

San Francisco Office

Market Forecast

Trends

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

Notable Leases

First Republic Bank
1 Front | 190,000 s.f. (Direct)

Otto
Pier 70 | 126,594 s.f. (Direct)

Affirm
650 California | 86,000 s.f. (Direct)

WeWork
655 Montgomery | 51,859 s.f. (Direct)

Notable Sales

Beacon Capital Partners
44 Montgomery | 631,225 s.f.
Purchased for \$475.4M or \$753/s.f.

Brookfield Office Properties
1 Post | 424,000 s.f.
Purchased for \$245M or \$578/s.f.

GAW Capital Advisers
555 Montgomery | 228,573 s.f.
Purchased for \$120.6M or \$528/s.f.

Sino-Ocean Land
1161 Mission | 65,600 s.f.
Purchased for \$42M or \$640/s.f.

With several new office towers rising and up to a dozen 100,000 s.f. tenants searching for space, the San Francisco office real estate market remains exceptionally strong. Occupancy levels were unchanged during the second quarter, which saw 16,679 square feet of positive net absorption, but the market added two more leases in excess of 100,000 s.f., bringing the 2017 total to eight. Asking rent trends varied by the type of space being marketed, with creative offerings seeing up to a 5% year-over-year rise in rents while traditional offices trended slightly downward, prompting Class A landlords to offer substantial tenant improvements to attract a wider range of users. Overall, Class A Financial District spaces averaged \$70.63, Class B offerings were at \$65.90, and Class C creative product was marketed for \$67.38. Both national and foreign investors found desirable acquisitions in San Francisco, which remains a gateway market for Asian developers eyeing assets across the Pacific. More than 6.5 million square feet of office space was under construction at quarter's end, but ample demand among technology giants from Amazon to Facebook suggests that rental rates for creative offices in the city are unlikely to fade despite the impending increase in supply.

Technology Sector

Established technology firms continue to grow in San Francisco and Silicon Valley, competing for the area's top talent and its most coveted real estate while striving to become market leaders in the industry's new frontiers. Tech companies' desire to form urban campuses in the city paved the way for several 100,000 s.f. or greater leases during the first quarter. The industry's expansion into fields like autonomous cars was a significant driver this quarter, and the advancement of new subsectors such as virtual reality could be a key factor in the quarters to come.

The period's largest tech sector lease was signed by Otto, the self-driving truck company owned by Uber, which took 130,000 s.f. at Pier 70, an attractive location because it can accommodate both the company's office and manufacturing space needs. That deal came shortly after GM Cruise, the self-driving car company known as Cruise Automation before its acquisition by General Motors, leased nearly 140,000 s.f. at 1201 Bryant. GM Cruise intends to use the building as offices for its engineers and a "development laboratory" for its autonomous vehicles, in the wake of a partnership with Lyft to develop a fleet of self-driving, ride-sharing cars. Both of these leases are in buildings classified as flex or PDR space, where the zoning code prohibits traditional office uses, but the evolution of the technology sector into fields that blur the line between office and manufacturing is a noteworthy trend in the tech-driven San Francisco market.

→ Continued, page 2

Area Review

Including Otto and GM Cruise's flex-space leases, there have been eight deals for more than 100,000 s.f. each signed in the city in the year to date. The San Francisco record for 100,000 s.f. deals in a single year is 17, set in 2014, and the activity in the last two quarters puts the city just shy of that pace. Multiple other technology giants, led by Amazon and Facebook, were rumored to be in the market for large blocks of office space at quarter's end, eyeing both existing availabilities and buildings under construction. Given these firms' appetite to increase their San Francisco footprint, the uptick in six-figure leases is likely to continue into the second half of 2017.

WeWork

The \$18 billion co-working startup WeWork continued its San Francisco expansion by signing a 52,613 s.f. lease at 655 Montgomery, taking over space formerly occupied by Hotwire. The lease puts WeWork in direct competition with Spaces, a subsidiary of International Workplace Group, which is opening a 35,300 s.f. Jackson Square location at 1160 Battery. WeWork now holds approximately 536,000 s.f. of San Francisco office space in long-term leases. While initially geared toward startups and smaller firms with rapidly changing space needs, it has recently attracted interest from established companies, forming a partnership with Amazon to operate several of its offices from Boston to San Jose. WeWork will officially open two locations, at 201 Spear and 650 California, during the third quarter.

Office Leasing

Direct asking rental rates in downtown San Francisco are up approximately 2% year over year, but are increasingly bifurcated between creative spaces and traditional office build-outs:

- Fully-serviced Class A spaces ranged from the mid-\$60s at the northern edges of the Financial District to the low-\$100s on the upper floors of choice properties such as 4 Embarcadero Center. A creative spec suite on the top floor of 49 Stevenson was asking \$73 FS.
- Availabilities in new office developments such as Park Tower and 181 Fremont were marketed in the high-\$80s or low-\$90s, NNN; the NNN expenses are estimated at \$25, bringing the fully serviced equivalents above \$100/sf.
- Full-floor Class B offerings varied widely. A large, top-floor opportunity at 875 Howard was being marketed for \$75 IG, while a more traditional, office-intensive space at 100 Bush was priced at \$58 FS.
- Class C SOMA product averages stayed in the mid-\$60s, spanning from the low-\$40s for non-creative listings to the mid-\$70s for spaces geared toward tech tenants. A ground-floor spec suite at 984 Folsom was listed for \$65 IG.

Absorption

The second quarter saw 16,679 square feet of positive net absorption, as most of the move-outs during the period were relocations within the city:

- The Mid-Market area added 271,244 s.f. of occupied office space, as Thumbtack (166,044 s.f.) and NerdWallet (104,850 s.f.) took over spaces subleased from Twitter at 1355 Market and 1 Tenth, respectively.
- Several North Financial District move-outs produced 192,274 square feet of negative absorption. AECOM left 38,701 s.f. at 1 Montgomery, Goodby Silverstein & Partners gave back 31,092 s.f. at 650 California, and Lithium Technologies placed 25,024 s.f. on the market for sublease at 225 Bush.

Spotlight: 650 California

Investors holding 650 California, a 478,392 square foot Class A tower in the northwestern corner of the Financial District, have gone through the ups and downs of the San Francisco market over the past two decades. The building has traded four times since 2000, for \$322/s.f. in October of that year, then \$627/s.f. in June 2007 ahead of the late-2000s recession, then \$457/s.f. in June 2012 before the ongoing tech boom, and most recently, for \$646/s.f. in August of 2014, a year before office rents in the city soared. UBS Group saw the asset's value drop by 27% from 2007-2012, while Tishman Speyer, which spent \$14 million on renovations including a revamped lobby and onsite parking garage, earned a 41% return on its purchase price in just 26 months. Columbia Property Trust was the buyer in that \$309 million transaction, and despite purchasing 650 California at a 3.7% cap rate, it viewed the deal as a significant value-add opportunity.

The building's leading tenants at the time were Credit Suisse, Littler Mendelson, and Goodby Silverstein & Partners, traditional office users with the buildouts to match. All three have since moved out, clearing the way for more than 200,000 s.f. of new leases. The updated tenant roster is led by WeWork, which took 60,576 s.f. in February, and the lending startup Affirm, which grabbed 86,000 s.f. in one of the second quarter's largest deals. The starting rents on the recent long-term leases are in the low-\$70s, but bringing those creative users well north of Market Street and BART required considerable concessions by the landlord. Columbia has loaded its new leases with more than \$100/sf in turnkey tenant improvements, tearing down office-intensive buildouts and recreating full floors from shell. As the San Francisco market increasingly favors creative spaces and users, for landlords looking to create value and preserve above-average rents, those triple-digit TI costs could become the norm.

- Lower SOMA saw 81,975 s.f. of negative net absorption, as Invitae Corporation dropped 38,963 s.f. at 475 Brannan while consolidating its San Francisco workforce at 1400 16th Street.

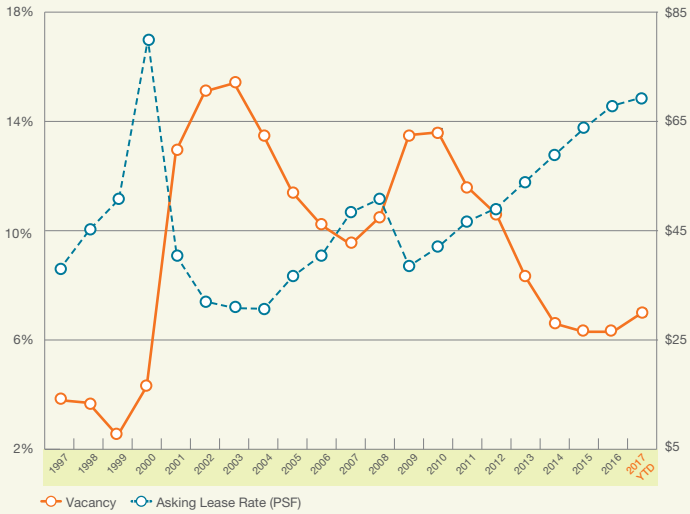
While traditional office spaces may face longer vacancy periods, the high volume of technology tenants in the market ensures that creative availabilities are quickly reabsorbed. New construction deliveries coupled with expansions by some of the city's tech giants should produce more absorption gains in the coming quarters.

Investment

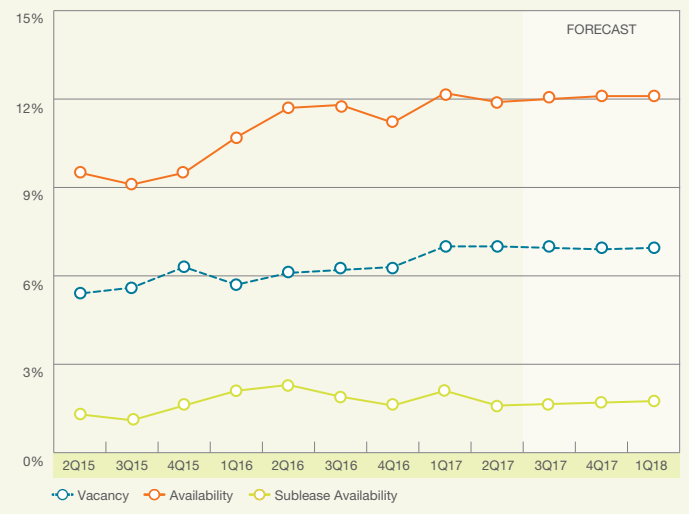
Office investment activity in San Francisco yielded more than \$1 billion in dollar volume for the fifth consecutive quarter, as 1.7 million square feet of real estate transacted at an average price tag of \$615/s.f. Boston-based Beacon Capital Partners acquired 44 Montgomery, a 688,902 s.f. Class A tower, for \$475.4 million or \$753/s.f., underwritten at a 3.9% cap rate. That price is near the top of the market for a north Financial District asset primarily occupied by traditional tenants such as law firms and the US Securities & Exchange Commission. On the other end of the office spectrum, Beijing-based Sino-Ocean Land bought 1161 Mission, a 65,600 s.f. Class B building in the Mid-Market area for \$42 million or \$640/s.f., the Beijing-based developer's first investment in the United States. The seller, Los Angeles-based Downtown Properties Holdings, a U.S. arm of Hong Kong-based Gaw Capital Partners, obtained the building for \$19.3 million in August of 2012, renovated the interior into creative space, and secured WeWork as an anchor tenant. WeWork's presence may have made 1161 Mission an appealing gateway investment for Sino-Ocean Land because the companies have an existing partnership in China.

Data Source: CoStar

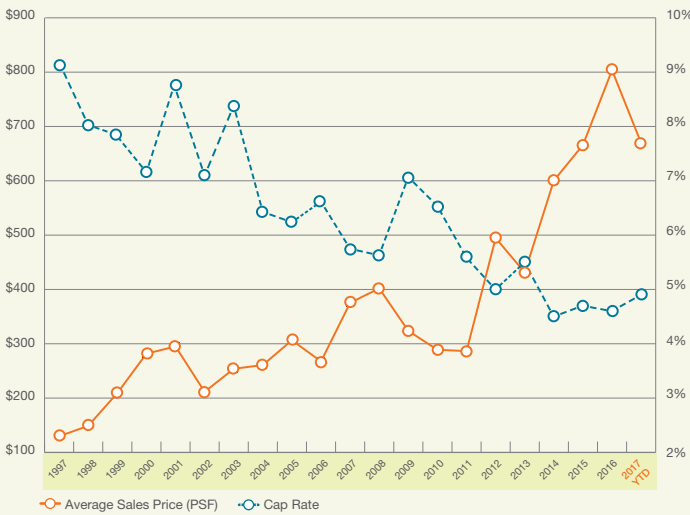
VACANCY VS FINANCIAL DISTRICT ASKING LEASE RATE



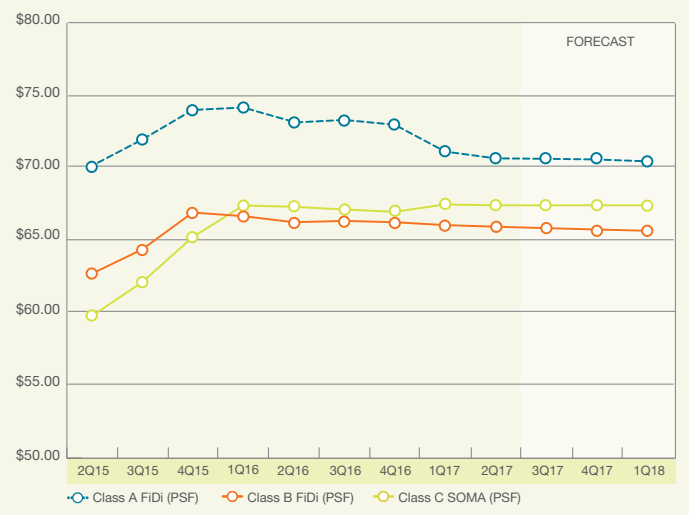
VACANCY VS AVAILABILITY



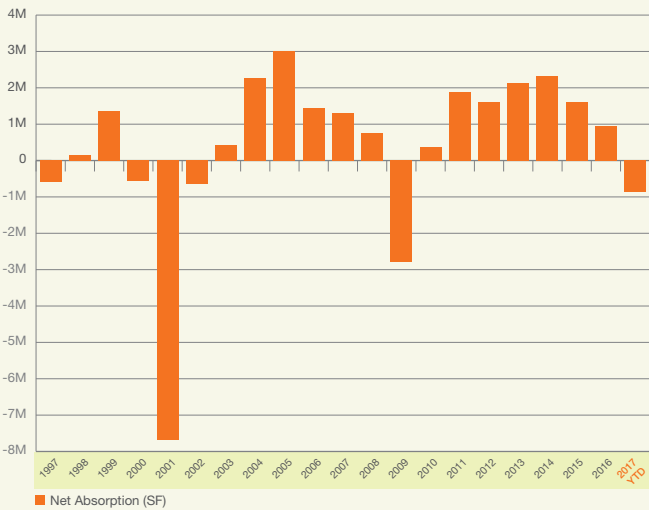
AVERAGE SALE PRICE & CAPITALIZATION RATES



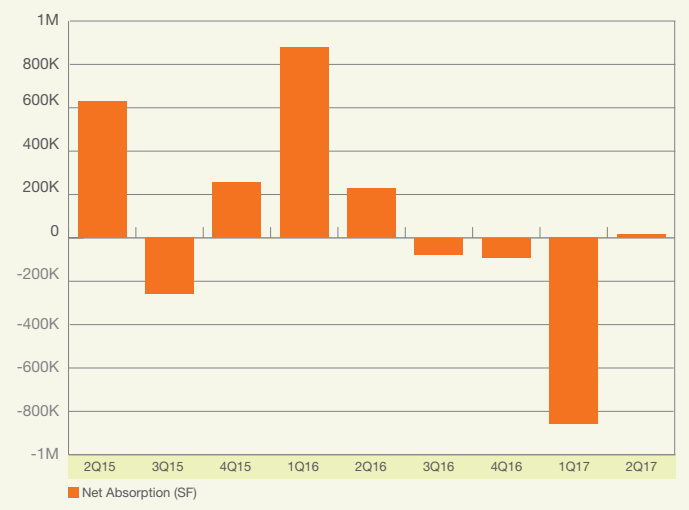
ASKING LEASE RATE



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

Los Angeles
213.880.5250

Long Beach
562.472.0071

Commerce
323.727.1144

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

Contact

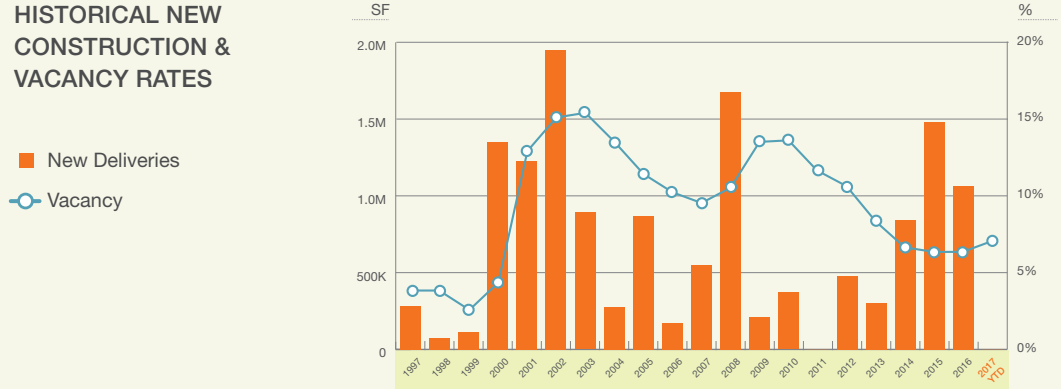
Mark Read
Executive VP, Brokerage
Northern California
415.229.8888
mread@kiddermathews.com

Designated Broker
Mark Read | LIC #00572743

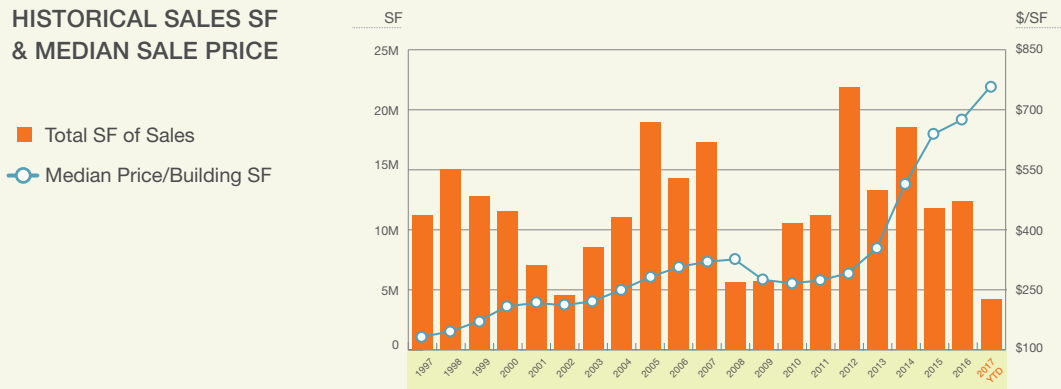
Market Breakdown

	2Q17	1Q17	2Q16	Annual % Change
Vacancy Rate	7.0%	7.0%	6.1%	14.8%
Availability Rate	11.9%	12.2%	11.7%	1.8%
Asking Lease Rate (Class A FiDi)	\$70.63	\$71.10	\$68.71	2.8%
Leased SF	1,727,480	2,540,291	2,381,815	-27.4%
Sold SF	932,454	2,222,182	995,774	-6.4%
Net Absorption	16,679	-858,265	228,262	N/A

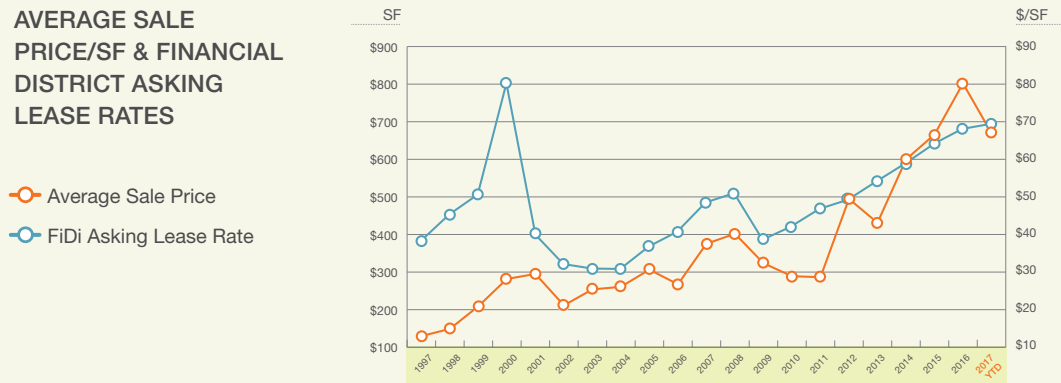
HISTORICAL NEW CONSTRUCTION & VACANCY RATES



HISTORICAL SALES SF & MEDIAN SALE PRICE



AVERAGE SALE PRICE/SF & FINANCIAL DISTRICT ASKING LEASE RATES



This information supplied herein is from sources we deem reliable. It is provided without any representation, warranty or guarantee, expressed or implied as to its accuracy. Prospective Buyer or Tenant should conduct an independent investigation and verification of all matters deemed to be material, including, but not limited to, statements of income and expenses. CONSULT YOUR ATTORNEY, ACCOUNTANT, OR OTHER PROFESSIONAL ADVISOR.