The

2014 and 2015 San Francisco

Commercial "Class A"

Office Market

-An Analysis and Study-

(January 2015)

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THE 2014 and 2015 SAN FRANCISCO COMMERCIAL OFFICE MARKET

An analysis....... and what it means to you and your current investment plans........

The intrinsic value of a well researched commercial office market report such as you will be reading here is to provide critical information that hopefully enables you to not only be professionally informed but also help you gain a multi-dimensional measurement of relevant factors directly and indirectly affecting our local market's performance past, present and upcoming events.

To accomplish this, you must have an informed vision of what our office market is today as it relates to; Who our "current" San Francisco office tenants are; How many there are; What their specialty is' and lastly, How they presently assimilate within our local social and economic environment and how they will sustain this simulation in the upcoming environment that will eventually surround them.

Our conversion going forward will review and analyze the syntax of 2014 market events and conditions including local commercial leasing activities along with their forward momentum, capitalization rate forensics, Class-A building re-sale events, and of course, new construction supply factors that all ultimately merge together as a part of our local 74,000,000 square foot downtown office supply inventory and market.

A quarter by quarter time frame will sequentially follow so you can get an insightful feel of the leasing and sales momentum trends and rhythms as well as local investor behavioral responses during the 2014 and 2015 years. As an added plus, also included are relevant, influential or trend-setting events from 2013 to give you added perspective and context.

Specific area sectors discussed here will focus on the North and South Financial Districts, East and South of Market area, Mission Bay, Jackson Square and North Waterfront sectors.

Class A
Office Supply and Vacancy

There are three driving issues that need to be incorporated into a 2015 investment strategy mindset regarding supply and vacancy. First, the amount of current office building supply, second, the type and design style of our current upcoming office supply and third, potential factors surrounding an unplanned "BLACK SWAN" negative economic event that could lead to an aberrational increase office supply or decrease in demand.

Factors Making Up and Affecting San Francisco Office Supply:

The original Downtown Development Plan, Proposition M and Proposition C, of 1985, 1986 and 1987, respectively continue to remain in place as predicted. They were recently memorialized by a recent voter affirmation in November 2014. Thus the new commercial office building approval cap for new construction permitting will limit new building supply construction permits to about 2,750,000 additional square feet as of today, late December 2014 – early January 2015. (This new construction cap equates to about four to five months worth of gross leasing demand and one to one and one-half years worth of net absorption at today's leasing velocity)

Currently, about 1,810,000 square feet of existing Class-A office buildings are finishing up their respective construction processes and are coming "On-Line" with another 1,671,000 square feet coming on-line over the calendar year 2015 . However, of all that square footage that is already built and/or coming online, only 891,000 square feet is available to lease between now through 2015. The balance completed or nearing completion is already pre-leased!

Further depressing office space availability to house incoming employers and their tenants, is the existing low *direct vacancy* rate of 4.9%; a *Direct plus Sub-lease* vacancy rate of 6.8% and; total inventory availability – *DIRECT, SUB-LEASE and SHADOW VACANCY* of 8% - 8.5%. That's only 3.6M, 5M and 6M respectively. We are very close to equilibrium vacancy now. (Equilibrium is Tenant Move-out Rhythm being in balance with tenant Move-ins) Also, as you can see in the summary on page 19, annual absorption for 2014 will approach 2.2 Million square feet. This rapid pace will continue through 2015 increasing to 2.3 to 2.4 Million square feet baring some outside catastrophic political or financial event (We will soon discuss this very item in a "*Risk Assessment*" sequel to this paper by separate cover in early February 2015.

Office Supply Restriction Mitigators:

There are efforts in play to water down Prop M. These attempts are currently being made gingerly by government bureaucrats so as not to roust up the original Prop M authors and/or her fellow advocates into a lawsuit potentially resulting in estoppel of any future changes. Proposed examples of mitigation measures under consideration currently include:

a) Add to existing building approval cap (currently 2,750,000 in 2014), 700,000 square feet of additional office space that is currently occupied by City offices

b) Add to existing cap, 600,000 square feet of future office space that is currently slated to be converted to Multi-Family apartment from its current office use zoned use.

c) Add to existing cap, 2.34 Million square feet of past office to apartment conversions having already taken place.

d) Add to existing cap, all office use previously granted under the Prop M allotment within the Presidio National Park area as it is federal, not city property.

There are two (2) remaining reasons how office supply may be increased by default: (One structural and one political):

First: Since 1986 (the birth of Prop "M") only 65.6% of "approved" applications over 50,000 square feet were actually built to completion. Only 52.2% under 50,000 square feet were actually built. That would obstensively plow 946,000 square feet of over 50,000 square feet of office space back into the supply chain.

Second: The current seven members of the San Francisco Planning Commission, as evidenced by their past decision actions, will surely affect their respective future tacit decisions to approve (or disapprove) new construction projects in the future:

<u>VOTING RECORD</u>

40%	-	No Build
20%	-	Let's Talk
40%	-	Let's Build

Supply Inventory of Specially Created Space and Its Future Trend:

Many landlords, architects and real estate industry non-profit organizations see a rising and nascent tech design trend that demands an office layout for technologies' "creative thinkers" featuring, shrunken down, non-partitioned offices with open areas and high ceiling features for maximum "collaboration". Many in this camp feel that this design scheme is a fad and is grossly overblown (Source: Urban Land Institute).

However, many in the San Francisco professional sales, development and architectural arena feel otherwise. To demonstrate this new design concept's availability foothold in San Francisco, of the 51 buildings that comprise our market analysis – (74,000,000 square feet) 6,500,000 square feet are already finished, rented, available to rent, or being built, converted, or earmarked to be converted into this creative open space and is now a part of our existing and upcoming supply chain. This trend will be a continuing one through 2015.

Please keep an open perspective in mind here; This 6,500,000 square feet of creative space is targeted more specifically to our San Francisco tech market sector which is 26% of our entire tech and related occupied office space inventory (<u>not</u> our leasing <u>demand</u> market) that is under discussion here (See Page 8). Therefore, this target tech market of 19,351,250 square feet already contains about 34% of creative office space demand availability at <u>some point in</u> time in 2014-2015. I think this empirically shows that our landlords and architects are "all over" this recent local trend and have it covered well to satisfy new demand.

Notwithstanding the above, this stripped down and re-compacted downsize driven trend can be an easily overblown and is a vulnerable design strategy over the longer term. Not all employees like to be crammed together like turtles in a zoo crawling all over each other with no significant privacy or personal space other than a designated 5' x 8' enclosed cubicle. There may be tenant pushback against their employers at some point and a redesign of this space put back into play in the future.

Office Vacancy as a Potential Surprise "Black Swan" Event:

There will always be a national or regional threat of some sort potentially souring local demand and supply availability of downtown office space. Today is no different. Negative event candidates are:

a) International conflicts or regional terrorism incidents

b) International economic recessions and/or currency wars amongst the sovereigns

c) Impromptu international trade slowdowns or protectionalisms affecting Bay Area Companies' earnings.

d) Stock Market Crash (-15% or more) or Correction (-5% or more)

e) Federal Reserve Monetary Events Affecting Real Estate Debt Costs or Availability

f) Local political restrictions, e.g. excessive employee tax levees; commercial lease revenue taxation, excessive city re-sale escrow assessments, inclusionary tenant or monetary set-asides, costly special assessment districts

g) Large employer shifts to buildings they would purchase in its entirety as an owner-user no longer having to lease from third-parties

These all spell problems affecting supply and demand.

Vacancy... A Risk Assessment Scenario:

Although our San Francisco employment profile consists primarily of Technology, Information, Legal, Finance, Health and Business sectors, our most potentially *volatile and vulnerable* sector base is that of Technology tenants.

The San Francisco direct tech and its related sectors currently represent a little over 19 million square feet and employs about 51,000 (Direct) and 159,000 (Direct and Related) workers respectively. Of the 19M square feet, about 62% is leased by privately held (non-traded) small to medium size tech companies and 38% are publically traded larger intellectual technology companies listed on the NASDAQ and NYSE.

Most of these larger public companies at present are fairly well capitalized as are many of our local medium sized private companies as well - *as of now*. However, according to U. C. Berkeley's economist, Ken Rosen, about 50% of these smaller private companies (5,900,000 square feet potentially) could go bust (this compares to his prior prognosis of 80% back in 1999). So add a worse case 50% "vaporization" event to the small company or tech supply mix (3,000,000 square feet) and you would quickly then have a 11.9%-12.5% Office Availability Rate – or more (8,800,000 – 9,250,000 square feet). That is where we were in 2011-2012 where rents were then at a $42 - $45 per square foot for "effective" rent for new lease turnovers and existing vacancies. This event could then regress and reconstruct our market back to $42 to $45 per square foot "effective" for renewal rents on vacant space over about 12-14 months. ("Effective Rent" in this context means the annualized actual collections for a space as it relates to it's square footage over one (1) fiscal year.) It is my conclusion that it would take at least a severe stock market correction (or crash) to make an event this drastic happen. (See page 19 for further quantification of Ken Rosen's recent vaporization claim applied to the San Francisco Market). Presumably, a combination of a financial and/or geo-political event would cause the tech plus their dependent spillover sectors to freeze. Nonetheless, this is one sample Black Swan – in spades if a-e on Page 5 happen independently or all at once to any major degree. Scenarios f) and g) are very localized and wouldn't immediately affect supply or vacancy but would definitely affect Cap Rates and future employer/tenant demand which will be discussed in our upcoming *"Risk Assessment"* sequel to this paper in February.

OFFICE DEMAND AND DEMOGRAPHICS

To further enhance our discussion into a *well rounded* insight of our San Francisco Office leasing market, allow me to introduce you to an added overlay for a more conceptual frame of reference:

First: Demographics

Let's start with the City and County of San Francisco:

Overall there are over 805,000 who live here. Of that, there is a 613,248 person workforce. It is generally broken down as follows:

*	Government	134,732 (22%)
*	Business	244,388 (40%)
*	Finance	79,318 (13%)
*	Tech Information and Related Sector	154,810 (25%)
		613,248 (100%)

Of the above, 466,500 people are San Francisco City residents in our market area of which only 21,500 (4.6%) of these residents that live here and are unemployed.

SAN FRANCISCO CITY AND COUNTY GROWTH TRENDS

	2013	2014
Gross Domestic Product	+3.9%	+5.2%
Population Growth - General	+2.6%	+2.8%
Employment Growth – General	+2.4%	+3.4%
Employment Growth – Tech Population	--	+14.2%
Payroll Growth – Tech Employees $	--	+10.0%

Note that San Francisco internally produces tech employment growth exceeding 7,200 – 8,500 new persons per year with respective employee compensation annual increases exceeding $7,000 per year or more! Some Bonus – eh? These new tech employment growth facts alone indicate a 2015 annual office sector leasing demand exceeding 1,100,000 – 1,300,000 square feet in 2015 versus prior year 2014 of tech office expansion and growth. This growth doesn't even count anticipated outside companies bringing in their own out of state employees which then spill over into our general leasing demand market. Now that's real growth "Perspective"!

Since Tech comprises a significant share of office space annual *leasing demand* activity (54% as of December 2014) a break-down of the tech sector into its service and product producing sub-sections materially matter. The principal reason is that the "IT" (Information Technology) industry sector is under continuous disruption and change due to the transformational nature of public demand and their esoteric lifestyles. Tech companies' general financial welfare and prescient knowledge of their respective challenges, products and services demands to the public at large are thereby very relevant to the financial welfare of the San Francisco office market sector's health overall. So, it is important for us to take note of this city's Tech firm employee business activity breakdown which *currently* is as follows:

	Specialty	# of Employers
1.	Computer Systems	34,860
2.	News and Information	9,034
3,	Internet Search Portals	3,457
4,	Electronic Shopping	2,330
5.	Software Publishing	1,853
	Total Tech Employees	51,534

Tech Sector as it Relates to Total Market

City Workforce	# of People	%
Total Workforce	613,248	100%
Tech Direct Employment	51,534	8.4%
Tech Direct & Related Employment	154,810	25.2%
	Square Feet	%
Tech Lease Demand – Annualized	2,917,000 Sq. Ft.	54.0%
Tech & Related Space Occupied	19,351,250 Sq. Ft.	26.0%
Tech Direct Space Occupied	6,441,750 Sq. Ft.	8.7%

So now you have the overlays. Again, for a bullet point perspective, keep in mind: Tech is 26% of our office occupancy for the overall San Francisco Marketplace; It is 8.4% of the entire workforce; Tech is 54% of leasing square footage demanded of our market (2,917,000 square feet as of 4th quarter 2014) and represented a major portion of our leasing net absorption velocity in 2012 through 2014.

Second: Leasing Demand

From a macro-economic perspective, information technology and the internet in our present world is not a passing fad. It has materially altered how we live, work and even think. (i.e. visualize *Big Data* and *IBM's Watson* as examples) The 21st Century "technological revolution" has replaced the "industrial revolution" of the 20th century.

To our fortune and mutual benefit, this Intellectual Technological revolution originated in the Silicon Valley and the surrounding Bay Area. By "Intellectual Technology," I mean robotics, bio-technology, fusion, human health development factors, medical instrument research and development, cyber-defense initiatives and military weapons technological development. All this growth emulated from Silicon Valley, mostly San Jose to Mountain View. Now the City of San Francisco has also become an integral part of that "IT" space revolution and is an integral part of the Silicon Valley employment sector. Our prior office demand sources were the "FIRE" Employers (i.e. Financial, Insurance and Real Estate). Now we can also include the ICE Employers (i.e. Innovation, Creativity and Entrepreneurship). San Francisco has assertively arrived in our nation's eye and is now recognized as a 24/7 – "Live, Work, Play" major destination city in the eyes of not only the nation but also international investment communities. It is only 1 of 4 "Gateway – Live, Work, Play" cities in the United States; i.e. San Francisco, Chicago, Boston and New York City. San Francisco is also the number one choice for office investment according to the Urban Land Institute's 2015 Survey and analysis.

Going back to our scripted overlay and tying all these facts and trends together, let's now take a moment to investigate a break-down of San Francisco's office leasing demand for the past two years. The following detail reflects the major office employment sectors in town and, also provides a graphic window in which to evaluate for future trend and momentum indices going forward.

EMPLOYER LEASE VOLUME
(IN # OF SQUARE FEET)

		(Overall Years) (Jan-Dec)		End of Yr. (Dec)	Demand Shift (2014)
		('000' omitted)			
	SECTOR	**2013/%**	**2014/%**	**2014/%** (See drill down On Page 15)	**BOY to EOY** % of Market
*	Tech	3691 (55%)	3671(72%)	2917 (54%)	72% > 54%
*	Business	1978 (30%)	979 (19%)	1286 (24%)	19% < 24%
*	Financial	528 (8%)	248 (5%)	610 (12%)	5% < 12%
*	Legal	460 (7%)	176 (4%)	552 (10%)	4% < 10%
		6057(100%)	5073 (100%)	5365 (100%)	100%/100%

NOTES TO LEASE VOLUMNE CHART ABOVE

Note 1) From beginning of 2013 into 2014, tech sector demand remained high but relatively flat year to year, however demand then decreased in 2014's fourth quarter to well below the 2013 and most of 2014 levels. This is a signal to watch.

2) Business sector demand alternatively went down from 2013 through 2014 but then increased somewhat as of December 2014 but not near 2013 levels. Slight improvements ahead, but not a lot.

3) Financial and Legal employer demand also went down in 2013 into 2014 only to increase significantly (relatively speaking) as of fourth quarter 2014 and well exceeding 2013. This indicates considerable movement in these sectors for 2015, especially legal. This warrants a further examination into San Francisco and National Legal Trends. (A separate paper for sure!)

General Take-Away:

It appears that subsequent leasing momentum in financial and legal sectors will continue to increase for demand in 2015 with Technology office demand starting to taper off somewhat to more recent normal, but still very high velocity levels nonetheless.

TODAY'S OFFICE LEASE GROSS DEMAND
"DRILL-DOWN by OFFICE SECTOR SIZE"
(As of December 2014)

(By Office Size Sector – Square Footage)
"000 omitted"

SECTOR TOTALS	SECTOR	5K-10K	11-25K	26-50K	51-99K	100K +
2,917 (54%)	TECH	211 (53%)	251 (36%)	375 (42%)	350 (40%)	1730 (69%) **
1,286 (24%)	BUSINESS	129 (32%)	367 (52%)	285 (32%)	205 (24%)	300 (12%)
610 (12%)	FINANCIAL	40 (10%)	35 (5%)	110 (12%)	75 (9%)	350 (14%)
552 (10%)	LEGAL	20 (5%)	52 (7%)	125 (14%)	235 (27%)	120 (5%)
5,365 (100%)	TOTAL DEMAND	400 (100%)	705 (100%)	895 (100%)	865 (100%)	2500 (100%)

** This includes SalesForces' 1.1M square feet lease in the Trans-Bay Office Tower.

Notes to Charts Above:

1. If SalesForce.com Trans-Bay office lease is *excluded* from tech leasing activity in 4th quarter, the 2014 tech sector leasing demand actually decreased 30% from 2013.

2. 95% of all tenants in 2014 leasing market were seeking space the same size or up to 20% larger than before.

3. Tech companies looking for space in San Francisco, as a percentage in 4th quarter ending 2014, with their lease demand of 2,917,000 square feet consisted of 62% privately owned companies of which 91% of them have been in existence at least 3 years and 9% were younger start-ups. This bodes well for continuing tech demand sustainability in 2015 due to this sector's business maturity. The remaining 38% are larger publically traded companies as referenced earlier on Page 5.

4. There were 20 large leases in 2013 of 50,000 Square Feet and up with an average size 126,000 square feet. There were 15 large leases in 2014 of 50,000 Square Feet and up with an average size of 98,000 square feet. (This excludes SalesForce lease in 2014, which materially skews average lease size)

An additional take away from #4 above, aside from the lower leasing velocity of large leases over 50,000 square feet in 2014, is that the higher level of large leases in 2013 may partially account for the higher overall tech lease volume in 2013 versus 2014 as shown in the previous demand chart on Page 10.

5. Super-Leases signed by companies leasing from 100,000 square feet and up.

2012	-	13	-	AVG Size	190K
2013	-	7	-	AVG Size	185K
2014	-	6	-	AVG Size	180K (Excluding SalesForce)

Currently there are 14 additional 100,000 Sq. Ft. tenants in market. That equals about 2.5M Square Feet in and of itself based upon averages above. These are solid gross demand numbers going into 2015 - 3,800,000 - 4,000,000 square feet - plus. This is exclusive of the 1.1-1.3 million square feet of structural tech employee growth demand (See Page 7). ***A solid lease demand base trend is now in place for 2015.***

6. An added note to tech and overall general lease demand trends:

Since 2010 when tech lease demand really took hold, 69,683 new tech jobs came into the San Francisco Bay Area under an employer umbrella consisting of 1,956 companies. 57% of these new jobs and companies settled in to San Francisco to work and live over these four years. That translates into a historical average of 9,929 jobs and 279 companies per year. In further support of 2015 lease demand the above bodes well for continued and consistent structural demand momentum into and through 2015.

The 2015 general "gross" leasing demand base should exceed 5.5 to 6.5 Million Square Feet wherein Financial and Legal sectors will increase their share even if Tech and Business demand sectors are flatter.

There have been 16 consecutive quarters (4 years) of positive net absorption and sustained general tenant demand base holding steady at 5.5 up to 6.5 Million Square Feet per annum. This will hold through 2015 unless that Black Swan, mentioned earlier, arrives at our doorstep. Net absorption amongst this continued and consistent demand should continue as well in the 2,100,000 to 2,400,000 square foot range to further nibble down the current 6.8% vacancy rate to 6.50%.

National Influences on Our Market

For strategic and planning purposes it is imperative we investigate and then predict as best we can, what influences are built into the *core* Cap Rate. Interest rates, inflation expectations and economic stability are its basic building blocks. This foundational component as a part of the total Cap Rate is what is known as the "safe rate" – in which we mostly use the U. S. ten year Treasury Bond rate as the real estate benchmark. (Note: Like a bond, duration or holding period can alter this safe rate higher or lower.) To this we add the risk premium that was discussed at much more detail in my 2013 Cap Rate Paper (banerfinancialinterests.com - Cap Rate Letter 2013). This risk premium is based upon the local investors' assessment of the economy both on a local and regional basis. For purposes of this paper, I'll attempt to explain and summarize my position on the present safe rate and to a lesser extent, the risk premium briefly in the two paragraphs following:

First: Interest Rates, the Federal Reserve and Forward Indices

The primary job of the Federal Reserve is two-fold: First, to *promote full employment* to the extent it can, and second, to *maintain financial stability* in and for our national U.S and International economic systems. During and after the recession of 2008 and 2009, the Feds instituted quantitative easing one, two and three, as well as specific housing and financial regulatory programs (TARP, Dodd-Frank and FINRA come to mind). For the short term, QE-1 and part of QE-2 worked (about 800 Billions worth). Then it faded in stimulative efficacy. Result - 4.5 Trillion dollars of printed money suspended out there in the form of newly created bank bonds, that were originated and then purchased from the banks by our Federal Reserve. The Bond purchase cash proceeds given the bank were then placed in the banks' excess reserve accounts that were (and are) owned and controlled by the banks but currently earmarked to pay back the Feds when called upon by them. (When this event happens it would be known as Credit Tightening). However to date, these stimulus reserve monies earmarked for new mortgage loans to the public didn't occur to any extent and never flowed into our U.S. financial monetary base because no loans were made. As a result, there has been no inflationary effect that would otherwise be due to this expanded money supply. That's where we are today.

Statistics that Drive National Interest Rate Policies:

a)	U. S. Unemployment	5.6%
b)	Target Unemployed by Federal Government	5.2% (The Ideal Unemployment rate to balance 2% Fed Inflation target)
c)	Nominal U.S. Unemployment	11.2% (those part-time & looking to work)
d)	Hourly Yearly Wage Increase	1.7% (Usually 3% per annum)
e)	*CORE* Inflation Rate (<u>Excluding</u> Food and Energy)	1.6% (Real Per Capita Income barely increasing)
f)	*General* "All Items" Inflation (<u>Including</u> Food and Energy)	.8%
g)	Inflation Expectations	2.4% (Lowest in 5 years) – 12 month
h)	U.S. Population Working	59.2% (Was 58.6% in 2014 but still flat, low participation rate on an average)
i)	Forward <u>Five Year</u> Futures Rate For Inflation adjusted Treasuries (TIPS)	1.86% (Today's 10 Yr Treasury = 1.91%)
j)	Forward <u>Ten Year</u> Futures Rate	1.583% (Good Trend Indicator)
k)	Job Growth	Currently 275,000 per month (need 200k/mo for break even growth)
l)	Unemployment	5.6% (December 2014)
m)	U.S. Dollar	Highest in 9 years ($1.21 to the Euro versus $1.36 in early 2014)
n)	Public & Private Debt	$18.0 Trillion (and climbing fast – was $16.7 Trillion last year) Not Good.

These statistics are relevant to allow us to forsee (as best we can) interest rate trends, past, present and future.

The interconnected conclusions and the resultant affects to our market of the above facts and analysis will follow below on Pages 15 and 19.

Second – Inflation, the Federal Reserve and the Markets:

Currently, our year over year inflation rate is but 1.2%. This compares to 3% in the 80's and 90's and 12% in the 70's. The rest of the world's economies are currently stagnant or deflating. Global oil is $49 versus $108 last year and $146 in 2013. It will be falling to $35.00 and thence stabilize at $50 to $55.

Europe is now looking to commence quantitative easing as we in the United States have just finished doing. Yikes! Earlier I said, that "short term QE works, but long term QE doesn't". QE for Europe (and parts of Asia) will only have temporary simulative benefits. Europe will ultimately have to "De-Value" their currency if they want to trade and have sufficient U.S. dollars as necessary for their respective foreign reserve currency accounts used for international import trading purposes.. This action will affect us directly via a massive reduction to our U. S. export market which is a significant component of our economy. Currency exchange rates will affect our import costs as well.

We in the United States also cannot escape the effects of world economic events even if we wanted to because of World Trade inter-dependencies and the U.S. as the World's reserve currency base. Our U.S. exports alone, equates to 9.7% of our Gross Domestic Product and imports 15.6%. A U. S. – Fed inspired Interest Rate increase would create a huge negative impact upon world trade financial fluidity.

With all this said, here are the conclusions:

National interest rates for 2015 will remain where they are and will not be raised as previously anticipated by myself and the markets back in 2013 and 2014. They may even go down, not up. *See Forward 5 and 10 year interest rate futures on Page 14.) The Federal Reserve, in the interest of their main mission "Economic Stability," cannot overtly raise rates under current U.S. conditions of its minimal per capita wage growth, high nominal unemployment (SLACK),low working participation rates, declining inflation expectations, plunging energy prices from $146 to $35 per barrel, and very importantly – *the very real prospect of the devaluation of the Euro* would cause International economic calamity as stated earlier. Accordingly, the dollar will continue to rise against other world currencies with new foreign currencies flooding in as new added investment into our treasury bond markets for safety, security and investment return further pushing down U.S. interest rates.

Lastly, because of our *relative* national economic stability, San Francisco's unique local position as a gateway investment market and the increasing value of our U.S. dollar, foreign investment "Hot Money" will especially be pouring into our region to invest in local infrastructure projects and Class A real estate office properties in which to park their currencies. This will be in the billions of dollars in 2015. The typical foreign investor not only sees huge upside momentum in a growing world class market such as San Francisco, he also sees that his converted currency will only increase in value against his own. He then gets a double rate of return when he brings his money back home and economic security while he's here. This will further put collateral downward pressure on all San Francisco Capitalization Rates.

2015 NATIONAL AND REGIONAL ECONOMIC SUMMARY

* Interest Rates - Flat or Down
* Inflation Rate – Flat
* Gross U. S. Domestic Product (GDP) - Up
* Energy Prices – Down, then Up slightly & stabilize
* U.S. Dollar - Up
* Foreign Capital Inflows - Up
* CMBS Debt – Up (from 96 Billion in 2014)
  (Commercial Mortgage Backed Securities)
* Bank Loan Risk Spreads - Up
* Capitalization Rates – Down
* Construction Costs - Up
* Real Estate Prices – Up
* Rents – Up
* Vacancy - Down

Office Rents, Operations and Sales

Rents: Gross rent revenues of Class A office property in downtown San Francisco have increased over 16% per year from 2010 to 2013 and another 15.5% per year from 2014 to 2015 topping out today at over $67/per square foot, fully serviced. Most of the higher end increases were in the SOMA and Mission Bay Districts. (Spiraling Land acquisition, construction and related general conditions costs are a driving condition that in turn require these increasing rents to justify building costs). *Development* Costs – ALL IN – including interest carry, land costs, city inclusionary costs and entitlements are approaching $825 per $850 per foot. This will eventually require rents of $82 - $85.00 per square foot. We are at $67 soon to be $69.

Today, neighborhood sub-markets and inferior B to B+ quality properties have started to also catch up and are now also sporting $60-62 per square foot rents fully serviced.

However, please note that *Industrial Gross* structured rents are now a growing local and regional trend and are commonplace amongst most tech tenants already. Don't forget, most of these relocating tech and information tenants originated from Research and Development properties that contained this type of rent structure before and is still commonplace. Industrial Gross rents in smaller Class B properties in San Francisco are $56 to $58 and $59 to $61 in the Class-A quality buildings as of now. Tenant reimbursements under this arrangement can bring in $5.00-$6.00 per square foot per year in additional rent within smaller buildings and $6.75 – $8.00 in larger Class A structures. Reimbursable expenses under this arrangement will include all utilities, fire and life safety, phone Telecom, Door Security (not including doormen), trash removal and janitorial services.

Double and Triple-net rents are additionally being bantered about with the real estate professionals but I've seen no evidence of their general implementation as of yet. When it does, it will start with the 100K square foot plus employers just like it already is now in Silicon Valley.

Operations: In a recent survey of Class A building operations, base operating costs are running $10 – $12 per square foot plus Prop 13 tax expenses at today's re-sale or construction prices that additionally command $7.00 - $7.50 per square foot for a total annualized operating expense of $17.00 - $19.50 per square foot excluding downtime vacancy, turnover renovation, leasing costs and special reserves for replacement which will vary from building to building.

Net Operating Income (NOI): NOI, or "Earnings" in Class A buildings 2015 – 2016 future re-sale (or asking) prices should look like this:

	Low	Medium	High
Market Rents	$65	$67	$69
Turnover/Vacancy	- 5	- 5	- 5
	$61	$63	$65
Operational	(17)	(18)	(19)
NOI	$44	$45	$46
Today's Cap Rate	5%	5%	5%
FUTURE MARKET VALUE:	**$880**	**$900**	**$920**

Sales – Cap Rates: The traditional benchmark for office income property sale pricing valuation assessment has been the Capitalization Rate (Net income then divided by Cap Rate Equals Investment Value). The lower the cap rate, the higher the price – like a bond. The difference is that bond yield (same as cap rate) is only calculated based upon its stated coupon income and affected by duration (remaining Bond Term). Cap Rates in real estate can be confusing in that they can be based either upon actual collected income or currently established market rate gross rent revenue levels. Thus in our San Francisco marketplace, Class A office cap rates can differ from 3% to 6.5% for the same building! For our purposes here we will assume *market* rent, expense and earnings. Today's Class "A" Market Cap Rates are in the 4.8% to 5.2% range depending on esoteric factors unique to each property and building sale and within our market areas under discussion (see Page 1).

Sales – Market Values:

Prices per square foot during 2014 for existing Class A and Class B office product have been all over the board depending upon on location, the property manager's ability to recycle leases, raise rents and locate or create the additional areas that could be added to the property for future revenue enhancement.

Re-sale prices at the low end were $520 in 2014 up to $823 in select Class "A" structures. Most pricing has been in the $640 to $710 range as of December 2014. In 2015 don't be surprised as you will see asking prices as indicated in the chart above.

As you can also see from this table, with market rents in place as currently valuated and good aggressive management, a $44 to $46 NOI is very possible. That's $186 to $226 per square foot additional upside still on the table in 2015 even at today's average price of $642 per square foot. That's 26% - 32% newly created money with good management, at today's acquisition prices, in 2015!

For *smaller* buildings, fully leased, sales prices of $700 to $725 are commonplace with highs of $880 in Jackson Square. Don't be shocked to see Menlo Park style $1,000 - $1,100 per square foot sales prices for this type property by end of year 2015 – early 2016. (Maybe even sooner than that.)

All of the above applies in a perfect world. Unfortunately the world is not. There are Black Swans galore swimming about.

Black Swan Event – Market Value Loss:

Historical evidence in San Francisco demonstrates that for every 100 basis points of Federal Reserve mandated short term interest rate increases, about 25-30 basis points of that will built into an increased cap rate (often up to 35-40 basic points in non-gateway U.S. Cities). By that example, a 100 basis point interest rate hike will cost you about $50 per square foot if you sold. Can you live with that?

If the stock market has a major correction (probability 80% in 2015) or crash (probability 25%), it's not the worst event that could happen in and of itself, but it will cost you tenant occupancy. As I said, 62% of tech office space is privately held which is the most vulnerable and volatile sector in our market here in San Francisco. This could translate to a 2.7% - 4% vacancy increase if many of these companies vaporize. That could cost you $72.00 - $90.00 per square foot in value. That's an 8% to 10% value haircut. Maybe you can live with that scenario but...... can you live with both the reduced value and effective rent revenue loss of $10 to $15 per square foot on your roll-over or vacant space that could go down with it? What about debt load costs and/or principle calls?

And of course, there is always going to be that real estate investor question d' jour, "Is this market sustainable?" I have been investigating the pros and cons of this question for some time and will attempt to put this into forensic closure featuring a new real estate investor risk assessment *model*, coming soon to you as a sequel to this paper in February 2015.

In the meantime, you now have the facts. I trust you now have a good idea as to what's behind these facts and where this all may take us.

What I can say with reasonable certainty "today" is, excepting for this Black Swan that could surface, there is nothing structurally to stand in the way of what should be the strongest market in office leasing and sales we have seen since the 1970's. (Yes, I was there then, in the real estate and securities business.)

A 2014 market recap is presented below along with my 2014 predictions previously made in 2013, actual results in 2014 and, my 2015 predictions made today for the coming year.

OFFICE LEASING FACT SUMMARY

(By Quarter – 2014)

		QTR 1	QTR 2	QTR 3	QTR 4	COMMENT
A.	RENTS (Class A)	$58	$63	$65	$67	Up 15% for year Up 22% Qtr for 2013
B.	VACANCY					
1.	Direct Leases	6.1%	5.5%	4.7%	4.5%	
2.	Direct Sub-Leases	8.2%	7.8%	7.1%	6.8%	(Historical = 10.5%)
3.	Availability	11%	9%	7.9%	8%	
C:	TENANTS IN MARKET:	6.3M	6.5M	6M	5.3M	(2013 = 6.1M) (2012 – 6.4M)
D:	ANNUALIZED ABSORPTION:	2.3M	3.1M	2.0M	1.8M	2.3M Average
E:	NET QTRLY ABSORPTION:	582K	763K	500K	450K (EST.)	2.3M Average
F:	SALES PRICE /SQ. FT (CLASS A)	$600	$630	$646	$694	$642 - 2014 Avg.

PRESCIENT ANALYTICS

	RENTS	TENANTS IN MARKET	NET ABSORPTION	DIRECT & SUBLEASE VACANCY	NEW SF EMPLOY-MENT	TREASURY 10 YR INT.	CREDIT LOAN SPREADS
2013 PREDICTION	$64	6.5M	1.7M	7%	20,000	3.4%	+225 (OOPS)
2014 ACTUAL	$63	6.1M	2.2M	7.4%	21,000	2.1%	+190 (Loan interest 4.5%)
2015 PREDICTION	$69	6.8M	2.4M	6.5 %	24,000	1.9%	+230 (Loan interest 4.2%) - spreads up -

CONCLUSION

The above dialogue, conclusion and predictions for 2015 are not the end of the story, but merely an adjournment of this story.

It is clear to us that:

a) New asking, fully serviced rents are going to continue to again increase in the financial district, SOMA and Mission Bay office markets by 10% to 13% in 2015 depending on area location

b) Direct, indirect and shadow vacancy will drop to as low as 5.5% direct; 6.5% direct and indirect and, 8% availability rates respectively.

c) Absorption should increase to 2.3 to 2.4 million square feet.

d) Supply coming on line from new construction will be the first to be leased and will absorb quickly in 2015.

f) New employment will approximate 22,000- 24,000 new people overall for 2015 with tech growing from 8.4% of our current employment base to over 10% (about 62,000 people). Tech as a leased office sector will also grow from 26% of our leased office market to 27-29% of our market

MACRO-CONCLUSION – We are in a "Momentum Market"

THINK SMART, STRATEGIZE, STAY FOCUSED AND MANAGE WELL!!!

Baner's wishes for a wonderful and prosperous 2015!

William B. Baner
Managing Member
Baner Financial Interests
San Francisco