

SAN FRANCISCO OFFICE MARKET

SECOND QUARTER 2016

Fundamentals Remain Strong

Despite some Q2 stumbles

For each of the past four quarters, a drop in the vacancy rate in one period has been followed by an equal increase the next period. Two of the last three quarters have seen rising vacancy and little or no rent increases. Macroeconomic factors, more restrained venture funding, and the high cost of living in San Francisco and the Bay Area are leading to slower business growth and slackened demand for real estate. The increasing amount of sublease space being put on the market, primarily by technology firms, is also adding to the sluggish performance of the market. Rental rates have plateaued, and for certain property types in some of the smaller peripheral submarkets, landlords are rethinking their asking rates and incentives. Investment sales activity rebounded after a relatively quiet 1st quarter with institutional investors and international capital still bullish on San Francisco.

ECONOMY

San Francisco employment steady, total workforce decreases

The San Francisco unemployment rate fell to 2.9% at the end of the 2nd quarter, from 3.3% the previous quarter. Although there was no job growth, the total workforce decreased slightly, accounting for the lower unemployment rate. Santa Clara County ended the 2nd quarter with a 3.3% unemployment rate, down from 3.9% in the 1st quarter. San Mateo County had a 2.6% unemployment rate, down from 2.8% in the 1st quarter. In Alameda County the unemployment rate was 3.8%, down from 4.0 in the 1st quarter, and Contra Costa posted a 4.0% unemployment rate, falling from 4.5% in the 1st quarter. The overall unemployment rate is 4.7% in California and 5.5% nationally. The Bay Area business climate remains robust, with challenges and opportunities for its critical industries and high growth companies.

SUPPLY & DEVELOPMENT

10 Msf in pipeline

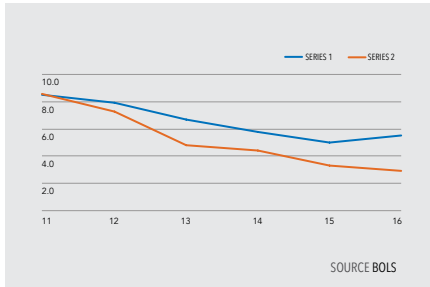
Two buildings are currently under construction in the north Financial District – 500 Pine Street and 350 Bush Street, for a combined total of 480,000 square feet. All of this space is unleased. Three buildings are under construction in the south Financial District – Salesforce Tower, 181 Fremont Street and 250 Howard Street, for a combined total of 2,500,00 square feet, about half of which has been leased. In addition, the Exchange at 16th is under construction for

TRENDLINES	
5-YEAR TREND	CURRENT QUARTER
<p>VACANCY</p>	7.6%
<p>ABSORPTION</p>	-384,304 SF
<p>RENTAL RATE</p>	\$67.96 PSF
<p>UNDER CONSTRUCTION</p>	3,788,322 SF
<p>PRICE PER SQUARE FOOT</p>	\$711 PSF
<p>JOB GROWTH</p>	0%

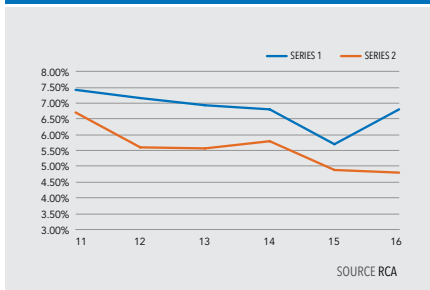
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UNEMPLOYMENT RATE



CAP RATE



700,000 square feet. Projects which have received City approval but have not yet started construction include Oceanwide Center at 50 1st Street (1.2 msf), 5M at the Chronicle site at 5th and Mission Streets (800,000 square feet), and Uber's 423,000 square feet in Mission Bay. Planned projects, which have not yet been approved and are all south of Market total another 5+ million square feet.

VACANCY

Vacancy rises in the 2nd quarter

The overall vacancy rate for Class-A and Class-B office space in San Francisco rose fifty basis points in the 2nd quarter, from 7.1% to 7.6%. Out of the ten submarkets in the downtown area, six experienced positive absorption, with negative absorption in four. In the CBD, the North Financial District had the fourth straight quarter of negative absorption, for an overall occupancy loss of over 511,000 square feet, while during the same period the South Financial District had four quarters of positive absorption totaling 605,000 square feet. Over 2 million square feet of sublease space is on the market from more than 90 companies, most of them in the technology sector.

DEMAND

Leasing activity slows

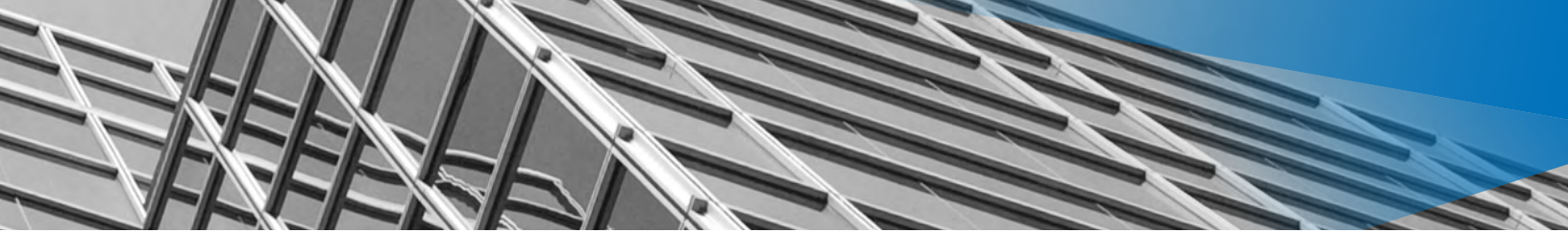
Net absorption was negative in the 2nd quarter as available space increased by more than 328,000 square feet. The North Financial District and SOMA/Rincon/Showplace Square were the submarkets accounting for most of the negative absorption. The largest lease in the quarter was FitBit's sublease from Charles

San Francisco Office Second Quarter Largest Lease Transactions

PROPERTY	TENANT	SF	TYPE	SUBMARKET
215 Fremont St	FitBit	212,868	Class A Sublease	South Financial District
185 Berry St (Warfside & Berry St)	Lyft	136,437	Class A Sublease	Mission Bay/China Basin
560 Mission St	TIAA-CREF	64,696	Class A Direct	South Financial District
560 Mission St	Seyfarth Shaw	49,965	Class A Direct	South Financial District
560 Mission St	Munger Tolles	41,491	Class A Direct	South Financial District

San Francisco Office Second Quarter Largest Sale Transactions

PROPERTY	BUYER	SF	PRICE PSF	SUBMARKET
555-575 Market St	Blackstone	770,000	\$657.00	South Financial District
100-120 Montgomery St	Vanbarton Group	420,523	\$678.00	Financial District
123 Mission St	HNA Group	345,595	\$738.00	South Financial District
180 Montgomery St	Sidra Capital	299,118	\$618.00	Financial District
353 Sacramento St	KBS Realty	284,751	\$595.00	North Financial District
799 Market St	ASB RE Investments	145,400	\$971.00	Financial District



Schwab & Co. at 215 Fremont Street. Since FitBit will occupy the space over time as Schwab vacates it, the transaction doesn't add to the net absorption. Demand has fallen slightly, although the total requirement for tenants in the market remains in the several million square foot range.

RENTS

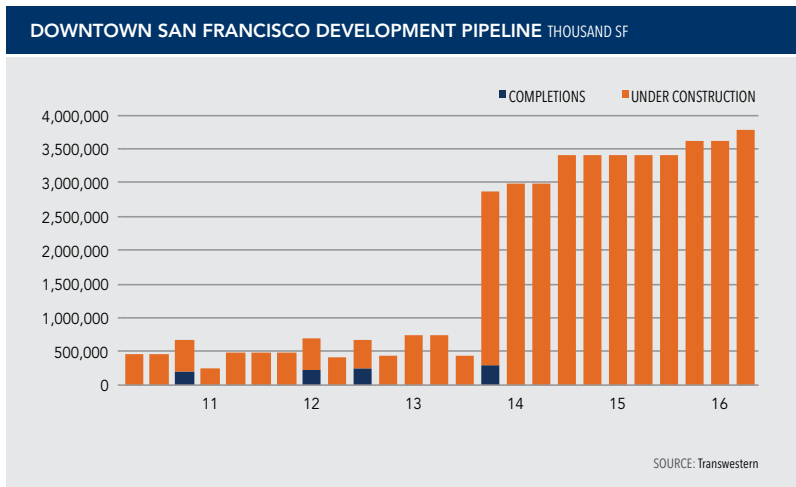
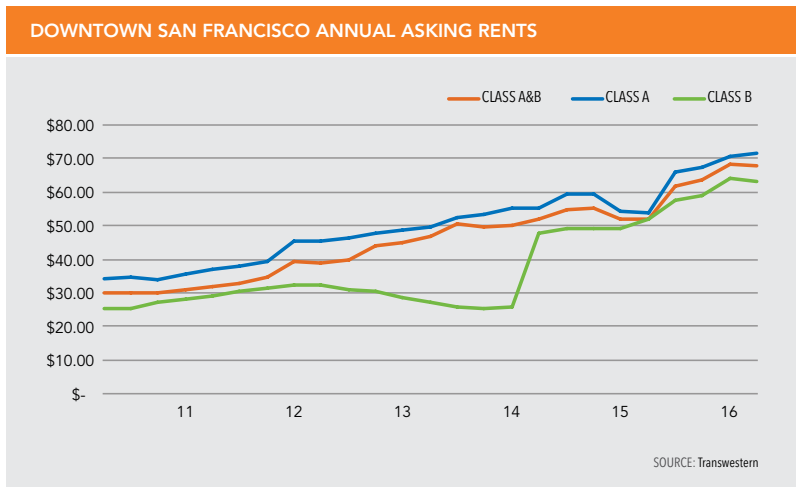
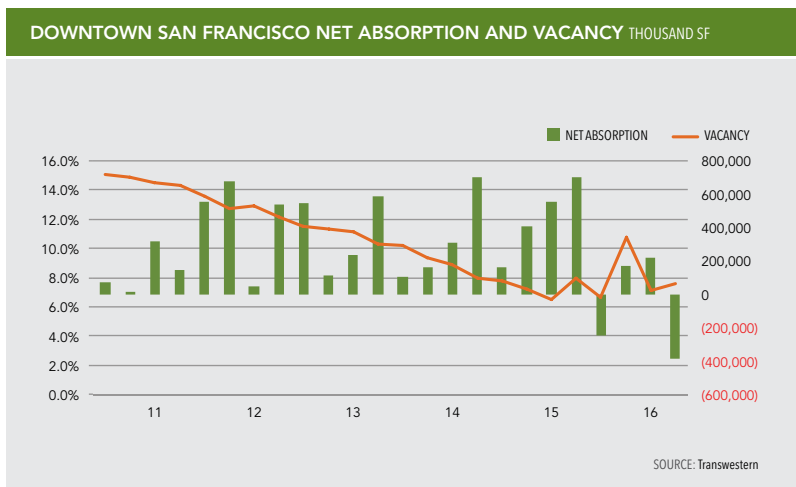
Increase for Class-A, decrease for Class-B

Average rental rates rose slightly over one percent, to \$71.54 per square foot for Class-A space and declined a little over one percent to \$63.13 per square foot for Class-B space in the 2nd quarter. For Class-A office space, the highest rental rates are found in Mission Bay/China Basin (\$76.09 per sf), followed by the North Financial District (\$72.63 per sf) and the South Financial District (\$71.68 per sf). The addition of several million square feet of sublease space to the market will start to lower average rents, but rental rates for premier buildings and locations have not yet begun to be affected.

INVESTMENT

Flurry of sales in 2nd quarter

Investment sales picked up in the 2nd quarter after a relatively slow 1st quarter. Among the five Class-A and one Class-B buildings sold, there was a higher per square foot price for the Class-B building in Mid-Market than for any of the Class-A Financial District buildings. Values for most recent office building sales have been between \$600 to \$700 per square foot. Four of the buildings sold in the 2nd quarter traded in that range. KBS Realty purchased 353 Sacramento Street below \$600 per square foot in part because the property was only 87% leased, while the four other had occupancy rates from 93% to 100%. 123 Mission Street sold for \$738 per square foot due to significant lease rollover coming up and the prospect of achieving future rent increases. The 55,000 square feet of prime retail leased to Ross Stores at 1779 Market Street substantially boosted its rental income, leading to the higher sale price of \$971 per square foot.



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Metro San Francisco Office Market Indicators

SUBMARKET	INVENTORY	UNDER CONSTRUCTION	QTR NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Class A	715,735	0	36,007	50,167	2.0%	0.4%	2.4%	\$61.59
Class B	2,408,053	0	777	29,722	5.8%	0.3%	6.1%	\$45.48
North Waterfront Subtotal	3,123,788	0	36,784	79,889	4.9%	0.3%	5.2%	\$47.18
Class A	120,000	0	459	2,555	1.2%	0.0%	1.2%	\$51.00
Class B	983,741	0	(9,289)	(49,114)	14.8%	0.3%	15.0%	\$49.53
Van Ness Corridor Subtotal	1,103,741	0	(8,830)	(46,559)	13.3%	0.2%	13.5%	\$49.54
Class A	444,347	0	12,174	2,599	6.1%	0.0%	6.1%	\$66.89
Class B	1,321,639	0	(820)	(25,286)	5.5%	0.4%	5.9%	\$64.73
Jackson Square Subtotal	1,765,986	0	11,354	(22,687)	5.7%	0.3%	5.9%	\$65.29
Class A	21,228,813	432,978	(213,886)	(373,677)	8.0%	1.4%	9.3%	\$72.63
Class B	6,146,334	80,000	(97,494)	(87,374)	10.6%	0.9%	11.5%	\$66.86
N Financial District Subtotal	27,375,147	0	(311,380)	(461,051)	8.6%	1.3%	9.8%	\$71.11
Class A	19,175,843	2,581,894	294,717	482,740	3.8%	0.7%	4.5%	\$71.68
Class B	3,493,916	0	(92,724)	(81,484)	5.5%	0.6%	6.1%	\$70.08
S Financial District Subtotal	22,669,759	2,581,894	201,993	401,256	4.1%	0.7%	4.8%	\$71.36
Class A	213,125	0	3,164	29,330	0.0%	0.0%	0.0%	\$-
Class B	3,053,177	0	17,065	(34,239)	6.2%	0.1%	6.3%	\$66.90
Union Square Subtotal	3,266,302	0	20,229	(4,909)	5.8%	0.1%	5.9%	\$66.90
Class A	553,917	0	58,611	97,359	1.1%	0.0%	1.1%	\$62.00
Class B	2,259,591	0	59,509	3,291	8.7%	0.6%	9.3%	\$64.97
Yerba Buena Subtotal	2,813,508	0	118,120	100,650	7.2%	0.5%	7.7%	\$64.89
Class A	2,330,503	0	12,956	25,159	1.3%	2.8%	4.1%	\$56.69
Class B	1,524,922	0	(6,624)	1,975	1.3%	0.0%	1.3%	\$50.42
Mid Market Subtotal	3,855,425	0	6,332	27,134	1.3%	1.7%	3.0%	\$55.64
Class A	1,916,434	0	(155,305)	(129,410)	6.6%	4.8%	11.3%	\$66.37
Class B	6,447,148	0	(185,461)	37,657	10.4%	1.4%	11.8%	\$62.43
SOMA Subtotal	8,363,582	0	(340,766)	(91,753)	9.5%	2.2%	11.7%	\$63.30
Class A	2,508,788	693,450	(118,140)	91,640	4.5%	1.1%	5.6%	\$76.09
Class B	0	0	0	0	0.0%	0.0%	0.0%	\$-
Mission Bay Subtotal	2,508,788	693,450	(118,140)	91,640	4.5%	1.1%	5.6%	\$76.09
Class A	49,207,505	3,708,322	(69,243)	278,462	5.6%	1.2%	6.8%	\$71.54
Class B	27,638,521	80,000	(315,061)	(204,852)	8.3%	0.7%	9.0%	\$63.13
TOTAL	76,846,026	3,788,322	(384,304)	73,610	6.5%	1.1%	7.6%	\$67.96

CONTACT

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METHODOLOGY

The information in this report is the result of a compilation of information on office properties located in the Bay Area. Transwestern obtained the information from a variety of primary and secondary sources including CoStar. This report includes single-tenant and multi-tenant office properties 10,000 sq. ft. or larger, excluding office condominiums, medical office facilities, flex and owner-occupied properties.



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