

San Francisco Office

Market Summary

	Q3 2016	FORECAST
Absorption	↓	↑
Vacancy	↑	↓
Rental Rate	↑	↔
Construction Deliveries	↓	↑
Under Construction	↔	↑

Notable Leases

Twitch
350 Bush | 185,292 s.f. Leased

Chartboost
85 Second | 41,315 s.f. Leased

Open AI
3180 18th | 37,104 s.f. Leased

Notable Sales

Blackstone
Market Center (555-575 Market) | 752,738 s.f.
Purchased for \$510M or \$678/s.f.

Hotung Family
760 Market | 298,124 s.f.
Purchased for \$374.5M or \$1,256/s.f.

Vanbarton Group
100 Montgomery | 431,407 s.f.
Purchased for \$284M or \$658/s.f.

HNA Group
123 Mission | 345,595 s.f.
Purchased for \$255M or \$738/s.f.

Ponte Gadea USA
Tiffany Building (360 Post) | 96,882 s.f.
Purchased for \$145M or \$1,497/s.f.

The San Francisco office real estate market enjoyed vigorous investment activity and steady leasing during the third quarter of 2016. More than a dozen buildings over 10,000 s.f. traded in the past three months, with 1,818,540 square feet sold, topping the 1,528,983 square feet leased for the first time since the fourth quarter of 2012. The third quarter saw a modest rise in vacancy rates, to 6.3%, after 185,672 s.f. of negative net absorption, the majority of which was tied to Twitter's downsizing at its mid-market headquarters.

Asking rents rose slightly from the second quarter, to averages of \$73.29 for Class A Financial District product, \$66.21 for Class B, and \$67.09 for creative Class C spaces south of Market. Technology sector firms continued to dominate leasing activity, led by Amazon's Twitch, which will grow into eight floors at 350 Bush when it opens. Five office projects, including the 1.4 million s.f. Salesforce Tower, were rising at quarter's end and will add 3,771,357 s.f. to the city's inventory upon delivery. Uber is expected to break ground on its future 435,000 s.f. Mission Bay campus in the fourth quarter. With multiple large tenants in the market and continuing growth in office-based sectors, the San Francisco market is positioned for a return to positive absorption, lower vacancies, and potentially increasing rental rates in the coming quarters.

Technology Sector

Technology companies remain the heartbeat of San Francisco office real estate, accounting for the bulk of the city's tenant activity and providing a window into the health of the local economy. The Amazon-owned videogame streaming company, Twitch, signed the quarter's largest lease pact, taking the second through ninth floors (185,292 s.f.) at the under-construction 350 Bush development for an estimated \$87/s.f. starting rent, including \$25 in operating expenses. Chartboost, currently at 420 Taylor, signed on for the first three floors of 85 Second (41,315 s.f.) to accommodate its early-2017 expansion plans. To the west, in Potrero Hill, the Elon Musk-backed research nonprofit OpenAI grabbed the entire, 37,104 s.f. Pioneer Trunk Factory building at 3180 18th, previously occupied by Stripe.

One indicator of the technology sector's influence is the demand for Class B and C office space, particularly in renovated industrial buildings, which offer the exposed ceilings, large floor plates, and open floor plans that creative and technology firms desire. At quarter's end, asking rents on many SOMA-submarket office spaces topped \$70/s.f., comparable to the rents sought by Class A landlords in the Financial District. The tech sector is also behind the southward shift in the market's "center of gravity," as companies prioritize proximity to the city's tech giants and access to public transportation.

Sublease Space

After peaking at approximately 2.73 million s.f. during the second quarter, sublease availabilities declined to 2,318,690 s.f. at the end of this period, still up by more than a million s.f. from the same time last year. Subleases' share of space on the market actually increased during the third quarter, to

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Area Review

more than 26%, a cycle high. Subleasing activity can reflect the dynamic nature of the tech sector, where rapid expansions and sudden downfalls are the norm, so a high volume of available space is not necessarily indicative of industry decline. The rapid turnarounds secured by some of the city's largest sublessors are a positive sign in that regard.

Twitter sought to become one of the city's largest sublandlords during third quarter, when it listed 78,792 s.f. on the seventh floor of 1355 Market and 104,850 s.f. on the fourth through sixth floors of 1 Tenth. Some of the new availability at its Market Square headquarters was never occupied, while the rest was vacated as part of the company's plan to stabilize its financials by streamlining operations. Although no subtenants were secured during the third quarter, Twitter was rumored to be drawing interest from Microsoft and at least one other San Francisco-based tech giant, so it could fill a sizable share of the space by the end of the year.

Office Leasing

Direct asking rental rates in downtown San Francisco have plateaued over the past few quarters, after rapid increases heading into 2016.

- Fully-serviced Class A spaces ranged from the mid-\$60s/s.f. near the northern edge of the Financial District to the low-\$100s on the upper floors of choice properties such as 4 Embarcadero Center, with availabilities in the Wharftside Building at 185 Berry splitting the difference in the mid-\$80s.
- Availabilities in new office developments were marketed in the high-\$80s or low-\$90s, fully serviced, factoring in an estimated \$25/s.f. in operating expenses.
- Full-floor Class B offerings came in between the high-\$50s for lower floors in the North Financial District and the low-\$70s in mid-size properties south of Market Street, such as 642 Harrison.
- Class C SOMA product averaged in the mid-\$60s, from the mid-\$40s for non-creative spaces to \$130 for the top floor of 2 South Park. A creative top-floor offering at 1126 Howard was being marketed in the high-\$60s.

Occupied office space fell by 185,672 s.f. during the third quarter, only the third time the city has experienced negative net absorption since the middle of 2010:

- The North Financial District led all submarkets with a 171,320 s.f. gain this quarter, as WeWork opened a new, 72,963 s.f. co-working location on the 11th-15th floors of 600 California.
- Mission Bay/China Basin added 123,864 s.f., most from Lyft's phased move into its new headquarters at 185 Berry.
- Twitter's downsizing at 1 Tenth and 1355 Market led to 194,173 s.f. of negative absorption in Mid-Market, that area's third straight quarter in the red.
- The South Financial District, which tops the city in office space added over the past year, shed 194,173 s.f. this quarter, after Zurich American Insurance contracted at 525 Market and Deem moved from 301 Howard to 642 Harrison, crossing the border into Rincon/South Beach.

Despite the modest quarterly loss citywide, San Francisco has recorded 857,117 s.f. of positive net absorption in the year to date, and steady leasing, strong local hiring, and robust tenant demand portend a return to absorption gains by 2017.

Investment

Investment activity boomed during the third quarter, as over 1.8 million s.f. of San Francisco office real estate transacted, amassing more than \$1.38 billion in dollar volume. The average price per s.f. surged to \$840.33, clearing \$800 for the first time on record, with investors trading some of

Spotlight: Flip This Skyscraper

Over the middle two quarters of 2016, 14 San Francisco office assets drew investments of at least \$30 million each. Six of those 14 were changing hands for the second time since the third quarter of 2012. That 42.9% share of extremely short-term holds reflects buyers' intent to jump on board during the early years of the ongoing cycle, add value to their buildings, and pass them on to new investors. In two cases, 755 Sansome and 123 Mission, investors turned 40% -or-greater profits in less than 16 months. At 944 Market, New Urban Properties poured \$1 million into renovations of the eight-story property amid the city's Mid-Market revitalization, and then nearly doubled its \$17 million purchase price from December 2013, selling to a joint venture between Synapse Development Group and Kuwait-based Aqarat for \$33.05 million in early June. On average, the half-dozen flips yielded a 59% profit for their sellers, stemming from improvements to the properties themselves and the rapid rise in San Francisco office rents. With rents leveling off in recent months but cap rates still in the mid-4.0% range or below, third-quarter investments tilted back toward stable, long-term buys, like retail-anchored Union Square assets, or value-add endeavors in buildings holding a large share of below-market tenants whose leases expire in the next 24 months. Time will tell if the spate of mid-2016 investments grants buyers their desired revenue streams or becomes an example of the "Greater Fool Theory" in action.

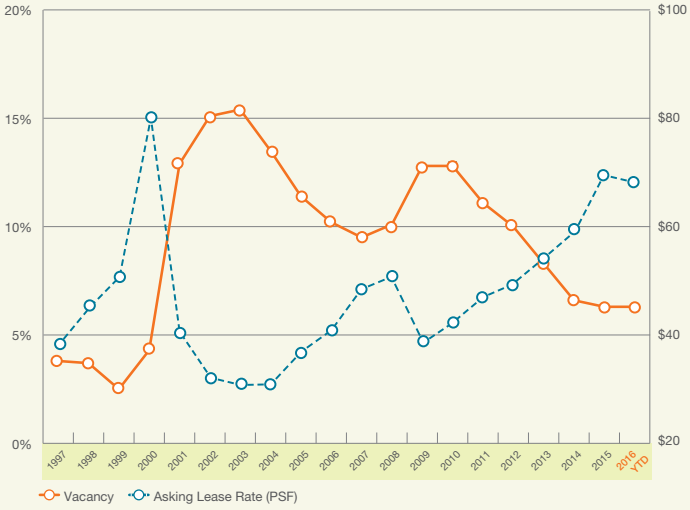
the most coveted assets in the city. In the largest sale by both square footage and dollar value, Blackstone Group acquired the two-tower Market Center at 555-575 Market from John Hancock Real Estate for \$510 million or \$677.53/s.f. The highest per-foot price tags were attained by mixed-use assets with high-end retailers on the bottom floors, which attracted foreign investors eyeing safe, long-term holds. In Union Square, 240 Stockton (which has a Gucci store on the lower floors) and the Tiffany Building at 360 Post, traded for \$1,978 and \$1,497/s.f., respectively. The landmark Phelan Building at 760 Market, featuring a Marshalls store and notable office tenants including Credit Karma and Obvious Ventures, went from Thor Equities to the Hotung Family for \$374.5 million or \$1,256/s.f., the highest per-foot outlay achieved in the third quarter outside of Union Square.

Macro-Economic Factors

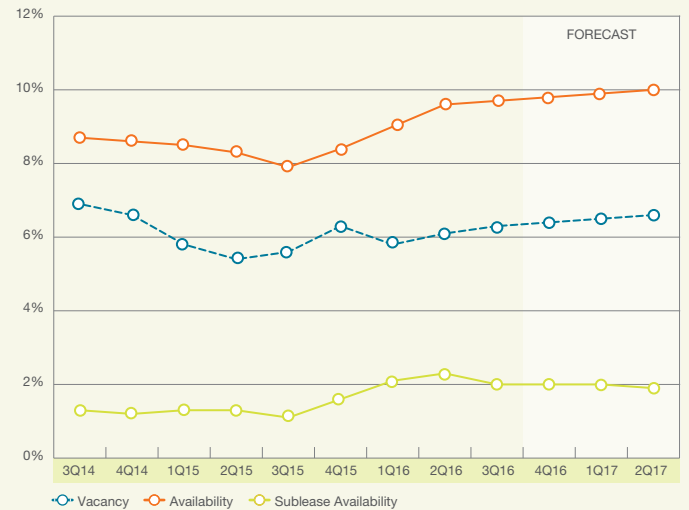
The Federal Reserve kept interest rates unchanged at 0.25-0.5% after its meeting in late September, citing competing trends in the U.S. economy, where positive employment markers masked sluggish overall growth. San Francisco and the Peninsula continue to outperform most of the country in job creation, with approximately 26,000 workers added during the year ending in August 2016, trimming unemployment to 3.4%. Professional and business services remained the area's strongest employment driver, tacking on 10,200 new jobs, about half of which were in the tech subsector. Construction led all industries with 8.3% employment growth year-over-year.

In tandem with global economic uncertainty, low borrowing costs, and robust tenant demand heightened the appeal of San Francisco's office real estate assets to American and global investors. While many acquisitions in the first half of the decade resulted in short-term holds, investors this quarter sought assets that could provide steady revenue streams well into the future. As a global city with a premium office market, San Francisco competes with the likes of London and New York for long-haul buyers who prioritize safety and stability over near-term rewards. With Britain's exit from the European Union stirring turmoil abroad, assets in the United States became relatively more desirable, potentially contributing to this quarter's San Francisco investment surge.

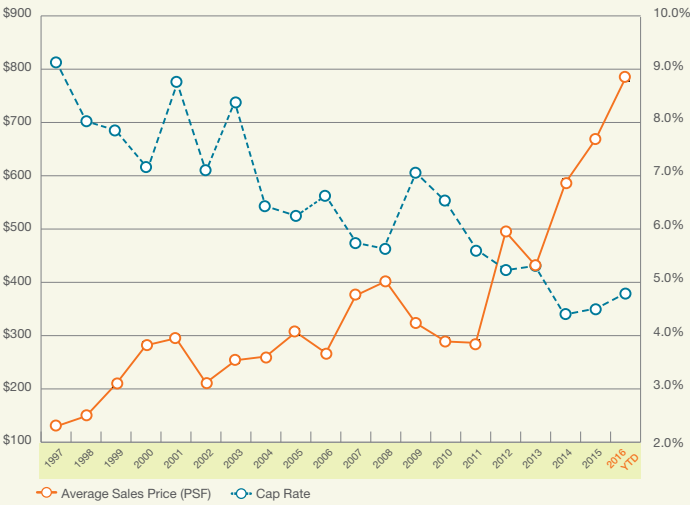
VACANCY VS ASKING LEASE RATE



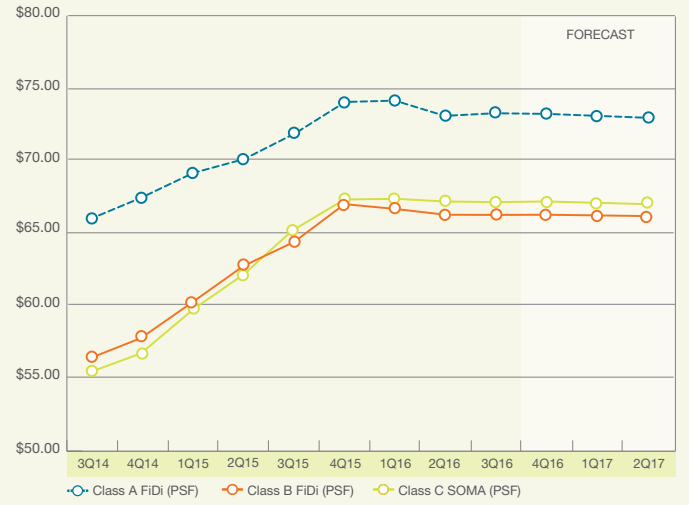
VACANCY VS AVAILABILITY



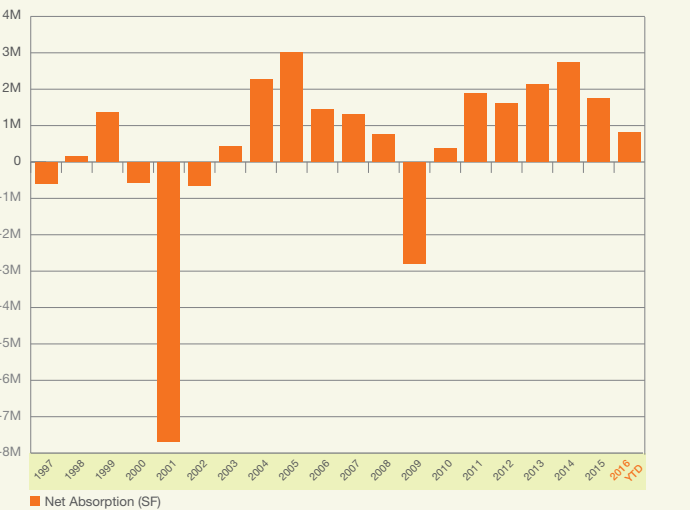
AVERAGE SALES PRICE & CAPITALIZATION RATES



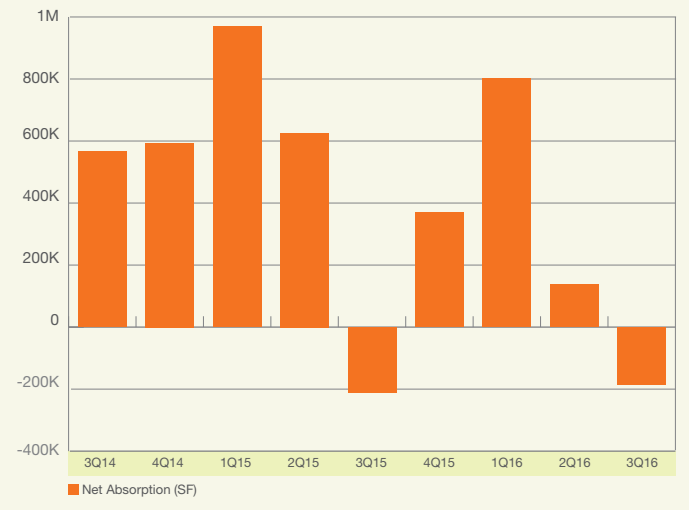
ASKING LEASE RATE



NET ABSORPTION - HISTORICAL



NET ABSORPTION - QUARTERLY



Offices

Seattle
206.296.9600

Bellevue
425.454.7040

South Seattle
206.248.7300

Tacoma
253.722.1400

Olympia
360.705.2800

Portland
503.221.9900

San Francisco
415.229.8888

Redwood Shores
650.769.3600

Silicon Valley
408.970.9400

Sacramento
916.970.9700

Roseville
916.751.3600

Orange County
949.557.5000

San Diego
858.509.1200

Carlsbad
760.430.1000

Reno
775.301.1300

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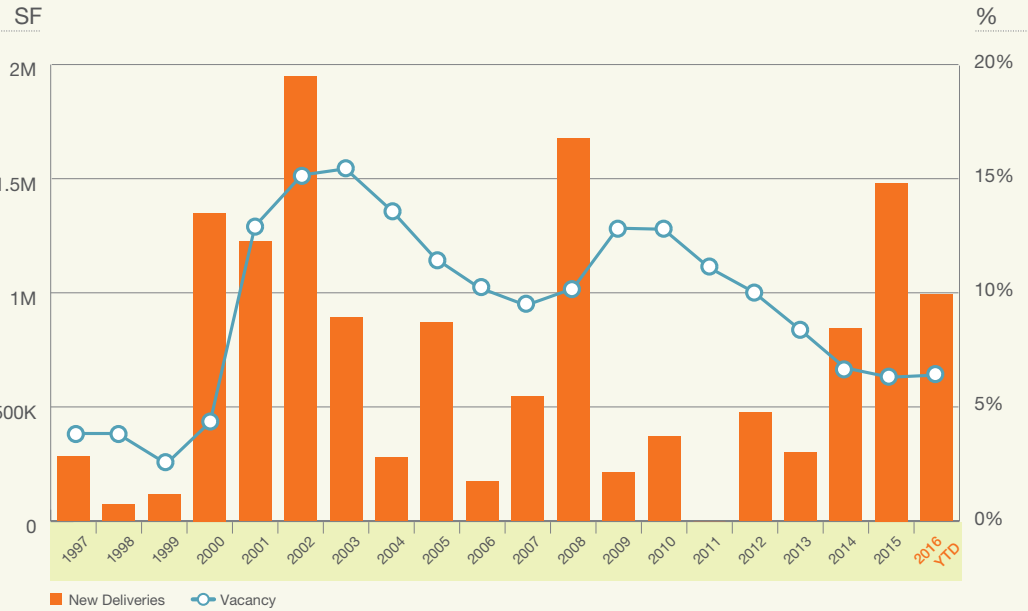
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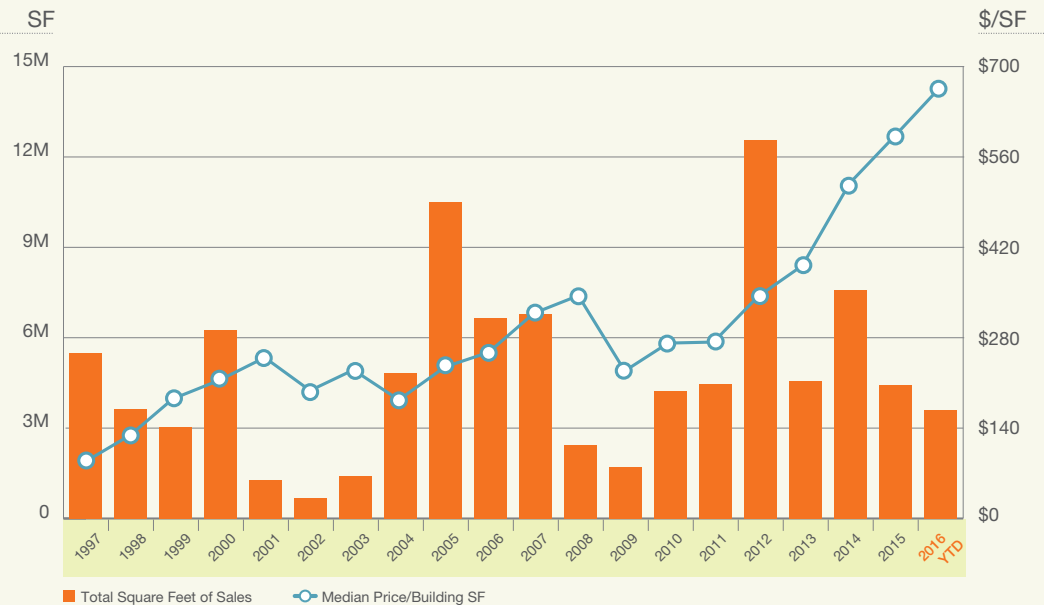
Market Breakdown

	3Q 2016	2Q 2016	3Q 2015	Annual % Change
Vacancy Rate	6.30%	6.10%	5.60%	12.50%
Availability Rate	9.70%	9.60%	7.90%	22.78%
Asking Lease Rate	\$73.29	\$73.21	\$71.93	1.89%
Leased SF	1,528,983	2,248,833	2,258,547	-32.30%
Sold SF	1,818,540	970,981	512,355	254.94%
Net Absorption	-185,672	138,121	-205,114	N/A

HISTORICAL NEW CONSTRUCTION & VACANCY RATES



HISTORICAL SALES SF & MEDIAN SALE PRICE



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