

MARKETBEAT

SAN FRANCISCO OFFICE REPORT

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION



1Q09

ECONOMY

If statistics at the end of 2008 provided a glimpse of what was to come, the first quarter of 2009 drove home the results of a softened commercial real estate market. Many businesses see uncertainty in the economy, stock market, commercial leasing market and debt markets resulting in sublease and overall vacancy growth and further erosion of absorption and sales activity. Some companies made adjustments to their business plans, resulting in hiring freezes, headcount reductions, expansion cutbacks, subleasing of excess space and office closures. Others have yet to fully grasp the effects of the recession on their business and what actions they will need to take to weather the storm.

OVERVIEW

Over the short term, tenants looking in this market will be flush with a number of viable lease options. Current tenants, with leases expiring in the near-term, will have options to move or leverage the growing pool of space to negotiate favorable renewals. Landlords are doing everything in their power to keep tenants and maintain occupancy in their buildings. Tenants, on the other hand, continue to look for the best deal. To sweeten lease transactions, landlords are finding it more economical to offer free rent rather than generous tenant improvement packages. With cash constraints, landlords are driven by their bottom line to keep expenditures in check. Free rent allows landlords to push a portion of the improvements back to the tenant. Roughly half of the direct leases and renewals signed during the quarter included free rent.

New, big-block vacancies dominated activity during the quarter causing vacancy to jump. These blocks include 81,000 square feet (sf) at 123 Mission Street, Schwab's 375,000-sf sublease at One Montgomery Street, Macy's 155,000-sf sublease at 22 Fourth Street and 180,000 sf at 875 Howard Street. These blocks contributed to negative 2.1 million square feet (msf) of overall absorption citywide and pushed overall vacancy to 15.1%. Their effect on rent was profound as the citywide overall rental rate for all classes fell 14.7% to \$37.13 per square foot per year (psf/yr) full service.

While the lack of sales data makes the re-evaluation of assets more troublesome, the accumulating demand for office properties will, at some point, force a backlog of sale transactions. The deepening recession and the ongoing credit crisis is forcing owners with maturing debt to modify their investment strategies and adjust price expectations to bridge the gap between buyer and seller presumed value.

FORECAST

The office market in San Francisco needs to establish a bottom before fundamentals can begin to recover. The problem remains as to when the market will reach that bottom. If demand and employment growth appear in late 2009, then the office market and rents should improve in early to mid-2010. Growth in the office market has largely been influenced by financing. Both tenants and landlords depend on new loans for capital improvements, business growth and expansion. With money essentially frozen, tenants are finding it harder to stay in business while landlords struggle to handle the debt on their properties. The unprecedented job losses in office-using sectors will continue to adversely affect this market in 2009. Job losses are expected to top 2008 levels forcing businesses to shed more office space or close. The question remains, how much space will tenants put on the market in 2009 and will the surge continue from financial service firms or from new sectors?

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BEAT ON THE STREET

"First quarter 2009's statistics strongly emphasize that San Francisco tenants have more leverage now than at any time since 2001. Landlords must be savvy and pro-active in working with both tenants and their brokers to retain their current occupancies, despite declining IRR's. Above all, the sublease market adds intense pressure to the lease negotiations of both tenants and landlords, as subleases now comprise 25% of all available space."

—Margaret Duskin, Senior Director

ECONOMIC INDICATORS

National	2008	2009F	2010F
GDP Growth	1.1%	-2.9%	1.8%
CPI Growth	3.8%	-1.0%	1.9%
Regional			
Unemployment	5.0%	7.6%	8.6%
Employment Growth	0.6%	-6.0%	-1.8%

Source: Moody's | Economy.com

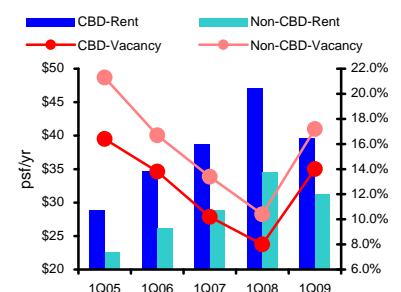
MARKET FORECAST

OVERALL ABSORPTION will remain negative as the addition of new availabilities will outweigh leasing activity during the year. ↓

SUBLEASE SPACE: Since the end of 2008, overall sublease space grew 76.4% to 2.1 msf. Expect the shakeout to continue well into 2009. ↑

DEMAND: Lack of demand, rather than oversupply, will hamper activity and force rents down throughout 2009. ↓

OVERALL RENT VS. VACANCY



MARKET/SUBMARKET STATISTICS

MARKET/ SUBMARKET	INVENTORY	NO. OF BLDGS.	OVERALL VACANCY RATE	DIRECT VACANCY RATE	YTD LEASING ACTIVITY	UNDER CONSTRUCTION	YTD CONSTRUCTION COMPLETIONS	YTD OVERALL ABSORPTION	DIRECT WTD. AVG. CLASS A GROSS RENTAL RATE*
NOMA Financial District	26,006,324	112	15.5%	11.0%	228,047	0	0	(911,794)	\$44.67
SOMA Financial District	22,032,963	98	12.3%	10.2%	149,371	0	0	(386,811)	\$43.34
CBD Total	48,039,287	210	14.0%	10.6%	377,418	0	0	(1,298,605)	\$44.03
Jackson Square	1,369,168	24	15.5%	15.0%	8,265	0	0	(41,275)	\$32.47
North Waterfront	2,394,975	31	10.4%	9.1%	12,504	0	0	(40,430)	\$31.23
South Beach/Rincon Hill	2,387,582	29	14.9%	10.4%	10,082	0	0	(103,139)	\$37.96
San Francisco S. of Market	5,276,088	44	31.5%	27.5%	7,332	0	0	(518,728)	\$40.85
West of Kearny	703,735	9	9.1%	8.2%	5,899	0	0	(52,167)	\$29.12
The Presidio	995,955	7	15.7%	8.5%	23,564	0	0	(158)	N/A
Union Square	4,035,868	58	9.2%	8.7%	8,997	0	0	(43,312)	\$29.51
Van Ness Corridor	4,379,522	34	7.8%	7.1%	2,492	0	0	(10,048)	\$32.53
Potrero Hill/Inner Mission	1,831,996	22	16.1%	16.1%	5,166	0	0	15,629	\$25.13
Mission Bay	1,006,272	4	48.1%	48.1%	0	0	0	0	N/A
Non-CBD Total	24,381,161	262	17.2%	15.2%	84,301	0	0	(793,628)	\$36.59
SAN FRANCISCO TOTAL	72,420,448	472	15.1%	12.2%	461,719	0	0	(2,092,233)	\$42.47

* Rental rates reflect \$psf/year

MARKET HIGHLIGHTS

SIGNIFICANT 1Q09 NEW LEASE TRANSACTIONS				
BUILDING	SUBMARKET	TENANT	SQUARE FEET	BLDG CLASS
45 Fremont Street	SOMA Financial District	Marriott	19,027	A
300 California Street	NOMA Financial District	Recurrent Energy, Inc.	15,457	B
Three Embarcadero Center	NOMA Financial District	Phillips, Spallas & Angstadt LLP	15,396	A
88 Kearny Street	NOMA Financial District	Bank of the West	13,483	A
825-875 Battery Street	North Waterfront	GCI	11,030	B
153 Kearny Street	NOMA Financial District	Birst, Inc.	9,967	C
343 Sansome Street	SOMA Financial District	Propertyware, Inc.	9,201	A
33 New Montgomery Street	SOMA Financial District	Convention Management Solutions	8,600	A
505 Sansome Street	NOMA Financial District	Women's Funding Network	7,921	A
343 Sansome Street	SOMA Financial District	Turner Construction	7,736	A
SIGNIFICANT 1Q09 SALE TRANSACTIONS				
BUILDING	SUBMARKET	Buyer	SQUARE FEET	PURCHASE PRICE
N/A				
SIGNIFICANT 1Q09 CONSTRUCTION COMPLETIONS				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
N/A				
SIGNIFICANT PROJECTS UNDER CONSTRUCTION/RENOVATION				
BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
One Kearny Street	Union Square	N/A	91,360	5/09

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