

San Francisco Office Insight Q4 2009

Economy

Unemployment in San Francisco finally stabilized during the fourth quarter after steadily rising for more than 18 months to 10.2 percent, its highest rate in more than 20 years. San Francisco was largely hurt by the loss of professional, legal, and financial services jobs in the Central Business District. While the first half of the year felt like a virtual free-fall, economic conditions moderated over the summer with confidence to make future plans returning to healthier levels by the year-end. Though many of the jobs lost will not be replenished in the near future, the current downturn has been mild compared to the 2001 recession. Over 28,000 office jobs were lost during the 2001 recession compared to 9,600 jobs thus far.

Market Conditions

San Francisco's office market continued to struggle with rising vacancies and deteriorating fundamentals as companies further reorganized and reduced occupancy needs. Large blocks of space in the sublease and, more importantly, the direct markets challenged landlords throughout the city. With space remaining on the market an average of 22 months, landlords began to feel the strain of low occupancy levels and competition requiring them to offer lower rents and more concessions. During the quarter, Morgan Stanley announced that it would be returning to its lender five buildings that it purchased in May 2007. Though this is not the first distress the market has seen since the start of the recession, it is the largest default thus far.

The weakened market has presented tenants with great opportunity now that vacancy has risen to 15.3 percent and rents have declined by 25 percent from its 2007 peak. Ten deals totaling 872,089 square feet were completed during the fourth quarter comprising nearly 40.0 percent of total leasing activity during the year. Tenants such as Levi's, Del Monte, Medivation, and Ropes & Gray found the market to be favorable financially and took advantage of substantially lower rates in top tier Class A buildings. Though many tenants continued to act on impending lease expirations alone, the final quarter of 2009 was starkly more positive compared to the first half of the year.

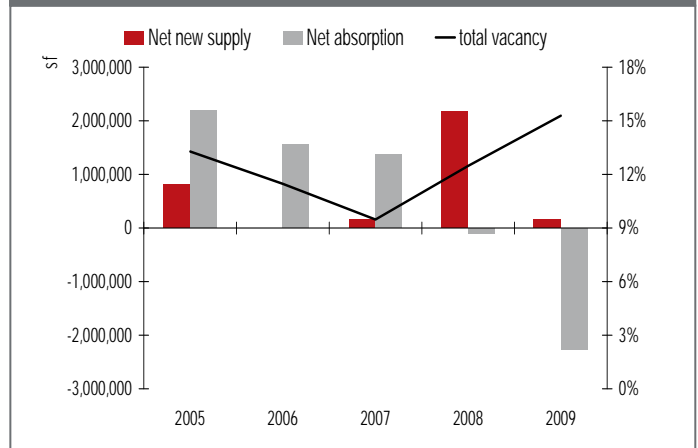
Outlook

The end of 2009 gave hope that stabilization would soon return to a market now plagued with high vacancy rates and distressed assets. Although challenging times still lay ahead for many tenants and landlords, 2010 promises to bring higher leasing volume and more stable occupancy levels. Low rental rates will persist in the office market until job growth can generate substantial absorption of vacant space; however, rental rates have most likely hit bottom.

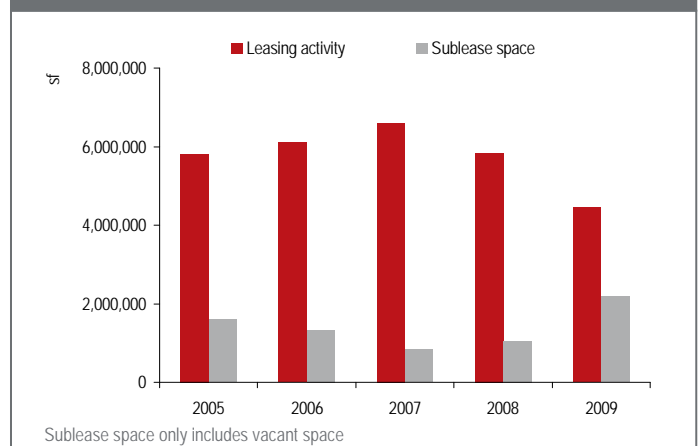
Key market indicators			12-month forecast
Supply	Supply	79,140,125 sf	▲
	Direct vacancy rate	12.5%	▲
	Total vacancy rate	15.3%	▲
	Under construction (% preleased)	305,000 (36.4%)	▼
Demand	Leasing activity 12 mo. % change	26.0%	▲
	YTD net absorption	-2,274,049 sf	▼
Pricing	12-month overall rent % change	-20.5%	▼
	Class A overall asking rent	\$35.84 psf	▼
	Class B overall asking rent	\$25.88 psf	▼

*Jones Lang LaSalle performed a year-end audit of individual building vacancies, resulting in material changes to quarterly statistics.

Net new supply, net absorption and total vacancy



Leasing activity vs. sublease vacant space

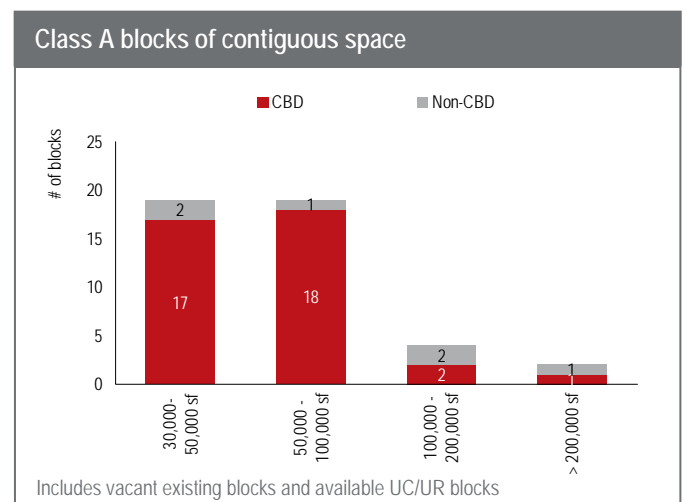
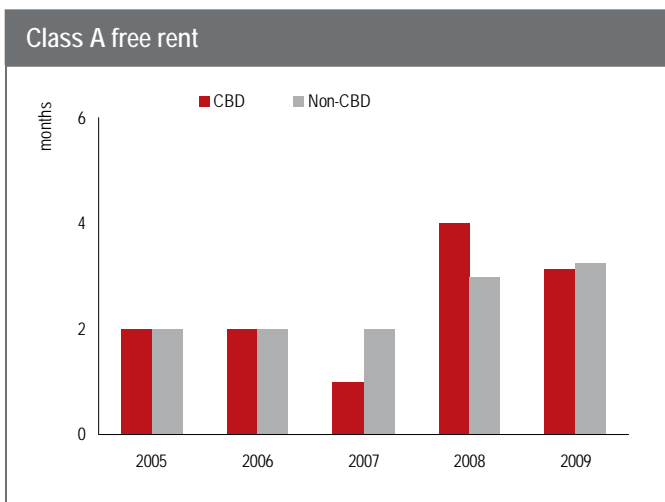
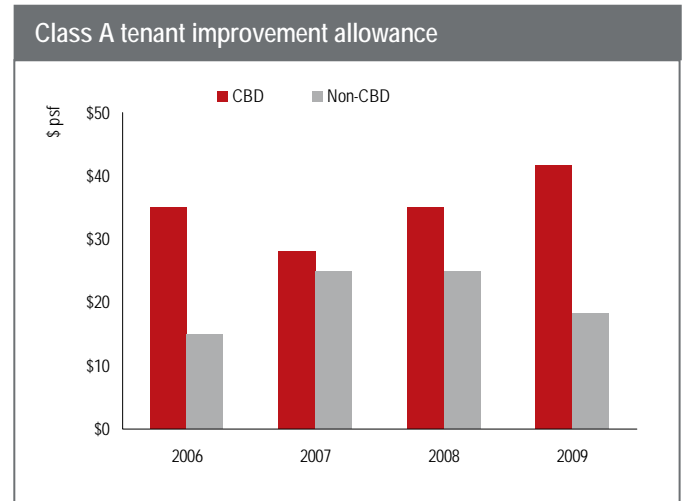
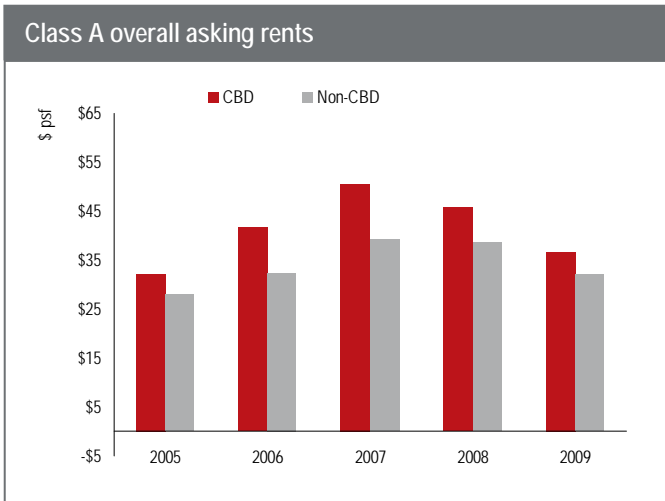


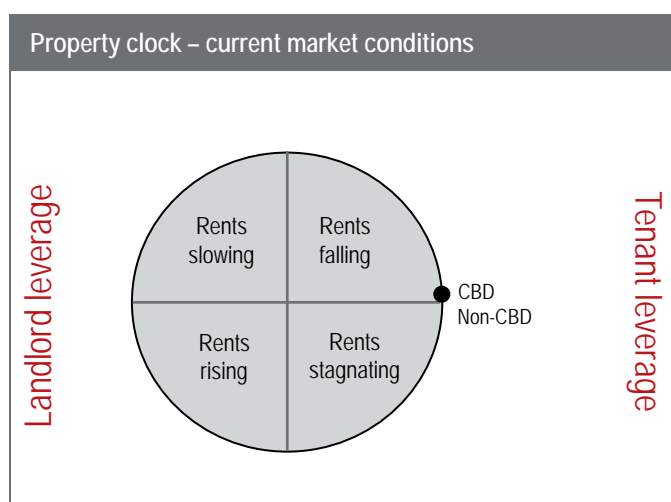
Tenant perspective

Tenants became increasingly more confident as the year came to a close. With rates dropping by 25 percent market-wide and Class A rates offering even deeper discounts, tenants that have remained financially stable during the recession realized a silver lining during this downturn. In addition to competitive rental rates, tenants are also enjoying an abundance of space options in all classes and submarkets. More than 15 million square feet were on the market at the end of 2009, representing 20.0 percent of the total inventory. Not only does this allow tenants to find the most appropriate space for their needs, but it has also given tenants greater negotiating leverage with landlords. Tenant improvement allowances in Class A buildings in the CBD have increased from an average of \$35 to \$42 per square foot. Many landlords are offering even higher improvement packages by building out the space to turnkey condition. Looking forward, tenants can expect to be met by a favorable market through 2010.

Landlord perspective

The recession has, undoubtedly, caused a severe decline in commercial real estate fundamentals. Landlords that previously commanded some of the highest rental rates in the market have been forced to consistently cut rates over the past year. While the inability to achieve high pro-forma rental rates has resulted in default for some Class A assets, others are now nearing rates that will just break even after operating expenses, tenant improvements, and commissions. Though rental rates have reached what many believe is rock bottom, it will take several quarters of positive job growth before landlords begin to see signs of meaningful rent appreciation. During the quarter, the buildings that generated the most activity were Class A assets located in the CBD. Moving into 2010 landlords will continue to face challenges presented by high vacancy and availability rates. As long as tenants have options to choose from, landlords will need to offer competitive rates, free rent periods and generous tenant improvement allowances.





Submarket leverage – market history and forecast

Submarket	2007	2008	2009	2010	2011
CBD	Landlord-favorable conditions	Landlord-favorable conditions	Tenant-favorable conditions	Tenant-favorable conditions	Balanced conditions
Non-CBD	Landlord-favorable conditions	Landlord-favorable conditions	Tenant-favorable conditions	Tenant-favorable conditions	Balanced conditions

■ Landlord-favorable conditions
 ■ Balanced conditions
 ■ Tenant-favorable conditions

Completed lease transactions

Tenant	Address	Submarket	sf	Type
Levis Strauss & Co.	1155 Battery Street	Waterfront/North Beach	354,797	Renewal
Del Monte	1 Maritime Plaza	North Financial District	152,917	New Lease
Medivation	345 Spear Street	Rincon/South Beach	63,817	New Lease
Credit Suisse	650 California Street	North Financial District	62,139	Renewal
Ropes & Gray	3 Embarcadero Center	North Financial District	50,403	New Lease
Cooper, White & Cooper	201 California Street	North Financial District	44,202	Renewal
Heald College	875 Howard Street	Yerba Buena	43,407	New Lease
Obscura Digital	2130 Third Street	Mission Bay/China Basin	36,000	New Lease
CARAT	875 Howard Street	Yerba Buena	33,291	New Lease
MarketTools, Inc.	150 Spear Street	South Financial District	31,123	Renewal

Completed sale transactions

Address	Submarket	Buyer / Seller	sf	\$ psf
49 Stevenson Street	South Financial District	Steven Pan / Invesco Real Estate	121,186	\$202
550 Terry Francois	Mission Bay/China Basin	GLL Real Estate Partners / TishmanSpeyer	283,000	\$479
120 Howard Street	South Financial District	Shorenstein Properties / Prudential Real Estate Advisors	142,819	\$170



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