



TRANSWESTERN

# SAN FRANCISCO OFFICE MARKET

Q3 2023



## VACANCY CLIMBS BUT AI EMERGES AS MAJOR TENANT AND CAPITAL SOURCE

Despite higher borrowing costs for businesses and consumers, economic conditions in the San Francisco metropolitan area remain strong, though moderating. The unemployment rate was 3.5% in August, up 60 bps from three months ago but still at historically low levels. While the pace of job growth has slowed over the past year, the San Francisco metropolitan economy still expanded by 27,900 jobs - a 2.3% annual growth rate and outpacing the national rate of 2.0%.

The labor market remains on sound footing, but hybrid work and recessionary fears have led to more vacant space in an already weakened San Francisco office market. In the third quarter, the total amount of office space available for lease in downtown San Francisco climbed to a record high of 38.5 million square feet. The vacancy rate rose 240 basis points (bps) on a quarterly basis to an all-time high of 33.4%. Net absorption was negative with 2.2 million SF of space returned to the market. Average rents consequently fell 15.3% year over year.

While supply and demand fundamentals look bleak, capital markets are recalibrating with the sale of a few notable buildings in which the buyers and sellers agreed on reduced pricing and helped narrow the bid-ask gap. Venture capital funding remains active with \$18.6 billion in Q3 2023, reverting toward pre-pandemic levels. Artificial intelligence has emerged as a bright spot, accounting for 49.4% (\$9.7 billion) of the quarterly total.

### TRENDLINES

	Q3 2023	Q3 2022	CHANGE	FIVE-YEAR AVERAGE
Nonfarm Jobs (Thous.)	1,216	1,188	2.3%	1,147
Office-Using Jobs (Thous.)	533	531	0.2%	494
Kastle Barometer - Occupancy (%)	43.6	39.2	4.4%	--
Sublease Availability (%)	11.2	9.5	170 bps	7.3
Net Absorption (Thous. SF)	-2,172	-1,607	-35.2%	-1,060
Overall Vacancy Rate	33.4	25.4	800 bps	17.4
Class A Direct Rents (\$/SF)	50.39	67.02	-24.8%	71.44
Under Construction (Mil. SF)	0.2	0.9	-74.7%	1.6
Investment Volume (\$ Mil.)	106	200	-46.8%	648
Venture Capital Funding (\$ Bil.)	18.7	24.7	-24.5%	31.7

Source: Transwestern, CA EDD, Kastle Systems, MSCI Real Assets, Pitchbook, Q3 2023.  
Note: Employment figures as of August 2023. Data not seasonally adjusted.



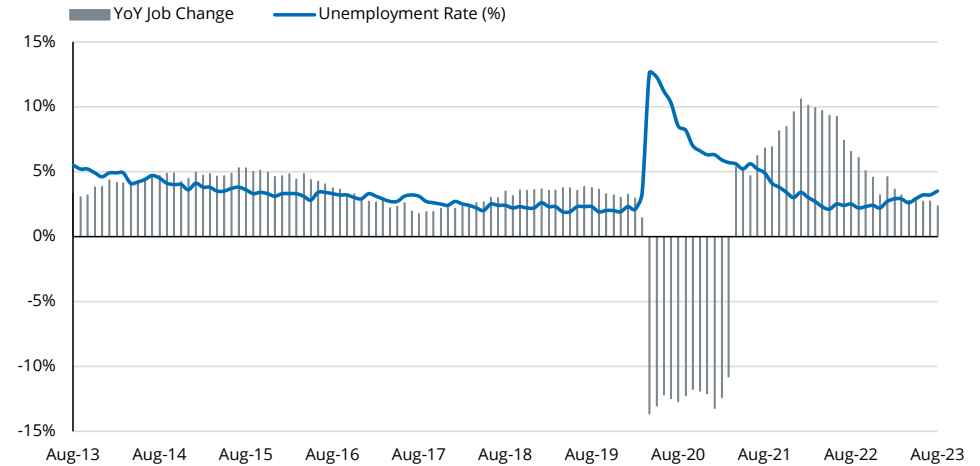
### ECONOMY

#### Job Growth Moderates to 2.3%

- The August unemployment rate in the San Francisco metro area rose 60 bps from three months ago to 3.5%. While it is up from 2.5% 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 27,900 jobs annually, or 2.3% year over year, outpacing the national rate of 2.0%.
- Jobs gains were driven by a year-over-year increase of 9.7% in Leisure and Hospitality employment (+11,600 jobs), the hardest hit sector during the pandemic. Education and Health Services also made a significant contribution, growing 6.2% and adding 9,300 jobs. Office-using industries added 1,800 jobs, up 0.2% from last year.

### UNEMPLOYMENT RATE AND OFFICE-USING JOBS

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

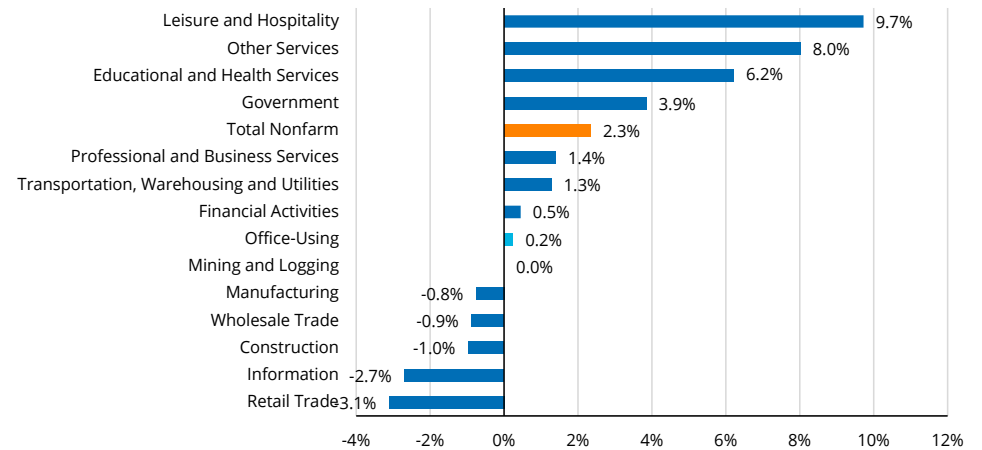


Source: Transwestern, CA EDD, August 2023.

Note: Data not seasonally adjusted.

### YOY EMPLOYMENT CHANGE BY INDUSTRY

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



Source: Transwestern, CA EDD, August 2023.

Note: Data not seasonally adjusted.

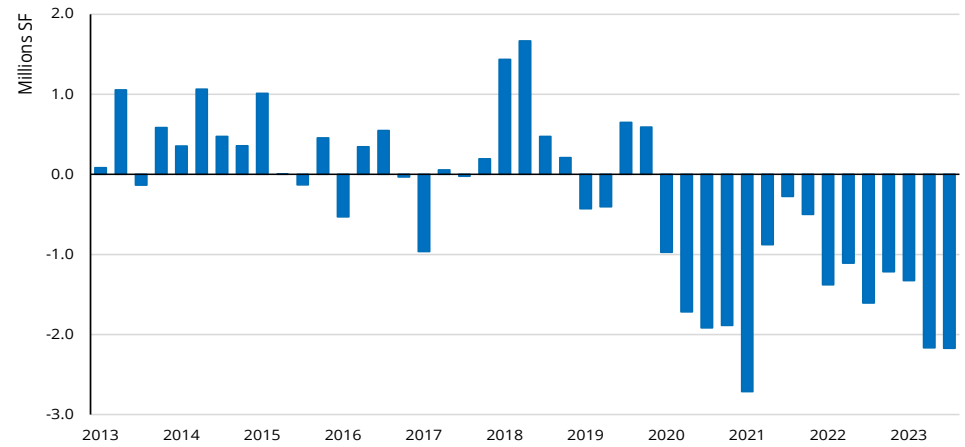


### SUPPLY AND DEMAND FUNDAMENTALS

#### Negative Absorption Continues; Office Occupancy Remains Steady

- 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 third quarter, marking it one of the weakest quarters on record as companies continued to downsize, relocate or give up space altogether. Total net absorption since the beginning of 2020 stands at negative 21.8 million SF.
- Office occupancy was largely unchanged in Q3 according to data tracked by Kastle Systems, with San Francisco seeing an average of 43.6% of workers swiping into offices for the week of September 20, 2023. San Jose had the lowest of the major metros tracked with a rate of 41.1%, reflecting the Bay Area's large concentration of tech jobs.

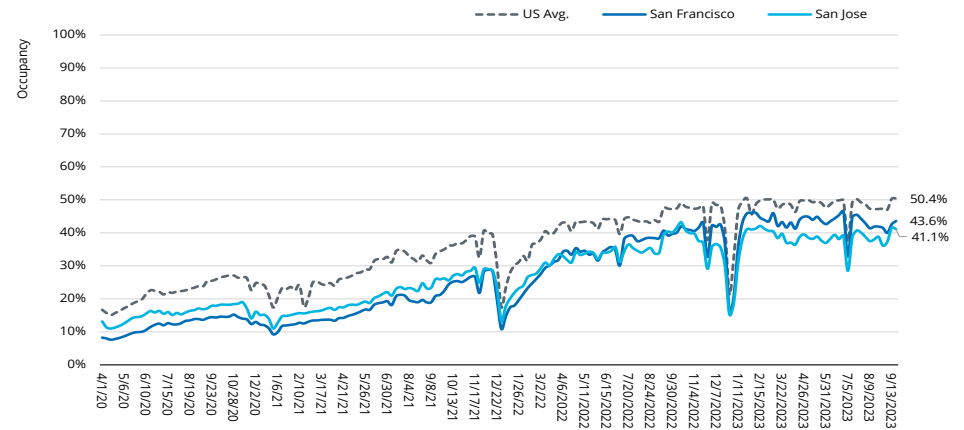
### NET ABSORPTION



Source: Transwestern, CoStar, Q3 2023.

### BACK TO WORK BAROMETER

#### Office Occupancy %



Source: Transwestern, Kastle Systems, September 2023.

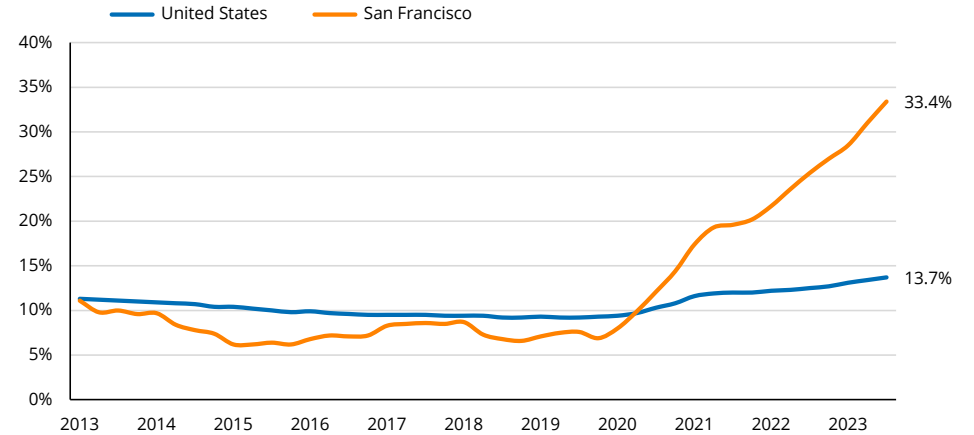


### SUPPLY AND DEMAND FUNDAMENTALS

#### Vacancy Rate Continues to Grow

- In Q3, the overall vacancy rate rose 240 bps on a quarterly basis to 33.4%, the highest level on record.
- Class A vacancy increased 290 bps to 31.3% in Q3 while Class B vacancy rose less sharply, by 190 bps to end the quarter at 36.9%.
- There was roughly 10.0 million SF of available sublet space, or 11.2% of total inventory. The sublease availability rate is up 170 bps from 9.5% one year ago as companies shed more space despite the market’s deeply discounted sublet rates.
- In the third quarter, there was a total of 289,000 SF in subleases composed of 32 leases averaging 9,000 SF per transaction.

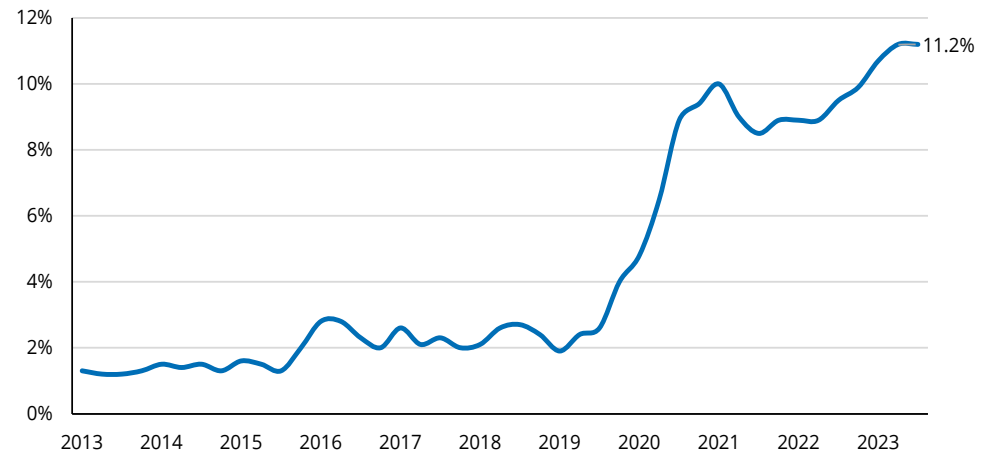
### VACANCY RATE



Source: Transwestern, CoStar, Q2 2023.

### SUBLEASE AVAILABILITY RATE

#### SF as % of Inventory



Source: Transwestern, CoStar, Q3 2023.

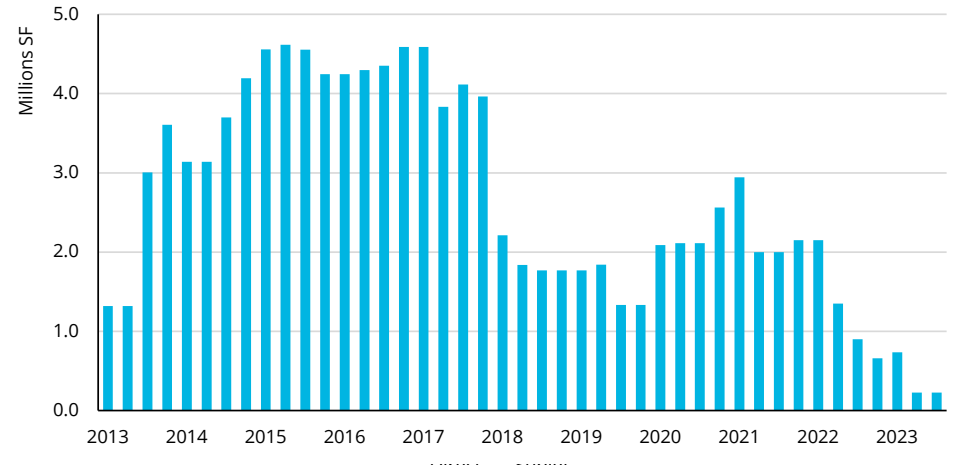


### SUPPLY AND DEMAND FUNDAMENTALS

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

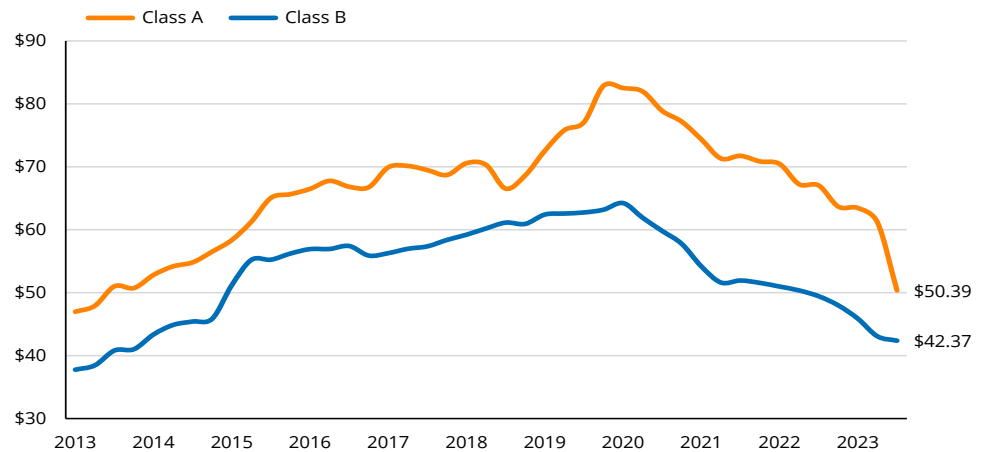
- Office construction totaled 228,000 SF in Q3, trending down since 2017. There are three buildings currently under construction. The largest development is 151,000 SF at 300 Kansas, a Class A property being developed by Spear Street Capital. At 531 Bryant, Urban Land Development is building out a Class B office building that will reach roughly 51,000 SF. The S. Hekemian Group is also constructing 29,000 SF of Class B space 828 Brannan.
- New construction typically slows when supply exceeds demand. As the market becomes increasingly saturated with vacant space, the industry will find opportunities for redevelopment. During the quarter, San Francisco developers had already expressed interest in converting eight office buildings to residential.
- Weakening office demand has driven overall asking rents down from their pre-pandemic levels. Direct rents fell 5.5% from the previous quarter to an average of \$42.73 PSF and declined 15.3% from one year ago. This compares with a pre-pandemic high of \$68.68 PSF.
- By class segment, Class A direct rents declined 17.6% from Q2 to end the quarter at \$50.39 PSF. Class B slowed by 1.6% to finish at \$42.37 PSF. Pre-pandemic peak rents were \$84.84 and \$64.23 for the two segments, respectively.

### UNDER CONSTRUCTION



Source: Transwestern, CoStar, Q3 2023.

### DIRECT RENTS, \$/SF



Source: Transwestern, CoStar, Q3 2023.

Note: CoStar rent estimates are conservative figures due to limited data.



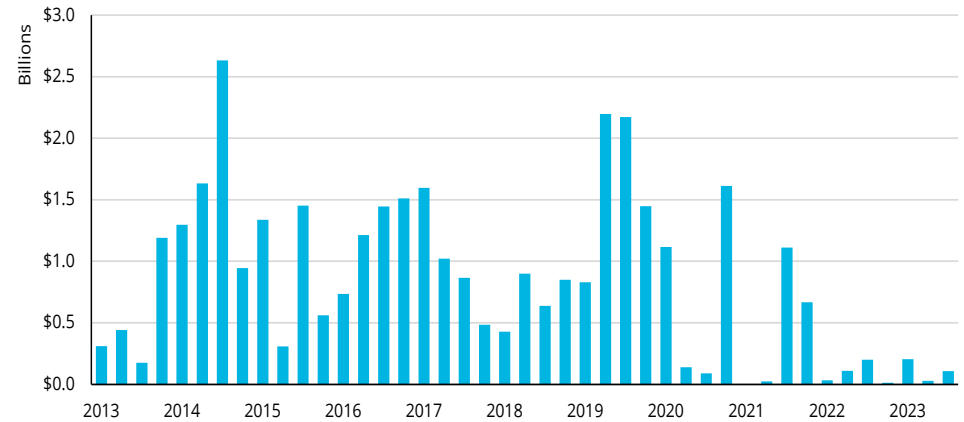
### CAPITAL MARKETS

#### Bid-Ask Gap Narrows and VC Funding Grows

- The office sector recorded \$106.5 million in Q3 deal volume in a market that frequently experienced over \$1 billion in quarterly investment during pre-pandemic years. Though investment was comparatively weak, there were a few notable deals in which buyers and sellers agreed on reduced pricing.
- In Q3, a partnership of The Swig Company and SKS Real Estate Partners purchased 350 California for \$61.1 million. The next largest transaction was a deal inked by Presidio Bay Ventures for 60 Spear at \$40.9 million. Peninsula Land and Capital bought 550 California for approximately \$40.5 million.
- Venture capital funding, a driving source of office demand in the tech-heavy San Francisco Bay Area, reached \$18.7 billion during Q3, a 13.6% increase from last quarter's \$16.4 billion. While funding has fallen from pandemic-fueled highs, capital is active and just above of the 2015-2019 quarterly average of \$18.5 billion.

### INVESTMENT VOLUME

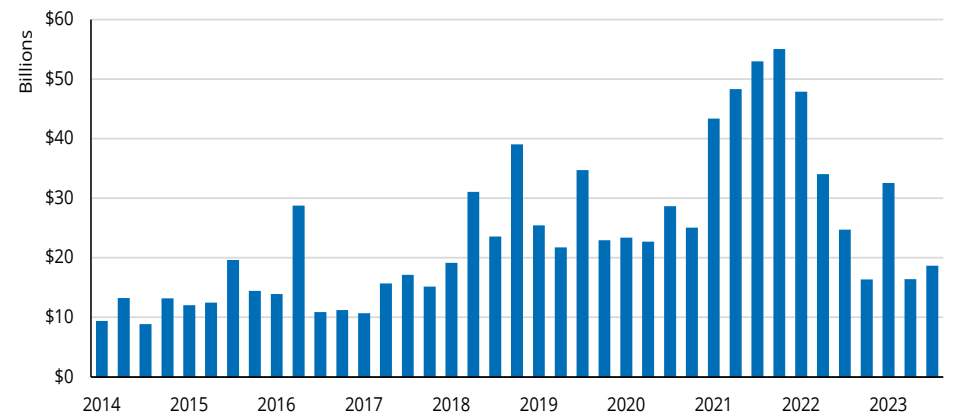
#### San Francisco CBD



Source: Transwestern, MSCI Real Assets, Q3 2023

### VENTURE CAPITAL FUNDING

#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q3 2023.



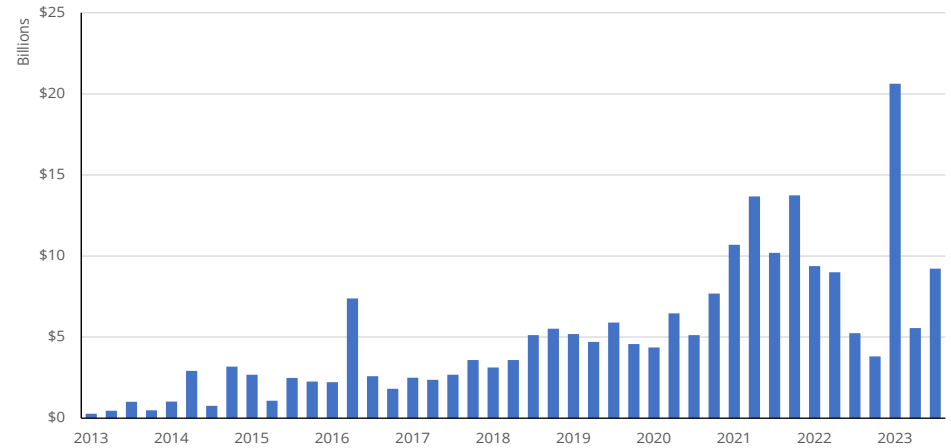
### ARTIFICIAL INTELLIGENCE

#### AI Accounts for Half of VC Funding

- While overall venture capital funding has fallen from previously unsustainable levels, capital invested into artificial intelligence has offset some of that decline. Companies operating in the AI vertical accounted for \$9.2 billion of the quarterly total, or 49.4% - the second largest share on record.
- The largest deal of the quarter was Amazon's \$4 billion investment in AI company, Anthropic. Databricks closed on a \$500 million investment from Andreessen Horowitz and Neuralink secured \$280 million from Advaita Capital.
- A rise in activity across the AI vertical is translating to increased tenant demand. Anthropic is in negotiations to sublease 230,000 SF from Slack at 500 Howard and Hive subleased 57,000 SF from Okta at 100 First. OpenAI is in negotiations to sublease 287,000 SF from Uber in Mission Bay at 1725 Third. Adept subleased almost 36,000 from Samsara at 350 Rhode Island and Hayden.AI subleased 41,000 SF from Scribd at 460 Bryant. Humane is touring the market looking for 50,000 SF.

### VENTURE CAPITAL FUNDING INTO AI

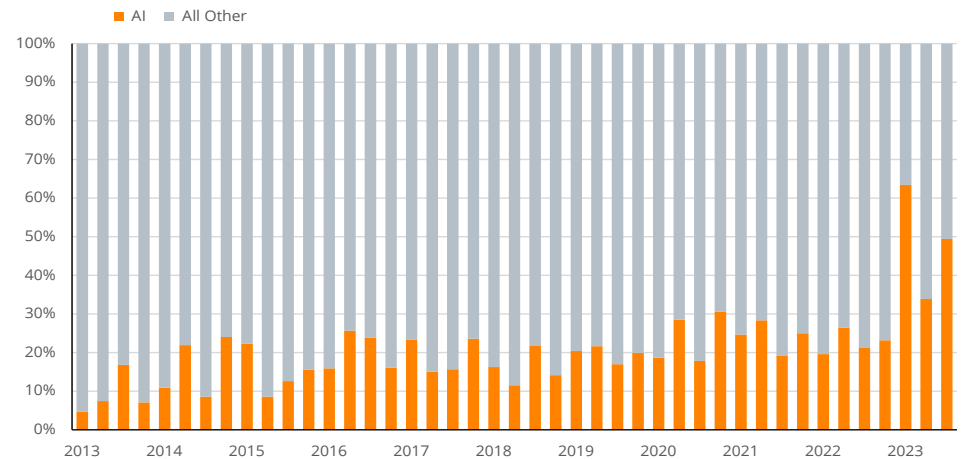
#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q3 2023

### VENTURE CAPITAL FUNDING

#### San Francisco Bay Area



Source: Transwestern, Pitchbook, Q3 2023.



## TOP LEASES

TENANT	ADDRESS	SUBMARKET	SF LEASED	INDUSTRY
ANTHROPIC	500 Howard St	South Financial District	230,000	Artificial Intelligence
QUANTCAST	795 Folsom St	Yerba Buena	45,000	Software and IT Services
HIVE	100 First St	Financial District	57,000	Artificial Intelligence
ADEPT AI	350 Rhode Island St	Showplace Square	35,834	Artificial Intelligence
YAHOO	680 Folsom St	South Financial District	35,385	Media & Internet

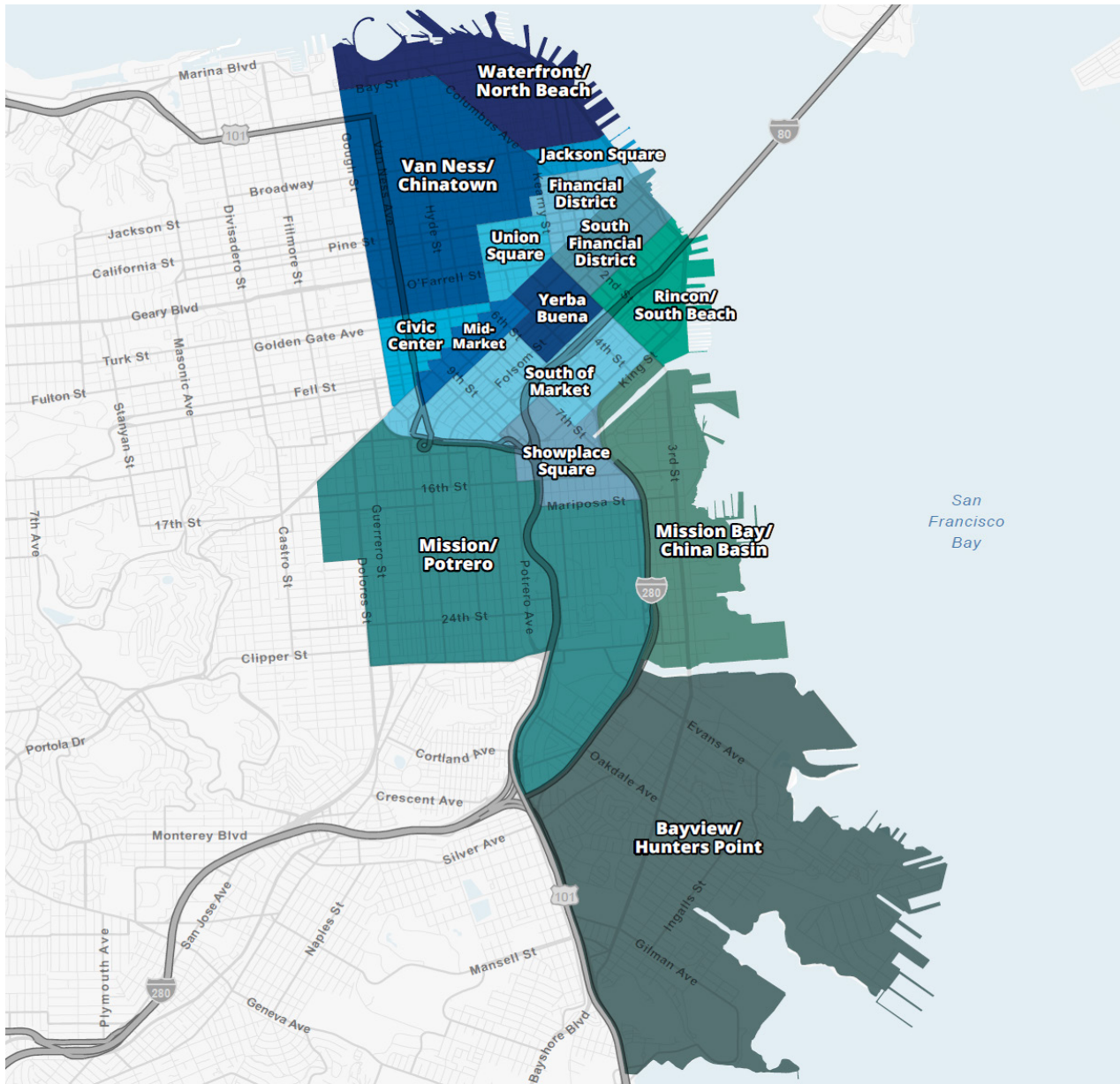
## SUBMARKET FUNDAMENTALS

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	551,819	3,910	48.9%	-2,796	350	0	\$39.92
CIVIC CENTER	343,080	2,165	55.6%	1,542	-2,523	0	\$35.33
FINANCIAL DISTRICT	29,557,674	198,279	29.3%	-631,171	-1,750,947	0	\$46.43
JACKSON SQUARE	1,710,204	57,838	30.7%	8,717	8,999	0	\$43.85
MID-MARKET	4,856,981	5,075	32.3%	-152,951	-443,262	0	\$28.92
MISSION BAY/CHINA BASIN	4,108,018	7,175	33.7%	-380,780	-648,759	0	\$39.00
MISSION/PORTRERO	1,688,087	35,088	29.4%	8,665	-152,754	0	\$40.32
RINCON/SOUTH BEACH	5,014,922	44,933	40.7%	-79,569	-574,220	0	\$40.85
SHOWPLACE SQUARE	3,442,829	2,885	43.9%	-59,927	-282,854	176,733	\$37.02
SOUTH FINANCIAL DISTRICT	23,667,958	167,539	30.6%	-498,369	-1,971,628	0	\$49.94
SOUTH OF MARKET	2,675,023	5,566	49.0%	-88,187	-446,769	51,223	\$43.72
UNION SQUARE	4,466,553	41,438	32.1%	-3,612	-75,404	0	\$45.21
VAN NESS/CHINATOWN	1,355,907	1,200	21.8%	-65,631	-92,745	0	\$46.48
WATERFRONT/NORTH BEACH	2,875,253	33,895	43.1%	-179,268	-212,260	0	\$37.62
YERBA BUENA	3,887,439	32,821	49.2%	-48,370	-232,596	0	\$43.87
<b>TOTAL</b>	<b>90,201,747</b>	<b>639,807</b>	<b>33.4%</b>	<b>-2,171,707</b>	<b>-6,312,550</b>	<b>227,956</b>	<b>\$44.02</b>

Source: Transwestern, CoStar, Q3 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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