Commercial Real Estate Facts, Trends, and Projections

(North and South Financial District/Jackson Square/SOMA/Mission Bay)

San Francisco-3rd Quarter 2012

Preface

This report and commentary is very likely the most important discussion we will have this year together regarding the commercial real estate leasing market in downtown San Francisco and it's collateral districts and referenced in the header above. The reason being is the incipient uncertainty created by the upcoming election and it's paralyzing effect on the making of strategic business hiring and relocation decisions by our local and regional corporate boards and individual business leaders. The outcome of the U.S. Election and "follow-on" Federal Reserve Monthly Policies will, one way or the other, dramatically affect their decision processes and decisions directly influencing office space demand in our local marketplace going forward.

I am looking forward to discussing with you four (4) major and critical areas that significantly affect our local commercial real estate market and it's parallel events that continue to formulate future inflective trends within the San Francisco Office Market.

They are as follows:

- *San Francisco **Employment** Facts and Trends*
- *Regional Commercial Real Estate and Business **Funding**: Sources and Trends*
- *Commercial Leasing Office **Supply and Demand**: Facts and Trends*
- *San Francisco Office **Rents, Vacancy and Absorption**: Facts and Projections*

The pages to follow reveal, in some researched detail, the factual basis for future office demand projections contemplated.

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San Francisco Employment Facts and Trends

It would be difficult, if not impossible to have a meaningful and relevant discussion of the current and future commercial real estate office market without addressing empirical facts allied with recent and past fluid events of San Francisco business employment. After all, employment is the primary driving force and building block of commercial office demand and it's subsequent leasing (or non-leasing) thereof.

Currently, San Francisco, with a population of 820,000 people, has an employment base of approximately 432,000. About 32,000 to 36,000 of these total jobs are in the technological industry. Of the 32-36,000 tech employees, high tech employment grew over 8,700 jobs in 2012 in San Francisco County versus a 6,000 person job growth in the Silicon Valley, it's employment grew times the national average and at present, the tech sector represents over 50% of the 16,600 person total job growth in San Francisco. You ask-So what? Well, not only do these empirical facts give you a better rounded perspective of local economic dynamics, these facts alone also translate into an auspicious and emerging growth trend in office space demand going forward. The annual tech growth by itself will generate between 1,200,000 to 1,700,000 square feet of office space demand just to house these new employees in 2012 and 2013.

San Francisco employment growth is not just a one time blip; this expansion has been occurring for the past 2 years. Rent growth in terms of dollars charged by landlords as a result of this growing and ostensibly consistent employment trend has averaged 19% per year since 2010 (Average rents grew from $31 then up to $49 today).

This high tech job growth of 8,700 persons per year also triggers a tandum progeny of commercial demand for retail, financial consulting, insurance services and legal business employment with hospitability growth sure to follow.

Most interesting, over 20% of San Francisco's high tech, service and new employment is coming from the Mountain View/Palo Alto commercial markets which are now 100% full with rents 25% higher than today's San Francisco's rents. Most of these employers are smaller tech and service companies coming into town. The larger Silicon Valley tech companies are staying put in Mountain View/Palo Alto and it's environs and "busing" their San Francisco resident employees to work and back into town. If San Francisco continues its business friendly policies (such as they are), the tech epicenter could transfer from Silicon Valley to San Francisco itself. This incredulous trend maybe open to question however.

On a related note, unemployment in San Francisco is down to 7% versus 8.4% in Silicon Valley and 10.4% statewide as of October 2012.

The overall near term trend for San Francisco employment growth will be steady or flat between now and year-end 2012. Employment growth from October- December 2012 will be about 2,100 additional new <u>tech</u> employees or 4,100 employees of all types <u>overall</u> with a distinct growth pickup beyond that in 2013. The magnitude of employee increases in 2013 depends on who our elected leader(s) will be (both President and Congress) and sequential policies enacted therefrom as referenced in the preface on page 1.

Money and Funding: Facts and Trends

As the philosopher Baeneur once said "It's always about money when you break it all down", and this again holds true in San Francisco as well. Money, financing, and funding availability and it's access are not only the driving force behind San Francisco's new employment hiring, it is the driving force for infrastructure development; and the driving force for new capital formation, office leasing demand, commercial building sales velocity and pricing as well. Current office building prices exceeding $850 per square feet demonstrate this fact.

There is a reason money and funding is flowing to San Francisco: This city is the iconic end game for personal lifestyle. It's lure attracts young talent and talent attracts money to develop new or expanded business enterprise. These events are the synthesis and cornerstones that attract new employers to locate here, and in particular, the downtown commercial area itself.

Foreign Capital: In addition to attracting business, San Francisco is attracting foreign capital as well. Over $685 Million over the past 90 days. Why? America and San Francisco are seen (and perceived) worldwide as a bastion of transparency, liquidity, real growth and affordability coupled with an effective and efficient legal system with a defined and enforceable rule of law. San Francisco is only second to New York City in the entire USA in attracting the volume of foreign capital it presently does. For example-as to the city's affordability;

Office Building Cost	**San Francisco**	**London**	**Hong Kong**	**Tokyo**
Average Cost Per SF:	$371	$928	$1,193	$1,247

Anecdote:
Office Rents Track with Building Cost

- ***Private Hedge Funds and Sovereign Capital Funds*** are also providing liquidity to our region in the form of private lending to commercial office borrowers via Security Companies and Investment Banks, joint ventures and infrastructure funding.

Example
Sovereign Wealth funding of Treasure Island and Hunters Point Shipyard Infrastructure

- ***Commercial Mortgage Backed Securities (CMBS)*** is another revived source of capital funding now available to the San Francisco commercial office market Building Owners and Buyers in 2012 and 2013. This source was all but extinct from 2008-2011. Funding availability and it's growth looked like this

(Historically in Billions of $):

2007	***2009***	***2010***	***2011***	***2012***
$238B	*$3B*	*$10B*	*$15B*	*$45B*

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The CMBS private secondary securitized market as provided by hedge funds, Investment Banks and private investor's capital was previously non-existent as can be seen by the above chart. The comeback didn't just happen by itself. The 2010 Dodd-Frank Federal Bill (regardless of it's regulatory extremes as currently written) put in new investor safeguards such as "operating adjusters" to oversee and help alleviate creditor-bondholder concerns for the prospect of default collection alienation from bond repayment if a collapse of this financial product should occur again.

CMBS current commercial rates are 4.35-4.65% and up to 75% LTV. The interest rate is commenserate with the loan term based on a matched libor based swap index used as the base plus a pre-set risk spread.

- ***Venture Capital*** is currently a major source of funds as it pertains to start-up companies and young business capitalization. It is critical for us to have a general understanding of this source of funds since these venture companies provide employer tenancy for a significant portion of the of San Francisco's office leasing market demand....estimated to be up to 40% of the market! These (and all) tenants are our "stock in trade" and their earning prospects and viability are critical to the quality of future income in our office buildings.

In 2000, during the last tech boom (and bust), VC Capital exceeded $50 Billion. Due diligence of these inchoate startups at that time was abstract and many of their business models questionable and dubious.

Much (not all) of and that has changed now. VC Capital is cautiously invested and is now just over $21 Billion. Their selection and funding of new companies is much more diligent, selective and focused. VC's are now asking tougher questions and demanding more realistic business models of these startups.

For example, regarding "focus", just mentioned, Venture Capitalists are now demanding:

a) Companies with strong brand identity
b) Ones that are oriented to consumer technology
c) Small to medium cap valuations

From the landlord and analyst's perspective the "Tenant Profile Quality" aspect that should be answered in advance as a due diligence question before leasing to them: "What are the major trends within the local tech industry itself and, what is the shelf life of that tenant"

A current area of pernicious concern in the tech industry is social networking and game companies. Many of their capital valuations are going down or are depressed for too many reasons to address here. This can create hiring (office demand expansion) or firing (office demand contraction) problems for the leasing market in the form of outright tenant default, lower demand or, increased sublease supply. Many of these employees also now have lower valued stock options as a direct result that could reduce their personal wealth as well as their options diluting a company's capitalization value as to outside stockholders. These lowered valuations could cause a lot of future employee turnover and movement in this sub-sector.

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Tech companies that are going to be most attractive to lease to in 2012-2013 are ones that specialize in:

- Website Development
- Business Products
- Business Analytics
- Wireless Networking Equipment
- Cloud Computing

This is where demand should be focused in the business market?

The influx of capital to the San Francisco business and commercial office market via Venture Capital, Sovereign Wealth, Hedge Funds and Mortgage Backed Securities is, and will continue, to provide employer funding who then in turn drive business expansion and new business formations. Investment Hedge Funds will continue to drive the real estate equity markets and, Mortgage Backed Securities, will help drive the commercial office building finance markets.

Supply and Demand

The previous discussion establishes facts that portend trends pertaining to local employment and growth from incoming businesses, who they are, where amongst them to focus and lastly, sources of cash from financial funds and business investors that serve to create many companies. The upshot is making the subsequent leasing of office space in San Francisco an executory reality. But what about the commercial supply of this office space as conflated with this business demand to occupy it all?

Supply

There are (7) seven areas of office space supply sources each with their inherent side effects that need to be understood and put into proper perspective. The first two of these areas will tend to restrict or delay supply.

1. ***Proposition M Law***
Prop. M caps put a commercial supply governor on new office building construction from coming on line too fast in the city. Proposition M has an existing accrued office building construction cap of 4,000,000 square feet for 2013. Currently, there is 1,700,000 under construction due to come online in 2013; 3,800,000 square feet currently approved by the City of San Francisco Building Department to construct anew; there is additionally 2,200,000 currently in Pre-Development Planning Approval process and,; 2,000,000 square feet which applications are plus 980, 000 square feet in Preliminary Assessment which is step #1 of the planning process. That's 8,980,000 square feet of potential office space! Another 1,700,000 square feet is under construction now as mentioned earlier. Of course, not all of this proposed will ever get built. Nonetheless, these figures give a vivid synthesis and perspective to as the future office building supply chain destined for San Francisco.

2. ***CEQA***
The California Environmental Quality Act (CEQA) is requiring the City Planners of San Francisco to re-focus on the next generation of employees, who they will be, what kind of work will they be doing and, in what setting should their anticipated functions be put. Building square footage, heights and building densities will be directly affected by future planning conclusions in 2013 (See #3 below for an expansion on this topic).
3. ***Office Corridors***
City of San Francisco Planning Policy used to be focused on housing and its collateral production of affordable and market rate units (Rincon Hill and Mission Bay are good examples of this policy).
Now, the city has a focus on office and jobs production (see CEQA #2 above). A good example of this is the rezoning and re-planning of the 4th Street corridor from King Street and Cal Trans Station north up to Market Street. Also, Mid-Market is a target area of office and retail use rezoning, planning overlay changes and redevelopment criteria. This particular corridor is between 5th Street thru 10th Street which is about a ¾ mile long

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corridor along both sides of Market Street. The city's anticipated time schedule for this redevelopment area is:

- 7th Street to 10th Street-Now
- 5th Street to 7th Street-5 Year Plan
- Tenderloin-5 to 8 Year Plan

4. ***Direct and Indirect Vacancy***
There is currently an office direct vacancy of 7.6% or 5,539,000 square feet in the 73,000,000 square foot downtown markets we are covering in this report. There is also an indirect (shadow) vacancy of up to 1,100,000 square feet of sublease space available but most still occupied by paying tenants. This is a sum of 6,639,000 square feet of available vacant space to lease right now. Of course, a zero vacancy rate is incredulous and impracticable to assume as there is a simultaneous constant turnover and demolition of office space as well. Also, a significant portion of this 1,100,000 square feet of sublease space in situate in the Van Ness Corridor and Union Square Areas not covered in this analysis and projection.
Nonetheless, this gives a second dimension (direct vacancy) and third dimension (Indirect Vacancy) as to the building supply chain besides construction.

5. ***Zombies***
As current office occupancy has increased over the past 15 to 18 months, at least $500 Million has been invested into the purchase and rehabilitation of old and/or empty office buildings (Zombies) that have since been rehabilitated. Most of this space is spoken for with some exceptions. Mid-Market mentioned in #3 above is an example.
A major cause of this trend is the cost of new land where it even exists. Entitled land in the North Financial/South of Market areas can run $180 per "buildable" square foot (over $1,000-$1,500 per square foot gross land surface area). This drops to $250 to $500 per square foot in the surrounding districts and $140 to $250 in the neighborhoods. This is in spite of Prop. M building restrictions referenced in #1 above.

6. ***Rent Floor Thresholds for Office Development***
Rents now have to be at $55-$60 for low to mid-rise building construction justification or $70 to $75 for high-rise in order to be remotely feasible. Rents are not quite there yet but almost.
Nonetheless, over 1,700,000 square feet is currently under construction due to come on line in 2013 in anticipation of these rents being in place at these stated rates with developers knowing full well the current $49 rents as they are now.

7. ***Sub-Lease Space***
As mentioned above, a large amount of sub-lease space has come upon the market in the 2nd and 3rd Quarter of 2012. Estimates are at 1,100,000 square feet. This is up from 750,000 last year in 2011, a 35% increase. Most of these sub-leasors are social network or gaming tech companies as well as some insurance, finance, law firms and retail. Many of theses sub-leasors are warehousing this space until they expand in the future.

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However, there is a heavy current demand for rent ready, short term office space for a large population of entry level startups or even established out of town companies wanting to generate an outreach facility in San Francisco. This sublease space should absorb fairly quickly and can currently be viewed as healthy trend.

Nonetheless, this activity should be watched with a wary eye to ascertain it doesn't emerge into a larger negative supply trend. Also, as mentioned in #4 above, a significant amount of this space is in Union Square and the Van Ness Corridor which is not covered in this report.

From a market perspective, current sublease space is only 16% of total direct and indirect vacancy versus 18% in 2009 and 45% in 2000 so it is not yet an alarming fact.

Demand

Current Demand and it's Trends

The balance of supply and demand of office space in 3rd quarter 2012 was slightly negative at worst or, 300,000 square feet positive, at best, depending how and, as of when it was calculated. Overall, leasing activity this quarter just past has flattened out. Business leaders and employers cite uncertainty. It is not the "Fiscal Cliff". It is the uncertainty of who will be our next president and their ensuing policies-Period.

Tenant Demand Trends

There is currently 2,000,000 square feet of new tenants (employers) searching in the market. Of that number, 800,000 square feet (40%) represent tech employers.

Many that are looking are seeking tenant improvement packages that include:

Interiors	**Building Cores (Low to Mid-Rise)**
-No Floor Coverings	-Operable Windows
-No Cubicles	-Side Core Elevators
-No Offices	-Side Core Mechanical Systems and Shafts
-Open Ceilings	
-Pendant Lighting	

Total build-out cost $65-$70 per square foot for the five improvements above.

As a side note, there is little evidence San Francisco bound tenants, existing or prospective, are seeking cheaper rents or alternative digs in the East Bay.

Absorption and Future Demand

As of October 2012, approximately 1,400,000 square feet have been positively absorbed versus tenants vacating their space and there are still remaining tenants in the market currently seeking to lease another 2,000,000 square feet in addition to the 1,400,000 already absorbed this year. Also, future tech employment growth is anticipated to be 8,000 to 10,000 for tech companies alone in 2013 based on current and recently past empirical evidence. This 2013 employment translates into an additional 1,600,000 square feet of tech space needed. Follow on service sector jobs in 2013 should be 4,000-6,000 more jobs which will generate at least another 800,000 square feet of additional space required by 2013 year end. With sublease space supply of 1,100,000 and new space coming on line at 1,700,000 in 2013, we will have 2,800,000 of rent ready office space in 2013. Assuming direct vacancy remains at 7.6% as it currently exists, and the entire 4,400,000 is absorbed in 2013, vacancy could drop from 7.6% to 5% or 6%.

Rents and Vacancies

Average rents in the financial district, South of Market and Jackson Square average $49 overall fully serviced. This is up 23% from 2011 and 59% from 2009 in which rents were $31. That's a 19% per year average increase!

Absorption of commercial office space was 2,100,000 square feet in 2011 and approximately 1,400,000 to date. It is projected to final out at 1,700,000 for all of 2012 with 2,000,000 square feet of tenants still in the market.

Office direct vacancy rate is 7.6% currently amid continuing and increasing asking rent rates for the sub-markets discussed here. However, if sublease shadow space is included, that vacancy rate increases to 11.8% out of a 73,000,000 square foot office inventory excluding Van Ness Corridor and Union Square.

Rents-Existing and projected to end of year.

	3rd Quarter 2012 (Existing)	4th Quarter 2012 (Projected)	4th Quarter 2013 (Projected-Page11)
North Financial	$46-48	$48-50	$53
South Financial	$48-50	$49-51	$55
Jackson Square	$45-47	$46-49	$51
South of Market	$52-53	$52-55	$59
Mission Bay	$55-56	$55-58	$63

The office rents, existing and projected, as indicated above are fully serviced. That is landlord pays all expenses of building operations and taxes.

When rents attain the levels we are currently at which are $45-$56 per square foot depending on the submarket, together with some AAA high rise rents topping $80-$85 in specific instances, operating expenses shifting to tenants is not only feasible, it is probable. This expense shifting trend already exists in Silicon Valley although mainly with larger, longer term tenants. In many cases, tenants pay not only their own electrical gas and janitorial expenses (i.e. single net-N) they are also paying all other operating expenses (i.e. double net-NN) and in some cases all expenses including R.E. taxes and insurance of the building in direct proportion to the amount of space they occupy (i.e. triple net-NNN).

Single Net (N also called industrial gross) and is commonplace in many buildings today and, as rents rise it is, becoming commonplace here as well, especially in Jackson Square and close in South of Market districts.

The additional savings to landlords (or cost to tenants) as the case may be, is in the following expense ranges per square foot depending on building size, condition and existing building services provided;

- Single Net (N) $4.50 to $6.50 per square foot occupied by tenant
- Double Net (NN) $7.50 to $12.50 per square foot occupied by tenant
- Triple Net (NNN) $12.50 to $18.50 per square foot occupied by tenant

This cost shifting trend should increase through 2013.

In conclusion, San Francisco currently is very fortunate when compared to the rest of the nation. Past and current employment trends are strong which in term will drive office occupancy requirements and its subsequent absorption of that demand.

Barring any material changes in the U.S., State or City business and tax policy, absorption of office space in 2013 of 2,000,000 to 2,400,000 is very possible. Supply and Demand balance should look like this:

Demand (In Square Feet of Office)

- 2,000,000-2012 Current Tenants in Market
- 700,000-2012New Demand-4th Quarter 2012
- 1,600,000-2013 Tech Demand-2013
- 500,000-2013 "Follow on" Service Demand-2013

4,800,000-Total 2012-2013 Demand

Supply-(Rent Ready)

- 1,700,000-New Construction Coming Online
- 1,100,000-Sublease Space
- 1,500,000-Existing Vacant Inventory Reduction

4,300,000-Available Supply

A 500,000 square foot cushion is considered in counter balance and equate for variances caused by financial unknown events.

Rent growth could indeed continue its spectacular 19% per year growth as it has the past two years. However, we should be prudent and use a lower increase projection range. Current $46 fully serviced average rents in Jackson Square, $49 average rents in the South Financial District and $52 rents South of Market should attain a level of $51 in Jackson Square, $55 in the South Financial District and $59 South of Market by the end of 2013 with vacancy dropping to 5.5 to 6% one year from now.

There are currently 3,466 apartment units being built in San Francisco and 38,986 in various stages of planning approval to accept the high volume of future employee growth through 2013.

Between now and the end of next year, interim updated reports on the market will flow thru the BFI organization to you.

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