Baner Financial Interests
San Francisco

San Francisco Office Market Year in Review and Analysis (November 2013)

Introduction:

This paper encompasses three separate dimensions of market analysis. *First:* A historical review of significant events and trends over the 2013 year to date (as of November 30th); *Second:* A summarizing economic snapshot of where our office market is, as of today; and *Third,* an empirical examination of the office building owner's stock in trade....employer companies as office tenants, including their organizational types and respective job field diversities. This *"three dimensional review"* along with a 2014 prescient financial market forecast, will provide you a reasonably well rounded perspective in determining your own future strategic plans and participation within our local market.

Of course, the final conclusions resulting from this review and analysis are only 70% of the final answers in order to plot your own course. The remaining 30% of strategic conclusions must come from an analysis and conclusions derived from outside influences upon our local market from governments, including national, city and state, as well as regional events that we cannot control. This is a subject to examine in another time. We will however, briefly examine future interest rates and risk spreads that should emulate from Federal government policies.

The 2013 San Francisco Office Market in Review

Rather than immerse you in statistical nirvana and flood you with a cacophony of sundry events and facts, it is planned here to treat each major market category as its own story in review for this 2013 year and 2014 going forward. That way all events are clearly sorted in collateral form and subject matter.

The class "A" office market events for summary review in the following pages are:

- Office Building Sales (Over 100,000 SF-Class "A")
- Office Building Supply and Vacancy Snapshot
- Tenant Demand and Absorption
- The employer tenant and his employees-defined
- Current Market Rent Review
- 2013 and 2014 Financial and Market Snapshot

Baner Financial Interests
220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com

Office Building Sales

Strong tenant demand that generates cash flows combined with the real estate investor's everlasting search for maximum dollar return at minimal risk is what mostly drives any building resale market. Add to that, higher than expected new construction costs (Fathom $725-$800 as a new fact at today's land prices) while piling on future new office development and supply restrictions under city Proposition "M" and *you have the formation of a perfect storm* for high resale velocity, higher market liquidity and high sustainable office building valuations evidenced by the same or lower cap rates.

To put this dynamic in perspective, one of our highest resale booms in San Francisco happened in 2007 when there was an office building sales bonanza exceeding $8.5 billion dollars in gross sales for the year. In 2012, the investor world recognized the remaking again of this "Perfect Storm", wherein over $6 Billion dollars of sales volume occurred that year. 555 Mission sold for over $800 per square foot with $1,000 per square foot projected for select future projects! (A la Palo Alto/Menlo Park).

Now, in 2013, the market has stabilized to a sustainable sales volume of 5 to 6 Billion dollars while still maintaining relatively high valuations. What with entitled urban land sales at $135-$140 per buildable square foot ($1,300-$1,500 per square foot of earth), new construction "all in" developer costs of up to $725-$800 per buildable square foot today is now non-fiction. Very importantly, and as a key rule of thumb, the historical average since 1994 where the rents justify a fair investment dollar return to new "all in" development costs, the ratio is 10x to 11x annualized per square foot rent. Therefore, justifiable rents that will have to be charged new incoming tenants in 2014 have to be $72 to $80! We're currently at $59 (see rent snapshot following on Page 5).

Also, of an important note is office inventory turn. In 2013 to date about 5.4 million square feet have sold and closed escrow out of a 52 million square foot class "A" inventory. That's over 10% per year turnover which velocity is sure to reduce or at minimum, maintain low Cap Rates going forward especially at our current deficient market rent level of $59 vs. $72 to $80.

Class "B" buildings that naturally track (or try to track) with Class "A" buildings are seeing considerable sales velocity as well within the value-added and opportunistic investor sector. Prop M supply restrictions don't apply to this Class B category yet as most of these properties are under the 75,000 square foot city-mandated threshold of which there is still considerable new construction allocation permissible versus the over 75,000 square foot large Class "A" properties we are discussing here.

In a nutshell, weighted sales prices of Class "A" properties for all of 2013 is about $461 per foot. Prices of $500-$550 per foot are becoming more prevalent currently at this year end and are no longer just "one offs". Class "B" prices are in the same value range ($500) although their price points are much more varied because of the individual buyer's strategic plans for these intrinsic properties (plans may include: Gut and Total Rehab, Partial Rehabilitation, Re-Tenanting only, Total Demolish and Redevelop, Buy As-Is and just rent or, as a User Occupant).

220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com

Over the year 2013, capitalization rates have been averaging 6.5% calculated on "market" level Net Operating Income and 5.5% to 6% as of late. Expect them to remain where they are today or even possibly go lower than 6% thru 2014. Why? The Federal Reserve will taper stimulus in the next 90-120 days but will leave short term rates alone. Intermediate term rates (10 Year Treasury) will spike and raise long term rates from 5% to 5.5% when the stimulus reduction occurs. This has the potential of raising cap rates 40% of that interest rate increase (about 20 basis points) only to be offset however by continuing local rising rents and NOI.

Office Building Supply and Vacancy Snapshot

In 2011 and all of 2012, investors came to realize that employment growth in San Francisco's downtown was growing at a rapid rate with existing supply (i.e. vacant space, shadow (space currently occupied but "for rent") and sublease space) reducing from 15% of Class "A" vacant and sublease inventory (7,900,000 SF in 2010) to 10% of inventory (5,200,000 SF in 2013). To make things tighter from a supply viewpoint, there were very few large blocks of space even available for lease for most of 2013. Currently there are 12 tenants seeking 100,000 square feet or more and only 5 spaces available. Of the supply of Class "A" space for rent, much of it did not fit the new use efficiencies or requirements that the new incoming and intra-city transferring office tenant cultures sought which further limited space selection.

This scenario dictated a clarion call for new construction development and rehabilitation or reuse of existing structures in both Class "A" and Class "B" quality properties within their respective locations. As a result, six developments representing over 3,000,000 square feet of office properties came (or is) under construction in 2012-2013 alone. All this space will come online from now on until early 2015. As an interesting note, about 1,500,000 square feet is coming online in 2014, starting next month of which 60% (900,000 SF) is already preleased! These new developments reflect many of the space efficient qualities of the new culture tenants as referenced above. This new and more efficient space is a very healthy addition to our markets as this diverse supply selection adds new found depth to our existing office inventory.

There is over 4.2 million square feet of office space pending approvals at City Hall but only 1.8 million is available under Prop. "M" restrictions. After that's used up, the rest of pending developments will have to get into the 875,000 limited square footage per year "beauty contest" queue and await their turn over future years.

As a result, we expect direct office vacancy to further drop from its current 7.6% to 7% in the coming months. To reinforce this conclusion, "Class A" sublease space is finally said to be at its lowest in years at about 2% of inventory (1,100,000 SF).

The bottom line today; When you have an office supply of 6,400,000 square feet remaining, coupled with about 600,000-750,000 of more "for lease" space coming online now and next year and, there are 5,000,000 to 7,000,000 square feet (depending who you

talk to) of tenants currently in the market "looking" for space, I'd say we have a pretty tight market in play going forward.

Office Tenant Demand and Absorption

San Francisco office leasing demand was somewhat volatile back in 2012. Unemployment downtown actually went up back then from 6.1% to 6.5% of our workforce. Make no mistake about it, when employment growth slows and/or unemployment goes up, it directly and concurrently slows leasing velocity. No lag here. Of course the opposite is true as well.

Nonetheless, investor confidence reigned and they were correct. In 2011 and 2012, 2,100,000 and 1,400,000 square feet respectively were absorbed, and in 2013 1,400,000 to 1,600,000 square feet will be absorbed by year end. This includes preleased new construction coming online in 2013 mentioned earlier on page 3. This is good if you are a landlord.

Currently, as I see it, there are prospective tenants representing over 5,800,000 square feet of demand in 2013. In 2012 about this time of year there were over 6,300,000 square feet of tenants in the market. However, the mix of users were dramatically different then as compared to now. Here's how our demand matrix compares:

Tenant Profile in Market (In Square Feet)

Size Blocks ***(In SF)***	**Education** ***Government*** *2012/2013*	**Tech** ***Companies*** *2012/2013*	**Finance** ***Insurance/Legal*** *2012/2013*
75,000-100,000	380,000/318,000	1,875,000/1,408,000	835,000/1,110,000
40,000-75,000	90,000/262,000	525,000/220,000	450,000/588,000
25,000-40,000	0/137,000	391,000/305,000	555,000/469,000
13,000-25,000	62,000/17,000	339,000/282,000	435,000/325,000
1,000-13,000	0/0	271,000/123,000	164,500/272,000
Total:	**532,000/734,000**	**3,401,000/2,338,000**	**2,440,000/2,764,000**
Percent of Total:	*8%/13%*	*53%/40%*	*39%/47%*

Total Tenants in Market: 2012-6,373,000 SF

Total Tenants in Market: 2013-5,836,000 SF

220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com

(Note: Some qualified sources quantify 6,300,000 tenants in market in 2013 with only 37% of square footage representing tech demand vs. 40% used above.)

We'll discuss more on this later but for now, even though general demand is 9% less in 2013 the demand shift has decreased in tech by 31% (over 1,000,000SF) which is now 40% of total tenant demand (see chart on previous page) and finance/insurance/legal has increased 18% which is now 47% of total tenant demand. This shift creates a more even balance of tenant demand requirements than before. This is good in that we are not as tech heavy as many pundits have previously thought.

You might also note that there is less square footage in demand in 2013 versus 2012 however there is the same amount of absorption of square footage (see page 3). Less tenants are dithering and are more serious prospects. Part of that phenomenon may be due to more prospective tenants that are new and coming into town from outside the Bay Area or from the Peninsula or South Bay and less of the tenants in our market are roll-overs by vacating their old space in San Francisco for relocation into a larger new space within the city.

To conclude our demand analysis section, new employment demand (as broken out in the chart on the previous page) is pouring into San Francisco at the rate of 18,000 per year according to the Fisher Institute in Berkeley. That translates into new space requirements of over 3,000,000 to 3,600,000 square feet at 175-200 square feet space requirement per employee. This projection doesn't even count the multiplier effects of follow-on employment (See Enrico Morretti's book *"The New Geography of Jobs")*. His studies reveal that one tech employee gets you 5 other follow-on employees in related support or collaborative services. This projection also doesn't count existing tenant expansions into expanded roll-over space.

From a demand perspective, it appears there is plenty of juice in this downtown San Francisco office market baring any national or government catastrophe or set-backs beyond our control.

2013-2014 Class "A" rent snapshot

	(2013) Quarter 1	*(2013) Quarter 2*	*(2013) Quarter 3*	*(2013) Quarter 4*	*(2014) Quarter 1&2*
			(Fully Serviced Gross)		
Class A:	**$52**	**$54**	**$56**	**$59**	**$61**
Class B:	**$48**	**$49**	**$50**	**$50**	**$53**

Cost to Build Driving Rents Up Further

(Special Note) There are some projects today coming online with "all in" development costs from the mid $600s to low $700s. However, keep in mind the land cost at the old sale date, the time when the guaranteed maximum price construction cost

220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com

contract (GMP) was then negotiated and, interest rates at the time during which the project construction was originally financed.

For office buildings coming online now or 2014, "entitled" raw land that costs $135 per buildable square foot today may have cost $90-$100 per square foot when previously purchased 2 to 3 years ago. GMP construction costs were 10% to 12% less one to two years ago, and finally, interest rates 1 ½ to 2 years ago were 80 basis points lower than today and certainly going forward for 2014. There's $100 to $125 per square foot "add on" right there!

For reasons referenced within the analogies of the above sections, 2014 rents should easily grow into the mid $65 to $66 range by this time next year on their way to $75 to $78 or more in 2015 with direct vacancy in 2014 at or below 7%.

The 2013-2014 Tenant-Employer (Our Stock-In-Trade)

We, in the real estate industry are most fortunate to concurrently be able to participate in this real estate market. The 2008 recession brought building values down 35%-40% and real unemployment up to one out of every seven people working here. That has all changed now. One out of every twenty (versus 1 out of 7 previously) is now unemployed in San Francisco.

Because the Bay Area is known worldwide to be one of the primary entrepreneurial and innovation centers for medical science, intelligence-internet-communications technology, biotechnology, and energy, employers together with employees are pouring into San Francisco at the rate between 18,000 to 22,000 per year of which 40% are currently tech, 13% government and 47% financial, business and legal (See page 4), That's a lot of folks in a town of 875,000. The reason that this 18,000 to 22,000 influx of employment figure is sustainable in the future is that all the new employees (Bay Area wide) want to live and work in San Francisco! Employers want and must have these high skilled employees to ensure their own success and therefore the bosses do all they can to locate their offices in town to lure the best employees who are willing to move if necessary. This city is a Mardi Gras at night and people coming here want to be a part of it and have the lifestyle they've only dreamt about. That's human behavior and that is the way it is. Unless there is a calamity such as idealistic city policies of business taxation or use restrictions, this employment growth is in fact, sustainable. That's why San Francisco is "currently" rated the top investment market in the United States only behind New York City.

As mentioned earlier, tech companies currently represent 40% of our entire market and growing at 6.5% per year. It is imperative we all know what these tenants, together with the culture they bring with them, are demanding of San Francisco landlords. Very importantly also; Who are these employer's employees and their additional contractors and/or part time co-mingled workforces? Does the office market really understand how they as individuals think? Lastly, what do these employees' bosses

want and require? To maintain a full building and minimize turnover, we better try our best to understand these most relevant facets of our trade.

First: Who are the employees that make up 40% of our market demand?

The majority of employees of these tech companies are what many call "The Millennial Generation" also known as Generation "Y". They were born after 1980 (22-33 years old). Most of these young folks have at least some college education or even a degree (usually not in business). They are intelligent and mercurial. Some of the other older generations including Generation "X" 1971-1979 (34-42); Baby Boomers (1946-1970 (43-67); and War Babies 1938-1942-My Generation, believe them to be materialistic, lazy, narcissistic, selfish, living only for the moment as a lost generation, obsessively fad prone and insecure. That may hold true for a portion of the Gen "Y" population along with their respective critics but not necessarily in my view at all. On the contrary, most are a bright and intelligent generation in flux and sustainably changing for the better in the future.

To offer an introspective view, rather than only chasing money, they are focusing on a career that makes them happy (as defined by meaning) with lots of perks (i.e. lifestyle) and working flexibility (Hours worked). Most importantly, they seek connection with each other and alongside with their bosses' as well, with all these young workers seeking approval of their work production by all that surround them. Also, they want to give to others as well as orient themselves to a larger purpose. In other words, they'll stick with their employer if they can and as long as they feel they can contribute and be rewarded in some way. Many are free thinkers and this all bodes well for what the market demands of the tech employer and employee as this favorable "flux change" takes hold.

Second: Who are the tech employers-the bosses and/or the people who sign the lease?

About 55% of the tech space I've examined consists of publicly traded companies.... about 7,100,000 square feet, But they only represent 20% of the number of tenants. Like the stock market, large blocks of space changing hands create unwelcome volatility which a sagging stock market can generate. We don't want that. Consistent turnover in small amounts creates more liquidity as it should.

These new incoming current employers (most, not all) are well funded with cash reserves. As mentioned, their firms are in the clean internet, bio-tech, energy and scientific fields which are very compatible to our environment. To satisfy their operational needs, they are seeking collaborative open spaces within smaller office footprints and the ability to create a space layout within this floor plate that is more efficient for their target business activity. Also, they are used to, and will accept, industrial gross rent protocols which is further facilitated and re-enforced by this low interest rate corporate debt finance market we are currently in.

I think you'll agree that your having this expanded insight of the tenant profile of a significant portion the San Francisco office market employer and employee is just as

important, if not more so, than reading and digesting supply, demand, absorption, and rent number raw statistics.

Froth in Market

No report can be complete without addressing the issue of *irrational exuberance* (i.e. froth). Previous comments and conclusions should have effectively refuted any current concerns of froth in our San Francisco commercial office market for the intermediate term (2 years). And, keep in mind, this paper is about San Francisco and not California or the rest of the United States' urban areas which may not be as fortunate as us right now but do envision a lag wherein they too will be asking the same questions and seeking to answer the very issues and facts that we are addressing here right now.

However, what about the stock market and why should we care? Because 25% (40% x 60%) of our real estate leasing demand and 55% of tech tenant occupied space in the are city publically traded companies which are very much affected by stock market volatility up or down.

There are empirical reasons to be concerned here in the near future for three reasons:

First: New private stock issues currently going public are massive in size, number and frequency now versus historical standards.

Second: "Real" corporate cash earnings quoted versus "nominal" earnings are fraught with deceptive stock buy-backs, refinancing at lower rates and alternative accounting techniques which can (and do) inflate earnings numbers. This proves back by S&P's 2013's flat gross sales revenues of public corporations with rising net profits which make nominal earnings quotes even more suspicious or, at a minimum, -dubious. Nobel Prize winner and Economist- Robert Shiller says the S&P Price/Earnings ratio now is 28x versus the inflation adjusted S&P claim of 16.5x.

Third: The Federal Reserve is the key mover now and maybe losing its ability to control the long end of the yield curve. That would remove a key bullish stock investment thesis right there.

On the flip side of the above facts of caution are some more comforting offsets as it pertains to the Tech Sector component of the S&P 500 corporate memberships. Per the Wall Street Journal, here are some compelling comparisons of tech stocks now versus their status just prior to the 2000 tech bubble bust:

	Tech in 2000	**Tech in 2013**
Share Valuation (According to S&P and not Shiller)	26.5x	16.5x
Share Price Rise of IPO's Stock Value After Issuance	87%	26%

Baner Financial Interests
220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com

Average Age of Tech Companies	4 Years	13 Years
Tech Presence in IPO Originations Going Public	75%	25%
Portion of Unprofitable Tech Companies	86%	66%

Summing up "Froth in the Market"

We have already established that tech companies comprise 37%-40% of total recurring office tenant demand or about 2,300,000 square feet during the year. Already existing and established tech companies in the downtown San Francisco markets comprise 20-25% of all occupied space with half of that square footage occupied by Public Tech Companies. About 70% to 80% of all the tech space is located in the south of market area. This is an impactful volume of specialized space that can and does have an effect on our overall market stature.

So yes, a rise or fall in the stock market will affect leasing volume demand and office occupancy in 2014. In particular if the stock market "correction" (not crash) occurs as anticipated. Tech leasing demand and their already existing presence here plus their high presence definitely demand close scrutiny.

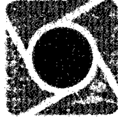
In the short term, the vacancy factor could rise 1.5% to 2% in mid- 2014 if the markets correct and tech companies release some of their space, but these events will be temporary and will re-stabilized in 4 to 6 months. The market must realize that intellectual technology and bio-technology are here to stay and we are its epicenter.

It should come as no surprise that, if you are a landlord, see to it your tenant profile has a diversity of businesses in your building. If you are also (or solely) an investor, this will be your opportunity to utilize your cash war chest to buy on this short opportunistic dip.

A Snapshot Summary For 2014 follows:
(In Square Feet)

	Rent	**Tenants in Market**	**Net Absorption**	**Vacancy (Direct)**	**New SF Employment**	**Interest Rates-Long Term**	***Interest Rates-10 YR Treasury***	**Loan Spreads**
2014	**$61-$64**	**$6.5M**	**$1.7M**	**7%**	**20,000**	**5.5%**	**3.4%**	**225**
2013	**$59**	**$5.8M**	**$1.6M**	**7.6%**	**18,000**	**5%**	**2.8%**	**240**

Further, with the upcoming stock market correction, substantial money will flow into real estate as an investment alternative, not only thru stock market investors selling out but by foreign sovereign funds coming into town as well.



Baner Financial Interests
San Francisco

A final closing footnote to all you building owners, investor partners and, if applicable, lenders please take note:

In 2014, put extra focus on managing your building operations for cash flow. Your vendors will be soon approaching you for long delayed price increases for their services.

Now you have it all for 2013 and beyond.

Sincerely,

William B. Baner
Managing Member

Baner Financial Interests
220 Jackson Street, Third Floor, San Francisco, California 94111
Telephone: (415) 362-2844 Fax: (415) 394-9789
Email: baner220@gmail.com Website:www.banerfinancialinterests.com