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Speedy San Francisco market prepares for a slowdown in 2008

Fewer companies looking for space; transaction market to dip

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San Francisco has flirted with $100-per-square-foot rents and conjured up the boom-boom days of 2000. Now, after a four-year run-up, even the most bullish of the city's commercial real estate players are sounding a dramatically more cautious note as they look forward.

Average rents in the central business district have been stuck between $49 and $50 a square foot since July. With an unusually small number of lease expirations in 2008 and more than 3 million square feet of new and renovated space flooding the market in late 2008, observers are expecting the market to stall and sputter at least through the first six months.

Tenant demand, estimated at some 2 million square feet, is seen as weak. Brokers are tracking an unusually low number of major lease requirements in 2008, especially from the law firms that represent the backbone of the financial district. **Gibson Dunn & Crutcher LLP** is looking at 50,000 square feet. **DLA Piper Rudnick** is in the market for 100,000. Carroll, **Burdick & McDonough LLP** needs 50,000.

But the biggest law firm that was on "tenant-in-the-market" lists isn't there anymore: O'Melveny & Myers signed a deal in November at Embarcadero Center.

"There will be less activity in '08 due to the fact that we'll see fewer lease expirations," said Wes Powell, managing director with **Jones Lang LaSalle**. A large number of big deals, he added, expire in 2009 and 2010.

In addition, the credit crunch and subprime mess hammering financial firms could result in hundreds of thousands of square feet hitting the sublease market.

Anton Qiu of **TRI Commercial** sees "a challenging year" ahead. He sees Wall Street tightening its lending criteria and hard-hit banks giving up office space toward the end of 2008.

The San Francisco Business Times reported in December that **Charles Schwab** would be shifting up to 1,400 jobs out of the city. That will put as much as 400,000 square feet on the sub-market.

Mind the gap

Qiu sees 2008 as a "transition market" with a widening gap between the tenants and buyers on one side and the landlords and sellers on the other.

"The expectation gap has widened significantly and deals are hard to make," said Qiu.

The brightest spot in 2007 was technology growth, and that should persist into 2008. After deals inked by the likes of Google, Microsoft, Adobe, Yahoo, Cisco, Salesforce, Autodesk and Bebo, there is no doubt that San Francisco is increasingly a must for technology firms hungry for top talent. Deals pending in January included Expedia-owned Hotwire's 44,000-square-foot deal at 655 Montgomery St. and Microsoft-owned Razorfish's 40,000-square-foot lease at 303 Second St. Other big tenants in the marketplace include LoopNet, looking for 70,000 square feet, and eBay, reportedly seeking at least 100,000 square feet.

South-of-Market area specialist Mike McCarthy sees ongoing robust demand from tech. He sees rents rising in SoMa from the low $40 per square foot to the "mid to high $40s." McCarthy is hopeful that some of the new construction will pay off.

He sees brisk touring activity at McCarthy & Cook's newly expanded China Basin and bets 2008 will be a good year for Mission Bay developer **Alexandria Real Estate Equities**, which has approvals to build 2.2 million square feet in the growing neighborhood. In October, Alexandria expanded its marketing efforts in Mission Bay, deciding to seek technology tenants as well as biotech.

"I would expect the decision by Alexandria to broaden marketing is going to prove to be a wise one for them," he said.

Investors scarce?

Investment sales should slow to a trickle in 2008, a trend driven by tightening credit as well as the fact that the vast majority of buildings have sold at least once since 2004. A Jones Lang LaSalle report found that 83 percent of central business district buildings have traded in the past three years, and 69 percent outside of the district have sold.

A leasing slowdown, even if temporary, could test the resolve of some of the landlords who bought buildings at the peak of the investment market in the first three months of 2007. But Powell said San Francisco's economy is still "hitting on all cylinders" and new owners like **Morgan Stanley** and Broadway Partners are patient.

"All of these buyers are disciplined and well-capitalized and optimistic long term about the market," said Powell.

While 2006 and 2007 marked the return of the speculative office building in San Francisco, 2008 will represent the year these buildings will actually be delivered. In particular, Tishman Speyer's 555 Mission St. will be ready for occupancy toward the end of the year and market insiders say the developer is in serious discussions with at least one major tenant, a law firm.