector colleagues that are downsizing, relocating, or expanding. NerdWallet is the city's largest new subtenant, signing on to replace Twitter in 104,850 square feet at 1 Tenth. Twitter's 1355 Market listing, for 78,792 square feet, was recaptured and subsequently leased to Thumbtack on a direct basis. In the largest sublease outside of Twitter's headquarters, AdRoll

→ Continued, page 2

# Area Review

will take over the entire, 65,493-square-foot building at 2300 Harrison in Potrero Hill, previously occupied by Lyft, which has relocated its headquarters to 185 Berry.

After cresting at about 2.73 million square feet during the second quarter, sublease availabilities fell to approximately 1.98 million square feet by the end of 2016, representing only a 150,000-square-foot increase year over year. Nonetheless, the dynamic nature of the technology sector should ensure a healthy supply of sublease offerings. When NerdWallet moves into 1 Tenth, it will leave its current offices at 901 Market and 810 Mission, where a total of 74,835 square feet is now listed for sublease. Thumbtack's current headquarters space, 22,800 square feet at 360 9th Street, was also on the market at quarter's end.

## Charles Schwab

When Charles Schwab, one of San Francisco's largest and most recognizable employers, announced plans to relocate jobs to Colorado and Texas, there were fears that the brokerage and banking corporation might leave the city entirely. The wearable technology firm Fitbit quickly snapped up Schwab's 315,000-square-foot sublease at 215 Fremont, but the news stoked concerns about San Francisco's viability for non-tech firms. Despite announcing plans to keep its headquarters in the Bay Area, Schwab was rumored to be looking beyond the city limits to avoid a sudden spike in costs, with the average rate in the city more than double its old \$31 per-square-foot rent.

In December, Schwab finally calmed fears of its imminent departure by committing to stay at its 211 Main offices through at least 2026. The 10-year renewal for 394,704 square feet is San Francisco's largest lease transaction of the year. More significantly, it's an indication that the city is not yet in danger of having an entirely tech-driven economy. Two other finance giants, Merrill Lynch and Morgan Stanley, also inked renewals in the fourth quarter, retaining their offices at 101 California.

## Office Leasing

Direct asking rental rates in downtown San Francisco plateaued throughout the last three quarters of 2016, after increasing rapidly in the final months of 2015 and early in the year:

- Fully-serviced Class A spaces ranged from the mid-\$60s per square foot near the northern edge of the Financial District, at 555 Montgomery, to the low-\$100s on the upper floors of choice properties such as 4 Embarcadero Center. A full-floor offering at 1 Kearny was asking \$73.
- Availabilities in new office developments such as Park Tower and 181 Fremont were marketed in the high-\$80s or low-\$90s, NNN, excluding an estimated \$25 per square foot in operating expenses.
- Full-floor Class B offerings came in between the high-\$50s for lower floors in North Financial District buildings, such as 100 Bush, and the low-\$70s in tech-oriented properties south of Market Street. A larger, 30,000-50,000 s.f. availability at 201 Third was asking \$75.
- Class C SOMA product averaged in the mid-\$60s, from the mid-\$40s for non-creative spaces to \$120-140 for offerings along South Park. A first-floor space at 633 Howard was listed for \$63.

San Francisco saw 49,732 square feet of positive net absorption during the fourth quarter, as move-outs in the Financial District were balanced out by new tenants in Rincon/South Beach and Showplace Square:

- Rincon/South Beach topped the city with 149,162 square feet of positive absorption, as Twilio moved into 91,823 square feet at 375 Beale and Formation 8 occupied 35,330 square feet at 625 2nd.

## Spotlight: Bought It, Reddit, Sold It

One of the virtues of the tech industry is the pioneering spirit of its leaders. For real estate, that means a willingness to venture into taboo neighborhoods, in search of the creative spaces that will attract the best talent. About three years ago, a joint venture of San Francisco's Seal Rock Investments, Orange County's PRES Real Estate, and Optimum Asset Management from Luxembourg bet on the possibility of a tech-sector advance into the Tenderloin, buying 420 Taylor, a 46,024-square-foot office building with a public parking garage, for \$27.25 million.

At the time of that sale, the office space was leased to the electronic health-record company Practice Fusion, which subleased its space to the mobile-game ad platform Chartboost. As that sublease neared its expiration, the investors secured the visible tech tenant they sought in the social news website Reddit, which signed on for the entire 46,024-square-foot office portion of the property in March 2016. At a starting rent of \$64/sf, Reddit landed a large block of creative space for much less than it would have paid for a comparable home South of Market, validating the joint venture's bet on the property.

That bet officially paid off in October, when New York-based Seven Equity Group paid \$45 million to buy 420 Taylor, giving the investors a 65% return on their purchase price after just a three-year hold. Seven Equity Group now intends to convert the parking portion of the property into a ground-floor retail space, further monetizing an asset in a location where such value might have seemed impossible just a few years ago.

- Showplace Square reported 110,670 square feet of positive net absorption on the strength of Change.org's 26,641-square-foot occupancy at 444 De Haro and iRhythm Technologies' expansion into 60,864 square feet at 650 Townsend.
- The South Financial District, which led the city in absorption gains in 2016, dropped 175,845 square feet in the fourth quarter, as the U.S. Department of Education left 57,403 square feet at 50 Beale and Berkshire Hathaway vacated a 28,704-square-foot space at 525 Market, subleased to Medivation.

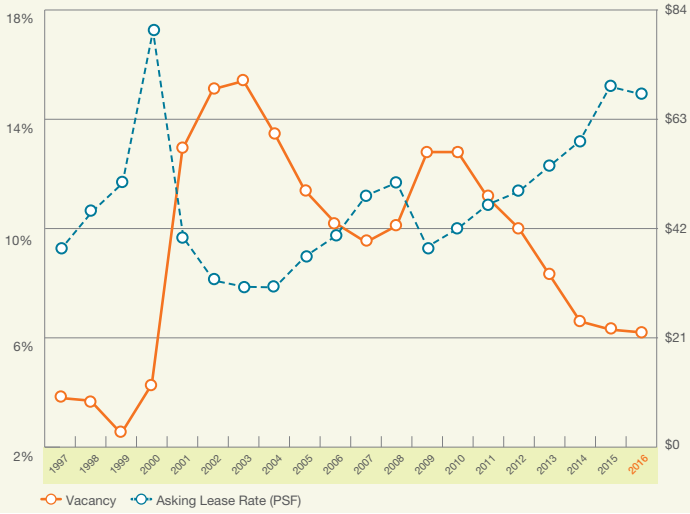
Absorption gains for the year totaled 1,103,311 square feet, but the biggest occupancies were clustered in the first six months. After adding more than 1.1 million square feet of occupied office space during the first two quarters, San Francisco shed 30,006 square feet in the latter half of the year.

## Investment

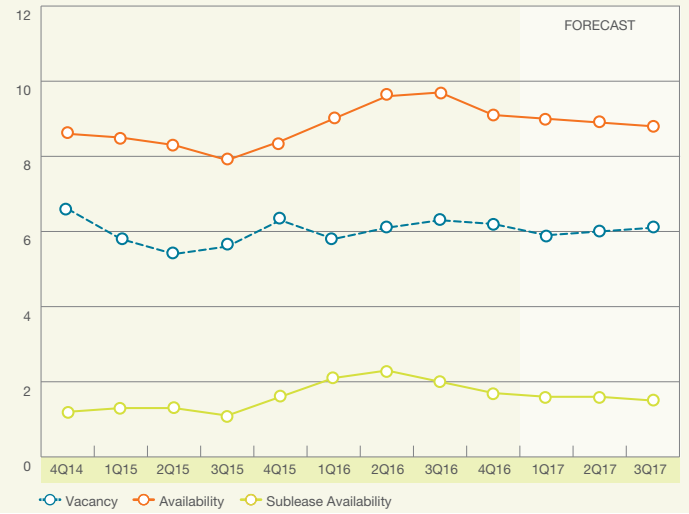
Cycle-high investment activity in the third quarter spilled over into the fourth, as over 1.1 million square feet of San Francisco real estate changed hands, totaling approximately \$719 million in dollar volume. The average price per square foot climbed from a record \$840.33 to \$864.07, as investors continued to trade some of the most coveted assets in the city. In the largest transaction by total outlay, Paramount Group acquired One Front Street from the Florida State Board of Administration for \$490.2 million or \$753/sf, underwritten at a 4.5% cap rate. American Realty Advisors cleared that dollars-per-foot price tag comfortably in its purchase of 505 Howard Street, obtaining the three-year-old building from its developer, Tishman Speyer, for just over \$332 million, or \$1,141/sf. Continuing a rapid-turnover trend that emerged in the middle quarters of 2016, five of the nine buildings that sold in the past three months had been acquired by their previous owners in or after 2011.

Data Source: CoStar

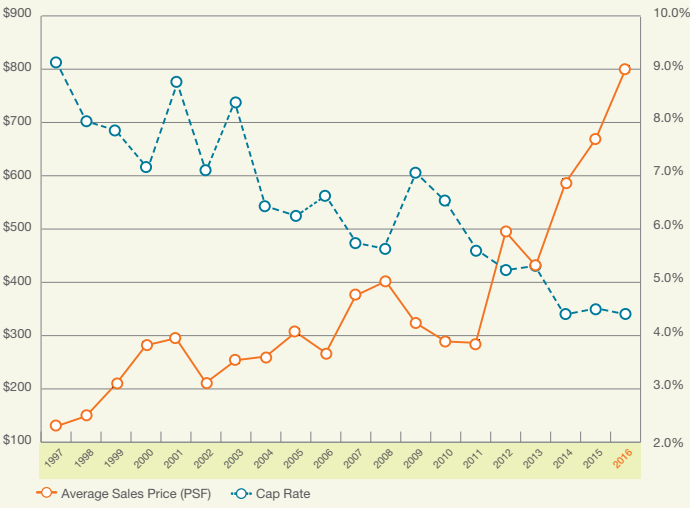
### VACANCY VS ASKING LEASE RATE



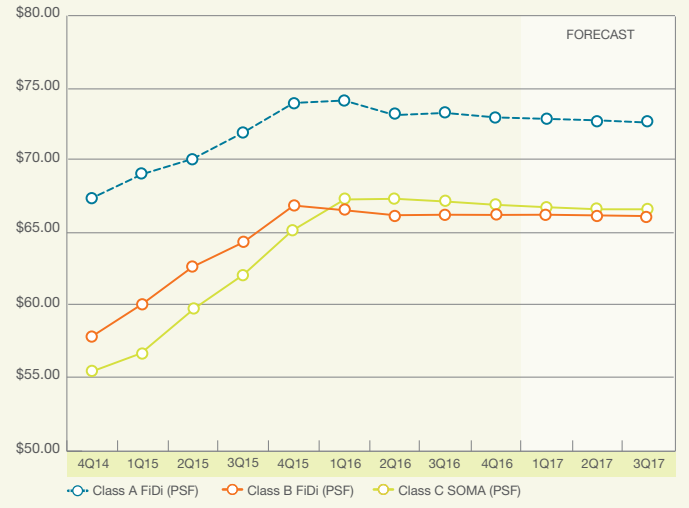
### VACANCY VS AVAILABILITY



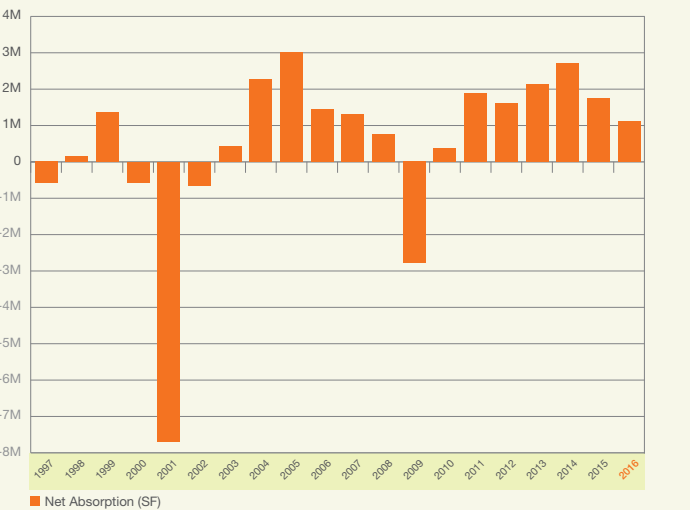
### AVERAGE SALES PRICE & CAPITALIZATION RATES



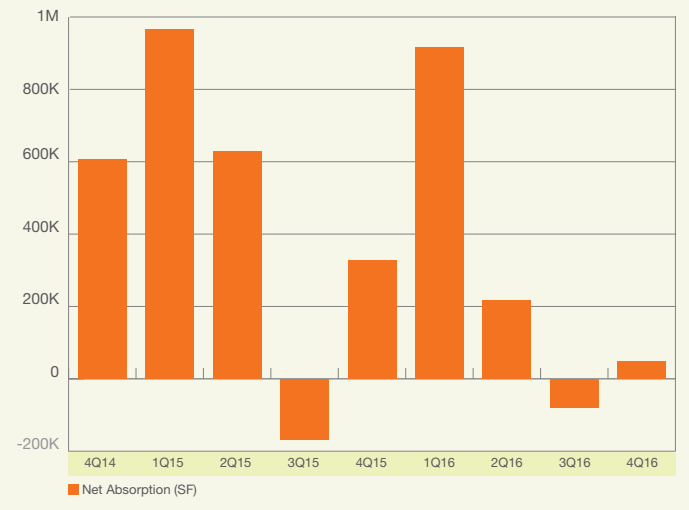
### ASKING LEASE RATE



### NET ABSORPTION - HISTORICAL



### NET ABSORPTION - QUARTERLY



**Offices**

Seattle  
206.296.9600

Bellevue  
425.454.7040

South Seattle  
206.248.7300

Tacoma  
253.722.1400

Olympia  
360.705.2800

Portland  
503.221.9900

San Francisco  
415.229.8888

Redwood Shores  
650.769.3600

Silicon Valley  
408.970.9400

Sacramento  
916.970.9700

Roseville  
916.751.3600

Orange County  
949.557.5000

Inland Empire  
909.764.6500

San Diego  
858.509.1200

Carlsbad  
760.430.1000

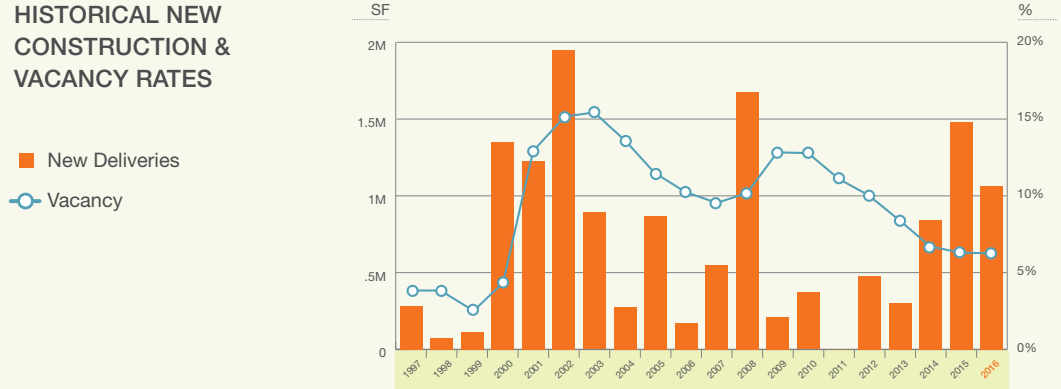
Reno  
775.301.1300

Phoenix  
602.513.5200

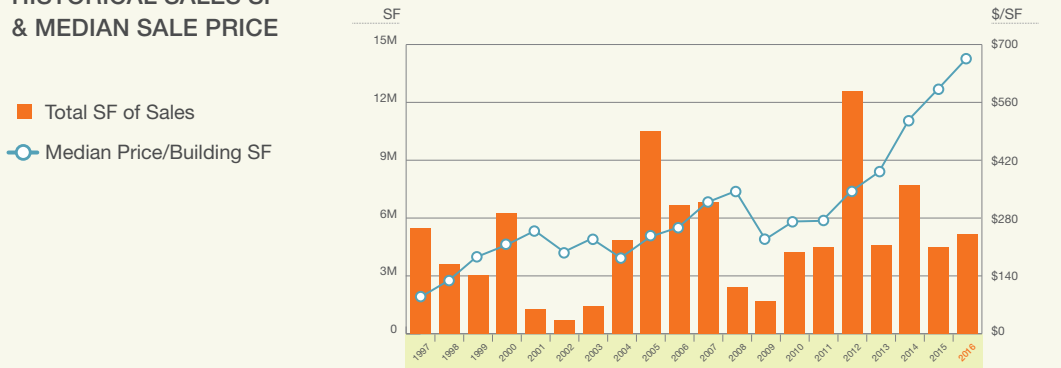
**Market Breakdown**

	2016	2015	2014	Annual % Change
Vacancy Rate	6.2%	6.3%	6.7%	-1.5%
Availability Rate	9.1%	8.3%	8.5%	9.6%
Asking Lease Rate (Class A FiDi)	\$72.98	\$73.80	\$67.39	-2.2%
Leased SF	8,661,490	10,591,169	13,136,404	-18.2%
Sold SF	5,144,339	4,484,285	7,693,024	14.7%
Net Absorption	1,103,311	1,754,066	2,704,099	-38.1%

**HISTORICAL NEW CONSTRUCTION & VACANCY RATES**



**HISTORICAL SALES SF & MEDIAN SALE PRICE**

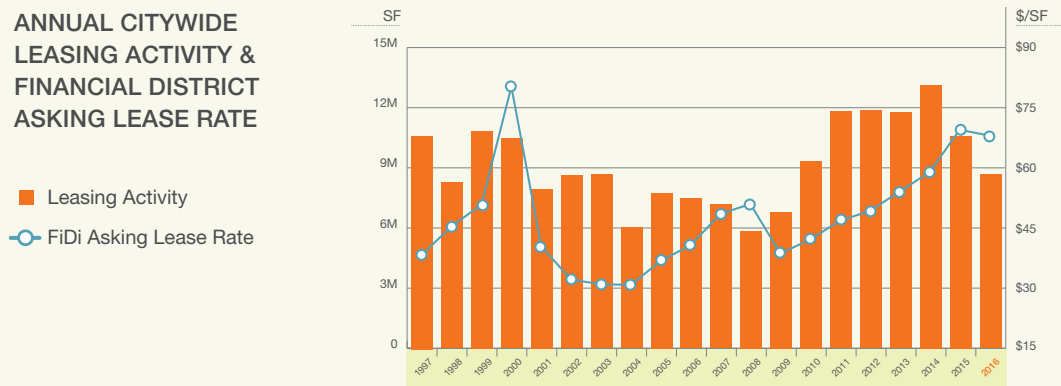


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**ANNUAL CITYWIDE LEASING ACTIVITY & FINANCIAL DISTRICT ASKING LEASE RATE**



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