MARKET REPORT

Office

San Francisco Metro Area

IPA INSTITUTIONAL PROPERTY ADVISORS

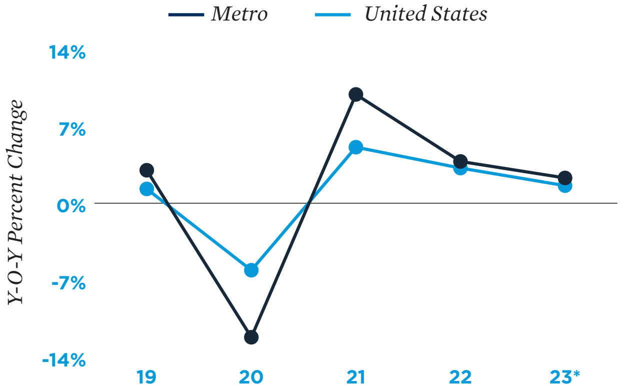
4Q/23

Core San Francisco Begins to Welcome Next Wave of Tech Firms, Suburbs Comparatively Strong

New businesses show interest in the metro. While the San Francisco office landscape has been uniquely troubled since the global health crisis, positive signs are emerging. Several prominent artificial intelligence software firms, such as Hive and Hayden AI, as well as video game developer Roblox, have signed major new commitments in the market. As this next wave of technology ventures mature and grow, so will their office needs; yet, this process will take time. In the short term, many San Francisco offices are contending with elevated availability, particularly in the central business district. The main exception is in Downtown West, encompassing Van Ness, Chinatown, Union Square and the Civic Center. Vacancy here was at 16.7 percent in June, compared to 32.1 percent for the rest of the CBD. Closer proximity to residential areas facilitates easier office visitation by employees, in turn bolstering tenant needs.

Office dynamics holding up well beyond the core. Vacancy outside the CBD, but still inside the city of San Francisco, was under 10 percent in June. While elevated over the pre-pandemic mark, the local rate is well below downtown San Francisco's metric. Offices in these lower availability areas tend to be much smaller, with a mean height of three stories, and closer to residential nodes, cutting down on commutes. Such spaces appeal to smaller businesses, who lack the budget or desire for trophy floor plans, and may also be more disposed to in-person work given close-knit office cultures.

Employment Trends



** Forecast*

Sources: BLS; CoStar Group, Inc.

Office 2023 Outlook

28,000 JOBS
will be created

EMPLOYMENT:

Intermittent spans of net job gains and losses will constrain employment growth in the market to 140 basis points below last year's 3.8 percent expansion. In the decade preceding 2020, the mean pace was 3.5 percent.

1,300,000 SQ. FT.
will be completed

CONSTRUCTION:

Deliveries fall to a three-year low in 2023. Developers are most active in San Mateo County, including projects in San Carlos, Menlo Park, Redwood City and San Bruno, where YouTube's Phase II expansion is underway.

550 BASIS POINT
increase in vacancy

VACANCY:

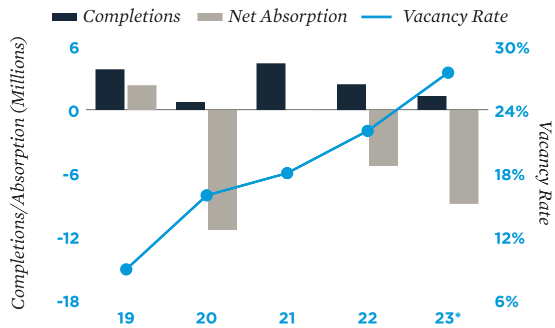
Ongoing turnover across the market continues to apply upward pressure to vacancy, which will hit 27.5 percent by year-end. The rate of increase is the largest since the initial pandemic shock in 2020.

4.5% DECREASE
in asking rent

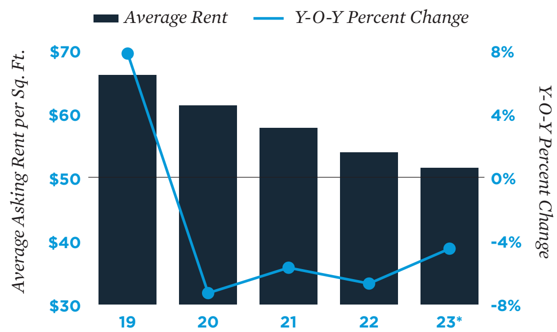
RENT:

The average asking rent will drop to $51.50 per square foot by the end of 2023, as operators continue to adjust rates in the face of high sublet availability. Rents were last at this level on average in 2015.

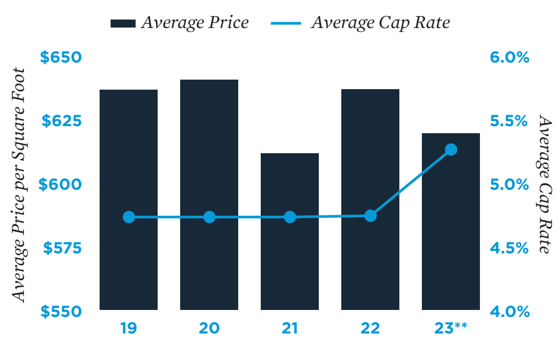
Supply and Demand



Rent Trends



Sales Trends



** Forecast ** Through 2Q*

Sources: CoStar Group, Inc.; Real Capital Analytics

2Q 2023 - 12-Month Period

CONSTRUCTION

1,754,000 sq. ft. completed

- SoftBank's 154,000-square-foot office in Menlo Park and Roblox's new space at Station 5 in San Mateo, spanning nearly 214,000 square feet, highlight the deliveries made in the first half of 2023.
- San Francisco's future pipeline is relatively subdued at 3.2 million square feet underway or proposed, less space than was delivered in 2021 alone.

VACANCY

540 basis point increase in vacancy Y-O-Y

- A 780-basis-point year-over-year jump in Class A office vacancy to 27.1 percent, along with a 290-basis-point lift to 23.0 percent among Class B/C properties, translated to an overall metro rate of 25.1 percent in June.
- Preliminary third quarter data shows a slight drop in space available for sublet, the first potential step in a broader stabilization to overall vacancy.

RENT

7.9% decrease in the average asking rent Y-O-Y

- San Francisco's average asking rent ended the second quarter at $52.22 per square foot, down 21 percent from the year-end 2019 mark.
- In contrast to the metro trend, the mean asking rent across the city of San Francisco's suburbs was 5 percent above the pre-pandemic mark in June. Meanwhile, the steepest rent correction has been in Downtown South.

Investment Highlights

- The rapidly-evolving artificial intelligence sector is fostering business formation, with potential benefits for San Francisco offices. As nascent firms grow, in-person collaboration is key to defining company culture. This factor and intellectual security concerns make physical offices highly useful and recent leasing trends among A.I. tenants support this, providing a key guideline for the market's long-term investment outlook.
- As the country's second-highest cost office investment market pre-pandemic, the subsequent shake-up to company space needs and capital costs had a profound impact on metro transaction activity. Sales velocity in the first half of this year was on par with the same stretches in 2009 and 2010, a fraction of 2014's peak. Local investment groups, however, have continued to show interest in the sector as some downward price adjustments and less competition open up opportunities.
- Despite the challenge to fundamentals, more offices have changed hands so far this year downtown than elsewhere in the metro. Investors are following asset-specific strategies, including a one-year sale leaseback, as well as conversions into other uses, such as for life science lab space.

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