# San Francisco Office Market Sees Record Absorption in Fourth Quarter

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By Meghan Hall

As a major employment, cultural and tourist hub, the City of San Francisco has one of the tightest office markets in the country and finished 2018 on a high note, according to Newmark Knight Frank's recently released 2018 Fourth Quarter Office Market Report. Commercial real estate activity continues to increase as the City faces the lowest office availability rates in over a decade, forcing tenants and brokers to think far head when considering growth strategies and space needs.

"Demand is strong, and as we're heading into 2019, [the market] is probably in a much stronger position than the last couple of years," said Newmark Knight Frank Research Director Andrea Arata. "Usually demand numbers dip at the end of the year, but we didn't see that at the end of the year. Demand is still incredibly high."

Availability rates in San Francisco hover at just 8 percent overall and 7.6 percent for Class A space. Class A vacancy fell 60 basis points to 2.8 percent, while overall vacancy dropped by 40 basis points to 3.5 percent, down from 3.9 percent in the third quarter. Class A vacancy was even tighter in the South Financial District and South of Market neighborhood — two of the city's most popular areas — where the rate dropped to 2.1 percent.

"I don't know how much more vacancy and availability can drop, but I've been saying that every quarter for the past year," said Arata of San Francisco's continuously tightening market.

San Francisco's diminishing office supply and the un-abating demand for space have created an increasingly competitive market that has ultimately impacted transaction volume. Quarterly leasing dropped to its lowest since 2016, but Arata emphasized that the San Francisco office market is still quick-moving and active.

"I think leasing was down only because there's just such a compressed market; there's fewer available spaces, so it slowed leasing down," Arata explained. "There's just as many tenants out looking for space, but it's harder to find. Brokers are busier now than they have ever been, because there's just less space, and they're having to work harder to find it."

The result has been an increase in leasing rates by 12.8 percent year-over-year to $82.4 per square foot. Companies — and brokers — are increasingly looking further into the future to get the space they need. Tenants leasing more than 50,000 square feet are paying a premium averaging nearly 10 percent, while tenants leasing more than 200,000 square feet are paying a premium of more than 20 percent, the report states.
Companies have to be on the ball if they want to secure the leases they need, said Arata. Salesforce made headlines last year when it leased Parcel F before Houston-based Hines and San Francisco-based Urban Pacific even managed to secure entitlements for the site.

"Companies have to think ahead," Arata explained. "Tenants are needing to be more creative and more aggressive for space if they know they have a long-term need for a large space."

When tenants vacate a building, the space is quickly leased up, leaving very little of what Arata termed "shadow space," a type of negative absorption. The vacancies normally left behind when tenants move are now snapped up quicker than ever, resulting in extremely high rates of positive net absorption, especially at the end of 2018.

"We wouldn't see this kind of spike [in absorption] if there was a lot of shadow space, because it would off-set new leases," said Arata. "But we're not seeing a lot. When a company is moving, their space is immediately snatched up by someone else. When you hear of a company's new lease, their previous space immediately has activity before it is being marketed."

Net absorption during the fourth quarter of 2018 closed out at 1,360,000 square feet, compared with 942,000 square feet during the third quarter. A year ago, absorption during the fourth quarter was negative 155,000 square feet, and the end of 2016 posted a similar number. According to Newmark Knight Frank the fourth quarter 2018 posted the highest level of end of year absorption since at least the fourth quarter of 2010. Only in 2015 did net absorption surpass 1,000,000 square feet.

“A couple of years ago when we were projecting out, we didn’t expect to see this much positive absorption,” said Arata. “We’re at a level of demand that we haven’t seen in a really long time.”