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San Francisco's Bipolar Office Market Riding a High

By Morris Newman

Like the weather in San Francisco, where morning mists burn off in noontime sun only to be followed by rain and fog, the office market in this city is given to sudden changes.

Consider that in 2000, the most coveted "view" spaces — the ones with panoramic vistas of the San Francisco Bay — were leasing for \$100 per sq. ft. full-service gross, which includes rent and most expenses. Take it or leave it. If you don't want it, the guy behind you will.

"San Francisco was more expensive than New York, at least at the high end," recalls Stuart Shiff, a principal at Divco West/Page Mill, a local developer and investor, referring to the Internet's glory years.

Three years later, however, when the effects of the dot-com bust hit full force, building owners felt virtually abandoned. "I couldn't get financing for fully leased buildings," he says.

San Francisco, in fact, has always been very volatile, according to Jeanne Myerson, president of Swig Properties, which owns three Bay Area buildings. The market, she says, tends to overcorrect and then bounce back again.

Now investors in this seemingly bipolar office market with its depressions and manias, appear ready to bounce back. After three years of slow recovery, downtown San Francisco is ready to relegate the tech fiasco to the past.

The tenant mix in downtown San Francisco is made up of professional, financial and a number of technology firms that survived panic and disinvestment.

No single industry dominates the leasing market as high-tech did in the early 2000s. What's more, there has been no space-hungry corporate tenant to take down a lot of space, much as Charles Schwab did in the late 1990s.

One of the great strengths of the market is the expansion of both large and small tenants, who apparently feel more confident in both the economy and their own prospects.

"A huge amount of that growth is very organic and very spread out among industries," says Mark Geisreiter, senior vice president of the San Francisco

region for Equity Office Properties Trust. "Even if a person with 5,000 sq. ft. leases another 1,000 sq. ft., that's a 20% increase."

Even the surviving technology clients in the market are expanding, albeit very carefully. "They are not the dominant market they were in the late '90s, but it is a growing sector [in the tenant base]," according to Schiff.

Rents are rising sharply for Class-A space, moving from the high \$20s to mid-\$30s per sq. ft. in just the past 12 months, and many landlords are asking in the low- to mid-\$40s for comparable space.

Downtown changes hands

The inspiration for those rent increases has been the rapid absorption of space in the downtown area. Vacancy rates for San Francisco office space have fallen 2.5% in the past year alone, to a still-paunchy 15.5%, down from their peak of 22.7% in mid-2003, according to brokerage Grubb & Ellis.

That equates to absorption of 2.38 million sq. ft. in 2005, or an 18.6% reduction in available space, according to figures from Studley, the national office brokerage.

Some investors and landlords think that rental activity will remain strong enough to allow them to contemplate vacancy rates once more sinking below the 10% mark — being the point, in the view of some owners, at which landlords regain the upper hand at the negotiating table.

Investors, of course, are not waiting for higher rents to arrive before starting to throw money at buildings. In the past two years, nearly half of all office buildings in the central business district changed hands in deals with an aggregate value of \$6 billion, according to Grubb & Ellis. Far from trading at discounts, the buildings are selling typically for \$250 to \$300 per sq. ft., with capitalization rates falling to near 5%, or even slightly below.

In June, the Irvine Co. of Orange County, Calif. agreed to pay \$400 million to Hines for 560 Mission Street, according to media reports. At \$700 per sq. ft., the price is the highest ever paid for a San Francisco office building. JP Morgan Chase occupies about half the building, and is halfway through a 15-year lease at \$52 per sq. ft. annually.

Skewing of rents, pricing

One voice of skepticism is that of Swig's Myerson, who says she recently passed on other deals that just wouldn't pencil. At the current rising prices, she points out, buildings cannot be profitable until rents grow to nearly twice their current levels — far from impossible, given the recent round of rent inflation, but far from certain as well.

"Everybody is piling into the market and paying very high purchase prices, which they say are justified on replacement costs," says Myerson. "People are using that justification for paying prices that require very steep double-digit rent growth."

True, rents have moved up. At the same time, Myerson says San Francisco has a highly stratified rent structure, ranging from \$60 per sq. ft. for "view" properties to Class-B buildings still renting in the \$20 per sq. ft. range.

"[Given the] huge dichotomy of rent levels," Myerson says it would be hard to predict when Class-A rents will rise dramatically. "As a landlord, I would love to see [higher rates]," she says. "Still, there is no iron-clad assurance that rental growth will actually happen."

The modest rate of job creation in San Francisco, in fact, does not argue for explosive growth in demand for office space. In the San Francisco-Marín County-San Mateo County area, employers created 21,500 new jobs in 2005, compared to 25,200 the previous year, out of a total labor market of 400,000 jobs, according to the California Economic Development Dept.

Many of those jobs are lower level service-industry jobs. They include few big gains in office workers like lawyers, finance and technology professionals, according to Randy Deshazo, a staff economist with the Association of Bay Area Governments, a public consortium representing nine Bay Area counties.

"We are not quite seeing as much growth as you might want to see if you are expecting to see rents increase sharply in office buildings," he says.

Cannibalizing tenants

Kevin Brenner, a managing director at brokerage Studley, in fact, cites at least one reason why rental growth will not skyrocket overnight. Many of the recent leases were signed by firms that were already downtown, shuttling from one building to the next, as another downtown firm leases their space, in turn, in a game of musical chairs.

"We have cannibalized our own tenant demand, and the job market is not growing," says Brenner. As a result, he says, the demand for office space is down 30% to 40% from a year ago.

Cannibalism aside, even owners who have sold properties into this lucrative market — including the nation's largest office owner, Chicago-based Equity Office Properties Trust, which already owns nearly 10 million sq. ft. in the region — investors are generally seeking to buy more, according to Geisreiter. "San Francisco remains an absolute core market for us."

So why did Equity Office Properties Trust sell two downtown office buildings, 310 Howard and 121 Montgomery Street? "Those buildings did not fit in with the balance of our portfolio, and it was a great time to sell," says Geisreiter. Translation: Equity Office Properties Trust probably thought it wise to sell the low-fliers in its portfolio into a hot market and re-invest the proceeds in buildings with either more reliable income, more upside, or both.

Moving target

"This market is moving so quickly right now that even the definitions are changing," says Divco's Shiff. Among those fast-changing definitions are what is a "normal" price versus an "expected" price of land.

Since October, Divco West/Page Mill sold four Bay Area properties, including its interest in the two Market Center office towers in downtown San Francisco, for a total of \$326 million. Divco bought the Market Center in 2003 in a partnership with RREEF Funds for about \$100 per sq. ft., when the building was only 17% leased. Earlier this year, when the building was nearly 70% leased, Divco sold its portion

to RREEF for approximately \$340 per sq. ft.

The most active investor in the downtown market currently is Boston-based Beacon Capital Partners, which purchased eight buildings in San Francisco and surrounding cities this year. The most recent is the 1 million sq. ft. Rincon Center in San Francisco for \$300 million.

Beacon Capital's investment criteria stress intellectual capital. "We want to be in cities that have a very highly concentrated knowledge base," says Alan Leventhal, chairman and CEO. "[Particularly those with] great colleges and universities, and great teaching hospitals that attract research dollars." Beyond the cities of the Bay Area, that short list includes Boston, London, New York, Paris, Washington and Seattle.

Cost of Building = Scarcity

Beacon's Leventhal seemed unflummoxed about paying comparatively high prices for buildings with relatively modest income streams.

"We looked beyond the cap rate and asked what does it cost to replace the asset?" With the cost of construction materials alone rising at double-digit rates, Leventhal sees that number continuing to grow.

High construction costs can cut both ways, especially for investors who want to build but have a hard time justifying the costs. Estimates of delivering a new office building to San Francisco range from \$500 to \$600 per sq. ft. Those estimates include the cost of land, the cost of "carry" during a long entitlement period, and the inflated costs of building materials.

According to one estimate, rents would need to be \$60 and higher compared to the mid-to-high \$30s for Class-A "commodity" space to justify those construction costs.

Yet there are investors who are looking for the nearest opportunity to build. Probably the first new building to start construction in the city in at least five years is a 10-story, 335,000 sq. ft. building being developed by Equity Office.

The building, which is 96% pre-leased by Barclays Global Investors, is considered by brokers to be virtually a build-to-suit for the international financial-services firm. Completion is expected in 2007.

Another developer reportedly eager to start is Tishman Speyer, which has all government permits in hand for a 560,000 sq. ft. building envisioned for 555 Mission St. Apparently, as of May, it had no pre-leasing either. Tishman Speyer representatives did not return phone calls for this story.

The most spectacular construction suggestion is for three towers, all higher than the iconic 853 Transamerica Tower on Mission Street near the planned Transbay Terminal. The proposed project would be a multi-billion-dollar transit hub for trains and buses. The high-rise is intended to defray the high cost of construction.

Swig owns two downtown development sites in partnership with the Shorestein Co. Together, those sites have permits for 350,000 sq. ft., although zoning and the local ordinances limit construction on one site to only 49,000 sq. ft. "Someday, [the construction sites] will be worth a lot of money," says Swig's

Myerson.

Power of internal expansion

For large and small tenants alike, business growth plans were postponed by the economic freefall that continued in the Bay Area at least from 2001 to 2004, says Geisreiter of Equity Office.

After the economic disruption earlier in the decade, he recalls, many tenants halted growth plans and shunned excess space. The current conservative attitude of tenants toward expansion contrasts with the pre-crash leasing habits of the dot-coms and high-tech types, and a number of law firms that leased 20% or more space than needed in anticipation of future growth.

When the bubble burst in 2001, much of that unused space became known as "shadow space," or minimally improved sublease space, plentiful in supply but difficult to lease. Some tenants, especially entrepreneurs with limited expenses, may have additional incentives for staying put in their existing building, including rent inflation.

Rents are increasing rapidly to the point of vertigo, especially for tenants who negotiated highly favorable lease terms in the range of \$20 to \$30 per sq. ft. during the dot-com hangover and may not be able to afford higher rents.

After years of being buffeted by the soft market and brokers specializing in tenant representation, landlords are starting to test the waters in San Francisco, says Divco's Shiff.

"You are almost doing yourself a disservice by setting the lease rate too low, if an increase is just around the corner," Schiff adds. He rejects the suggestion that San Francisco investors are reaching too high, too fast.

Investors have been disciplined in the wake of the dot-com implosion and can be expected to behave rationally, he says. "San Francisco has been through an extra business cycle that the rest of the country did not go through."

In a market afloat in capital and almost giddy optimism, the test for investors may be to keep themselves from rebounding too fast and too hard from the impact of hard times to the heights of good times.

Morris Newman is based in Los Angeles.

SAN FRANCISCO - BY THE NUMBERS

POPULATION: 724,538

Source: U.S. Census Bureau

UNEMPLOYMENT RATE: 4.4%

Source: U.S. Dept. of Labor

LARGEST EMPLOYERS:

Kaiser Permanente

33,200 employees

2. Sutter Health & Affiliates
22,600 employees

3. Safeway
19,012 employees

METRO AREA VITAL SIGNS Office:

15.5% vacancy, 1Q 2006
19.5% vacancy, 1Q 2005
\$35.20 rent per sq. ft., 1Q 2006
\$29.45 rent per sq. ft., 1Q 2005
Source: Grubb & Ellis Research

Multifamily:

4.2% vacancy, 1Q 2006
5.2% vacancy, 1Q 2005
\$1,607 asking rent, 1Q 2006
\$1,534 asking rent, 1Q 2005
Source: Reis

Retail:

3.0% vacancy, 1Q 2006
3.2% vacancy, 1Q 2005
\$28.52 rent per sq. ft., 1Q 2006
\$28.09 rent per sq. ft., 1Q 2005
Source: CBSadasdllis

Industrial:

6.3% vacancy, 1Q 2006
6.6% vacancy, 1Q 2005
\$0.48* rent per sq. ft., 1Q 2006
\$0.43 rent per sq. ft., 1Q 2005
*Monthly rents
Source: Grubb & Ellis Research

Hotel:

67.9% occupancy, May 2006
65.5% occupancy, May 2005
\$133.07 average daily rate, Q1 2006
\$122.06 average daily rate, Q1 2005
Source: Smith Travel Research

MAJOR PROJECTS:

Millennium Tower at 301 Mission, a 58-story luxury residential tower located in the heart of San Francisco's financial district. The project will include 437 condominium units, 18,900 square feet of amenity space, and 8,000 square feet

of retail space.

Cost: \$400 million

Developer: Millennium Partners

Completion: 2007/2008

One Rincon Hill, a two-tower residential development story at 55 and 44 stories respectively with a total of 695 condominiums and 14 townhomes. The towers will be tall and slender and are located where the San Francisco Bay bridge lands.

Cost: \$290 million

Developer: Urban West Associates

Completion: 2007/2008

300 Spear Street I and II, a two-tower, mixed-use high-rise residential development. The 40- and 35-story towers will boast views of the San Francisco Bay and the financial district.

Cost: \$600 million

Developer: Union Property Capital

Completion: 2007

High bidding for office tower

San Francisco investor optimism in the office market broke through the roof in March, when a group of Hong Kong investors — real-estate moguls Vincent Lo and Henry Cheng — and New York developer Donald Trump, completed the purchase of the 52-story Bank of America building for a record-setting \$1.05 billion, or \$583 per sq. ft.

The price was nearly 20% higher than the price paid roughly two years earlier by Pacific Gold Enterprises. The group, headed by New York investor Mark Karasick, paid \$880 million, or \$489 per sq. ft., in a pair of transactions dated July and October 2004.

The building at 555 California Street has a history of notable price escalation that could be seen as an indicator of the growing esteem that investors have for downtown San Francisco. In 1985, in fact, the Shorenstein Co. paid Bank of America \$660 million, or \$428 per sq. ft., in a two-part transaction noted as one of the largest of the Reagan years.

Shorenstein developed the building in 1969, which was notable for a saw-tooth profile that provided nearly every periphery office with “corner” views.

“[The building has a] special cachet, because it is one of the three or four most recognizable buildings in San Francisco, in the company of the pyramidal Transamerica Tower and 101 California,” says Michael Seifer, managing director of Jones Lang LaSalle’s San Francisco office. “The sale reflects rapid rental

growth and the rising opinion of investors in the San Francisco market.”

As incredible as \$1.05 billion may seem to some observers, that price was probably justified in economic terms, according to Seifer. “That project was largely occupied by a single credit tenant and written at a high rent,” says Seifer. The seller, the Irvine Co., declined to comment.

Records, however, are made to be broken. Only a few months after the Bank of America sale, the Irvine Co. reportedly promised to pay \$400 million, or approximately \$700 per sq. ft., for 560 Mission, the 31-story Class-A office building in downtown San Francisco.

Seifer says the deal ironically had an economic basis, dating back to the “Age of Irrational Exuberance.” Indeed, half of the building is occupied by a single credit tenant, he notes, “at rents well in advance of those that can be achieved in today’s market.”

— **Morris Newman**