

San Francisco Market Report mid third quarter review

By Peter Rosenthal

It has been three since the collapse of the dot.com market for commercial landlords. Across the country office vacancies sorted to over 20% in most major markets throughout the United States. Mid year results suggest that the worst is definitely over and the office market is definitely on a rebound.

The San Francisco Bay Area market was particularly hit hard during this downward cycle. Vacancies in San Francisco soared to over 28% when sublease space swelled the market place. The end of June figures now shows San Francisco office vacancy at just over 17%.

Property Class	San Francisco Vacancy Rates		
	Q4-03	Q1-04	Q2-04
<i>Class A</i>	20.8%	20.2%	19.8%
<i>Class B</i>	17.8%	17.5%	17.3%

* Source Costar

San Francisco is on track to show a positive absorption of vacancy in office space of around 800,000 square feet. During the last boom and bust cycle between 1986 and 1998, San Francisco averaged a positive absorption of around 600,000 square feet per year. During that cycle the vacancy hit 18.9% for direct space offered by landlords and combined with sublease space 28%, almost identical to this current cycle. If this absorption rate continues San Francisco should see a 1-2% declining vacancy rate over the next several years.

The overall net absorption in the CBD office market was 250,188 in the 2nd-quarter of 2004. This compares favorable to the overall trend in the last three quarters whereby net abortion has been positive Q1-04 306,736 square feet, Q4-03 314,654 square feet. Tenant moving into large blocks of space during the second quarter include Genentech, 249,732 square feet, the US Department of Housing and Urban Development 77,687 square feet at 600 Harrison street and Cutera Inc took 66,002 at 3240 Bayshore Blvd.

MARKET ANALYSIS

Tenants may be encouraged that the vacancy is still in the high teens but a closer look suggests that tenants are in for a surprise. Vacancy rates less than 5,000 square feet continue to shrink to low single digits. Currently the vacancy rate in the core downtown areas is running less than 6%, under 3,000 square feet the vacancy is less than 4%. As a result rents are now rising. In the last year rents have risen 10-15% in the core financial district on spaces under 5,000 square feet.

Larger building owners are slowly converting larger floors into multi-tenanted floors to meet this demand. However, the continued rental rates make this move hard to follow given high costs of improvements to create these multi-tenanted floors. According to a recent press release from Equity Office Properties and Trust the Chicago based REIT 72% their deals this year have been in spaces smaller than 5,000 ft.

Tenants shall brace themselves for a smaller amount of choices, with less tenant improvements offered by landlords to attract them to sign leases and definitely higher rental rates on the horizon. Tenants with a lease within a year of expiring should begin in earnest to secure their new office "home" quickly or risk paying higher rental rates in the future.