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COMMERCIAL REAL ESTATE

# San Francisco's Goldilocks Market



Peter DaSilva for The New York Times

Douglas W. Shorenstein, the chief executive of his family business, sold his company's interest in the Bank of America Center and three other properties in San Francisco in the last 18 months.

By [TERRY PRISTIN](#)

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**S**AN FRANCISCO - Once this city's largest office landlord, the privately owned Shorenstein Company has sold its interests in four properties over the last 18 months, including its flagship [Bank of America](#) Center, which is often described as the financial district's best address.

Disposing of a substantial portion of its office portfolio here is consistent with Shorenstein's new strategy as it evolves from a local business to a company that invests in commercial real estate throughout the country.

The company is also taking advantage of an investment market that seems surprisingly feverish for a city that has yet to recover from the collapse of the dot-com industry.

"Prices are staggeringly high relative to the returns and the underlying fundamentals," said Douglas W. Shorenstein, the chief

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executive of his family business, in an interview in his 49th-floor corner office at the Bank of America Center overlooking San Francisco Bay. "If somebody is willing to pay a lot more than I would pay, then we're a seller."

Shorenstein's role as the city's top landlord has now been assumed by Equity Office Properties, the nation's largest owner of office real estate. But Equity Office has put five of its buildings here on the market, in the hope of either selling them outright or forming joint ventures with other investors.

Nearly \$2 billion worth of prime office buildings changed hands in 2004, exceeding the 1998 record of \$1.92 billion, with some properties drawing as many as two dozen bids. The average price for all buildings in the central business district was \$304 a square foot last year, up from \$235 a square foot in 2003, according to Reis Inc., a New York research firm.

Several buildings have traded for \$400 a square foot or more, including 555 California Street, which is no longer the national headquarters of Bank of America but has a roster of blue-chip tenants, including [Goldman Sachs](#).

The 52-story reddish-brown granite tower and adjacent buildings were bought by a group of New York investors, led by Mark Karasick and David Werner, for \$825 million, or about \$487 for each rentable square foot. Mr. Shorenstein's father, Walter, acquired the building from the bank in 1985 and later sold a half interest back to the bank.

The investment market here is beginning to resemble that of Washington, where the average trading price last year was \$363 a square foot, according to Cassidy & Pinkard, a local real estate services company. But the average vacancy rate in Washington was just 7.5 percent in the fourth quarter of last year.

In this city, by contrast, some brokers estimate that the top buildings have a vacancy rate of 19 percent, with most of the empty space on the lower floors. Employment has only just begun growing slowly after four years of job losses. Employment is expected to increase 1.2 percent this year, said Mark Zandi, the chief economist for [Economy.com](#).

The spike in commercial real estate prices here has left many real estate specialists scratching their heads. Only two years ago, Tishman Speyer Properties was forced to sell Market Center, two buildings on Market Street that were 83 percent vacant, for \$79.5 million, less than half of the \$189 million it had paid for the complex in 1999.

For the last year and a half, landlords in San Francisco have gained more new tenants than they have lost, but new leases are being signed at 1997 levels, with owners paying \$35 or more a square foot to help with remodeling.

"We're still seeing \$50 worth of work and a year's worth of free rent," said Jacque Ducharme, a vice chairman at Studley, a real estate firm that represents tenants.

Although rents for the more desirable space on higher floors are slowly inching up - sometimes reaching \$40 a square foot - space below is getting \$25 to \$30. On average, rents are 45.4 percent of what they were at their peak in 2000, according to Moody's Investors Service.

"What we are seeing is a further widening of the spread between rents for view space and nonview space," said Michael van Konynenburg, the chief executive of Secured Capital, which has represented landlords in several recent high-priced sales.

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Jeanne R. Myerson, the chief executive of the Swig Company, a private company based in San Francisco that has real estate holdings across the country, has been looking for properties to buy here. But she said that the high prices suggest that many buyers are overly optimistic that there will be enough job growth to drive up rents. "It's hard to make the numbers work on a lot of the buildings right now," she said.

This is hardly the only real estate market currently attractive to investors, in light of low interest rates, the sluggish stock market and the widespread availability of cheap capital. With a lack of alternative investment vehicles, many people are willing to accept much lower initial returns than they were a few years ago, hoping for greater cash flow in the future.

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Steel and concrete prices have been rising, adding to the cost of developing new buildings so that any price that is safely below the so-called replacement cost - as much as \$450 a square foot in this city - can look like a good deal.

In a report issued last week, however, [Moody's](#) said the city is the riskiest major office market in the country. The ratings agency warned that many tenants here were still paying high rents negotiated during the technology boom and would expect a sharp reduction when their leases expire.

"The point is that rents could be stable for the next three years, and then cash flow could decline materially," said Sally Gordon, a vice president and senior credit officer. "We're alerting people to the fact that you might see an increase in defaults."

Few real estate specialists doubt that this city will rebound in the long run, both because it appeals to highly educated people willing

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to make sacrifices to live here and because it is hard to build here. An initiative approved in 1986 limits commercial high-rise construction to 875,000 square feet a year.

In fact, apart from a jazzy federal building rising at Seventh and Mission Streets, no office buildings are currently under construction, although the city is awash in residential projects and several lower-grade office buildings are being converted into condominiums. Owners with lots authorized for commercial construction say they will not build until they can charge \$65 a square foot annually for rent, utilities and services.

No longer the financial capital it once was, this city now relies mainly on smaller tenants - advertising agencies, boutique law firms and hedge funds - to fill its office towers. Last year, three-quarters of the companies that signed new leases took 6,500 square feet or less, according to Newmark Pacific, a real estate services company here.

Unlike the corporate tenants of the past, who were willing to put their back-office employees on lower floors, many smaller businesses insist on giving everyone access to a view, making it hard to find takers for much of the ordinary space, said Jim Sullivan, an analyst at Green Street Advisors, a research company in Newport Beach, Calif.

Because of the growing premium paid for view space, a current owner of Market Center, Divco West Properties, a real estate firm based in Palo Alto, said it was not in a rush to lease the top floors of the building, which is now more than half full. "We're holding out for better rents on the upper floors," said Stephen J. Pilch, the chief operating officer.

Last year, the city's only sizable new tenant was Gymboree, a children's clothing retailer, which relocated its offices from Burlingame, Calif., to a new building at 500 Howard Street, south of Market Street. The building is in a once-seedy neighborhood, sometimes known as SoMa, that blossomed with new office buildings during the technology boom.

In moving to the city, Gymboree sublet space from [Sun Microsystems](#), the building's sole tenant. Though this was a record deal in terms of price per square foot, Monica Finnegan, a managing principal of Newmark Pacific, said it was an aberration because Sun Microsystems had signed an unusually long lease, giving the new owner an assured income stream for the next decade. In 2003, Equity Office Properties sold 500 Howard to the Utah State Retirement System and Cottonwood Partners, a private investment firm, for \$119.4 million, or \$512 a square foot.

Equity Office, which has withdrawn from markets like Philadelphia, is not giving up on this city, although it wants to limit its holdings to properties it considers strategic, especially those with great views, said Jeffrey L. Johnson, the chief investment officer.

But Kevin Brennan, a senior vice president at the Staubach Company, which represents tenants, said that the sell-off by Shorenstein and Equity Office should serve as a warning to other potential investors. "We don't see where the market is going to be tightening anytime soon," he said.

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