3rd Quarter
2017

Real Estate Market Review

San Francisco Office

A rising wave of new construction accommodated soaring technology sector tenant demand during the third quarter, stabilizing the San Francisco office market. The city's vacancy rate has leveled off between 6.5-7.0% since the beginning of the year, and rental rates have plateaued over the same period, prompting landlords to boost tenant improvement allowances to retain higher face rents. On average, the Class A Financial District asking rent was just over $70 FS, Class B offerings were in the mid-$60s, and Class C tech product in SOMA was in the high-$60s, all up less than 1% year-over-year. Landlords marketing creative spaces that appeal to technology users continue to see shorter vacancy periods than traditional office owners, who are increasingly motivated to renovate despite the surging cost of construction.

After peaking in early 2017, office investment sales dipped during the third quarter, as value-add buyers struggled to find opportunities in San Francisco and instead looked east to Oakland or Sacramento. More than 6.8 million s.f. of future office space was under construction as the third quarter closed, including 4.6 million s.f. set for delivery by the end of 2018.

Technology Sector

After calming briefly during the first and second quarters, the San Francisco office leasing market roared back over the past three months with the busiest period by square footage leased since early 2015. Tenant demand jumped well above 5 million s.f. in the early part of the quarter, and as technology giants satisfied their appetite for San Francisco office space, leasing volume eclipsed 3.2 million s.f. More than 2.6 million s.f. came off the market in direct deals signed this quarter, and creative firms' preference for plug-and-play opportunities generated over 600,000 s.f. of subleases, indicative of a healthy and dynamic tech sector where companies seeking expansion space can still find it within the city limits.

While most technology leaders have sought to form urban campuses, spread across multiple midrise buildings with expansive floor plates, Facebook chose a vertical arrangement for its San Francisco offices. In September, the social media signed the city's largest lease in three years, securing the entire non-residential portion of Jay Paul's 181 Fremont tower, which includes more than 400,000 s.f. of office space and the ability to curate its ground-floor retail. Facebook's Instagram division will be the first to occupy 181 Fremont when the building is delivered in 2018, and the company will gradually grow into the rest of the space, easing the commute for employees who live in the city but currently work out of its headquarters in Menlo Park.

Market Forecast Trends

ABSORPTION	↓
VACANCY	↑
CLASS A RENTAL RATE	↔
UNDER CONSTRUCTION	↑

Notable Lease Transactions

Facebook
181 Fremont, San Francisco
432,000 s.f. leased (includes retail)

Airbnb
650 Townsend & 699 8th, San Francisco
287,000 s.f. leased

Amazon
525 Market, San Francisco
175,727 s.f. leased

Notable Sale Transactions

Tishman Speyer
222 2nd Street, San Francisco
452,418 s.f. | $542.9M or $1,200/s.f. (buyout)

PGIM Real Estate / Madison Capital
150 Post Street, San Francisco
105,833 s.f. | $69.33M or $655/s.f.

American Realty Advisors
3180 18th Street, San Francisco
37,104 s.f. | $34M or $916/s.f.

Area Review

Airbnb and Amazon were this quarter's runners-up, together producing another 460,000 s.f. of new leases. The home-sharing giant, which is one of San Francisco's largest employers, added 287,000 s.f. at 650 Townsend and 699 8th to its Showplace Square inventory, to go with its 320,000 combined s.f. at 888 Brannan, 999 Brannan, and 99 Rhode Island. The gaming company Zynga will now function as Airbnb's landlord, after briefly marketing the buildings for sale last year. Amazon, meanwhile, grabbed 175,727 s.f. on seven floors in 525 Market, boosting its Bay Area presence while also announcing plans to seek a second headquarters city to pair with its 8.1 million s.f. base in Seattle.

New Construction

Thirteen office buildings totaling more than 6.8 million s.f. were rising in San Francisco at the end of the third quarter, the highest volume of construction in decades. Approximately 2.96 million s.f., or 43% of the future inventory, was listed as available following the completion of Facebook's lease at 181 Fremont. 350 Bush, a 447,000 s.f. tower set for delivery by the end of the year, was rumored to be 100% leased at the close of the third quarter. The Salesforce Tower, 80% leased at quarter's end, is expected to come online in early 2018, along with 181 Fremont and Adobe's campus at 100 Hooper. Developers are still awaiting tenants for The Exchange at 1800 Owens, a 750,000 s.f. complex that could become life-science space, and Park Tower at 250 Howard, where 752,000 s.f. is on the market. Both projects are set for delivery in the coming 15 months and represent the next wave of large-block availabilities in San Francisco. Despite the recent rush of 100,000-plus s.f. leases, tenant demand remains around 4 million s.f., suggesting that rental rates in the city are likely to prove robust against next year's new supply. After Park Tower's anticipated completion in late 2018, the next project in the pipeline, the Oceanwide Center at 50 First Street, won't be ready until 2022.

Office Leasing

Direct asking rental rates in downtown San Francisco are essentially unchanged year-over-year, but creative listings are generating more demand than traditional offerings. Tenant improvement packages have grown substantially over the past two quarters, as landlords aim to preserve higher face rents and the cost of small-scale construction continues to rise.

- Fully-serviced Class A rates have plateaued since the beginning of 2017, averaging around $70. Traditional spaces away from BART and Market Street were available in the mid-$60s, while the upper floors of choice properties such as 4 Embarcadero Center approached $100. A plug-and-play sublease high up in 555 Mission was asking $80.
- Availabilities in new office developments such as Park Tower were marketed in the high-$80s / low-$90s NNN; the NNN expenses are estimated at $25, bringing fully serviced equivalents above $100/s.f.
- Class B offerings ranged from the high-$50s in the northern reaches of the Financial District to the low-$80s for creative product in the South Financial District, Rincon/South Beach, and Yerba Buena. A full floor opportunity at 583 Howard was listed for $75 IG.
- Class C listings run the gamut of asking rates, depending on their appeal to tech tenants. The SOMA average remained in the mid-$60s, but some well renovated industrial buildings with exposed brick and high ceilings were priced in the mid-$70s or higher.

Absorption

San Francisco office buildings reported 82,984 s.f. of negative net absorption during the third quarter, but strong gains appear on the horizon as large technology tenants expand in the city.

Spotlight

Technology companies are in a perpetual talent war, often battling competitors a stone's throw away for the best and brightest workers in the industry. The quest to maximize human capital and venture capital funding drives tech firms' location decisions, from Airbnb and Google's urban campus ambitions in San Francisco to startups' willingness to pay sky-high lease rates to stay in the city or in Silicon Valley. Now those companies may face a new challenge: a shortage of skilled workers in the Bay Area, spawned by the steep cost of housing in the region.

Over the year ending in May 2017, tech employment growth slowed to just 0.8% in San Francisco and the Peninsula, according to Beacon Economics, despite ample openings in engineering, data science, and other positions in the sector. The forecast released in July anticipated a sluggish 0.7-1.1% job growth rate in the area for the rest of 2017, and data from the Employment Development Department showed that professional, scientific, and technical services jobs in San Francisco and San Mateo Counties were down 1.8% year-over-year in September. While the talent shortage and stagnant employment have yet to manifest in reduced demand for office space in the market, they are trends worth monitoring in the coming quarters.

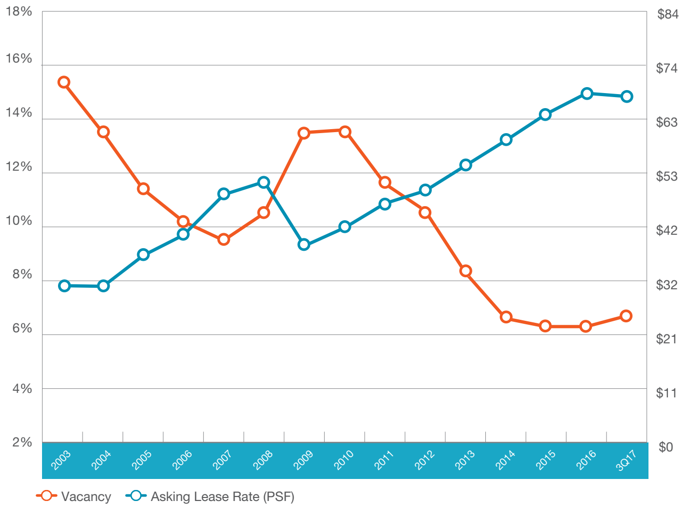
- The South Financial District dropped 137,915 s.f., as AIG vacated 154,928 s.f. at 121 Spear. Google takes over that space in early 2018.
- WeWork accounted for more than 125,000 s.f. of positive net absorption during the quarter, opening 64,858 s.f. at 201 Spear and a 60,576 s.f. branch at 650 California, with more on the way.
- Yerba Buena recorded the greatest gain in occupied office space, picking up 59,564 s.f., mostly from Glu Mobile's 57,074 s.f. occupancy at 875 Howard.

The high volume of 100,000-plus s.f. leases signed in the first nine months of the year, coupled with the new construction projects nearing completion, should yield a return to positive absorption in the quarters to come.

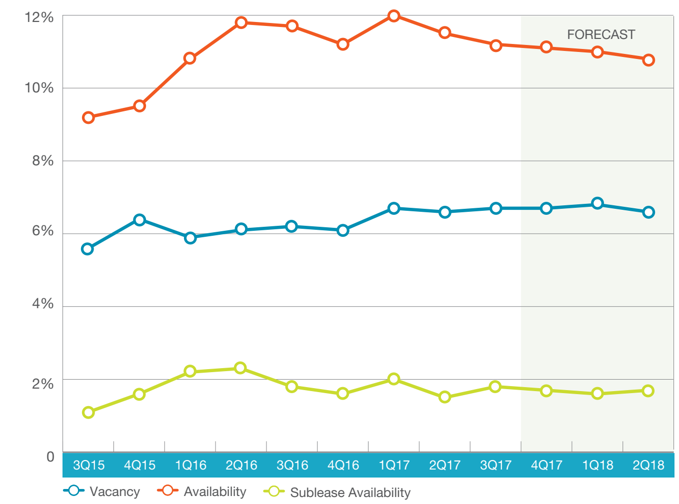
Investment

Investment activity in San Francisco relaxed during the third quarter, as dollar volume slipped to $775 million, the lowest total amassed since the first quarter of 2016. The slowdown is primarily attributable to dwindling value-add opportunities for short-term buyers, not to a decline in confidence among investors. Most of San Francisco's premium office assets are now in the hands of long-term owners or have caught up to market rental rates, and the few exceptions are trading at record-high sums. The quarter's largest transaction was a buyout, in which Tishman Speyer obtained sole ownership of 222 2nd Street, the San Francisco offices of LinkedIn. Tishman Speyer built the property in 2015 with financial backing from JPMorgan Chase, which sold its share this quarter for $542.9 million or $1,200/s.f. North of Market Street, a joint venture of PGIM Real Estate and Madison Capital acquired 150 Post Street in Union Square for $69.33 million or $655/s.f. The asset has six floors of office space, which was 95% occupied at significantly below-market rents, atop ground-floor retail, which was 50% leased at sale. Finally, American Realty Advisors bought the former Pioneer Trunk Factory building at 3180 18th Street, wholly occupied by the Elon Musk-founded OpenAI, for $34 million or $916/s.f. Bridgeton Holdings, the seller in that transaction, nearly doubled its $17.5 million initial investment in 40 months.

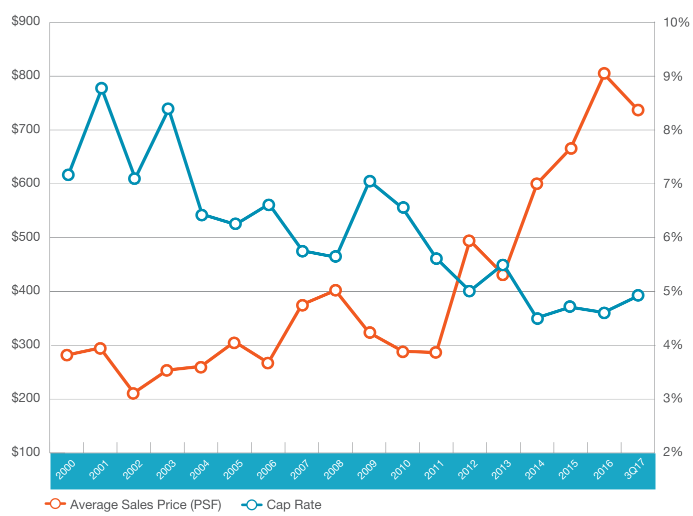
VACANCY VS FINANCIAL DISTRICT ASKING LEASE RATE



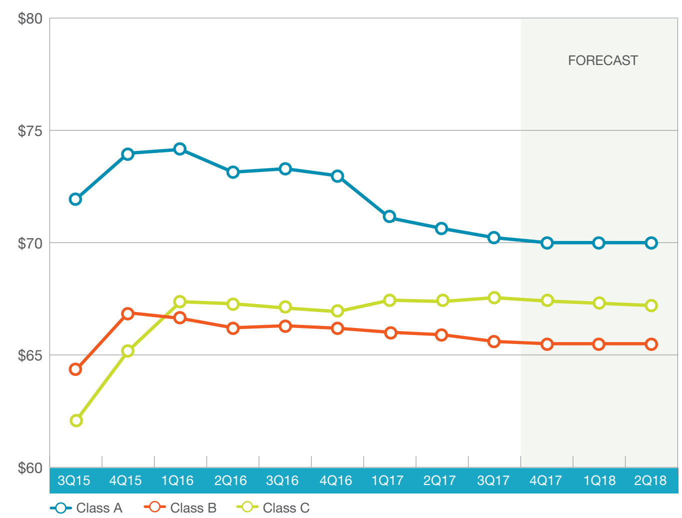
VACANCY VS AVAILABILITY



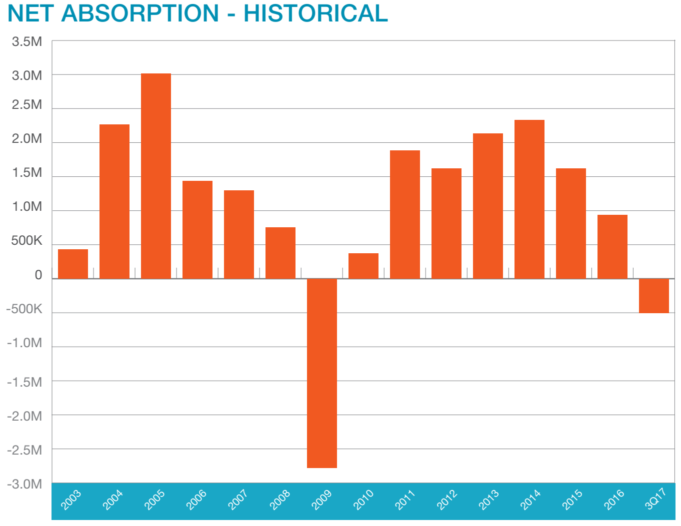
AVERAGE SALES PRICE & CAPITALIZATION RATES



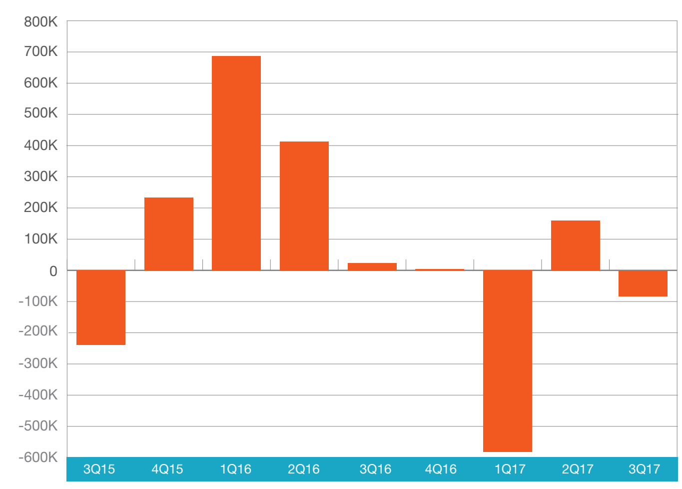
ASKING LEASE RATE



NET ABSORPTION - HISTORICAL



NET ABSORPTION - QUARTERLY



kiddermathews.com

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

Commerce
323.727.1144

Long Beach
562.472.0071

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

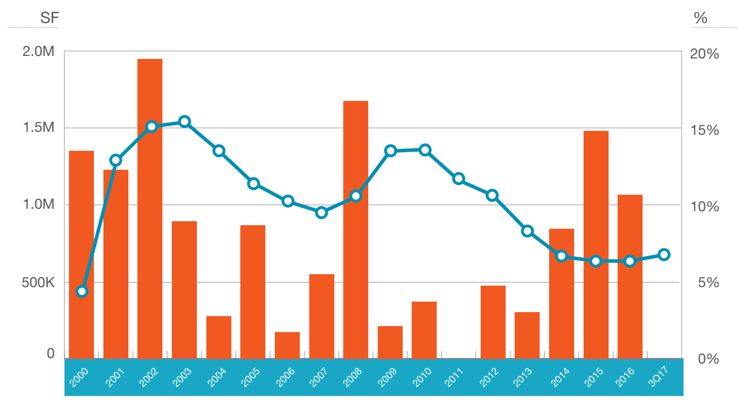
Designated Broker
Mark Read | LIC #00572743

Market Breakdown

	Q3 2017	Q2 2017	Q3 2016	Annual % Change
Vacancy Rate	6.70%	6.60%	6.20%	8.00%
Availability Rate	11.20%	11.50%	11.70%	-4.30%
Asking Lease Rate	$70.22	$70.63	$69.66	0.80%
Leased SF	3,207,868	2,706,453	1,956,614	63.90%
Sold SF	1,022,518	1,681,555	2,222,854	-54.00%
Net Absorption	-82,984	158,845	23,010	N/A

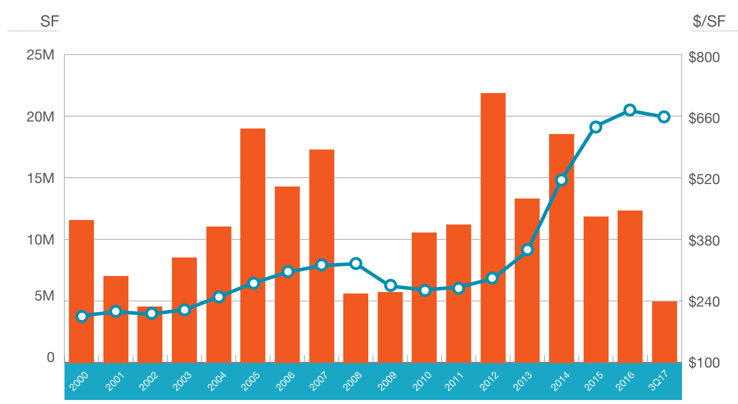
HISTORICAL NEW CONSTRUCTION & VACANCY RATE

New Deliveries
Vacancy Rate



HISTORICAL SALES ACTIVITY & MEDIAN SALES PRICE

Total Square Feet of Sales
Median Price/Building SF



HISTORICAL AVERAGE SALE PRICE & ASKING LEASE RATES

Average Sale Price / SF
Asking Lease Rate