



TRANSWESTERN

# SAN FRANCISCO OFFICE MARKET

Q2 2023



## VACANCY RATE SURGES BUT VC FUNDING REMAINS STEADY

Despite higher borrowing costs for businesses and consumers, economic conditions in the San Francisco metropolitan area remain strong, though moderating. The unemployment rate in May was unchanged from three months ago at 2.9%. While the pace of job growth has slowed over the past year, the San Francisco economy still expanded by 31,300 jobs - a 2.7% annual growth rate and outpacing the national rate of 2.6%.

The labor market remains on sound footing, but hybrid work and recessionary fears have led to more vacant space in an already struggling San Francisco office market. In the second quarter, the total amount of office space available for lease in downtown San Francisco climbed to a record high of 37 million square feet. The vacancy rate surged 250 basis points (bps) on a quarterly basis to an all-time high of 31.6%. Net absorption was negative with 2.2 million SF of space returned to the market. Average rents consequently fell 12.6% year over year.

While supply and demand fundamentals look bleak, venture capital funding bottomed out two quarters ago and posted \$25.0 billion in Q2 2023, reverting toward pre-pandemic levels. Artificial intelligence has emerged as a bright spot, driving a growing share of that capital, to the tune of \$10.9 billion (or 42.6% of the total).

### TRENDLINES

	Q2 2023	Q2 2022	CHANGE	FIVE-YEAR AVERAGE
Nonfarm Jobs (Thous.)	1,211	1,179	2.7%	1,143
Office-Using Jobs (Thous.)	529	521	1.5%	490
Kastle Barometer - Occupancy (%)	45.4	34.7	10.7%	--
Sublease Availability (%)	11.5	9.1	240 bps	7.2
Net Absorption (Thous. SF)	-2,172	-1,091	-99.1%	-952
Overall Vacancy Rate	31.6	24.1	750 bps	16.3
Class A Direct Rents (\$/SF)	61.17	68.14	-10.2%	72.33
Under Construction (Mil. SF)	0.2	1.4	-83.1%	1.5
Investment Volume (\$ Mil.)	18	109	-83.8%	674
Venture Capital Funding (\$ Bil.)	25.0	33.0	-24.3%	31.9

Source: Transwestern, CA EDD, Kastle Systems, RealPage, MSCI Real Capital Analytics, Pitchbook, Q2 2023.  
Note: Employment figures as of May 2023. Data not seasonally adjusted.



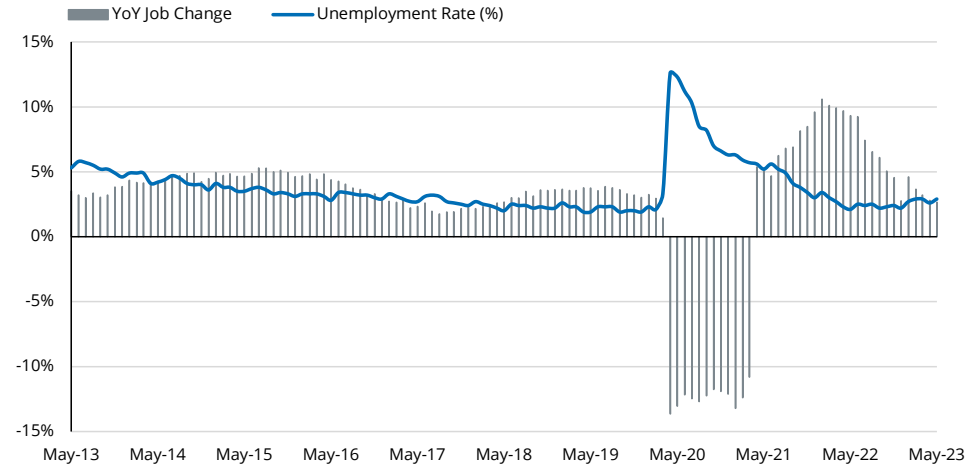
### ECONOMY

#### Job Growth Moderates to 2.7%

- The May unemployment rate in the San Francisco metro area was unchanged from three months ago at 2.9%. While it is up from 2.1% one year ago, it remains a tight labor market with strong job gains despite businesses and consumers facing higher borrowing costs.
- The regional economy showed pockets of strength despite cooling from a blistering pace last year. Employers added 31,300 jobs annually, or 2.7% year over year, outpacing the national rate of 2.6%.
- Jobs gains were driven by a year-over-year increase of 11.0% in Leisure and Hospitality employment (+12,700 jobs), the hardest hit sector during the pandemic. Education and Health Services also made a significant contribution, growing 7.2% and adding 10,900 jobs. Office-using industries added 7,900 jobs, up 1.5% from last year.

### UNEMPLOYMENT RATE AND OFFICE-USING JOBS

#### San Francisco-Redwood City-South San Francisco MD

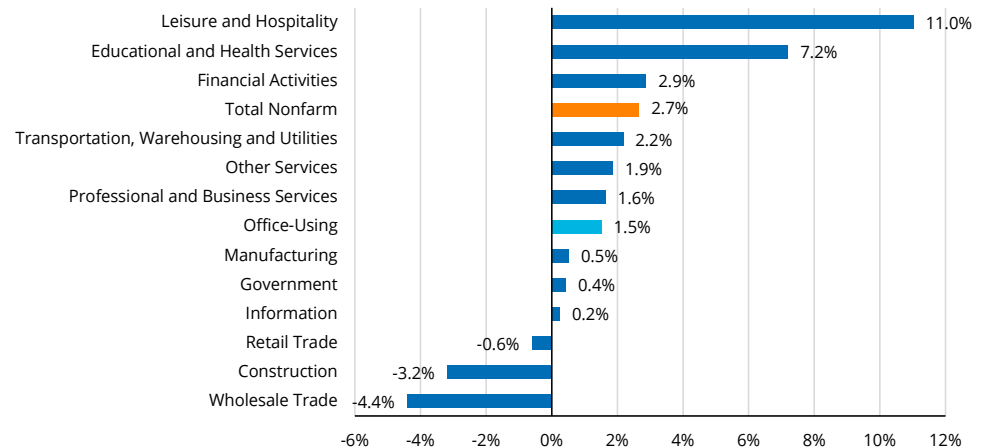


Source: Transwestern, CA EDD, May 2023.

Note: Data not seasonally adjusted.

### YOY EMPLOYMENT CHANGE BY INDUSTRY

#### San Francisco-Redwood City-South San Francisco MD



Source: Transwestern, CA EDD, May 2023.

Note: Data not seasonally adjusted.

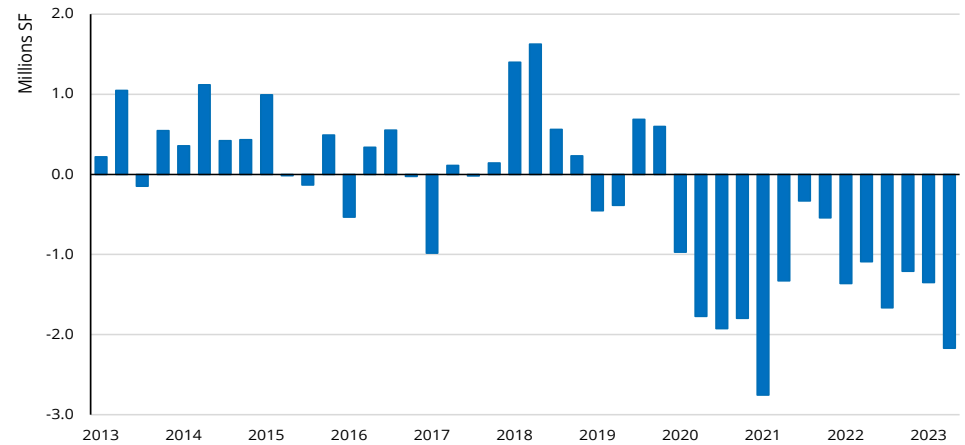


### SUPPLY AND DEMAND FUNDAMENTALS

#### Companies Continue to Reduce Space

- A shift to a hybrid-based work model combined with recessionary fears have taken a large bite out of occupancy levels in San Francisco. Net absorption was negative 2.2 million SF in the second quarter, marking it one of the worst quarters since CoStar recordkeeping began in 1997 as companies continued to downsize, relocate or give up space altogether. Total net absorption since the start of 2020 stands at negative 20.3 million SF.
- Office occupancy plateaued in Q2 according to data tracked by Kastle Systems, with San Francisco seeing an average of 45.4% of workers swiping into offices for the week of June 21, 2023. San Jose had the lowest of the major metros tracked with a rate of 38.1%, reflecting the Bay Area's large concentration of tech jobs.

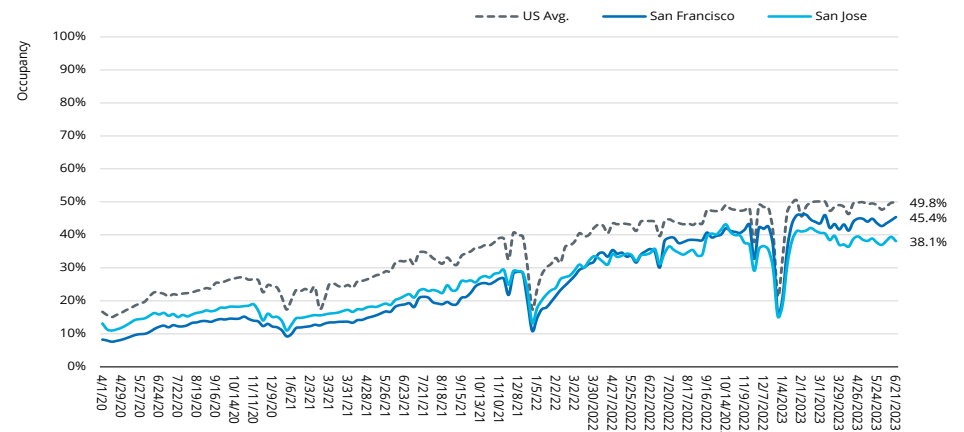
### NET ABSORPTION



Source: Transwestern, CoStar, Q2 2023.

### BACK TO WORK BAROMETER

#### Office Occupancy %



Source: Transwestern, Kastle Systems, June 2023.

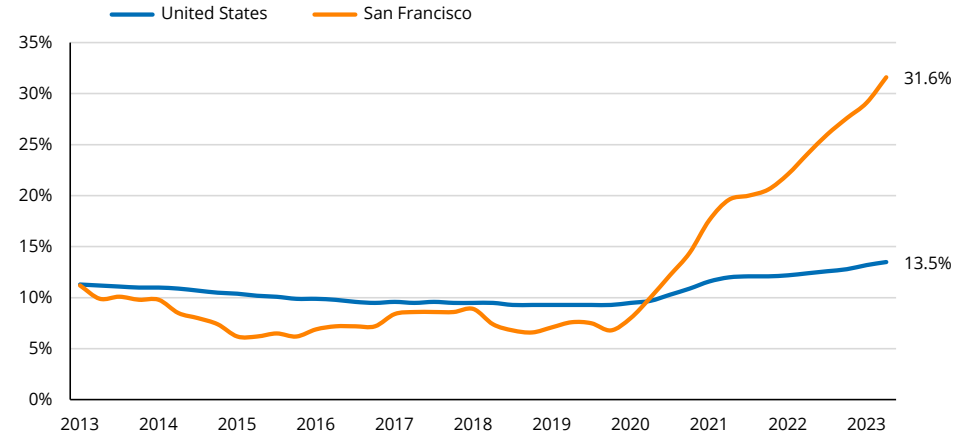


### SUPPLY AND DEMAND FUNDAMENTALS

#### Vacancy Rate Continues Upward Ascent

- In Q2, the overall vacancy rate surged 250 bps on a quarterly basis to 31.6%, the highest level on record. This was the largest jump in two years as numerous companies gave up space.
- Class A vacancy increased 240 bps to 29.1% in Q2 while Class B vacancy rose more sharply, by 330 bps to end the quarter at a higher rate of 35.6%.
- In Q2, there was roughly 10.3 million SF of available sublet space, or 11.5% of total inventory. The sublease availability rate is up 140 bps from 9.1% one year ago as companies shed more space despite the market's deeply discounted sublet rates.

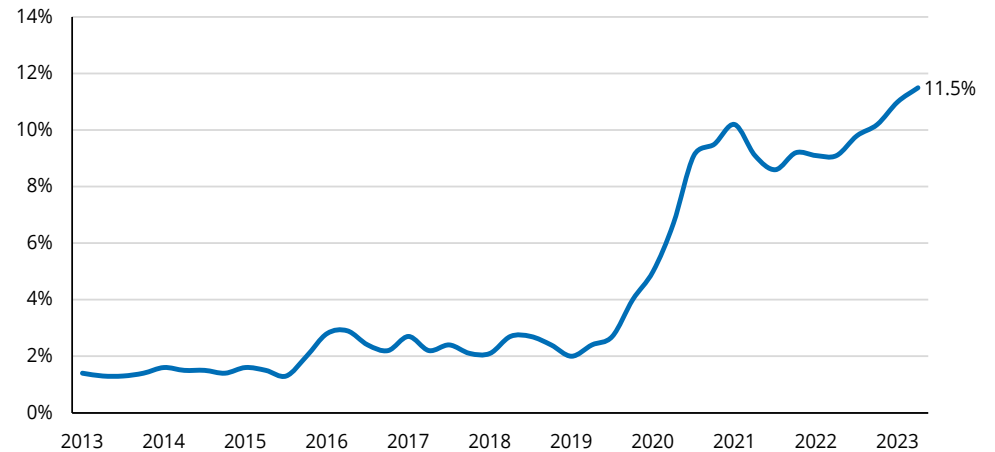
### VACANCY RATE



Source: Transwestern, CoStar, Q2 2023.

### SUBLEASE AVAILABILITY RATE

#### SF as % of Inventory



Source: Transwestern, CoStar, Q2 2023.

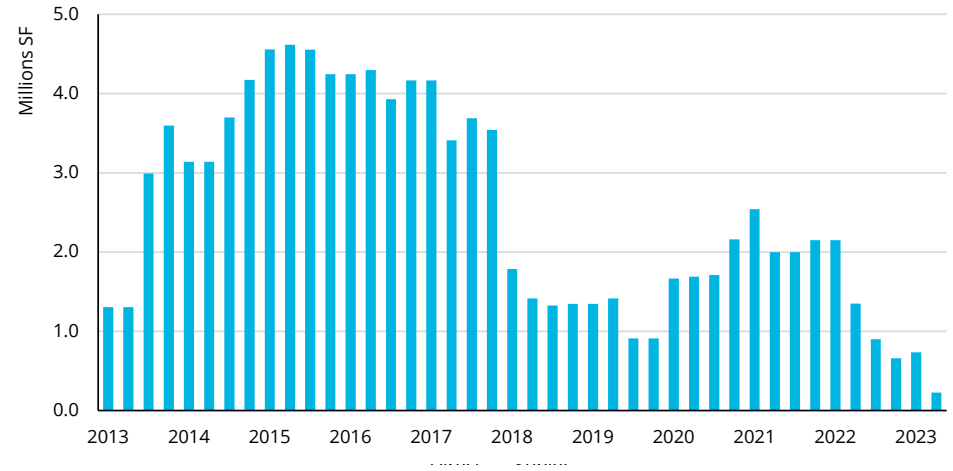


### SUPPLY AND DEMAND FUNDAMENTALS

#### Rent Growth Slows as More Space Hits the Market

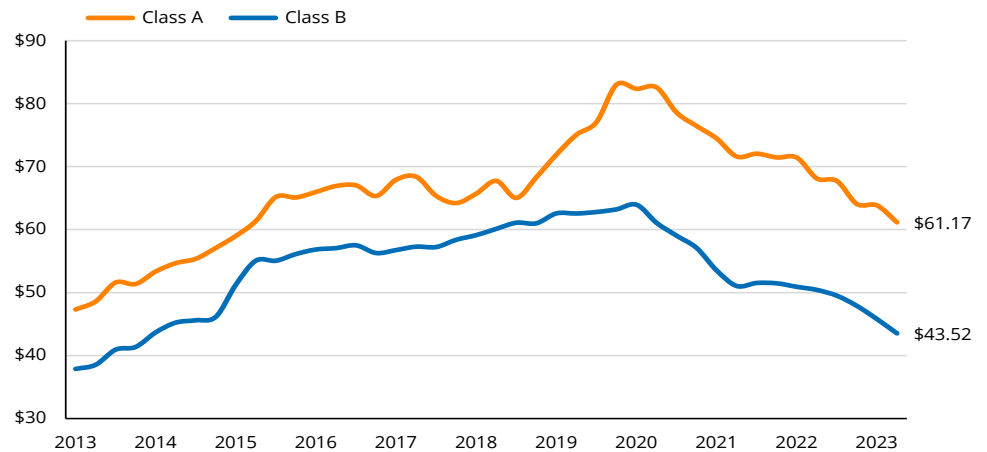
- Office construction totaled about 228,000 SF in Q2, trending down since 2017. New construction typically slows when supply exceeds demand. As the market becomes increasingly saturated with vacant space, development will continue to be muted for the remainder of 2023 and beyond.
- With office demand waning, asking rents continued to decline from their pre-pandemic peaks. Overall direct rents were down 4.3% from last quarter and fell 12.6% year over year.
- On a quarterly basis, Class A rents declined 4.2% to end the quarter at \$61.17 PSF. Class B rents decelerated 5.0% to \$43.52 PSF, reflecting the flight to quality. Companies are being strategic about about securing high-quality spaces that will encourage a return to the office as occupancy levels remain stagnant.

### UNDER CONSTRUCTION



Source: Transwestern, CoStar, Q2 2023.

### DIRECT RENTS, \$/SF



Source: Transwestern, CoStar, Q2 2023.



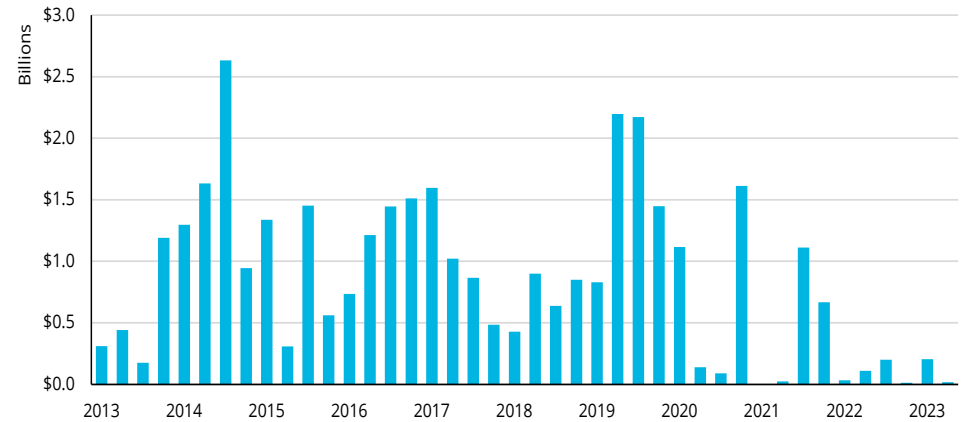
### CAPITAL MARKETS

#### Investment Volume Subdued but Venture Capital Funding Improves

- Office deal volume in Q2 grinded to a halt as many banks have stopped issuing loans to office buildings. Volume was just \$17.6 million in a market that typically experienced over \$1 billion in quarterly investment during pre-pandemic years.
- Venture capital funding, an important source of office demand in the tech-heavy San Francisco Bay Area, reached \$25.0 billion during Q2, down slightly from last quarter's \$25.9 billion. Q2's total was skewed upwards from a \$10 billion megadeal in which Microsoft invested in OpenAI.
- Year over year, VC funding fell 24.3% though activity in the first two quarters of this year still exceeded pre-pandemic levels (the quarterly average from 2015 to 2019 was \$19.7 billion).

### INVESTMENT VOLUME

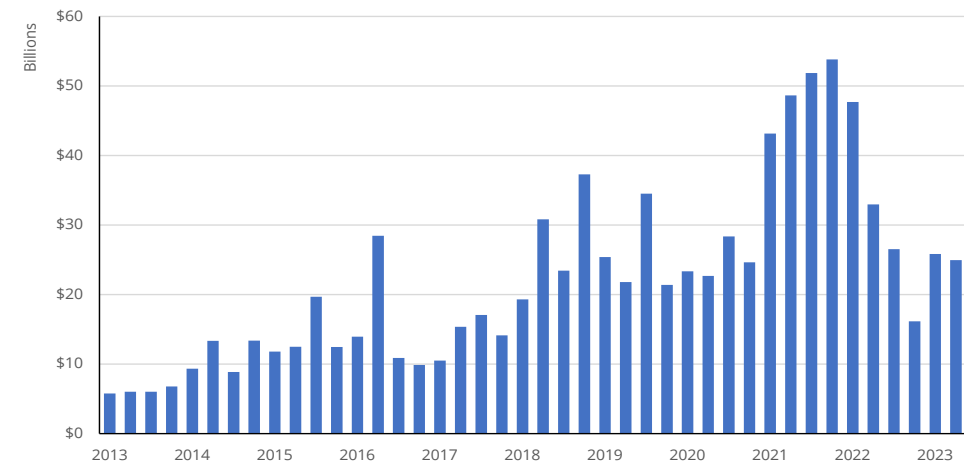
#### San Francisco CBD



Source: Transwestern, MSCI Real Capital Analytics, Q2 2023

### VENTURE CAPITAL FUNDING

#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q2 2023.



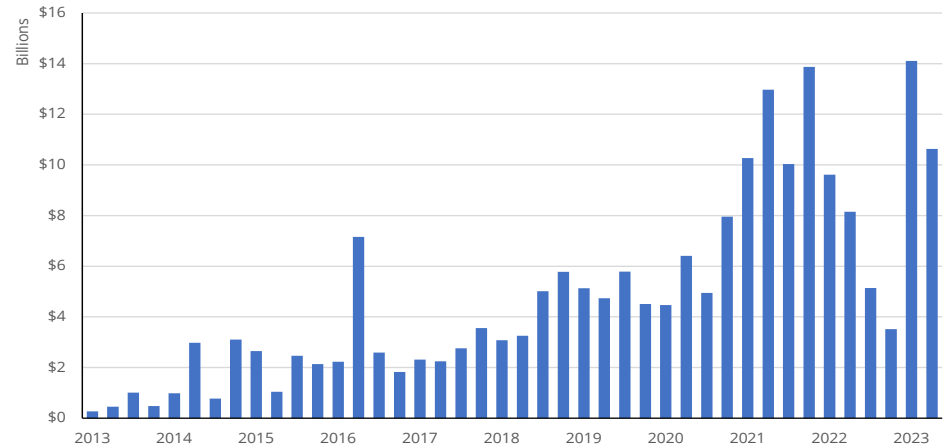
### ARTIFICIAL INTELLIGENCE

#### AI Accounts for Growing Share of VC Funding

- While overall venture capital funding has come down from previously unsustainable levels, capital invested into artificial intelligence has offset some of that decline. Companies operating in the AI vertical accounted for \$10.6 billion of the quarterly total, or 42.6% - the second largest share on record. While last quarter's share was 54.6%, the figure was inflated by Microsoft's \$10 billion investment in OpenAI.
- Excluding Q2's megadeal in which Stripe raised almost \$6.9 billion, the composition of this quarter's deals has a greater number of large, late-stage deals. For example, Anthropic raised \$450 million while OpenAI secured another \$300 million. Cohere closed on \$270 million in funding and KoBold Metals raised \$195 million.

### VENTURE CAPITAL FUNDING INTO AI

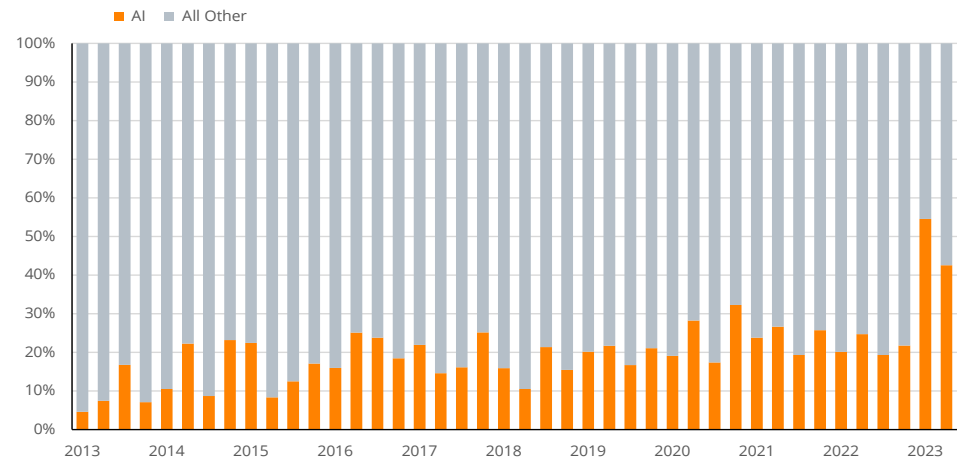
#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q2 2023

### VENTURE CAPITAL FUNDING

#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q2 2023.



## TOP LEASES

TENANT	ADDRESS	SUBMARKET	SF LEASED	INDUSTRY
AUTODESK	1 Market	South Financial District	92,820	Information Technology
STIFEL, NICOLAUS & COMPANY, INC.	1 Montgomery	Financial District	68,446	Financial Services
UNKNOWN	100 First St	South Financial District	57,117	Unknown
WILLKIE FARR & GALLAGHER	333 Bush	Financial District	44,050	Legal Services
UNKNOWN	555 Market	South Financial District	23,635	Unknown

## SUBMARKET FUNDAMENTALS

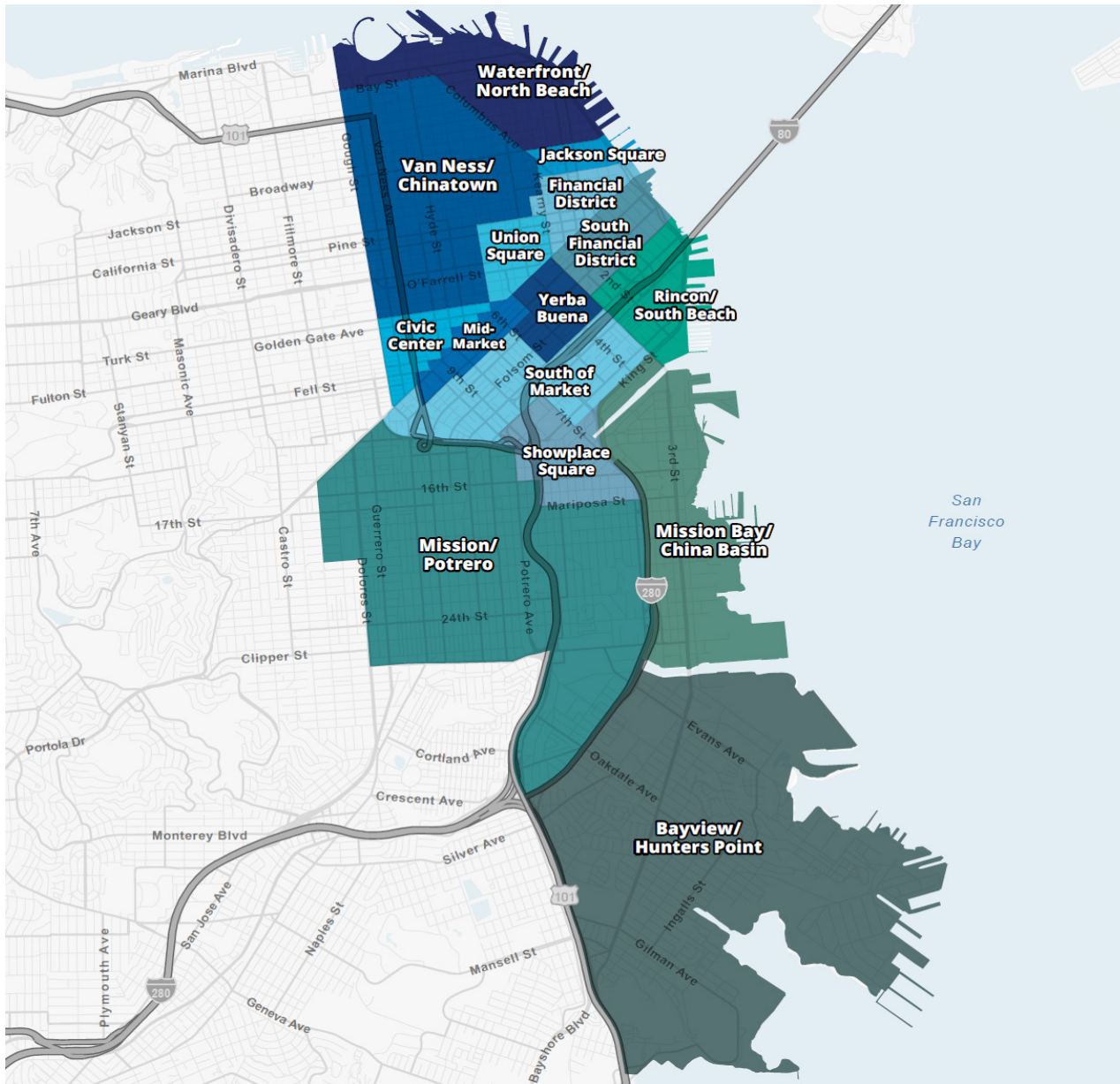
SUBMARKET	INVENTORY SF	LEASING ACTIVITY SF	VACANCY RATE %	QUARTERLY NET ABSORPTION SF	12-MO. NET ABSORPTION SF	UNDER CONSTRUCTION SF	DIRECT RENT \$/SF
BAYVIEW/HUNTERS POINT	577,123	1,260	46.5%	12,901	-11,141	0	\$39.66
CIVIC CENTER	431,789	16,455	46.9%	-8,316	-2,498	0	\$35.28
FINANCIAL DISTRICT	29,678,750	334,108	27.1%	-191,709	-1,687,131	0	\$56.16
JACKSON SQUARE	1,721,953	21,463	32.5%	65,228	-91,616	0	\$45.93
MID-MARKET	4,889,981	12,852	29.2%	-411,230	-184,307	0	\$28.86
MISSION BAY/CHINA BASIN	2,929,148	12,117	34.4%	149,195	-220,468	0	\$33.83
MISSION/PORTRERO	1,727,324	29,852	31.2%	-74,267	-170,299	0	\$40.25
RINCON/SOUTH BEACH	5,050,654	17,758	38.7%	-310,171	-558,511	0	\$42.39
SHOWPLACE SQUARE	3,509,258	26,987	41.9%	-165,339	-384,169	176,733	\$39.59
SOUTH FINANCIAL DISTRICT	22,992,958	336,855	29.6%	-1,096,153	-2,359,657	0	\$52.19
SOUTH OF MARKET	2,681,717	18,722	41.2%	-124,398	-376,936	51,223	\$43.98
UNION SQUARE	4,498,521	37,167	32.0%	-38,815	-70,445	0	\$46.76
VAN NESS/CHINATOWN	1,503,684	378	15.9%	16,272	-14,117	0	\$46.89
WATERFRONT/NORTH BEACH	2,738,145	1,942	38.6%	23,479	-100,972	0	\$42.96
YERBA BUENA	3,783,258	12,979	50.2%	-18,348	-167,977	0	\$46.51
<b>TOTAL</b>	<b>88,696,863</b>	<b>880,895</b>	<b>31.6%</b>	<b>-2,171,671</b>	<b>-6,400,244</b>	<b>227,956</b>	<b>\$46.89</b>

Source: Transwestern, CoStar, Q2 2023.





SUBMARKET MAP



FOR MORE INFORMATION

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RESEARCH METHODOLOGY

The information in this report is a compilation of single- and multi-tenant office properties 10,000 SF and larger in downtown San Francisco. Medical offices and government-owned buildings are excluded from analysis.

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