- Introduction -

Our San Francisco Office Market

-2015 in Review, Today Market and 2016 Going Forward-

The end game of this report is an altruistic one - that is to establish factual economic and business benchmarks as of today in order to measure and ascertain where we believe the San Francisco office financial market to be headed.

Why? So we as investors and building owners can develop targeted business goals to implement the most advantageous practices for investment planning with an informed view to implement best actions.

Our firm has analyzed substantial volumes of relevant real estate, along with third party macro and micro economic studies, papers and articles. We also have had numerous interviews with commercial tenants (our own included), owners, architects, brokers, lenders and asset managers on most all matters related to San Francisco's office market activity.

From those outreach efforts, a collation of key points learned were then evaluated, weighted as to impactful importance and incorporated into systematic order flow that were again re-analyzed re-evaluated and summarized to conclusion and outlook.

As mentioned, with each event we have given a weight for its specific impact and its relevant influence to our own local market. We do this extra step to put all cogent matters in proper perspective- much like we did in SREA appraisal and CCIM (Certified Commercial Investment Member) evaluation training years ago.

First, with your indulgence, I'll start with San Francisco office market facts already past and established in 2015 up through today March 2016. The summation of these facts will be our fundamental financial benchmarks and foundational building blocks that helping us to look ahead with more certainty.

I thank the competent San Francisco brokerage, banking, and economic community along with others for their contributions and support along with regional and local real estate asset managers offering their views as well.

Second, we'll review -to be developed - 'Class A' office development 'real' costs plus their pro-forma lease-up rents in our current market. From these conclusions we can forecast realistic pricing trends directly influencing existing office product pricing 'for lease' in the near future.

Third, we'll explore national, regional and local factors and trends that serve to affect the technology industry, a sector of our market that comprises 18-19 million square feet (24 - 25%) of our 75,000,000 square foot office market inventory we are analyzing here.

Fourth, we'll put it all together in a risk analysis narrative that brings into view impactful world macro events that directly affect the U.S. economy and subsequently trickle into our own local real estate market.

We will also explore, U.S. economic events that directly serve to influence our San Francisco office market and, finally, we will review specific San Francisco macro and micro local current trends with all their idiosyncrasies that directly affect and influence our downtown commercial office rental and investment market pricing.

Fifth and Lastly*,* we'll take the weighted and adjusted summation of the World, U.S. and local economic and political events and build a super-forecast projection reflecting the probability and the cost of these events and issues that will directly affect us and our financial markets in 2016 and early 2017.

2015 San Francisco Office Market Review - Financial Facts:
-Rents, Vacancy, Supply, Absorption, Demand-
(First Stage of our Report)

The benchmarks we referred to earlier will set the stage to quantify and qualify future market events. They are our bedrock of reference. The facts you are about to read will serve to help quantify to what extent we inherit the economic reward or damage contrails that will be left from these occurrences.

Rents: Thanks to a narrowing supply of space and continuing demand, office rents have increased over the past couple of years at a 12-14% annual clip - about a $8.00 - $9.00 per square foot per year increases. this is extraordinary however we all know a trend like this is not sustainable over time. As of now, it is becoming evident that future annual office market rent increases are calming down to a rent rise of about $5 - $6.00 per foot in 2016 - still phenomenal.

Currently Class "A" Rents on existing product is $68 to $70, fully serviced, per square foot with Class "B" rents not far behind after playing significant catch-up since 2010. Note here: There are aberrations in specific sub-markets both higher - SOMA at $89 and lower $62 - North Waterfront.

Within the Class "B" category however, most of its rents are now structured as "Industrial Gross vs. Fully Serviced (e.g. tenants pays janitorial, electric, gas, trash and security monitoring which translates to about $5.00 - $5.25 per square foot). We are also witnessing double and triple net rent structures in some of the 'Class A' high rises - a coming trend in San Francisco.

Class "A" rents for new buildings currently under construction are requiring rents between $75 to $85 per square foot. They have to, as you will readily see in our 'development costs' verses 'Developer cash flow" requirements model appearing as Exhibit I attached to this report. (If you would, please view this at this juncture).

Vacancy: In spite of aggressive past and current rent escalations in our seventy-five million square foot market study area, *vacancy availability* has continued to decrease 50 to 65 basis points per year. Unfortunately, this 'availability' decrease will come to a halt this year and flatten out or even produce a net increase of 2.55% due to the sporadic addition of sublease, shadow space availability and the increased intra-market roll-overs by mainly tech and 'follow-on' tenants who have had to cut costs or alternatively have over-estimated their immediate growth needs.

"Direct" vacancy (non-occupied or uncommitted space) has been established by significant consensus to be 6.4% (4,800,000 sq. ft.) with "vacant availability" which additionally includes space that is for sublease, assignment and/or in intra-market roll-over to be 8.3% overall (6,225,000 sq. ft.). This nets out to approximately 1,425,000 square feet of sub-lease or shadow space on market - about 100 days of gross absorption. A wary eye needs to be affixed on this added space availability trend. It will also be addressed later in tech facts upcoming.

Supply: Additional office supply coming to market for lease beyond vacant 'availability' is mostly limited to newly constructed offices ready to move into.

The 1,200,000 square feet that came on line in 2015 is leased. There is 35% - 40% of newly constructed remaining non-committed office space coming on line in 2016. Still to be leased (and this is a very fluid number) is another 800,000 to 1,000,000 square feet. So between sublease availability and new construction net availability in 2016 is about 2.2 - 2.3 million square feet available space coming into our market to lease as of today - about 150 days-worth of gross absorption at 2015 rates. This number assumes gross absorption of 5.5 million sq. ft. with 2 million sq. ft. annual net absorption that would be required to eliminate this surplus under current conditions. Prop. 'M' restrictions however could serve to help speed this absorption process up by limiting tenant space availability options.

Demand: There has fortunately been a gross demand volume over the past few years of 8-10 million square feet per year that nets down to 5.5-6 million square feet of actual leasing activity with final net annual absorption close to or slightly over 2,000,000 square feet per year for the past 2 - 3 years.

The leasing activity nomenclature has tended to trend as follows: 75% were lease renewals or relocation movements into larger or smaller spaces within our market and, 25% consist of new incoming employers and companies from out of town or the surrounding Bay Area. This 25% represents new activity of about 1,500,000 square feet gross absorption thereby creating about 7,500 fresh employees per year coming aboard to further expand our San Francisco office demand market.

Rent Trending

(Second Stage of our Report)

Rent Trending: This review brings into view an important investment fact that needs your attention regarding prescient predictions for our market's future cost and of rents:

In the 49 years I've been in the Real estate and Securities industries, new and renewal rents, over time, always - always track with reproduction cost new whether it be Miami, New York, Toronto or San Francisco.

If you think not, and proceed to pay more than cost new or to replicate like new via ground-up construction or rehabilitation methods, you'd better look over your shoulder - and often. The only exception to your being able to enjoy complacency of this fact would occur if you actually believed you knew something nobody else did. Even that presumption has to smack of arrogance, naivety or overconfidence - pick one.

What I define to be reproduction cost new is what is commonly referred to as "Development Cost" of, in our case here, "Class A" office high-rise buildings. This includes, land acquisition, project delay and environmental costs, debt service and/or accruals, entitlement and legal costs, tenant build out, broker and lender fees, government taxes, special assessments, hard and soft construction costs-union scale.

Today, with land scarcity in San Francisco what it is, coupled with costs of environmental delays and expensive urban driven general conditions costs to build in a city setting, depending on location, it costs $825 to $950 per square foot of gross building area developed to bring a Class "A" office property on line and fully rented as of March 2016.

As you have seen through "Exhibit One" referenced earlier, new buildings entitled to start this year or next will have to command and demand rents of $85 to $95 per square foot to meet their investor's or investment fund's cash funding criteria in order to justifiably raise necessary cash equity plus also receiving construction and take-out lender's willing concurrence to fund the remainder of development costs.

Based upon today's market rents, the spread between existing rents that track directly with cost new is currently deficient $15 -20 per square foot for existing product and $5 to $10 per foot for new building product already under construction. The latter but smaller deficiency is mitigated somewhat due to less expensive dirt by previous acquisition and the entitlement costs incurred already behind them. These new development - cost facts have to be considered in trending forward future rents on all existing office product.

New Class "A" and "B" existing supply with this upwardly revised minimum rent requirement to create new supply must prevail regardless of current or future demand or supply availability. It is what it is.

To no-one's surprise, whether the office properties are Class "A" or Class "B" (or Class "C" for that matter), a new development cost revision gives rise to benchmark a revised leading indicator to support property management expectations of a continuing rising office rent in the near future.

San Francisco City Growth Facts

(Third Stage of our Report)

San Francisco urban growth has been consistently growing at 6 - 8% per annum with tech sector job growth at 22% per year since 2013.

That growth puts the San Francisco tech population at 65,000 - 70,000 jobs today (about 15%) of a currently employed city market place of 466,500 plus 4.3% unemployment totaling a 486,000 job market in 2016.

Even though tech employment is only 15% of San Francisco's employment base, it accounts for 27%-28% of our studied 250,000 square foot marketplace - one out of every four employees! This is significant and deserves outsized attention in our future discussions.

What is contributing to overall employment growth consistency is, that according to the Business Times, 85% of California college graduates continue to remain in California while 15% of all east coast graduates from the major institutions also move directly to just California within 60 months of their graduating. These are people we want.

On the less positive side, San Francisco's limits on housing availability and quirky small business credit is slowing employer expansion and growth. Housing costs are somewhat a factor with new residents, but when tech employees average starting pay (not necessarily salaries) start at $130,000 per year and go up from there, affordability is not the main issue (e.g. $130k - pay; $30k - stock options; 50k signing bonus). - It's the availability of any attractive housing in San Francisco is what matters today.

Nonetheless, employees want to live and work in San Francisco. Its not only business collaboration by day, its also social collaboration by night. After 8:00 P.M., San Francisco is a Mardi Gras - Monday through Sunday and many employers and employees want to be part of this lifestyle They'll pay the price in rent willingly - and are.

San Francisco City Lease Trends

The preferred tech working sector of the San Francisco office market for locational preference is Mission Street between the Embarcadero and 5th Street where landlords fetch over $89 per square foot today. It's no wonder. Employers can attract employees from the Peninsula and East Bay as well because of the upcoming Trans Bay Transit Center, Cal-Train extension station and the cross-town Central Subway.

City Lease Trends - Cont'd

Also, as referenced earlier, many of the new high rises coming on line are being built or just being built in the immediate vicinity of these very transit centers and are commanding $89 - $95 rents right now and this will continue into the future.

The local building construction limitations emulating from the 1985 City Ordinance - Proposition 'M' continue to remain in place as of now. Considerable pressure from developers, housing advocates and others is being put to City of San Francisco Planning to relax the 950,000 square foot office building new annual development limitations. The advent of the coming Central Subway is yet an additional pressure point in an advocates attempt to justify more surrounding office development and increase city employment.

There can be no doubt a legal battle will come about this year or early next regarding a modification of Proposition 'M' restrictions. But, with the flattening out of leasing absorption that will be reviewed later in this report - Proposition 'M', as it exists, will most likely remain as written with no changes. If there are modification, lawsuits will fly.

On a unrelated but important financial note, due to foreign countries' capital restriction policies being put in place by them regarding outbound private and sovereign money transfers because of the U.S. strong dollar, large inbound blocks of cash capital will continue to flow into San Francisco infrastructure projects, its commercial office properties and new development projects well into 2017-2018.

Foreign corruption, currency translation, safe haven and emigration are the principle reasons for this continuing major trend.

San Francisco Business Trends
(Fourth Stage of our Report)

Although San Francisco market demand is somewhat less this year than the previous 5 years, tech office demand is still at market highs historically.

Much of these high demand levels are due to what I call "Systemic Inertia". What I mean by that metaphor is that the tech sector as a vital industry, is more immune than other industries to Macro-economic events world-wide or nationally much like consumer staples are more immune (e.g. food, clothing, gasoline, etc.).

<u>Businesses need technology</u> and e-commerce applications to maintain their competitive productively. <u>Consumers need technology</u> to sustain accessible connectively and social awareness of their peers.

Whether or not there are temporary financial ups or downs, technology is here to stay although its formatting and processes may change to adjust with markets.

When there is a slow down, many San Francisco companies both tech and financial have already built cash reserve war chests to sustain themselves if necessary. As versed to 1999-2001, today's businesses had, and continue to have, genuine cash flows allowing them to build these liquid protections.

In addition to tech companies' having a likeness to consumer staples, as to public demand, there also remains another bastion of their inherent sustainability and that fundamental quality is the sector's deep rooted propensity for "Collaboration". I know this word has been overused and misused, but it definitely applies to business sustainability. Technology companies' tendency to cluster and group together serves directly to create new ideas, alternatives and efficiencies they would not otherwise have thought of. This unification can also encourage and define better governance amongst their peers. (Much like a hospital is to practicing doctors in an area).

By virtue of this sector characteristic, there continues to remain investor enthusiasm and underlying financial heft to continue support of properly run start-ups and maturing private firms in our market place.

Nonetheless, no one company can think of themselves to be immune to outside and seemingly unrelated events they have no control of: By this I mean world economies and their respective financial idiosyncrasies that then affect our U.S. National economy along with its own idiosyncrasies which eventually trickles down to our local market with our own respective idiosyncrasies.

Our firm has done its own extensive review and analysis of all printed and publically discussed international and national events and policies for the sole purpose of ascertaining how they indirectly affect us - item by item.

The upshot? The East Asian, South African, Mid-East, Chinese and European and East European policies will have outsized burden on our U.S. economy which is determined to lead in its own way. From currency devaluations, outsized corporate and sovereign debt, negative interest rates, European unity, slowing international trade, commodity futures, and political conflict, we in the U.S. have our hands full and will definitely be affected. All these events affect us here in San Francisco and more than many think. (Research data on file).

Locally, we also have to recognize that we have a host of start-up "niche' companies with loose-net corporate governance. Things will have to change in this sector. We have a high volume of 'software as a service' companies that are renown for being the riskiest of all tech companies.

To pile on further negativity but nonetheless reality you have the negative backwash from the momentum effects of investor perception of public stock markets. Right or wrong, local people hear rumors - good or bad - right or wrong and its repeated enough so as to become fictional fact in the eyes of the public. This may be wrong headed but it is life in real time.

All these events and actions can serve to propel a leasing or sales market into "Irrational Exuberance" or "Depression".

Our Conclusion

Based upon 'cycles and lags' alone, we are most probably going to see a slow down in early 2017 as a reoccurring economic phenomena.

From now till then, our 2016 office market demand will continue to be strong. By that we mean - Gross demand, 7,000,000 square feet; Leasing activity 3,800,000; but Net Absorption at 1,200,000 for the year.

Vacancy availability and re-rent rates are the biggest variable for 2017.

To quantify our projections, we use a vacancy range from probable to worst case. To qualify, we project most layoffs will be in the tech private sector although there will be some in the public sector also.

Here are our assumptions:

- Total Citywide Employees = 455,500 (96%)
- Total Tech Sector Employees = 70,000 (15%)
  (45,500 Private/ 24,500 Public Co.)
- Market Study Employment = 250,000 (100%)
- Market Study Occupied Inventory = 71,000,000 (94%)

(11,750,000 Sq. Ft. Private and 6,000,000 Public Co.) 18,000,000 Sq. Ft.

- 11,550,000 Sq. Ft. - Private 46,200 Employees
  at 12% Layoff (5,544 Employees x 250/ sq. ft.) = 1,386,000
- 6,000,000 Sq. Ft. = Public Co. 24,000 Employees
  at 5% Layoff (1,200 Employees x 250 Sq. ft.) = 300,000

Total Added Vacancy = 1,686,000 Sq. Ft.
Probable Added Vacancy = 2.25%

- 11,550,000 at 20% Layoff = 9,240 Employees = 2,310,000
- 6,000,000 at 7% Layoff = 1,680 Employee = 420,000

2,730,000 Sq. Ft.
Worst Case Advice Vacancy 3.65%

To quantify, there would be a vacant availability add on to the existing availability of 8.3% for a potential and probable 2017 availability of 10.55% or worst case - 11.95%.

Based upon the rent loss of 10 - 11 per square foot recent value in the 2008 recession and the proportional relationship of the vacancy increase this will translate into a 5 to 6 recent loss off the $68 to $70 today.

This is not a terrible hit but a hit nonetheless based upon our 2015 pre-established benchmarks.

Added:
National and Regional Tech Trends and Facts
(Fourth Stage of our Report)

Technology development, as we know it today is more than internet information services, telecommunications and e-commerce.

It has evolved into an economic ladder for product developments that are changing our lifestyle, business administration, medical research protocols and national health practices to the direct benefit of our general U.S. population. Technology is a U.S. business sector that is firmly entrenched and will never go away. It will continue to exponentially expand continually in our lifetime.

Already, we have forged from technologies nascent beginning in defense weapons and space exploration in the 1950's and 1960's; to wireless communications in the 1970's; to networks in the 1980's; to the internet in the 1990's; to software and services in the 2000's. Not bad progress for 60 years of effort.

Today, in my view, we are harnessing what we have learned and polishing the stone by our making existing products better and more useful. We are therefore learning to apply and recycle what we have already discovered to become more efficient and effective as a population.

As a part of our financial economy technology as a sector today represents only a small 7.5% of U.S. Gross Domestic Product and 12% of U.S. public and private payrolls. Nonetheless, the outsized influence and impact of the technology sector is immense and continually growing exponentially, much to our grand benefit and improved personal standard of living.

The cyclical economic status of tech companies will, of course, deviate over time. Our financial economic cycles today last 7 verses 5 years and have done so repeatedly since 1992. Since the 'official' end of the 2008 recession in late 2009 - early 2010, that will then put our cyclic U.S. expansion bottom in late 2016 or early 2017.

The question then comes up - How will this negative event affect the overall global, national and San Francisco economic picture now and when the economic cycle's nadir appears.

After all, since the 1980's, the tech industry has tracked directly with, and loyally lagging the NASDAQ stock exchange indexes up and downs by 6 - 9 months consistently.

If you see the NASDAQ indexes today, this should give you protective pause around late 2016 - 2017. This fact further serves to confirm the national 7-year cycle trend.

"Diversity" is an operative word I'd like to employ at this point to further describe our technology market today.

In the mid to late 20^{th} century (1950 - 1990), the tech industry was mostly focused on the internet and telecommunications sectors. During that time has expanded through fazes of internet technologies of unique variance. Today, mostly (and fortunately) in our own Silicon Valley and San Francisco the tech industry has now expanded into multiple sub-sector disciplines such as:

a) Software development
b) Clean tech
c) Web-sites and applications
d) Product design
e) Content
f) Algorithms

This diversification has enabled most of the well run tech companies a flexibility to diversify, specialize, divest or invest.

To promote business practice flexibility and financial sustainability, the U.S. congress enacted the 2012 'Jobs Act'. (Jumpstart Our Business Start Ups now) allowing not only tech but <u>all</u> private business start-ups to grow up to 2000 share-holder verses just 500 as before. This permits small businesses to stay private longer and to mature longer before being required by SEC rules to register as a public company. This is significant as it allows for private syndications, fin-tech funders, crowd funding or added stock purchasing of existing private companies be they tech, financial or otherwise, to maximize internal their cash equity and liquidity.

To demonstrate added financial sustainability, in 1999, the NASDAQ top ten stocks were worth 2.2 Trillion dollars. Today the top 10, although, different companies, are now worth 2.6 Trillion dollars however they make 5 x more cash flow! Result, they are more liquid and richer.

However, a disturbing trend has evolved in the public sector and, I would presume the private sector as well although there is no way of knowing.

Out of the 117 Initial Public Offerings (IPO's) since 2013, 77 of them, or two out of three, have experienced decreased valuation as of today. They were, and possibly still are, overvalued in the first place, mismanaged or, the victim of stock market negative momentum - in this current case sector sell - offs.

To add further pressure today's company earnings decline, the U.S. Standard Accounting Board will require all companies using General Accounting Standard Principals (GAAP) to show leased space on their books as a liability which directly serves to reduce earnings and their subsequent stock valuation verses their just posting a financial statement footnote - off balance sheet as before. This rule matters when you lease 100,000 square feet and have to show it on your financial statements.

IPO valuations are 30% lower then last year and in some cases - 50%. Venture Capital, Mutual, and Pension Fund funding are down 25% and so far in 2016 - not a single IPO has occurred. There're all staying private! Financial "Angels" and Private Family Investors (tourists) are the more recent investors d' Jour ("tourists") for the early stage investments and Mutual Funds in latter stage investment circle.

Today, new investors (and existing ones too) are demanding Series B 'preferred' stock, demanding lower stock valuations, requiring added stock options and warrants upon certain triggers and delayed founder and insider stock "lock-ups".

Where are the private and public tech companies looking to expand when not acquiring each other - Go West Young Man!

South East Asia, India and Europe are the while now focusing on retail services and e-commerce verses the usual licensing rights as before.

This strategy allows current companies to use research and development they have already done and market what they already have in place. The smart phone is a good example of this strategy. India is a major market if you have the staying power.

Our Report Conclusion

We have on file data summarizing over thirty (30) world and U.S. economic events (all happening now) that, to some extent impact us right here at home.

Our conclusion of those efforts clearly demonstrate that world events will and are, having a dramatic effect on future U.S. growth prospects in 2016. The weighted numerical margin we found to be two to one - the world events to be twice as impactful as not.

Will the world pull the U.S. into recession? No- but our findings definitely foresee it pulling back the U.S. economy verses what it would otherwise be doing. Obviously, this all will affect business in San Francisco no matter how you look at it.

How does it affect us? It will serve to pull back (not eliminate) outsized employer expansions and thus slow new office leasing. Also, it is now promoting "Herd Mentality" negative investment community economic expectations adding to negative momentum theory as mentioned earlier. It's always safe to be negative as there is no personal consequence. Our conclusion however is we will do well this year although not as vibrant as 2013 - 2015.

What is the quantification of these events for us in 2016-2017?

a) Net Absorption = 1,200,000 Sq. Ft. vs. 2,000,000
b) Rents = Potentially drop $5 to $63-$65
c) Vacancy - Direct = 7% from 6.4%
d) Vacant availability = 10.5% - 11% from 8.3%

We approached these conclusions based upon vacancy mostly in the tech sector - about 18,000,000 square feet or employ 65,000 - 70,000 people. The private sector companies will lay off 20that and public companies 5% permitting them to restructure financially for the future restructure for the future.

Rent decline was based upon the $10 to $12 decline in rents from 2008 - 2010 when over 3,000,000 square feet of space became available. This time, it will be half of that at most - not too bad.

From today until September/October 2016, the market will remain strong - steady - consistent.

These events are a little negative but nonetheless healthy and very sustainable in the intermediate and long run.

Please review our Web-Site, should you have an opportunity –
www.banerfinancialinterests.com

Respectfully Submitted,

William B. Baner
Managing Member
March 2016

Attached: 'Exhibit 1'