

MARKETBEAT

SAN FRANCISCO OFFICE REPORT

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION



4Q08

ECONOMY

The San Francisco Bay Area has historically been well positioned to weather a variety of financial and economic complications. Due to its diverse economies, technology strength, high income and quality of life, that statement has typically held true in the most challenging of times. But recent business contractions, layoffs, unemployment growth and waning business confidence is chipping away at that stability. Business confidence in the Bay Area continued to fall with many executives believing the economy will worsen in 2009. Pessimism abounds as layoffs continue to outweigh new hiring plans. Continued trouble in the financial services sector and new troubles in the legal sector dominated activity in San Francisco during the second half of 2008. Most notable were the unexpected breakups of the Heller Ehrman and Thelen Reid & Priest law firms. Substantial revenue shortfalls, lawyer defections and tight credit weakened these firms forcing them to dissolve and add large blocks of office space to the market.

OVERVIEW

In short, demand continues to shrink, available space is growing and asking rents are falling. Tenant demand, in both the number of active tenants and square footage, fell throughout 2008. Some tenants reassessed their space needs and reduced their requirements while others signed short-term leases to get them through the uncertain economic times. New construction has not been a major component of vacancy, but the growth of new direct and sublease space forced landlords to be flexible with asking rents. To help close deals, landlords frequently used free rent or increased tenant-improvement concessions in their negotiations.

The investment market continues to stay frozen. There are several reasons for this, but primarily the debt markets have dried up making financing of projects difficult and expensive. More recently, with the economic downturn, valuations have come down significantly due to rents dropping and vacancies increasing. In addition, there is a prevalent belief that real estate has become a more risky asset, causing investors to require higher rates of return for properties that they buy. All of this created an environment in which building valuations are down 20% to 30%, although these numbers are hard to confirm since only a few buildings have actually sold. Many sellers are holding back, unwilling to sell at these levels.

FORECAST

There may be little short-term relief from the multi-faceted economic downturn the commercial real estate markets are experiencing. Job growth will be closely watched in 2009 and 2010 to see if and when growth will translate into expanding tenant requirements and absorption. The current environment has forced landlords to rethink strategies and lower asking rents in order to maintain building occupancy. Tenants have definitely taken the upper hand in lease negotiations and will continue to hold an edge throughout 2009. The next 12 to 18 months will expose a variety of space options for bargain hunting tenants. Long-term, however, San Francisco and the entire Bay Area will continue to fare well due to its diverse economies, entrepreneurial culture and well-educated workforce. It will also remain one of the top choices in the world for real estate investment. Once the national economy stabilizes, San Francisco should be on the leading edge of those markets expected to experience a strong and early recovery.

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BEAT ON THE STREET

"There is continuing decline across virtually the entire U.S. economy and unemployment numbers have risen dramatically over the last quarter. Expect the increase in vacancy and the drop in rents to continue. Furthermore, we have yet to realize the full impact of the financial meltdown on Wall Street. However, there remain opportunities in the market. The acute focus of landlords will be on tenant retention where tenants can expect more flexibility from landlords."

—John Walsh, Senior Director


ECONOMIC INDICATORS


National	2007	2008	2009F
GDP Growth	2.0%	1.2%	-1.5%
CPI Growth	2.9%	4.2%	0.9%
Regional			
Unemployment	4.0%	5.0%	6.7%
Employment Growth	2.6%	1.3%	-3.4%

Source: Moody's | Economy.com

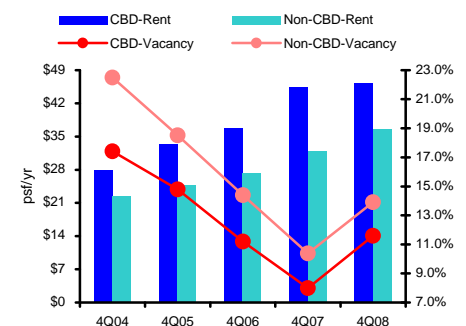
MARKET FORECAST

OVERALL VACANCY grew in every quarter during 2008. With current economic worries hampering growth, we can expect more of the same in 2009. 

OVERALL ABSORPTION is expected to stay negative in 2009 as more subleases and future availabilities come into play. 

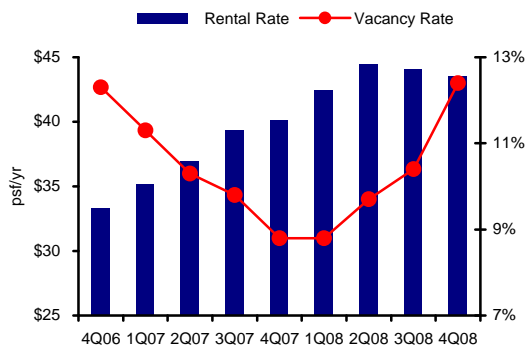
NEW CONSTRUCTION totalled 1.6 million square feet (msf) citywide in 2008. Weakened demand and tight financing will stall projects in 2009. 

OVERALL RENT VS. VACANCY

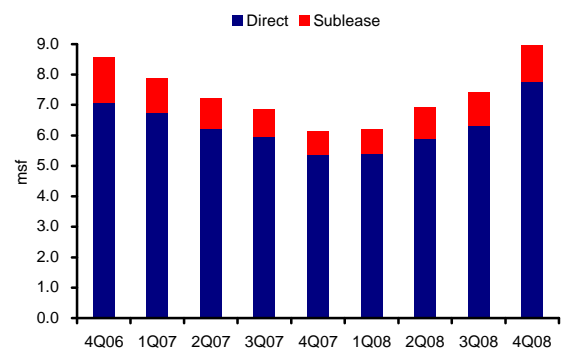


CITYWIDE

OVERALL RENTAL vs. VACANCY RATES



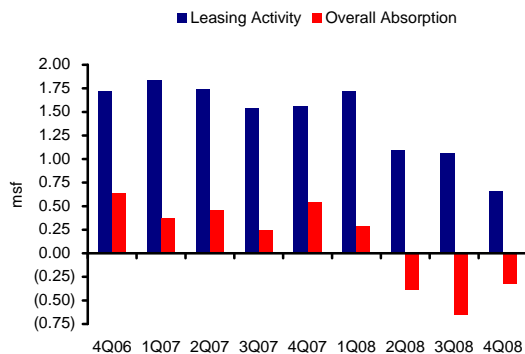
DIRECT vs. SUBLEASE SPACE



- There has been significant increases in overall vacancy in most of the San Francisco submarkets. The Central Business District (CBD) added 1.8 msf while South of Market added 0.4 msf, representing increases during the year of 47% and 55% respectively.
- As some tenants shuttered their floors, landlords began to market the new availability as direct rather than sublease. This, along with tenants leasing sublease space, helped to temporarily curb overall sublease growth.

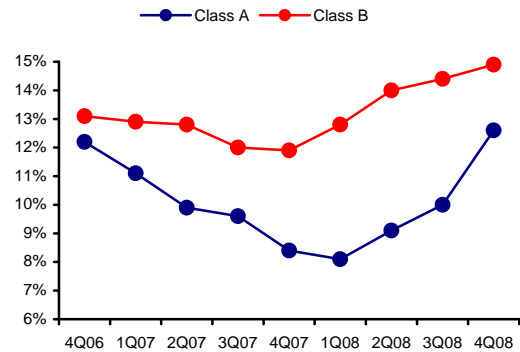
- Currently, sublease space represents 13.4% of the total square feet available in San Francisco. The CBD contains an overwhelming majority (82%) of sublease space due to the large concentration of troubled financial firms.
- Direct space grew substantially during the fourth quarter with the renovation of 370 Third Street in the South of Market submarket. The availability, nearly 369,000 square feet (sf), represents one of the largest blocks of vacant space in San Francisco.

LEASING ACTIVITY vs. OVERALL ABSORPTION



- Following 19 consecutive quarters of positive overall absorption earlier this year, San Francisco experienced three negative quarters. The pipeline of future availabilities and evaporating tenant demand will stifle growth and further weaken absorption.
- The number of tenants looking in the market contracted nearly 20% during the year. This will improve once businesses regain confidence and look to expand their footprint in San Francisco.

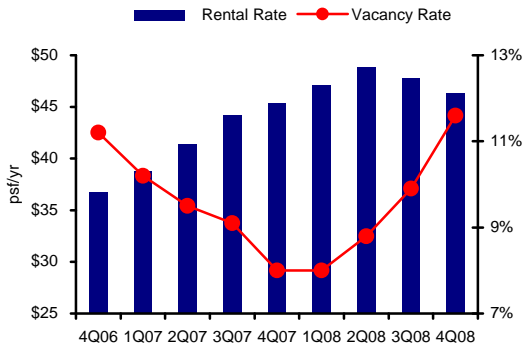
OVERALL VACANCY RATES CLASS A vs. CLASS B



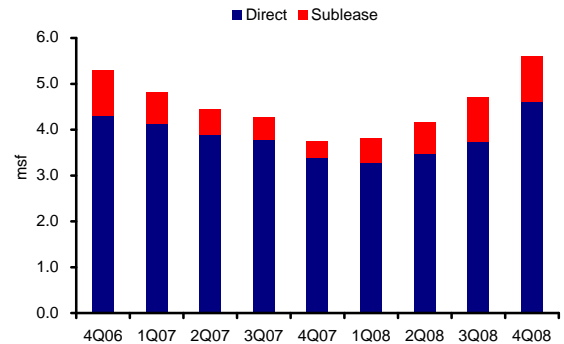
- A year ago, this market had a shortfall of full-floor vacant availabilities. Now, class A inventory boasts 178 full-floor vacancy options while class B has 86 options for prospective tenants.
- Citywide, notable class A and B buildings with overall vacancy over 35% include: 500 Terry Francois Blvd, 370 Third St, 555 Mission St, 333 Bush St, 185 Berry St-Berry St Bldg, 650 Townsend and 101 Second St.

CBD

OVERALL RENTAL vs. VACANCY RATES



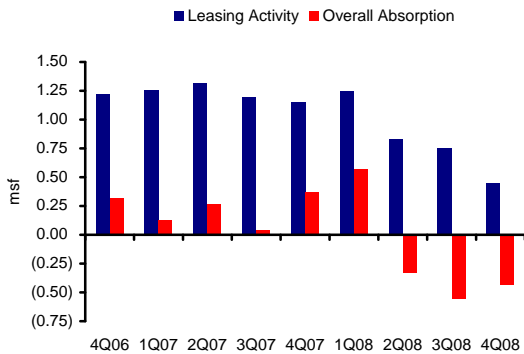
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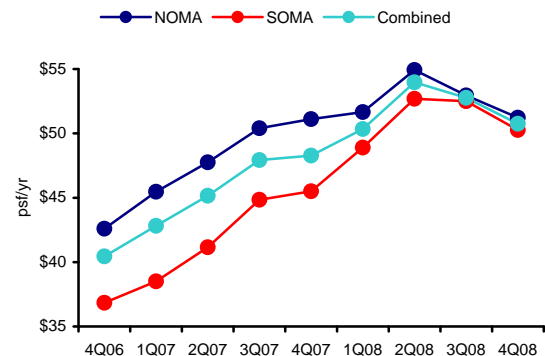
- The 11.6% overall vacancy rate in the fourth quarter marked the highest level since 12.0% reported in the third quarter of 2006. Legal and new construction vacancies accounted for a large portion of new vacancy at year-end.
- The completion of 555 Mission Street during the fourth quarter represented the first class A CBD completion in five years. Leasing activity in early 2008 brought in DLA Piper, Gibson, Dunn & Crutcher and Sequoia Capital but nearly 380,000 sf remains vacant.

- Since the third quarter, direct space grew 22.9% to 4.6 msf. The completion of 555 Mission Street and the failures of legal firms Heller Ehrman and Thelan Reid added nearly 750,000 sf of newly vacant direct space.
- NOMA Financial District had nearly twice as much sublease space as SOMA Financial District by year-end. Both submarkets experienced significant growth during the second and third quarters as tenants shed excess space.

LEASING ACTIVITY vs. OVERALL ABSORPTION



CLASS A DIRECT ASKING RATES



- Tenants continued to look for more economical alternatives as the year came to a close. In the CBD, five out of the top ten leases during the fourth quarter were sublease deals.
- Reflecting the lack of business confidence and growing economic troubles, leasing activity in the CBD fell 64.5% from the 1.3 msf in the first quarter of 2008. Absorption remains negative as new sublease and direct space additions outweighed leasing activity.

- The spread between NOMA and SOMA Financial District class A direct rents contracted as the year came to a close. The growth of competitive space options in both submarkets forced landlords to soften rents and focus on occupancy.
- The growth of rents during the first half of 2008 was achieved because many landlords stood firm on rents. The year progressed with rents falling as vacancy motivated landlords to act.

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. CLASS A GROSS RENTAL RATE*
NOMA Financial District	26,051,324	113	12.2%	9.7%	1,617,284	0	0	(1,111,963)	\$51.22
SOMA Financial District	22,032,963	98	10.9%	9.4%	1,652,220	0	872,334	127,049	\$50.27
CBD Total	48,084,287	211	11.6%	9.6%	3,269,504	0	872,334	(984,914)	\$50.75
Jackson Square	1,369,168	24	12.5%	12.2%	70,616	0	0	(120,149)	\$33.30
North Waterfront	2,394,975	31	8.8%	8.7%	99,699	0	0	(31,423)	\$40.00
South Beach/Rincon Hill	2,387,582	29	10.5%	8.6%	206,044	0	0	(44,836)	\$40.06
San Francisco S. of Market	5,260,498	44	21.5%	20.8%	313,476	0	0	(186,227)	\$44.81
West of Kearny	703,735	9	1.7%	1.7%	10,463	0	0	(3,667)	\$31.13
The Presidio	995,955	7	14.9%	6.2%	14,589	0	0	(103,445)	N/A
Union Square	4,035,868	58	8.2%	7.8%	223,881	0	0	55,613	\$36.16
Van Ness Corridor	4,379,522	34	8.2%	7.6%	114,709	0	0	56,061	\$33.81
Potrero Hill/Inner Mission	1,766,140	21	16.1%	16.0%	216,155	0	0	47,096	\$25.13
Mission Bay	1,006,272	4	48.1%	48.1%	0	0	723,272	239,000	N/A
Non-CBD Total	24,299,715	261	13.9%	13.0%	1,269,632	0	723,272	(91,977)	\$40.41
SAN FRANCISCO TOTAL	72,384,002	472	12.4%	10.7%	4,539,136	0	1,595,606	(1,076,891)	\$48.32

* Rental rates reflect \$psf/year

MARKET HIGHLIGHTS

SIGNIFICANT 2008 NEW LEASE TRANSACTIONS

BUILDING	SUBMARKET	TENANT	SQUARE FEET	BLDG CLASS
633 Folsom Street	SOMA Financial District	California Pacific Medical Center	175,000	A
555 Mission Street	SOMA Financial District	DLA Piper	82,785	A
555 Mission Street	SOMA Financial District	Gibson Dunn	63,475	A
560 Mission Street	SOMA Financial District	Arup	49,672	A
595 Market Street	SOMA Financial District	Visa	43,800	A
303 Second Street	SOMA Financial District	Avenue A/Razorfish	42,659	B
100 First Street	SOMA Financial District	WTAS	38,866	A
303 Second Street	SOMA Financial District	Kennedy Jenks	38,175	A

SIGNIFICANT 2008 SALE TRANSACTIONS

BUILDING	SUBMARKET	Buyer	SQUARE FEET	PURCHASE PRICE
CSAA Headquarters	Van Ness Corridor	Vornado & Patson Van Ness Holdings	549,392	\$120,000,000
199 Fremont Street	SOMA Financial District	PNC Realty Investors	397,300	\$260,000,000
500 Terry Francois Boulevard	Mission Bay	CBRE Investors	291,129	\$149,000,000
760 Market Street/Phelan Building	Union Square	Thor Equities	267,000	N/A
235 Pine Street	NOMA Financial District	TA Associates	149,147	\$52,500,000

SIGNIFICANT 2008 CONSTRUCTION COMPLETIONS

BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
555 Mission Street	SOMA Financial District	Gibson Dunn	547,000	10/08
370 Third Street (renovation)	San Francisco South of Market	Comcast Sportsnet	400,000	11/08
400 Howard Street	SOMA Financial District	Barclays Global Investors	321,545	1/08
500 Terry Francois Boulevard	Mission Bay	N/A	291,129	6/08
409 & 499 Illinois Street	Mission Bay	Fibrogen	239,000 & 211,000	11/08
185 Berry Street (two-floor addition)	San Francisco South of Market	N/A	175,000	1/08

SIGNIFICANT PROJECTS UNDER CONSTRUCTION/RENOVATION

BUILDING	SUBMARKET	MAJOR TENANT	SQUARE FEET	COMPLETION DATE
N/A				



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*Market terms & definitions based on BOMA and NAIOP standards.

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