Office Leasing Market Analysis
(2011 and 2012)
Historical Review-2011

Significant events shaped the 2011 commercial office leasing year and will serve well to define our upcoming commercial leasing strategies in 2012.

In the **1st Quarter of 2011**, three events occurred that improved and shifted local office space demand:

1. The City of San Francisco's 6 year moratorium of the employee payroll tax assessment on businesses in the 965-1455 Market Street corridor was, and is, of significant importance to the re-development of the area. This event served to draw major tenants with high employee counts to a sector that would otherwise not have located there as it was in the Tenderloin fringes and the properties sub-standard.
2. Sublease space availability was at the lowest availability level since the third quarter of 2008 (514,000 square feet in 2011 verses a high of 1,273,766 in 2009). Prior to and during the boom years ending in late 2007, sublease space availability averaged 400,000-500,000 square feet. This reduction of sublease (shadow) space now will put increased pressure on new and prospective tenants into selecting "direct" space inventory, pulling the overall office space vacancy rate downward in 2012.
3. The professional business mix of prospective tenants in the market was 35% tech and 25% financial. This leaves the remaining 40% to other business services such as legal, accounting, design and consulting to support the tech and financial sectors. This emerging diversification of tenant mix will serve to draw from the currant and predominant leasing sector (South of Market Area-SOMA) to now flow into immediate surrounding sectors such as the north and south financial districts and Jackson Square (The shift).

The **second quarter** (April-June 2011) brought in a significant additional surge of the above referenced 40% group; namely white collar and legal service tenants to support the tech and financial communities in larger numbers than the first quarter.

In the **third quarter**, because of the financial and political uncertainties nationally and worldwide, leasing volume flattened caused by increased uncertainty in the business community. Nevertheless, some existing tech tenants were still in an expansion mode with this demand further bolstered by new incoming tech tenants looking to surrounding areas besides SOMA, especially in the north financial district. Commercial Rents were now being pushed upward in these surrounding areas, with north financial district lease rates finally catching up with south financial district, and to some extent, SOMA (i.e. $41 in north financial district versus $42 in south financial district versus $48 in SOMA)..

The **fourth quarter** of 2011 experienced a significant diversification of tenant occupational profile throughout all the subject areas with increased volume (velocity) as well. This was economically very healthy.

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A. During the year 2011, the following market conditions existed:

1. As of now, January 2012, the historical average of 2011 and current rents were and are as follows (*)

	Jan. 2011	Jan. 2012
North Financial District	$37.29	$42.00
South Financial District	$38.46	$43.50
Jackson Square	$33.00	$38.00
South of Market	$40.21	$50.00

(*) The rates reflect "A" and above average "B" class properties.

2. During the same time period, average overall vacancies were as follows:

	Jan. 2011	Jan. 2012 (Today)
Area averages described above	14.25%	9.3%

3. During the same time period, unemployment in these areas was as follows:

	Jan. 2011	Jan. 2012 (Today)
Area averages described above	10.1%	7.6%

B. Leasing Fundamentals for Future Projections

Absorption of existing space (both direct and shadow) are key to projecting rental rate trends into the future. From 2007 thru 2010, absorption has actually been negative in the amount of -959,000 square feet per year in this 69,000,000 + square foot office market inventory in our surveyed specific areas (North and South Financial District, Jackson Square and SOMA). However, it must be noted that in spite of the negative absorption in each of the 2008, 2009 and 2010 years, there was 1,700,000 square feet of positive absorption in 2011. This was a game changer for office rent levels. It should continue into 2012 although at a slightly slower pace, as I anticipate at best, an economic slow down or, at worst a mild national recession this year (see special note (D) below). However, the reason for this continued positive absorption in the face of a possible recessionary relapse is that the business profile and employer base indigenous to San Francisco will be more resistant to material and statewide recessionary effects due to the product type developed, marketed and sold by these local employers coupled with their local counter-dependency on supporting industries such as legal, accounting, and intra-related consulting businesses citywide.

To further support this conclusion, the commercial building inventory has slightly contracted since 2010 from a supply of 70,226,872 square feet to 69,899,054 square feet in 2012. In addition, very little new space is currently being built or even on the market for lease because of past financing unavailability, slack demand and above average existing space availability..

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This will bode well in the rising tide of local lease rates as well as driving some tenants into class B and C space as a cheaper alternative. It should be noted however, that 300,000 to 450,000 square feet of new and rehabilitated space will most likely come on line South of Market in 2012 which will slightly affect the SOMA vacancy rate but not much, as much of it is already spoken for.

C. 2012 Lease Rate Vacancy and Absorption Projection

In the absence of a financial credit lock-up of both banks and CMBS (Commercial Mortgage Backed Securities) markets and also realizing a volatile national recovery in 2012, the following San Francisco local leasing projections should hold for the upcoming calendar year:

Vacancy (Systemic)	**January 2012**	**December 2012**
North Financial District	9%	7%
South Financial District	7%	5%
SOMA	5%	3%

Unemployment	**January 2012**	**December 2012**
	7.6%	5.5%

Absorption	**January 2012**	**December 2012**
North and South Financial District-Jackson Square and SOMA	1,696,000 Sq. Ft.	1,400,000 Sq. Ft.

Fully Serviced Rental Rates	**January 2012**	**December 2012**
(Upper End Properties-Fully Serviced)		
North Financial District	$42.00	$49.50
South Financial District	$43.50	$51.00
Jackson Square	$38.00	$47.00
SOMA	$50.00	$62.00

A recent commercial leasing phenomenon and trend that has taken hold is regarding brick and timber, upper-end buildings that tend to attract tech tenants and design firms. They are commanding a modified rent structure termed "Industrial Gross" versus "Fully Serviced". This means the new tenant will now pay janitorial, utilities (including PG&E, Water) plus security and elevator monitoring whereas before they didn't pay these expenses. This translates into an additional $4.43 per square foot per year for these landlords. Thus, even if "industrial gross" rents in say, the Jackson Square area are $45.00; that translates into $49.43 fully serviced, a $2.43 rent premium over fully serviced rents as of December, 2012.

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D. A Special Note: National, Bay Area and San Francisco Recovery-2012

The economic recovery of California state wide and U.S. national levels are mixed. That is to say, some economic events will effect some industries and not others. Our focus here is San Francisco, California and its relevant regional employment base.

First, and on a macro scale, the European financial crisis is going to directly and negatively affect U.S. trade volume and indirectly affect our banking, and thus restrict our credit sectors. Over 30% of all our world trade is with Europe whose economic stagnation, slow down and upcoming recession will reduce our U.S. gross domestic production demand and negatively affect the U.S. manufacture of industrial component parts and thereby slow U.S. transportation sectors (These sectors represents 28% of gross domestic product). On the financial front, many of our major banks have considerable loan and bond exposure to the European Central Bank as well as many European banks, directly affecting their U.S. affiliate or banking subsidiaries that are intrically woven into our U.S. financial (and local) credit fabric (for example, French bank BNP Paribas is Bank of the West here). To the extent these banks are affected by European Bond default exposure or capitalization requirements, these events will negatively affect us in the Real Estate credit sector as to credit availability.

Secondly, China is deliberately slowing their inflation and have thus created a mild recession for themselves. To make it's slow down worse, their delinquent debt is at critically high levels with their own sovereign bank (Bank of China, a division of the Chinese Finance Ministry) and regional banks which are very limited in their ways to be paid back by the local province industries they've financed. This is specifically due to China's, government directed slowdown. Unemployment is rising in their countryside dramatically causing much social discontent and unrest. The internet via twitter and cell phone intra-communication amongst the general population themselves is a material factor for this phenomena. Not good for a Chinese communist government that depends on full employment to keep their population uninformed and at bay.

Thirdly, developing countries in Asia including Australia, Brazil, Vietnam, Cambodia, South Korea and Indonesia are highly dependant on a growing China (and U.S.) to sell their principal product-natural resources. With the demand slowing down in China, this will put downward pressure on commodity prices upon which these emerging countries depend. Conversely, to counter balance this trend and because of the financial instability in Europe, much of European domestic cash is now flowing into these same emerging countries (hot money), putting the countries' borrowing rates for their government bonds yields to record lows (4.5-5.5% vs. 8-15%). This is good in the short term for them as it temporarily reduces their cost of sovereign debt. Also, record numbers of trained European workers are also emigrating into these countries as well to escape the European slowdown and uncertainty of employment in their sovereign country.

All three areas above serve to affect us all directly. Financial, basic commodity and energy markets will continue to be unpredictable and volatile Our dollar will strengthen in 2012 because of our perceived stability and shear size but our trade exports will weaken because of the slowdown in Europe. However, in spite of the above, credit markets for commercial real estate may improve notwithstanding the European banking crisis. Why? Already, 3 and 6 month treasury bills in Germany, Switzerland, and the Netherlands are yielding "negative" interest bolstered by European and Asian flight money flowing into their "demand deposit" coffers as a

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safe haven for fleeing cash. The U.S. is next in line for a lot of this flight money and this is good for real estate finance as bank reserves will be funded to the new regulatory minimums and U.S. bond prices soring even higher resulting in yields even lower than now (January 2012).

While the macro-economic activity referenced above can be seen as somewhat conflicting in general, our focus here is San Francisco, its resultant demographic trends and it's ever changing and increasing employment base unique to our Bay Area sectors. In San Francisco's case, these sectors are financial and technological industries. For example, a significant and recent trend impacting our commercial office market forecasting in 2012 is that major U.S. mid-western and east coast employers (i.e. Ford, BMW, Volkswagen, Comcast, American Express, and Dell and others) are locating new facilities in Silicon Valley and San Francisco with a goal to link up with our already existing research and development and tech companies to develop and joint venture new digital and licensed technology products for their own use and production. Call it **"co-creation"**. This event is a new and powerful trend having immediate impact on real estate leasing trends in the Bay Area. To support this fact, area moving companies logged in 30% more family move-ins than move-outs in the Bay Area in 2011 (The move-ins are mostly from New York and Chicago).

E.

In summary, employment in the tech and financial sectors is on the mend which will benefit San Francisco's two (2) primary industries and serve directly to reduce commercial vacancy, increase office space demand and further substantiate our projected rents for San Francisco office space in 2012.

END

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