

## SF Office Market Continues to Tighten

SAN FRANCISCO-The second three months of the year saw San Francisco's overall and class A vacancy rates both fall more than 100 basis points to 13.9% and 12.7%, respectively, according to a second quarter report by Cushman & Wakefield. C&W's locally based senior director Chris Schroeder tells GlobeSt.com that vacancy in the Downtown class A market fell to 11% from 11.7% in the second quarter and should be in single digits by this time next year, setting the stage for higher lease rates and new development.

"Everyone expects rent spikes to occur when that happens," says Schroeder. "We're already over \$40 (per sf per year, full service) in the North of Market area and the (CBD) average is very close to \$40."

Companies that inked significant expansions this quarter include Capital Group, Winston Strawn, FTI Consulting, O'Melveny & Myers and Merrill Lynch. Although net absorption is down a little bit from previous quarters, Schroeder says several large lease deals are expected to be signed, which should boost absorption figures. BEA Systems, McKesson Corp., Blue Shield, Bain & Co. and Army Corps of Engineers all are likely to sign deals over 75,000 sf during the third quarter, though some are likely to be renewals, says Schroeder.

"In general, you are seeing a lot of big tenants expanding where they are at," says Schroeder. "My personal guess is this time next year we will have seen job growth; it's not only the big sized companies growing but also the small to mid-sized companies. I am continually receiving calls from brokers representing tenants I've never heard of, which means the tech market is coming back to some extent."

The specter of single-digit vacancy rates and, therefore, higher lease rates, have some developers moving ahead with office projects. Tishman Speyer and Beacon Capital are both said to be moving forward on neighboring Mission Street projects, and Shorenstein Co. and Equity Office Properties Trust also are vying to become the first out of the gate. Their completion wouldn't occur before 2009 at the earliest, however, which means CBD vacancy likely will continue to fall for at least the next 18 months, says Schroeder. In addition, he says some owners of class B and C assets who were considering residential conversions are now taking a second look at whether they might just as well rehab the buildings for office use.

Eventually, the higher lease rates could force some companies to consider expanding outside of the city limits. The added benefit of a move outside the city could be lower taxes because a payroll tax that went away in 2001 may be reinstated with the recovering market. Board of Supervisors President Aaron Peskin earlier this month announced plans to seek voter approval for 1/10th of 1% tax on gross receipts of businesses that bring in more than \$2 million. The measure also would apply to large commercial landlords, who would be forced to pay a 1.4% tax on their lease and rent revenue income above \$2 million. If approved by the Board of Supervisors, the legislation would go before the voters in November.

"San Francisco has definitely rebounded since 2002 and 2003, but to continue to attract new and expanding companies, our city government needs to be very careful to not take advantage of our tenant base and developers with new taxes," says Roeder.

According to the report, CBD class A asking rental rates continued to climb in the second quarter, albeit at a slower pace than last year. After experiencing a 19.7% increase in 2005, the CBD class A rate increased 4.6% in the first quarter and 3.1% this quarter to currently stand at \$39.36 per sf.

Rent growth in Tier One assets have also decelerated, experiencing a 6.2% increase over the first two quarters this year after surging 26% in 2005. Despite that, Tier One view space is now commanding upward of \$60 per sf for the first time since 2001, according to the report.

The surge in rents for premium space has left many tenants opting for class B space instead. As a result, CBD class B rents jumped 7.5% in the second quarter, from \$25.44 per sf to \$27.36 per sf. The rent growth in the class B market has attracted the interest of many investors. Schroeder says many investors are looking for buildings containing lots of rollover space because they are anticipating further rent spikes in the future.

Others are looking for more stabilized assets, including the Irvine Co., which has placed 560 Mission under contract for \$400 million. Leased in entirety through 2017 by JP Morgan Chase, the building sale would become the third plus-\$600 per-sf sale over the past year, joining the sales of 555 California and the Gap building at 550 Terry Francois in Mission Bay.

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