

Real Estate Market Review

San Francisco Office

The San Francisco office market got its second wind in the fourth quarter, closing 2017 with surging technology sector demand, rising rental rates, and intense competition for space. After leveling off around their late-2016 peak, rental rates began to climb again, as landlords marketing creative or recently renovated offerings had their pick of an increasingly robust roster of tenants. Average asking rents rose to the low-to-mid \$70s FS for Class A space, the high-\$60s FS for quality Class B product, and around \$70 FS for creative Class C offerings in SOMA, up about 2% year over year, with more substantial rate hikes likely to come. The market is poised to build on this quarter's 240,993 s.f. of positive net absorption, as 4.16 million s.f. of office space, 75% of which has already been leased, will be delivered over the next 12 months. With its bellwether tech industry expanding to include new fields like autonomous vehicles and virtual reality, the San Francisco market is racing full speed ahead into the new year.

A Diversified Tech Portfolio

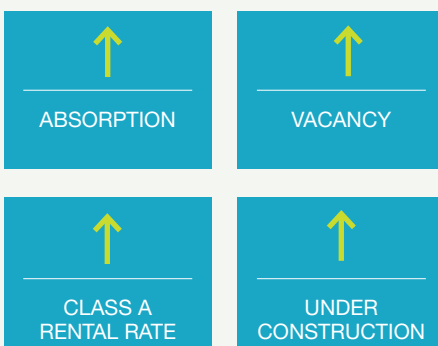
Twenty-one companies signed leases for more than 100,000 s.f. of office space in 2017, breaking a San Francisco record set at 17 in 2014. The list teemed with tech sector luminaries, from Dropbox to Facebook, Amazon to Salesforce, Google to Airbnb, all eager to establish or boost their presence in the city before a lack of large-block supply sounds the buzzer on the latest round of musical chairs. As the industry broadens to include a greater variety of products and customers, the label "technology sector" is a nebulous concept that does not truly capture its scope. The more diverse the sector becomes, the less vulnerable it is likely to be when the next economic downturn arrives. Hence, the ongoing boom appears to have

more staying power than previously thought, and even maintaining the current levels of demand would sustain rental rates and vacancies for years to come.

Displacement of Non-Tech Office Tenants

Tech firms' growing appetite for space has revived a headline from 2015-2016: traditional office firms leaving San Francisco for more affordable markets. Last summer, Delta Dental, which was headquartered in 188,000 s.f. at 100 First, signed leases to split its Bay Area workforce into 82,000 s.f. in downtown Oakland and about 43,000 s.f. at 560 Mission. Delta Dental's move-out from 100 First made room for Okta, a tech company

Market Forecast Trends



Notable Lease Transactions

Dropbox
1800 Owens Street, San Francisco
736,550 s.f. leased

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

Airbnb
650 Townsend Street, San Francisco
287,000 s.f. leased

Notable Sale Transactions

Beacon Capital Partners
44 Montgomery Street, San Francisco
688,902 s.f. | \$475.4M or \$690/s.f. (3.6% cap)

The Blackstone Group
211 Main Street, San Francisco
417,266 s.f. | \$292.9M or \$702/s.f. (3.34% cap)

Rockpoint Group
100 Pine Street, San Francisco
402,534 s.f. | \$287.5M or \$714/s.f.

Area Review

that operates an identity management and secure log-in platform, to expand into 207,066 s.f. on a 10-year lease. By size, Okta's deal trailed only the 736,550 s.f. Dropbox lease, the largest in San Francisco history, among those signed in the fourth quarter. While the Dropbox signing did not directly displace another tenant, The Exchange also drew interest from large life-science users, who must now look outside of the city. Tech firms' real estate decisions are much less cost-elastic than those of their counterparts in other sectors, because the need to attract the industry's elite talent justifies paying higher rents. Absent an increase in supply or an unexpected dip in tech space demand, displacement of non-tech users figures to intensify in the coming quarters and years.

New Construction

The year's only office delivery was 350 Bush, a 447,000 s.f. structure completed this quarter. More than half of the 21-story building was pre-leased to Twitch, which will move in next quarter. Two other tenants, Atlassian and Publicis, were rumored to be taking the balance.

Fifteen office buildings totaling approximately 7 million s.f. were under construction at year's end, but less than 30% of the future space was available for lease. Tech-sector giants have already captured the lion's share of the scheduled 2018 completions, leaving less than 25% available on a direct basis, though more will likely be marketed for sublease. Of the largest projects on next year's slate, the Salesforce Tower was approximately 88% leased, The Exchange was fully leased to Dropbox, 181 Fremont was fully leased to Facebook, 510 Townsend was fully leased to Stripe, 100 Hooper was about 80% leased to Adobe, and 501 Brannan was fully leased to Pinterest. As an equity partner in the Golden State Warriors development, Uber is likely to occupy much of the 640,000 s.f. office component, and its Mission Bay headquarters development accounts for another 435,000 s.f. of the construction total. That leaves Park Tower at Transbay, a 755,024 s.f. project at 250 Howard, as the only wholly available development set for delivery before 2022, the completion target for the Oceanwide Center at 50 First. Several tenants, including one tech giant, were rumored to be eyeing space in Park Tower at the end of the 2017.

Asking Rental Rates

Direct asking rental rates in downtown San Francisco began to rise again in late 2017, landing at around a 2% increase year over year. Rents had climbed by an average of about 6% per year from 2012-2015, before leveling off in 2016. Year-end demand levels suggest that a return to 3% or greater growth is possible next year.

- Fully-serviced Class A rates ranged from the mid-\$60s away from Market Street to over \$100 for the upper floors of premier properties such as 4 Embarcadero Center. An office-heavy space in the middle floors of 101 Montgomery was asking \$65 FS, while a penthouse spec suite at 75 Hawthorne was priced in the mid-\$70s FS.
- Class B availabilities spanned from the high-\$50s for traditional build-outs in the northern reaches of the Financial District to the low-\$80s for creative spaces in the South Financial District and SOMA. A creative full-floor offering at 611 Mission was asking in the high-\$60s IG.
- Creative Class C product in SOMA averaged in the mid-to-high \$60s IG, but well renovated spaces with exposed brick and high ceilings eclipsed \$70. A small, full floor at 95 Minna boasting those desired features was asking in the low-\$70s IG.

Amid the reinvigorated market, creative space landlords had ample demand to achieve their desired face rents. Landlords with less desirable build-outs were increasingly willing to provide turnkey renovations or tenant improvement allowances to upgrade their spaces for the long term.

Spotlight: Central SOMA Takes Center Stage

Since 1986, office development approvals in San Francisco have been capped by the voter-enacted ballot measure Proposition M. As the city faces an office supply crunch exacerbated by the rapid growth and diversification of the tech sector, the Prop. M cap is an obstacle to meeting the demand for large blocks of space and is partly responsible for the "hole" in the construction pipeline between late 2018 and 2022. That could change in June of 2018, when the city's voters will decide whether to exempt the Central SOMA district from Prop. M restrictions. With more than 5.5 million s.f. of office space already planned in the Central SOMA area, led by Kilroy's Flower Mart project and the Tennis Club proposal from Alexandria and TMG Partners, the ballot measure could have a tremendous impact on the city's office market in the coming decade.

Absorption/Vacancy

San Francisco office buildings enjoyed 240,993 s.f. of positive net absorption in the fourth quarter, and the construction deliveries anticipated in early 2018 should enable further gains in the near term:

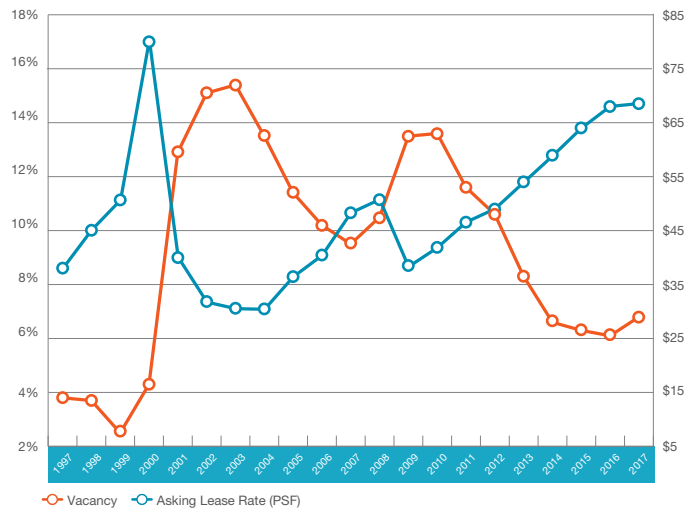
- The Yerba Buena submarket led the city with 132,492 s.f. of positive net absorption this quarter. Snap Inc. is the largest new tenant, occupying 33,291 s.f. at 875 Howard.
- North Financial District properties recorded 125,761 s.f. of positive net absorption. Venable LLP moved into 38,317 s.f. in 101 California, WeWork partially occupied its new location at 44 Montgomery, and General Electric took over 25,791 s.f. at 2 Embarcadero Center.
- Showplace Square was one of the few submarkets to report significant negative absorption this quarter, as Travana vacated 41,403 s.f. at 600 Townsend and MetaSwitch left 28,726 s.f. at 208 Utah.

Many notable move-ins are on tap for the first half of 2018, including Dropbox at The Exchange, Twitch at 350 Bush, Facebook's Instagram division at 181 Fremont, and Salesforce and Accenture at the Salesforce Tower (415 Mission). Nonetheless, the impending supply jolt is likely to produce a brief spike in vacancy, as the tenants occupy their new spaces in phases and secure subtenants for the portions earmarked for future expansion.

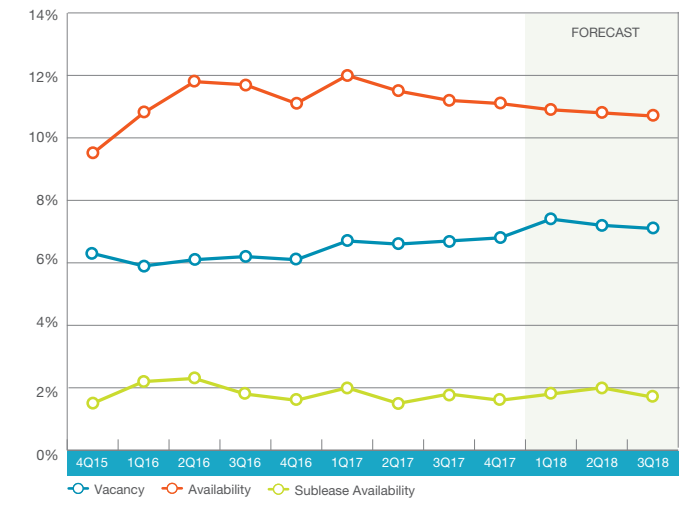
Investment

With few value-add opportunities left in San Francisco, institutional investors have turned to secondary and tertiary markets, limiting sale volume in the city. The largest fourth-quarter transaction in the Financial District involved 201 California, a 243,213 s.f. Class A asset, which traded for \$179 million or \$736/sf. Boston-based Beacon Capital Partners acquired the property from Barings Real Estate Advisers as a value-add play, with approximately two-thirds of the building's rent roll expiring by 2020. South of Market Street, Ponte Gadea USA, funded by the Spanish fashion mogul Amancio Ortega, spent \$469.5 million on the Pacific Place portfolio at 22 4th Street and 801 Market Street, which includes 329,335 s.f. of office, retail, and hotel space; the \$1,425/sf outlay reflects the retail component along Market Street. Ponte Gadea USA previously purchased the Tiffany Building at 360 Post Street in Union Square and likely views its new San Francisco assets as long-term holds. The fourth quarter's investments brought sale activity for the year to 5.32 million s.f. traded at an average price tag of \$658/sf and an average cap rate of just under 5%, the lowest annual sale volume by square footage since 2013.

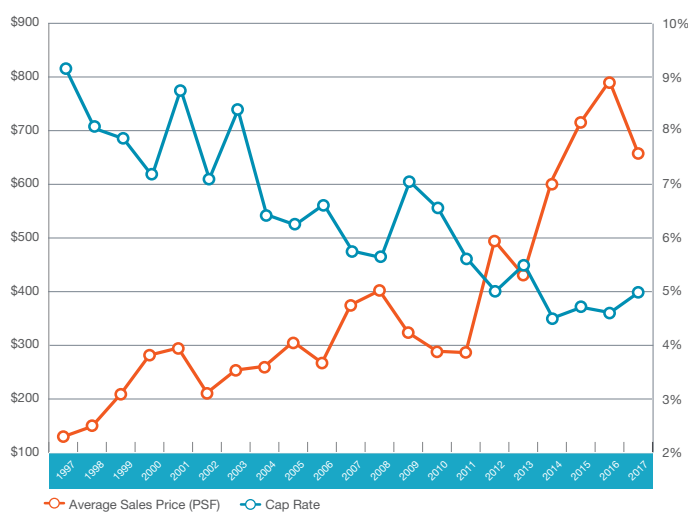
VACANCY VS FINANCIAL DISTRICT ASKING LEASE RATE



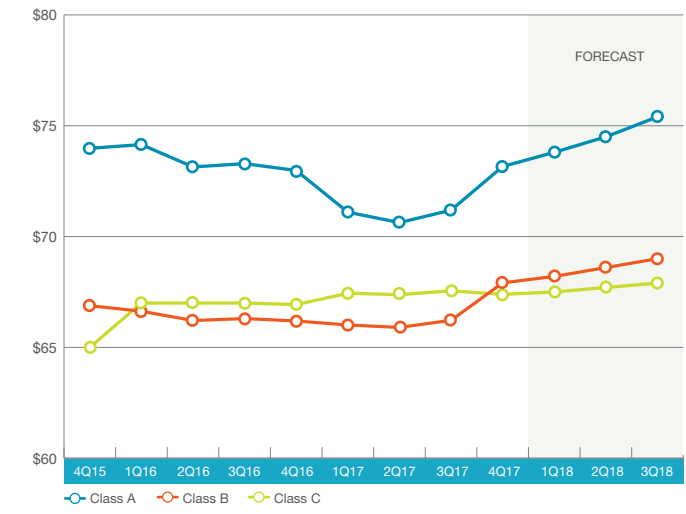
VACANCY VS AVAILABILITY



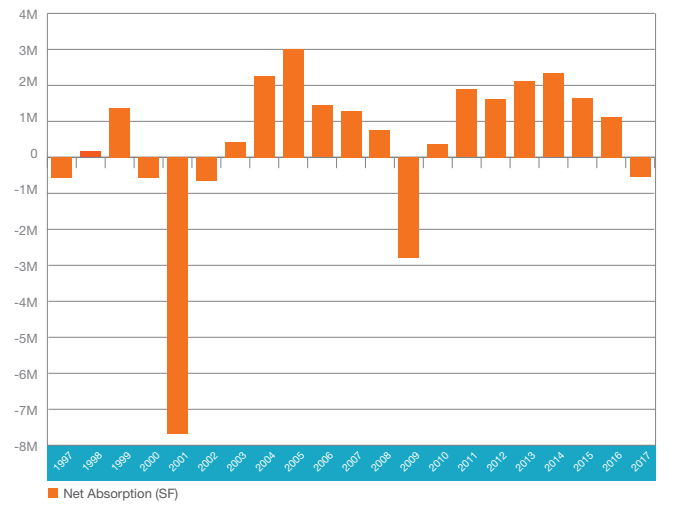
AVERAGE SALES PRICE & CAPITALIZATION RATES



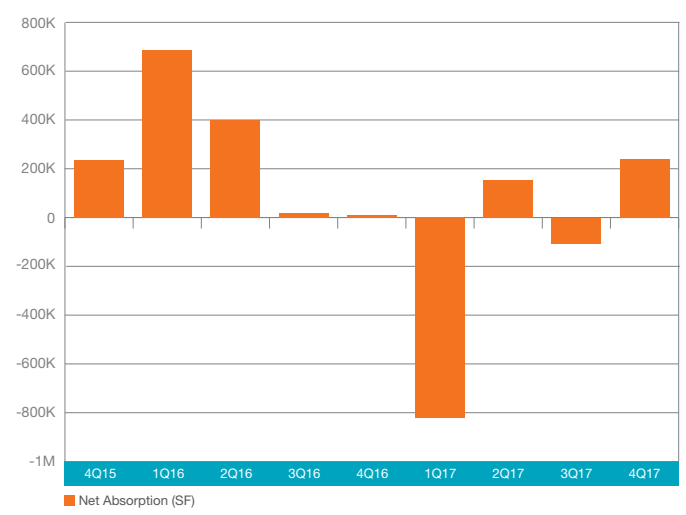
ASKING LEASE RATE



NET ABSORPTION - HISTORICAL



NET ABSORPTION - QUARTERLY



Market Breakdown

Offices

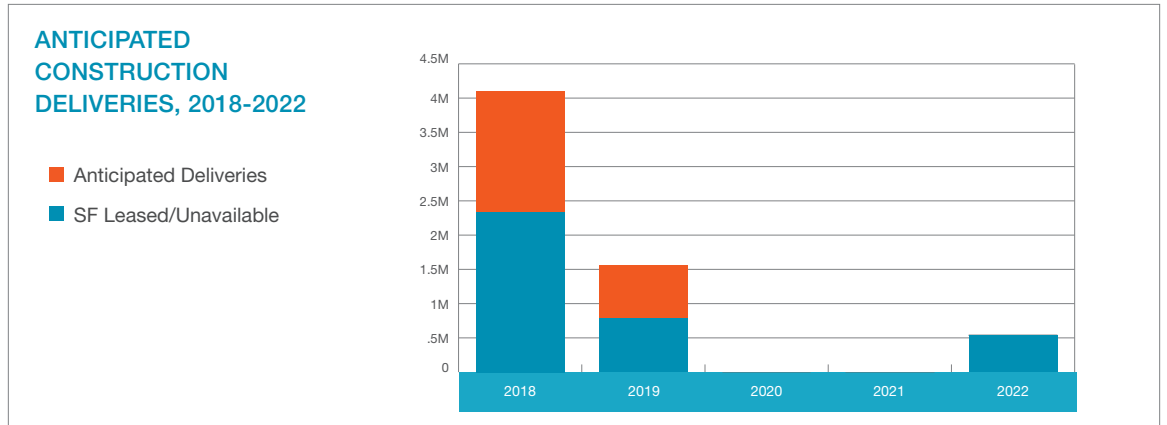
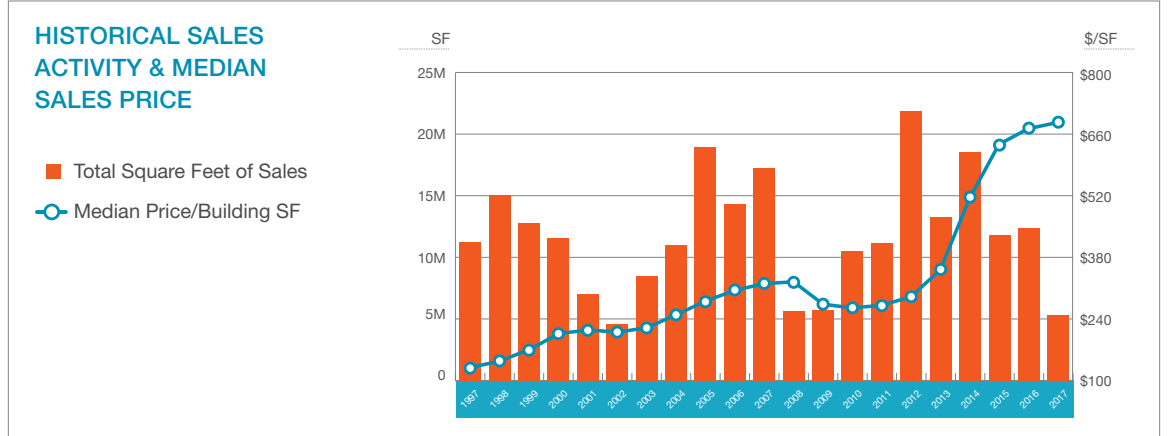
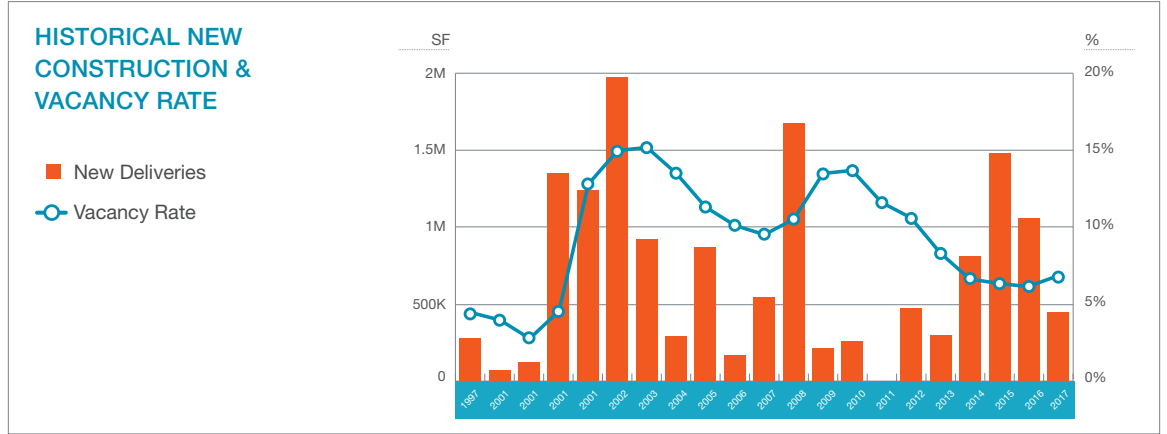
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	2017	2016	2015	% Change from a Year Ago
Vacancy Rate	6.80%	6.10%	6.30%	11.50%
Availability Rate	10.20%	11.10%	9.50%	-8.10%
Asking Lease Rate (Class A Financial District)	\$73.16	\$71.80	\$64.87	1.90%
Leased SF	11,589,664	9,668,249	10,643,432	19.90%
Sold SF	5,323,714	7,569,242	6,545,563	-29.70%
Net Absorption	-535,297	1,118,308	1,637,823	N/A



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