

Vacancy Rates Improve, But Will Progress Continue?

A single set of statistics can stir up a lot of attention and lead to assumptions or conclusions then they should realistically be understood to support. That's especially true when those numbers seem to point to something extremely desirable and fervently wished for, like a recovery in a specific market following a long downturn.

A case in point are the recent figures showing a positive performance in San Francisco's office market during the third quarter of 2003. As has been noted in many recent articles, office vacancy rates in San Francisco went down during the quarter for the first time in over three years. The numbers: vacancy rates dropped 10 basis points to 24.0 percent, a development driven by a positive net absorption of slightly over 100,000 square feet. Available sublease space declined by approximately 9 percent (or 400,000 square feet) as well. Rents leveled off during the third quarter of 2003, at \$27.97 per square foot for Class A and \$20.56 per square foot for Class B.

It's Important to Understand the Challenges

So, the first improvement in the market in over three years! That news raised some eyebrows and caused many to wonder whether it means that the San Francisco office market has finally started on its way back up along with the stock market and corporate profitability figures.

I'd like to report that this is so, but the facts of economic life in our region just don't support that kind of optimism at this point. Probably the most important indicator along these lines are our local employment figures. Obviously, companies won't be needing more office space if they're not hiring employees to work in those offices. So if we're going to see vacant offices filling up, we'll have to see higher employment rates. Unfortunately, local employment numbers are still going in the opposite direction.

The FDIC's Winter 2003 California State Profile reported that employment in California had fallen 0.2 percent for the year ending third quarter 2003. Worse for us was the following: "The San Francisco Bay Area continued to lose jobs as a result of the downturn in high-tech manufacturing, software and dot-com sectors. As of third quarter 2003, payroll employment in the area fell 1.8 percent year-over-year."

What of those rising corporate profits we've been reading about? Unfortunately, those increased profits have come overwhelmingly from cost-cutting practices, including layoffs, rather than from improved sales figures. That's nice for stockholders and bonus-minded CEOs, but it obviously doesn't do anything to populate Financial District work stations.

Urban Land Institute Conference Highlights the Issues

In her report on the non-profit Urban Land Institute's (ULI) 2003 annual fall meeting in San Francisco, ULI's Tricia Riggs cited frequent references to "a report from Forrester Research predicting that as many as 3 million service jobs could be sent overseas by 2015, resulting in as much as 500 million square feet of office space [nationwide] that may no longer be needed."

A key hope for the future, according to many speakers at the ULI conference, is U.S. economic integration with the economies of countries most clearly poised for growth. Riggs reported the comments Kenneth Curtis, vice chairman of Goldman Sachs Asia in Tokyo, who believes that "the dominant global economic occurrence of this century will be the extraordinary growth of China's economy."

"The issue is how to integrate the economies," Riggs quoted Curtis, "We will gain from economic growth in China more than we will lose to jobs going over there. The fear of having everything transferred abroad is a false fear."

No doubt San Francisco will be well positioned to profit from any such economic integration with China. But it seems unlikely that the "China factor" will be filling up our office space next year or the year after. In the meantime, our employment rates continue to flounder.

Kenneth T. Rosen, chairman, Fisher Center for Real Estate and Urban Economics, Haas School of Business, at the University of California at Berkeley also spoke at the ULI meeting. According to Riggs, he called the recent economic growth spurt "an illusion," predicting economic growth rates of no more than 2 to 3 percent and including San Francisco among the cities with the least promising prospects for employment growth.

Interestingly, the *San Francisco Business Times*, reporting Rosen's talk before Cushman & Wakefield's real estate conference in early October, said Rosen "saw a 70 percent chance of good or strong economic growth, nationwide and locally, during the remainder of 2003 and 2004." ("Rosen's predictions laid 'bear,'" *San Francisco Business Times*, October 9, 2003). So, you can pick your Kenneth Rosen prognostication, I guess. But even here, the *SF Business Times* said Rosen predicted that "improvements will be slow, with a full recovery in the local office market five to seven years off," and said an improvement in the job market would be "critical."

Setting Realistic Expectations

The FDIC even singled us out for bad news in the private housing market, reporting, "Low interest rates boosted demand and prices for homes throughout the state. However, price appreciation in the San Francisco Bay Area remained relatively weak in response to employment declines."

So while we wait for figures of fourth quarter 2003 and hope for further improvements, our eyes and ears tell us that we are probably not looking at the beginning of an extended trend toward improvement in the San Francisco office market. A better bet is that we can expect a leveling off and, at best, a long, incremental climb back up. And even that is contingent upon the creation of an appreciable number of new local jobs. In the meantime, landlords seeking to keep tenants happy or woo new renters will continue to offer considerable concession packages.

It's almost surely a mistake to make business plans based on an expectation of significantly lower vacancy rates or significantly higher rents coming any time soon.