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San Francisco Real Estate Market: The City, the Peninsula and the East Bay

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SAN FRANCISCO REAL ESTATE MARKET:
THE CITY, THE PENINSULA AND THE EAST BAY

BY

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SAN FRANCISCO REAL ESTATE MARKET:
THE CITY, THE PENINSULA AND THE EAST BAY

by

Kenneth T. Rosen
The University of California at Berkeley

Susan Jordan
Salomon Brothers Inc

Working Paper No. #88-152
November, 1988

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ABSTRACT

In this report, we evaluate the history and prospects for the economy of and real estate markets in the San Francisco Bay Area, California. We focus on the city of San Francisco, the San Mateo Peninsula and the East Bay. A future report will examine the San Jose/Silicon Valley real estate market.
San Francisco Real Estate Market: 
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INVESTMENT SUMMARY

The San Francisco Bay Area has adjusted to the corporate restructurings of 1983-86 and is poised to reassert its economic strength. In the year ended July 1988, the Bay Area region grew by 2.6% -- on par with the Los Angeles region. During this period, the region gained 71,000 jobs -- more than in any other year this decade except 1984.

The employment growth rate is increasing in both the San Francisco and San Jose metropolitan areas, which added 19,000 jobs and 17,000 jobs, respectively, in the past year. Job growth has slowed in the Bay Area’s other large metropolitan area, Oakland-East Bay, but is still outpacing San Francisco and San Jose. The Oakland-East Bay Primary Metropolitan Statistical Area (PMSA) added 25,000 jobs in the past year.

The Bay Area’s strong economic performance is reflected in the accelerating population growth in the past few years. A nearly 300,000 increase in the Asian population since 1980 is a strong positive force for the future of the Bay Area.

The turnaround in economic growth in San Francisco and San Jose follows a very weak economic performance in the mid-1980s. The city of San Francisco had until 1986 shown virtually no growth in office sector jobs and had actually lost 5,000 Finance, Insurance and Real Estate (FIRE) jobs in the 1980-86 period. San Jose also experienced a poor economy in the mid-1980s, losing
8,000 jobs in the 1985-86 period.

To retain its position as an international financial and commercial center, San Francisco must address the inevitable limit that its severe cap on office construction will place on employment growth in the next decade. Through the early 1990s, the Downtown Plan and Proposition M will sharply reduce the Financial District Class A vacancy rate from its current 13.5% level, which could enable rents to increase substantially to their peak 1982-83 levels.

The scarcity of affordable housing, reflected in a median single-family home price of $216,000, is also a constraint -- which is shared by many other California and East Coast metropolitan areas -- on the future growth of the Bay Area.

Investment values remain exceptionally strong in the top tier of the San Francisco Financial District office market. Indicative capitalization rates for prime Class A buildings are in the 5.5%-7% range. These buildings were not affected substantially by the relocation to the suburbs of large back-office users faced with high rents and a lack of expansion space in 1984-85. The trend toward out-migration has reversed, and rents are rising as the vacancy rate declines.

About 54% -- 57 million square feet -- of the metropolitan area office inventory is located in the suburbs. Almost 20 million square feet have been added to the East Bay's Interstate 680 Corridor in this decade. Growth in this corridor has slowed dramatically because of vacancy rates in the 20%-30% range, growth control initiatives and traffic congestion. Oakland is
experiencing a moderate resurgence, and its relatively low
vacancy rate, proximity to San Francisco and development
incentives will support continued growth.

The industrial market is primarily warehouse and
distribution oriented, with vacancy rates in the 8%-10% range.
Consistent with the national situation, research and
development/flex space is approximately 25% vacant. High land
costs have contributed to declining construction in the 1987-88
period, and the relocation of industrial users to lower-cost
outlying areas has recently sparked activity in the North Bay and
in California's Central Valley. Capitalization rates for quality
warehouse/distribution and light manufacturing product are 7.5%-8.5%.

The retail property market is relatively balanced, with
generally low vacancies, high sales productivity and average
square footage per capita. Slower though steady sales growth will
constrain near-term rent growth, but strong demand for well-
located retail product will maintain indicative capitalization
rates in the 7.5%-8% range for neighborhood centers, 8.5%-9% for
strip centers and 5.5%-6.5% for regional malls.

The apartment market remains a seller's market in the post-
syndication era, with capitalization rates in the 7%-8% range for
prime quality product. Occupancy is improving, and rents are
recovering from the 1984-86 construction boom. High home prices
will sustain strong apartment demand, while land constraints will
limit supply.
ECONOMIC OVERVIEW

San Francisco is one of the world's leading commercial and financial centers, as well as one of the most physically attractive cities. It is well-known internationally for its high quality of life, natural resources and mild weather, low levels of air pollution, and striking architecture, which make it one of the most desirable locations to live and work. San Francisco is in the heart of the Bay Area, a nine-county metropolitan region, which includes San Jose, Palo Alto and Cupertino to the south; Oakland, Walnut Creek and the I-680 Corridor to the east; and Marin, Santa Rosa, Vallejo, Napa, and Sonoma to the north (see Figure 1). With a population of 5.8 million and 2.8 million jobs, the Bay Area is the fourth-largest metropolitan area in the nation.

The Bay Area economy has expanded at a sustainable pace of 2% annually, adding roughly 50,000 jobs per year thus far in the 1980s (see Figure 2). Except for 1986, when a recession in Silicon Valley and a wave of mergers, acquisitions and restructurings in San Francisco caused slow employment growth, the Bay Area economy has grown at about the same pace as that of the United States. Over the past year, growth in the Bay Area has accelerated, with 71,000 jobs gained in the July 1987-88 period. In percentage terms, growth in the Bay Area is now on par with growth in the Los Angeles region, which outpaced the Bay Area in the 1985-86 period.

The Bay Area economy is about half the size of the Los Angeles region economy, which has six million jobs. A popular
Figure 2. Bay Area and California Economic Performance, 1972-Jul 88
(Annual Employment Growth; Pct. Rate and Absolute Change in Jobs in Thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Bay Area Regiona</th>
<th>San Francisco PMSA</th>
<th>Oakland PMSA</th>
<th>San Jose PMSA</th>
<th>Los Angeles Regionb</th>
<th>California</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate</td>
<td>Jobs</td>
<td>Rate</td>
<td>Jobs</td>
<td>Rate</td>
<td>Jobs</td>
</tr>
<tr>
<td>1972-80</td>
<td>4.0%</td>
<td>80.2</td>
<td>2.9%</td>
<td>22.3</td>
<td>2.7%</td>
<td>16.2</td>
</tr>
<tr>
<td>1981</td>
<td>1.4%</td>
<td>34.0</td>
<td>1.3%</td>
<td>11.4</td>
<td>0.5%</td>
<td>3.2</td>
</tr>
<tr>
<td>1982</td>
<td>-0.7%</td>
<td>-34.0</td>
<td>-1.7%</td>
<td>-11.4</td>
<td>-1.4%</td>
<td>-3.2</td>
</tr>
<tr>
<td>1983</td>
<td>1.8%</td>
<td>42.9</td>
<td>0.0%</td>
<td>0.4</td>
<td>2.2%</td>
<td>14.9</td>
</tr>
<tr>
<td>1984</td>
<td>5.8%</td>
<td>145.3</td>
<td>3.4%</td>
<td>30.0</td>
<td>6.2%</td>
<td>42.8</td>
</tr>
<tr>
<td>1985</td>
<td>2.5%</td>
<td>65.1</td>
<td>1.7%</td>
<td>15.0</td>
<td>4.4%</td>
<td>32.1</td>
</tr>
<tr>
<td>1986</td>
<td>0.6%</td>
<td>26.1</td>
<td>0.2%</td>
<td>2.1</td>
<td>2.5%</td>
<td>19.4</td>
</tr>
<tr>
<td>1987</td>
<td>2.3%</td>
<td>62.1</td>
<td>1.3%</td>
<td>11.6</td>
<td>3.2%</td>
<td>24.8</td>
</tr>
<tr>
<td>1988c</td>
<td>2.6%</td>
<td>71.1</td>
<td>2.0%</td>
<td>18.5</td>
<td>3.1%</td>
<td>24.9</td>
</tr>
<tr>
<td>1981-88</td>
<td>2.0%</td>
<td>53.3</td>
<td>0.9%</td>
<td>8.6</td>
<td>2.7%</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Other PMSAs in the Bay Area

<table>
<thead>
<tr>
<th></th>
<th>Santa Rosa Rate</th>
<th>Vallejo Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972-80</td>
<td>6.4%</td>
<td>4.3%</td>
</tr>
<tr>
<td>1981-88</td>
<td>4.3%</td>
<td>3.8%</td>
</tr>
<tr>
<td>1988</td>
<td>4.0%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

a San Francisco, San Mateo, Marin, Alameda, Contra Costa, Santa Clara, Sonoma, Solano, and Napa Counties.
b Los Angeles, Orange, Riverside, San Bernardino, and Ventura Counties.
c 12 months ended Jul 88.
misperception portrays the Bay Area in decline relative to Los Angeles. In fact, in terms of total employment, there has been virtually no decline in the Bay Area relative to Los Angeles over the past 13 years (see Figure 3). The Bay Area has experienced a relative decline in its share of FIRE employment from 59.3% of Los Angeles FIRE employment in 1975 to 51.7% in 1988. In part, this reflects a net loss of 5,000 FIRE jobs in the city of San Francisco in the 1980-86 period. In our view, the change in share of FIRE employment is due to the restructuring of the banking industry in San Francisco and reflects a natural rebalancing of the two economies.

Like most metropolitan areas, the economic base of the Bay Area has shifted since the 1970s from goods production toward office-intensive, service-oriented activities and high technology research and manufacturing. International trade -- spurred by the Bay Area's excellent harbors and long-standing relationship with the Far East -- as well as the legal, finance, engineering, and real estate sectors, have been growing especially fast. Future economic growth is projected to occur primarily in the service, retail, international trade, FIRE, and biotechnology sectors.

Relatively low unemployment rates throughout the Bay Area, as well as high labor force participation rates, reflect the strength of the region's economy. As of July 1988, the Bay Area unemployment rate was 4.8%, compared with 5.4% nationally. Although unemployment in the Bay Area is lower than the national average, it has not reached the near record lows of the Northeast where the labor supply is so tight that additional job growth is
Figure 3. Bay Area versus Los Angeles Region — Relative Size of Employment Base, Jul 75-Jul 88 (Jobs in Thousands)

<table>
<thead>
<tr>
<th></th>
<th>Bay Area Region&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Los Angeles Region</th>
<th>Bay Area as Pct. of Los Angeles</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Jobs</td>
<td>Total Jobs</td>
<td></td>
</tr>
<tr>
<td>Total Nonagricultural Employment</td>
<td>1,947</td>
<td>3,998</td>
<td>48.7%</td>
</tr>
<tr>
<td></td>
<td>2,838</td>
<td>6,036</td>
<td>47.0%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>356</td>
<td>979</td>
<td>36.4</td>
</tr>
<tr>
<td></td>
<td>486</td>
<td>1,277</td>
<td>38.1</td>
</tr>
<tr>
<td>FIRE</td>
<td>137</td>
<td>231</td>
<td>59.3</td>
</tr>
<tr>
<td></td>
<td>219</td>
<td>424</td>
<td>51.7</td>
</tr>
<tr>
<td>Services</td>
<td>405</td>
<td>823</td>
<td>49.2</td>
</tr>
<tr>
<td></td>
<td>752</td>
<td>1,542</td>
<td>48.8</td>
</tr>
</tbody>
</table>

<sup>a</sup> San Francisco, San Mateo, Marin, Alameda, Contra Costa, Santa Clara, Sonoma, Solano, and Napa Counties.

<sup>b</sup> Los Angeles, Orange, Riverside, San Bernardino, and Ventura Counties.

inhibited. The Bay Area’s labor force is among the best-educated in the United States. One fourth of the region’s population 25 years old or older had finished four or more years of college in 1980, compared to 17% nationwide.¹

San Francisco Metropolitan Area residents enjoy the second-highest per-capita income in the United States -- 60% above the national average. However, Bay Area residents as a group, and San Francisco households in particular, bear a disproportionate economic burden for homeownership. The median sales price of an existing single-family home has soared in the past decade, making the Bay Area the third most expensive housing market in the nation (see Figure 4). By August 1988, the median price was more than $216,000, implying that less than 12% of households in the Bay Area could afford to buy the median-priced single-family home. Prices are higher in San Francisco and San Mateo counties, which are not included in the survey. The shortage of affordable housing will influence location decisions of large employers and may constrain the Bay Area’s growth.

Employment Trends

The Bay Area comprises five PMSAs -- Oakland, San Francisco, San Jose, Santa Rosa, and Vallejo. The three largest -- Oakland (830,000 jobs), San Francisco (950,000 jobs) and San Jose (800,000 jobs) -- each have a different economic specialization (see Figure 5). The San Francisco PMSA is primarily a finance and professional service economy, although San Mateo County is a major transportation center and has developed a biotechnology base. The East Bay, or Oakland PMSA, has a transportation and
Figure 4. Median Price of an Existing Single-Family Home in the Bay Area\textsuperscript{a} and the United States, 1982-Aug 88

\textsuperscript{a} Excludes San Francisco and San Mateo counties.
Source: National Association of Realtors.
Figure 5. Employment Concentrations -- Major Bay Area PMSAs versus the United States, Dec 87

<table>
<thead>
<tr>
<th>Employment Sector</th>
<th>San Francisco PMSA</th>
<th>Oakland/East Bay PMSA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>San Francisco</td>
<td>San Mateo</td>
</tr>
<tr>
<td>Total Jobs (Thousands)</td>
<td>572.6</td>
<td>288.7</td>
</tr>
<tr>
<td>Office Intensive</td>
<td>30.4%</td>
<td>17.5%</td>
</tr>
<tr>
<td>FIRE</td>
<td>14.3</td>
<td>7.2</td>
</tr>
<tr>
<td>Business Services</td>
<td>9.4</td>
<td>7.9</td>
</tr>
<tr>
<td>Legal, Engineering and Accounting</td>
<td>6.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Services</td>
<td>32.3%</td>
<td>25.6%</td>
</tr>
<tr>
<td>Office Intensive</td>
<td>16.2</td>
<td>10.3</td>
</tr>
<tr>
<td>Nonoffice Intensive</td>
<td>16.2</td>
<td>15.3</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>20.0%</td>
<td>27.8%</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>5.8</td>
<td>8.1</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>14.2</td>
<td>19.7</td>
</tr>
<tr>
<td>Transportation and Pub. Utilities</td>
<td>7.0%</td>
<td>12.1%</td>
</tr>
<tr>
<td>Transportation</td>
<td>3.7</td>
<td>10.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7.4%</td>
<td>11.4%</td>
</tr>
<tr>
<td>Construction and Mining</td>
<td>3.1%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Government</td>
<td>15.9%</td>
<td>11.0%</td>
</tr>
</tbody>
</table>

a County data is only available on a December basis. b Includes Marin County, not shown. c Includes Santa Rosa and Vallejo PMSAs, not shown. NA Not available. Sources: U.S. Bureau of Labor Statistics, the WEFA Group and California Employment Development Department.
distribution-based service-oriented economy in Alameda County and concentrations of office employment in both Contra Costa and Alameda counties. San Jose (Santa Clara County), or Silicon Valley, is well-known as a high technology center.

In keeping with national suburbanization trends, the suburban PMSAs of the Bay Area are growing more rapidly than the San Francisco urban core. Thus, overall, the urban core is declining in importance relative to the suburban areas. Specifically, the San Francisco PMSA's share of total Bay Area employment has fallen from 40% in 1972 to 34% in 1988, while the San Jose PMSA's share has increased from 22% to 28%. After declining slightly during the 1970s, Oakland has regained its 29% share of the total; within the Oakland PMSA, growth in the suburban corridors of Contra Costa has outpaced growth in the urban areas of Alameda County.

The post-recession restructuring of the San Francisco PMSA's employment base included absolute gains in trade and services, with declines in manufacturing, transportation and public utilities and banking. Over the past four years, the San Francisco PMSA grew at an average rate of 1.2% with a net gain of 45,000 jobs. The service sector was responsible for most of this gain. With a growth rate of 4% per year, services employment grew by 43,000, accounting for 95% of the total net gain. The wholesale and retail trade sector added 11,300 new jobs. The FIRE sector, despite the city of San Francisco's losses in banking employment, was stable. In contrast, manufacturing decreased at an average rate of 2%, losing 6,600 jobs, and transportation and public utilities declined by 2.8% per year, losing 9,300 jobs.
Over the past year, the San Francisco PMSA has shown some of its best growth in the decade, adding 18,500 jobs.

The city of San Francisco is a headquarters location for many finance, transportation and manufacturing companies, as well as for Government agencies. San Francisco is dominated by services with 32% of the total jobs and by FIRE with 14% of total jobs. An estimated 30% of San Francisco's jobs is office jobs, making San Francisco more than twice as office intensive as the nation.

As Figure 6 shows, the FIRE sector experienced an absolute decline in employment of more than 5,000 jobs in the 1980-86 period. The banking sector has been hurt significantly over the past few years, with the most publicized losses being the staff cutbacks associated with the Bank of America's loan losses and its cost-cutting efforts, the acquisition of Crocker Bank by Wells Fargo and the relocation of many back-office bank employees to Contra Costa County. The job loss appears to have bottomed in 1986, and we expect this sector to show some recovery in 1988. As California moves toward reciprocal interstate banking in 1991, employment in banking should increase in the 1990s. In addition, major investment banks and numerous foreign banks have a strong presence in San Francisco.

The city has the highest number of attorneys per capita in California and at least eight firms with more than 100 attorneys. All of the "Big Eight" accounting firms have regional headquarters in San Francisco. Fostered by the growth of Pacific Rim trading, heavy merger and acquisition activity, technology-
Figure 6. San Francisco City and County Office-Intensive Employment, 1980-88E (December Data, Jobs in Thousands)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total FIRE</td>
<td>87.3</td>
<td>90.3</td>
<td>88.2</td>
<td>84.5</td>
<td>83.8</td>
<td>85.2</td>
<td>81.8</td>
<td>81.8</td>
<td>83.0</td>
</tr>
<tr>
<td># Finance</td>
<td>48.4</td>
<td>52.2</td>
<td>52.1</td>
<td>52.7</td>
<td>52.6</td>
<td>53.0</td>
<td>49.6</td>
<td>48.7</td>
<td>49.0</td>
</tr>
<tr>
<td># Insurance</td>
<td>29.1</td>
<td>28.2</td>
<td>25.9</td>
<td>21.4</td>
<td>20.4</td>
<td>20.8</td>
<td>20.5</td>
<td>21.2</td>
<td>21.5</td>
</tr>
<tr>
<td># Real Estate</td>
<td>9.8</td>
<td>9.9</td>
<td>10.2</td>
<td>10.4</td>
<td>10.8</td>
<td>11.4</td>
<td>11.7</td>
<td>11.9</td>
<td>12.5</td>
</tr>
<tr>
<td>Business Services</td>
<td>41.0</td>
<td>46.4</td>
<td>39.1</td>
<td>44.3</td>
<td>45.9</td>
<td>46.5</td>
<td>50.7</td>
<td>53.6</td>
<td>57.0</td>
</tr>
<tr>
<td>Legal Services</td>
<td>10.3</td>
<td>11.1</td>
<td>11.5</td>
<td>12.5</td>
<td>13.7</td>
<td>15.1</td>
<td>16.5</td>
<td>18.5</td>
<td>20.5</td>
</tr>
<tr>
<td>Engineering/Accounting</td>
<td>23.6</td>
<td>25.3</td>
<td>26.3</td>
<td>23.9</td>
<td>23.6</td>
<td>21.9</td>
<td>20.4</td>
<td>20.4</td>
<td>21.0</td>
</tr>
<tr>
<td>Total Office</td>
<td>162.2</td>
<td>173.1</td>
<td>165.1</td>
<td>165.2</td>
<td>167.0</td>
<td>168.7</td>
<td>169.4</td>
<td>174.3</td>
<td>181.5</td>
</tr>
</tbody>
</table>

E Salomon Brothers Inc estimate.
Sources: California Employment Development Department and Salomon Brothers Inc.
related legal issues, and the importance of legal specialization, the legal services and accounting sectors are expected to maintain their long-term growth trend. Legal and business services together account for 85% of the estimated total office job gain in the 1986-88 period. While FIRE employment has been flat in the past two years, business services has gained approximately 6,000 jobs, with average growth of 6% per year. Similarly, strong growth averaging 10% annually has occurred in legal services with the addition of 4,000 jobs over the two-year period.

In the transportation and public utilities sector, communications employment has declined for several years, mainly reflecting Pacific Telesis's relocation of many workers to Contra Costa County. Convention and tourism activity is a major source of service and retail trade employment in San Francisco. Overnight visitors spent $1.7 billion in the city in 1987, a 7% increase from 1986. Future convention business growth will be supported by a major expansion of the Moscone Convention Center, to be completed by 1992.

Benefiting from its prime location between San Francisco and Silicon Valley, San Mateo County has a diverse economy with a mix of services, trade and manufacturing. With the San Francisco International Airport and associated transportation and distribution services as well as several communications and utilities firms located in the county, 12% of San Mateo's employment base is in transportation and public utilities, compared with 5% for the nation. Continuing expansion of air transportation, as well as increases in trucking facilities, will
fuel growth in many industries that rely on transportation services, including wholesale trade. After several years of employment declines, San Mateo’s small manufacturing sector gained jobs in 1987, and growth is expected to continue. Growth should be particularly strong in the chemicals and allied products sector, which includes the fast-growing biotechnology industry. Genentech Inc., the world’s largest biotechnology firm, is based in South San Francisco.

With 840,000 jobs, the Oakland PMSA -- comprising the East Bay counties of Alameda and Contra Costa -- has the second-largest employment base in the Bay Area. Of the three large PMSAs, it has grown the fastest over the past four years, posting an average annual growth of 3.3%, compared with 1.9% for the entire Bay Area, 1.2% for San Francisco and 0.6% for San Jose. Alameda County accounts for two thirds of the jobs in the East Bay, but has been losing share to Contra Costa County. Although growth in Contra Costa has slowed from the earlier boom years, its growth still outpaces that of Alameda, and it will continue to gain share from Alameda because it has more land and attractive suburban locations.

Alameda County has grown by 1.9% annually in the 1980s, representing 10,000 jobs per year. Alameda County’s employment base is 30% more Government intensive than the nation’s employment base, reflecting the University of California’s headquarters and regional Government offices in Oakland. With the Port of Oakland, Oakland International Airport and a majority of the Bay Area’s warehouse and distribution facilities on its I-880
Corridor, Alameda is 20% more concentrated in transportation and public utilities than is the nation.

Contra Costa County has increased by 3.9% annually in the 1980s, representing 9,000 jobs per year. Contra Costa’s employment base is 50% more concentrated in FIRE than the U.S. employment base, reflecting the emigration of San Francisco office jobs in the mid-1980s. Pacific Telesis’s facility and distribution operations located on the I-680 Corridor contribute to transportation and public utilities concentration that is 50% more intensive than the nation’s.

The San Jose PMSA, defined as Santa Clara County, is known primarily as a leading center of high technology and accounts for 28% of all the nonagricultural jobs in the Bay Area. Although high technology industries enjoyed several boom periods over the past two decades, the industry experienced a recession in 1985-86 and lost more than 14,000 jobs. Positive growth has resumed in 1987 and is expected to continue, benefiting from the national manufacturing recovery. Nearly 17,000 jobs were added in the past year. With 33% of its employment base in manufacturing, San Jose is almost twice as manufacturing intensive as the nation. Employment in electric and electronic equipment manufacturing accounts for almost 13% of total nonagricultural employment, making high technology manufacturing more than six times as concentrated as it is in the nation, which has only 2.0% of total employment in this sector. Transportation-related employment will surge with American Airlines’s development of a major West Coast hub at San Jose International Airport, commencing December of this year.
Population Trends

With 5.8 million people, the Bay Area accounts for 21% of the state's population. Population growth accelerated from 1.1% in the 1970s to 1.4% in the 1980s, but still lags the 2.2% annual statewide growth. Two North Bay counties have grown the fastest, with Solano County posting a 3.2% annual gain in the 1980-87 period and Sonoma growing at 2.3% per year, reflecting the affordability of housing and a spillover of growth from Contra Costa County. The East Bay counties, Contra Costa and Alameda, had the next fastest growth at 1.7% and 1.5%, respectively.

Population growth trends in the Bay Area's two most densely populated counties have reversed in this decade. After declining in the 1970s, San Francisco County's population has been growing at a 1.1% annual rate since 1980. In contrast, population growth in Santa Clara County has slowed from 2.0% annually in the 1970s to 1.3% during the 1980s.

The Bay Area has become a magnet for Pacific Rim migrants. The Asian ethnic groups grew at 6.7% annually in the 1980-87 period, increasing from 10% of the population in 1980 to 14% in 1987 (see Figure 7). With the addition of 290,000 people, the Asian population is a strong positive force in the growth of the Bay Area.

San Francisco has a tradition of tolerance for different cultures and life-styles and has long been known for its highly visible gay community. That group has been hit hard by the AIDS (Acquired Immune Deficiency Syndrome) crisis. About 4% (30,000 people) of the city's residents is believed to be infected with
### Figure 7. Bay Area Population Growth by Ethnic Group, 1980-87
(Population in Thousands)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian and Other&lt;sup&gt;a&lt;/sup&gt;</td>
<td>508.7</td>
<td>800.0</td>
<td>14.1%</td>
<td>6.7%</td>
<td>291.3</td>
<td>57.2%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>632.5</td>
<td>780.3</td>
<td>13.7%</td>
<td>3.0%</td>
<td>147.8</td>
<td>29.0</td>
</tr>
<tr>
<td>Non-Hispanic White</td>
<td>3,579.2</td>
<td>3,628.4</td>
<td>63.8%</td>
<td>0.2%</td>
<td>49.2</td>
<td>9.7</td>
</tr>
<tr>
<td>Black</td>
<td>459.3</td>
<td>480.7</td>
<td>8.4%</td>
<td>0.7%</td>
<td>21.4</td>
<td>4.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5,179.7</strong></td>
<td><strong>5,689.4</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>1.4%</strong></td>
<td><strong>509.7</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

<sup>a</sup> Other includes Pacific Islander, Native American and Eskimo.

Sources: California Department of Finance; California Population Characteristics, Regional Market Update and Projections, 1988 Edition, published by the Center for Continuing Study of the California Economy; and Center for Real Estate and Urban Economics, University of California, Berkeley.
the AIDS-causing human immunodeficiency virus, and 3,000 have already died. San Francisco’s caring and cost-effective response is considered a model for cities throughout the world. The city spent $24 million, including $10 million of local revenues, for AIDS-related services last year. Substantial continued Federal assistance will be needed to cover costs in the future.

Topography has shaped the Bay Area’s development, with commercial construction concentrated in the flat corridors and exclusive residential development in the hills. The most heavily developed corridors are those closest to the Bay — Highway 101 on the Peninsula and I-880 in the East Bay. The wave of suburban development that began in the late 1970s and accelerated during the 1980s pushed beyond the East Bay’s first range of hills into the I-680 Corridor. The availability of executive housing in many suburban areas has supported the growth of office nodes. However, because of the intense development around the Bay, most of the affordable housing is east of the I-680 Corridor and in the North County areas.

The linkages between the Bay Area’s major bridges and its highway system are incomplete, and there are often traffic bottlenecks on both sides of the Golden Gate and Bay Bridges at rush hour. Traffic congestion has not reached the critical level straining the Los Angeles region’s road system, in part because of more compact nodes of development. In addition, the Bay Area — unlike Los Angeles — has an extraordinary regional mass transit system that consists of rail and an extensive bus system, including AC Transit and SamTrans. Since 1972, the Bay Area Rapid
Transit (BART) modern passenger electric rail system has linked cities and towns in Alameda and Contra Costa to San Francisco. BART ridership is nearly 205,000 per day, and major expansions of the BART system are planned. Planned extensions would add 10 stations in San Mateo, Alameda and Contra Costa counties in the next decade. BART is linked to MUNI, a trolley-type subway system serving the city of San Francisco.

The Bay Area has three international airports -- San Francisco, Oakland and San Jose -- with San Francisco's airport handling 75% of passenger volume. San Francisco International is the nation's sixth-busiest airport and the third-largest origin and destination airport in the United States, with 55 airlines providing direct service to more than 90 domestic cities and 50 international destinations. It is also a major cargo airport, ranked sixth in the United States in terms of air cargo tonnage.

The Port of Oakland and its excellent rail and highway connections form the foundation of the Bay Area's role in intermodal shipment across the United States and the globe. The Oakland-San Francisco ports handled 5.5 million metric tons of liner cargo in 1987, compared with 16.3 million and nine million for Los Angeles-Long Beach and Seattle-Tacoma, Washington, respectively. Three mainline railroads -- Santa Fe, Southern Pacific and Union Pacific -- have their western terminus in close proximity to the Oakland Waterfront. I-80, a major cross-country route, terminates in San Francisco, but I-5, the main north-south highway of the coastal states, bypasses the Bay Area, passing through Sacramento.
The Port of San Francisco handles only about a quarter of the total cargo tonnage volume of Oakland, but it is the leading wholesale fish receiving and distributing port on the West Coast (outside Alaska), the dominant ship repair base in northern California and a popular port of call with cruise passengers.

Seismic Risk

San Francisco is a seismically active area -- the San Andreas Fault bisects the San Mateo Peninsula; the Hayward Fault runs along the base of the East Bay’s Foothills; and at least eight more active fault systems pervade the region. San Francisco has not experienced a major earthquake since 1906. Since then, several moderate earthquakes have caused only minor damage.

Building codes were revised in California following a midsized earthquake in 1971 and now are the most stringent in the nation. As a result, modern buildings are expected to withstand a major earthquake, just as they did in Mexico City’s 1985 quake. Still, pre-World War II buildings pose a significant hazard. Because earthquake insurance premiums typically equal 1% of the structure’s value, most commercial buildings have no coverage and some have limited coverage.

OFFICE MARKET

San Francisco

San Francisco’s office market contains more than 48 million square feet of Class A and Class B office space, excluding six million square feet of owner-occupied and single-tenant space. ³
Approximately 36 million square feet are in the Financial District, bounded by The Embarcadero to the east, Washington Street to the north, Kearny Street to the west and Folsom Street to the south (see Figures 8 and 9). The core of the district was historically north of Market Street, but there are now several Class A projects along Mission Street. Addresses on California and Montgomery streets are considered the most prestigious in the city.

Comprising approximately 57 square city blocks, the Financial District core is the most compact and dense concentration of office space in the western United States. The compact downtown provides a range of amenities, from first-class restaurants and retail shops to world-class hotels, all of which contribute to one of the more attractive and high-quality working environments in the world. Fourteen Fortune 500 Industrial and Service companies, including Chevron, Pacific Gas & Electric, Transamerica, Pacific Telesis and McKesson, are headquartered in San Francisco. The City is also home to Bechtel and Levi Strauss Corporation.

As a center for national and international finance, San Francisco’s largest space-user group is the banking industry, with FIRE users as a whole occupying nearly 42% of office space in San Francisco. More than 75 major banks are located in San Francisco, as well as the headquarters of five of California’s ten largest banks, including the world headquarters of Bank of America, Wells Fargo Bank and Bank of California, and regional headquarters of Security Pacific National Bank, First Interstate Bank and Citicorp. The Pacific Stock Exchange, the Federal
### Figure 8. San Francisco Central Business District Office Market, Jul 88-Jul 90P (Square Feet in Millions)

<table>
<thead>
<tr>
<th></th>
<th>Existing Class A and B Inventory</th>
<th>Vacancy Rate</th>
<th>Under Const. Jul 88</th>
<th>Absorption Forecast&lt;sup&gt;b,c&lt;/sup&gt;</th>
<th>Vacancy Forecast&lt;sup&gt;c&lt;/sup&gt; Jul 90P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial District</td>
<td>36.3</td>
<td>14.5%</td>
<td>1.2</td>
<td>1.0</td>
<td>11.9%</td>
</tr>
<tr>
<td># Class A</td>
<td>31.5</td>
<td>13.8</td>
<td>1.2</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td># Class B</td>
<td>4.7</td>
<td>19.1</td>
<td>0</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Other</td>
<td>12.1</td>
<td>17.1%</td>
<td>1.0</td>
<td>0.3</td>
<td>18.7%</td>
</tr>
<tr>
<td><strong>Total San Francisco</strong></td>
<td><strong>48.4</strong></td>
<td><strong>15.1%</strong></td>
<td><strong>2.2</strong></td>
<td><strong>1.3</strong></td>
<td><strong>13.7%</strong></td>
</tr>
</tbody>
</table>

<sup>a</sup> We do not expect projects not yet under construction to be completed by midyear 1990.  
<sup>b</sup> Average annual rate.  
<sup>c</sup> Assumes no recession in the forecast period.  

Sources: Cushman & Wakefield, Coldwell Banker and Salomon Brothers Inc projections.

3 There is approximately 14 million square feet of Class C space.
Reserve Bank of San Francisco and the Federal Home Loan Bank of San Francisco also are located downtown. More than 45% of space is occupied by tenants who use 100,000 square feet or more. However, strong annual demand exists for multitenant office space by a variety of smaller users.

San Francisco's office market has evolved into a multitiered market. The top tier is generally perceived as comprising six buildings (Bank of America, Transamerica Pyramid, Embarcadero Center, 101 California Street, 345 California Street, and Telesis Tower), which together contain approximately seven million square feet, or 15% of the market. These buildings command substantial rent premiums over the market generally. This elite group of properties has proven resistant to downturns in the market, retaining high rents and low vacancy rates -- currently less than 5%, compared with 13.8% for Financial District Class A space overall -- despite the record amount of Class A space completed in the 1983-July 1988 period, which totaled approximately nine million square feet. By preventing first-tier buildings from being constructed, the Downtown Plan and Proposition M, a voter-approved zoning ordinance, should maintain this trend, widening the margin of rental rates and values between this first tier and other buildings.

The remainder of the Financial District Class A inventory -- 24.5 million square feet, or 50% of the market -- are shorter than the top-tier buildings and generally have less premium view space, smaller floor plates and somewhat lower-quality materials. Some of the better-located, high-construction-quality buildings
may achieve rents similar to those in top-tier buildings as the market tightens.

Rents are generally quoted on a full-service (gross) rental basis. Class A gross annual rents are quoted currently at $25-$45 per rentable square foot. This wide range reflects dramatic differences in views as well as location factors -- a California Street versus south of Market Street address, for example -- and construction quality. Free rent of six and 12 months for five- and ten-year leases, respectively, has been a standard concession. Concessions in the past six months have begun to decline with a tightening of the market. The standard tenant improvement allowance for new space is $25-$35 per rentable square foot. Operating expenses are typically $8-$11 per square foot.

The remainder of the market, 17 million square feet of space (35% of the market), is mainly in Class B buildings, including 4.7 million square feet in the Financial District and 12 million square feet in the Van Ness Corridor, Civic Center, Waterfront, and other areas. We define Class B buildings as those built in the 1940-59 period, as well as older renovated buildings and buildings that are Class A by construction standards, but which are smaller (generally less than 200,000 square feet), shorter and less well located than Class A buildings. Many of these properties were rushed to completion just before passage of the Downtown Plan out of fear of the Plan's severe development restrictions. They might not have been constructed, given the market demand at the time. These third-tier properties are the most vulnerable to market fluctuations and tend to suffer rental
rate and occupancy decreases more severely than, and before, the rest of the market. They also tend to recover more slowly than buildings in the top two office market tiers.

**Dynamics of Office Supply and Demand**

Historically, San Francisco has enjoyed a general balance between supply and demand. After the economy rebounded from the 1974-75 recession, demand surged for office space. Vacancy rates plunged to below 1% by 1980 as demand continued to outpace supply (see Figure 10). Office space became virtually unobtainable until the end of 1981. In this two-year period, rents for first-class space increased at an unprecedented rate of 1.5%-2.0% per month to all-time highs.

Absorption was approximately 1.9 million square feet per year from 1980-83. Although this indicates a strong demand for office space, the real magnitude of demand was understated by the absorption figure: Virtually all of the office space constructed in the 1980-81 period was fully leased prior to completion. Had more space been available, much of it probably would have been absorbed because of pent-up demand. Numerous tenants were forced to seek alternate locations in suburban markets.

The relocation of large back-office/clerical tenants because of high rental costs and the lack of expansion space in San Francisco was the main cause of the drop in absorption in the 1984-85 period. Major back-office space users, such as Bank of America, Chevron and Pacific Telesis, began moving some of their nonexecutive support staff and clerical personnel to East Bay
<table>
<thead>
<tr>
<th>Year</th>
<th>New Construction</th>
<th>Net Absorption</th>
<th>Class A Vacancy</th>
<th>Class A Gross Effective Rents(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0.86</td>
<td>1.90</td>
<td>0.4%</td>
<td>$25</td>
</tr>
<tr>
<td>1981</td>
<td>1.87</td>
<td>2.10</td>
<td>0.1</td>
<td>36</td>
</tr>
<tr>
<td>1982</td>
<td>2.20</td>
<td>1.70</td>
<td>0.3</td>
<td>38</td>
</tr>
<tr>
<td>1983</td>
<td>4.20</td>
<td>1.80</td>
<td>5.9</td>
<td>36</td>
</tr>
<tr>
<td>1984</td>
<td>1.30</td>
<td>0.45</td>
<td>7.0</td>
<td>33</td>
</tr>
<tr>
<td>1985</td>
<td>0.50</td>
<td>0.50</td>
<td>11.3</td>
<td>32</td>
</tr>
<tr>
<td>1986</td>
<td>2.80</td>
<td>1.10</td>
<td>16.5</td>
<td>26</td>
</tr>
<tr>
<td>1987</td>
<td>1.70</td>
<td>1.60</td>
<td>15.5</td>
<td>26</td>
</tr>
<tr>
<td>1988E</td>
<td>1.70</td>
<td>1.30-1.50</td>
<td>13.5</td>
<td>27</td>
</tr>
<tr>
<td>1989P</td>
<td>0.80</td>
<td>1.30-1.50</td>
<td>12.0</td>
<td>28</td>
</tr>
</tbody>
</table>

\(^a\) Typical Financial District core lease rate.
E Salomon Brothers Inc estimate.
P Salomon Brothers Inc projection.
Sources: Coldwell Banker, Cushman & Wakefield and Salomon Brothers Inc estimates.
locations, including Walnut Creek, Concord and Bishop Ranch in San Ramon, while maintaining their executive headquarters staff in San Francisco. The wave of mergers and acquisitions and corporate restructuring also substantially reduced the demand for space during this time period. Concurrently, however, the oversupply of secondary office space, combined with steady but moderate demand, caused a reduction in downtown San Francisco rental rates to the point of parity with suburban market rates.

The trend toward out-migration has been reversed, as demonstrated by recent leases to large space users who previously thought they could not afford space in downtown San Francisco. For example, Pacific Gas & Electric decided in late 1985 to lease 800,000 square feet, including all of the 322,000 square feet at 123 Mission street in addition to its leases at 333 Market Street and One California Street; the General Services Administration leased 175,000 square feet at 901 Market Street; the Department of Labor occupied 140,000 square feet at 71 Stevenson Street; Pacific Telesis occupied more than 200,000 square feet at Pacific Telesis Tower (formerly Crocker Center) at One Montgomery Street; and Delta Dental will occupy 225,000 square feet at 100 First Plaza. In addition, many smaller leases in the 30,000-100,000 square foot range have been signed by ATT, IBM, investment bankers, law firms, public accounting firms, high technology firms, and foreign financial institutions. As a result, in the past year, the demand for space has resurged in San Francisco, with absorption in the 1.3- to 1.5-million square foot range, consistent with the long-term historical average of the city.
New construction followed the pattern of demand for office space, although with substantial lag. Little new construction occurred in the late 1970s, so that strong demand forced vacancy rates down and rents up sharply. In the 1981-84 period, nearly ten million square feet of space was built, and demand was more than satisfied. As a result, vacancy rates soared and rents fell. In the 1986-87 period, new construction surged as developers rushed to build in anticipation of increased development costs and severe building restrictions to be imposed by the Downtown Plan. As a result, vacancy rates soared to a peak of 16.5% by year-end 1986 and rents fell further. From this point onward, the future development of office space in San Francisco is a function of the Downtown Plan and Proposition M.

The Downtown Plan and Proposition M

The Downtown Plan was passed in 1985 to accomplish the following: (1) limit new construction throughout San Francisco to 950,000 square feet per year until 1988; (2) reduce the floor-to-area ratio (FAR) for new buildings north of Market Street from 14:1 to 9:1; (3) decrease the floor plate size and adjust setback requirements (reducing efficiency) of new buildings; (4) reduce height limits; (5) increase the number of historical landmark buildings; (6) require developers to provide amenities, such as housing, child care, art, and a minimum amount of open space; and (7) establish a discretionary selection process for building permits controlled by the City Planning Department and the Planning Commission. Proposition M, passed by voters in 1986, further reduced the quota of new office construction to 475,000
square feet per year beginning in 1987 in all of San Francisco until 1996. Thus, it will be impossible to construct modern high-rise office buildings with large- (more than 25,000 square feet) and medium-sized (18,000-24,000 square feet) floor plates.

Buildings Under Construction or Planned

Currently, six multitenant Class A office buildings of more than 200,000 square feet each are under construction and scheduled for completion in the 1988-90 period. Twelve other multitenant buildings are planned and/or approved for commencement of construction during the same period. No buildings were approved by the Planning Commission in 1986, and only three buildings were approved in 1987: 343 Sansome, planned for 230,000 square feet by Gerald Hines; 235 Pine Street, planned for 140,000 square feet by London & Edinburgh Trust; and 600 California Street, planned for 300,000 square feet by the Federal Home Loan Bank for its regional headquarters. No buildings have been approved in 1988.

At least 11 other office buildings have been proposed for completion after 1990. However, as long as the Downtown Plan and Proposition M are in effect, most projects that are planned but not approved face a low probability of being constructed in the foreseeable future. Total development costs, including land, are more than $300 per rentable square foot. San Francisco's restrictive development posture is reflected in city charges for new construction of approximately $13 per square foot, including transit development fees.
South of Mission Area

It is clear that future development will be directed away from the Financial District core to the peripheral area south of Mission Street, an industrial district that is undergoing transition to secondary office use. The future of this area will be enhanced by the Planning Department's attempt to direct growth to this area. However, it is extraordinarily difficult to assemble a site adequate for a Class A project, given height limits and other restrictions and the lack of sites even in peripheral locations. Over the next 18 months, about 800,000 square feet of space will come on line in this area, keeping vacancy rates around 20%.

Expected Rent Growth

Rents in San Francisco have shown dramatic cyclical fluctuations in the past seven years in response to supply and demand forces in the market. Rental rates for new leases peaked at $38 per square foot for Class A buildings in 1982. The rise in rental rates was a result of less than 1.0% vacancy in 1981 caused by a lack of expansion space and pent-up demand.

Similarly, falling rents in the following years, 1984-87, resulted from excess space caused by the construction boom in the 1983-87 period. The bottom of the rent cycle was reached in mid-1987, and rents rose by at least $1 per square foot by the first half of 1988.

Given the limits on supply imposed by the Downtown Plan and Proposition M, vacancies have declined significantly and are
expected to approach 5% in the Financial District core by 1992. Below a 10% vacancy factor, rental rates have tended to rise in a nonlinear fashion as vacancies fall.4

Thus, investments in San Francisco office buildings in 1988-89 will be based on rents that are at the low point in the rental rate cycle. The rental rate figures should increase substantially as the projected severely restricted supply of Class A office space forces vacancy rates down and rental rates up. However, the very presence of Proposition M will deter expansion of firms in San Francisco that require large blocks of contiguous space.

Outlook

San Francisco’s office market outlook is positive. Although the city’s institutional base has been reduced as a result of recent mergers and acquisitions, the depth of potential demand, especially from professional service firms and financial institutions, is still very strong. Professional service firms will continue to grow, and the advent of reciprocal interstate banking in 1991 should herald more growth among financial institutions. Increased Pacific Rim trade during the next decade also should spur future growth.

Demand for Class A space, especially in the best buildings, is increasingly strong because of renewed expansion of financial service companies and professional firms. These companies place great importance on locations at prestigious addresses in downtown San Francisco and are willing to pay higher rent for them.
The buildings that continue to lease the fastest and attain the highest rental rates have prime locations and views. Secondary space, nonview space and peripheral locations are leasing at a slower rate and at lower rents. Investment values in first-tier buildings remain exceptionally strong. This stability reflects investor confidence in the controls on growth and the long-term strength and desirability of San Francisco. Capitalization rates are in the 5.5%-7% range.

As the Downtown Plan and Proposition M severely restrict the addition of new supply while demand remains even moderately strong, vacancy rates will decrease and rental rates could surge and possibly exceed their highest 1982-83 levels by the early 1990s, resulting in an increase in investment value. The ultimate result of the restrictions that have been imposed on a mature Financial District market is that first-class office space in downtown San Francisco will continue to be one of the most valuable office assets in the United States.

East Bay, Peninsula and Marin

About 54% of the metropolitan area office inventory -- approximately 57 million feet -- is located outside of San Francisco. The major office alternatives to San Francisco are in the East Bay. Oakland, which has experienced a moderate resurgence in the past five years, is the most urban alternative. The I-680 Corridor from Concord to Pleasanton offers a suburban environment. Marin County, San Mateo County and other East Bay locations, such as Emeryville, Berkeley and Lafayette, together
offer a wide range of alternatives for office users. In Figure 11, we show the distribution of office space, new construction and vacancies by submarket.

I-680 Corridor

The I-680 Corridor offers the most extensive and active submarket outside of San Francisco, containing 24 million square feet of multitenant space. The type of space available varies from the highly urbanized Walnut Creek, which contains 7.1 million square feet of space, to the award-winning Bishop Ranch office park in San Ramon, which houses numerous blue chip corporate users, including Pacific Telesis, Chevron U.S.A. and SmithKline Beckman Instruments.

Since 1980, almost 20 million square feet of space has been added to the I-680 Corridor in central Contra Costa and eastern Alameda Counties. This development represented a sixfold increase in the existing stock of space. The rapid pace of change sparked the implementation of antigrowth policies in Walnut Creek, Pleasant Hill and Concord.

The stage for this explosive growth was set in the 1960s and 1970s with the construction of I-680 and I-580 and the BART system. These transportation systems allowed residents and employers to locate outside of the central cities of San Francisco and Oakland, while still retaining the economic opportunities of the cities.

The major market impetus to growth occurred in the early 1980s, when downtown San Francisco office space became virtually unavailable and extraordinarily expensive. This encouraged the
### Figure 11. East Bay, Peninsula and Marin Office Markets, Jul 88-Jul 90P
(Square Feet in Thousands)

<table>
<thead>
<tr>
<th>Area</th>
<th>Existing Class A and B Inventory</th>
<th>Vacancy Rate</th>
<th>Under Constr. Jul 88</th>
<th>Estimated Comple  Jul 90P</th>
<th>Absorption Forecast&lt;sup&gt;a&lt;/sup&gt;,&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Vacancy Forecast&lt;sup&gt;c&lt;/sup&gt; Jul 90P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater Oakland</td>
<td>7.2</td>
<td>18.1%</td>
<td>950</td>
<td>950</td>
<td>450</td>
<td>16.6%</td>
</tr>
<tr>
<td># Central Business District/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lake Merritt Class A</td>
<td>4.9</td>
<td>12.6%</td>
<td>950</td>
<td>950</td>
<td>400</td>
<td>13.1</td>
</tr>
<tr>
<td>Berkeley/Emeryville</td>
<td>3.0</td>
<td>14.0%</td>
<td>310</td>
<td>550</td>
<td>300</td>
<td>10.4</td>
</tr>
<tr>
<td>Oakland Airport/Alameda</td>
<td>3.0</td>
<td>31.3%</td>
<td>0</td>
<td>250</td>
<td>150</td>
<td>27.4</td>
</tr>
<tr>
<td>Southern Alameda County</td>
<td>1.8</td>
<td>31.9%</td>
<td>0</td>
<td>250</td>
<td>150</td>
<td>25.7</td>
</tr>
<tr>
<td>I-680 Corridor</td>
<td>23.8</td>
<td>19.8%</td>
<td>625</td>
<td>2,350</td>
<td>1,555</td>
<td>15.1</td>
</tr>
<tr>
<td># Walnut Creek</td>
<td>7.1</td>
<td>15.6%</td>
<td>150</td>
<td>150</td>
<td>250</td>
<td>10.5</td>
</tr>
<tr>
<td># Pleasant Hill BART/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pleasant Hill/Martinez</td>
<td>2.4</td>
<td>30.5%</td>
<td>0</td>
<td>350</td>
<td>200</td>
<td>24.9</td>
</tr>
<tr>
<td># Concord</td>
<td>3.9&lt;sup&gt;d&lt;/sup&gt;</td>
<td>24.4%</td>
<td>10</td>
<td>350</td>
<td>250</td>
<td>19.0</td>
</tr>
<tr>
<td># Lafayette/Orinda/Moraga</td>
<td>0.9</td>
<td>7.1%</td>
<td>100</td>
<td>100</td>
<td>30</td>
<td>10.4</td>
</tr>
<tr>
<td># San Ramon/Danville/Alamo</td>
<td>3.3&lt;sup&gt;e&lt;/sup&gt;</td>
<td>19.3%</td>
<td>165</td>
<td>700</td>
<td>375</td>
<td>14.7</td>
</tr>
<tr>
<td># Pleasanton/Dublin/Livermore</td>
<td>6.1</td>
<td>19.6%</td>
<td>200</td>
<td>700</td>
<td>450</td>
<td>14.6</td>
</tr>
<tr>
<td>North San Mateo</td>
<td>2.8</td>
<td>22.4%</td>
<td>140</td>
<td>550</td>
<td>300</td>
<td>17.2</td>
</tr>
<tr>
<td># South San Francisco</td>
<td>1.2</td>
<td>39.9%</td>
<td>140</td>
<td>400</td>
<td>--</td>
<td>--</td>
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<td># Other</td>
<td>1.6</td>
<td>9.2%</td>
<td>0</td>
<td>150</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Central San Mateo</td>
<td>8.4</td>
<td>18.7%</td>
<td>300</td>
<td>550</td>
<td>300</td>
<td>17.0</td>
</tr>
<tr>
<td># Burlingame</td>
<td>2.2</td>
<td>21.8%</td>
<td>0</td>
<td>50</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td># San Mateo</td>
<td>4.8</td>
<td>18.2%</td>
<td>70</td>
<td>200</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td># Foster City</td>
<td>1.4</td>
<td>16.0%</td>
<td>230</td>
<td>300</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>South San Mateo</td>
<td>3.9</td>
<td>12.4%</td>
<td>120</td>
<td>450</td>
<td>200</td>
<td>12.3</td>
</tr>
<tr>
<td># Redwood City/Belmont/San Carlos</td>
<td>1.5</td>
<td>14.7%</td>
<td>0</td>
<td>50</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td># Redwood Shores</td>
<td>1.1</td>
<td>6.1%</td>
<td>0</td>
<td>200</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td># Menlo Park</td>
<td>1.3</td>
<td>15.0%</td>
<td>120</td>
<td>200</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Marin</td>
<td>3.2</td>
<td>11.0%</td>
<td>0</td>
<td>100</td>
<td>100</td>
<td>9.4%</td>
</tr>
</tbody>
</table>

<sup>a</sup>Except Class A and B inventory, which is in millions of square feet.

<sup>b</sup>Annual average.<sup>c</sup>Assumes no recession during the forecast period.

<sup>d</sup>Excludes one million square feet of single-tenant/owner-occupied space.

<sup>e</sup>Excludes 3.2 million square feet of single-tenant/owner-occupied space.

<sup>P</sup>Saloomon Brothers Inc projection.

Sources: McMasters & Westland, Keegan & Coppin, Grubb & Ellis, Cushman & Wakefield and Salomon Brothers Inc.
major movement of jobs to the I-680 Corridor by Pacific Telesis, Chevron, Wells Fargo, and Bank of America. In addition to convenient transportation, these and other employers found a high-quality clerical labor force and relatively affordable housing.

Construction along the I-680 Corridor has slowed since 1986 primarily in response to vacancy rates in the 20%-30% range. Strong absorption in 1987 and the first half of 1988 reduced the overall vacancy rate by five percentage points to 19.8%, but leasing has slowed in the second half. Growth control initiatives, the skyrocketing price of housing and increasingly severe traffic congestion will limit both demand and additions to supply. Construction of improvements to the I-680/I-24 interchange will aggravate both highway and surface street congestion in Walnut Creek for several years beginning in 1989. Much of the new development is focused in the southern portion of the corridor in Pleasanton and San Ramon, but more than three million square feet are planned at the Pleasant Hill BART station. Rents in the corridor vary widely, depending on the quality and location of space. Gross effective rents are $12-$25 per square foot, with downtown Walnut Creek commanding the highest rents.

Oakland

Oakland's central business district and campus-like Lake Merritt area represent prime alternatives to San Francisco. Oakland has experienced a moderate resurgence since 1980, adding more than 2.5 million square feet of space. Major buildings
include Kaiser Center (1.1 million square feet), Citicorp, Transpacfic Center, and Golden West Tower. Older anchor buildings include the First Interstate, Wells Fargo, Kaiser Permanente, and Clorox buildings. The recent announcements of plans by the U.S. General Services Administration to build one million square feet of space downtown at City Center and by the University of California to move to Kaiser Center on Lake Merritt indicate that Oakland can attract major tenants, albeit Government ones. City Center, a four million square foot phased development project -- a joint venture of Bramalea Pacific and the Oakland Redevelopment Agency -- is achieving rents comparable with the Lake Merritt area. Gross effective rents are $15-$25 per square foot for most Class A space. Nearly one million square feet are under construction, and the fairly low vacancy rate indicates that new development will be forthcoming in the next several years.

Other Markets

The 15-million square foot San Mateo County office market is 18% vacant. This market’s main advantages are its location between San Francisco and Santa Clara counties and the presence of San Francisco International Airport. Its primary disadvantage is the high cost of housing, which continues to impel relocations to the East Bay. There are several nodes of low-rise and mid-rise Class A office space, including the traditionally industrial South San Francisco, Burlingame (near the airport), Foster City (accessed by the San Mateo Bridge) and San Mateo. Construction is
expected to pick up by early 1989 as vacancy rates continue to tighten. Class A full-service effective rents generally range from $16-$21 per square foot, depending on location. Palo Alto, largely because of stringent growth controls, is the exception: Class A gross asking rents are $34-$36 per square foot and concessions are minimal.

The majority of Marin County’s 3.2 million square feet of multitenant office space is located in San Rafael and the southernmost cities, but there is a supply of undeveloped land and a potential back-office workforce in Novato. The vacancy rate is among the lowest of the San Francisco suburbs at 11%, and gross rents are $12-28 per square foot, depending on location, type and quality of space. New development in Marin is very limited, because substantial restrictions exist, perpetuated by moratoriums on building and a general lack of developable land.

**INDUSTRIAL MARKET**

The San Francisco Bay Area industrial market primarily supports distribution to the vast local market — the greater Bay Area is the fourth-largest metropolitan area in the nation — and international trade activity. The volume of trade through the Port of Oakland has grown steadily, increasing at a compound annual rate of 5% since 1981, and exceeded 14 million metric revenue tons in 1987. The Bay Area plays a much smaller role in regional distribution than does the greater Los Angeles area, which has nearly three times the approximately 300 million square feet in the greater Bay Area industrial market. The San Francisco-Oakland Metropolitan Area contains an estimated 210
million square feet, and the bulk of the remaining 90 million square feet is in Santa Clara County. About 85% of the San Francisco-Oakland inventory consists of warehouse and distribution and light manufacturing space. The area's industrial base has evolved from primarily manufacturing to warehouse and distribution.

About 75% of the traditional industrial space is in the I-880 Corridor in Alameda County in proximity to the Port of Oakland and the termination points of the Santa Fe, Southern Pacific and Union Pacific rail lines. Research and development and flex space is dispersed among several locations in the San Francisco-Oakland metropolitan area,\textsuperscript{5} serving the spillover from Silicon Valley in the South Bay and the biotechnology industry on the Peninsula and in the Emeryville/Berkeley area.

Industrial building permits have averaged an estimated six million square feet per year in the 1980s, except for 1981-82, during the national recession. Construction picked up in 1984 in response to the manufacturing recovery and growth in wholesale trade employment (see Figure 12). High vacancy rates and land costs prompted the easing of construction activity in the past 18 months, but developers who previously purchased land continue to build. Land prices have jumped by as much as 40% since 1984 and are edging higher as sites become scarcer.

High land costs throughout most of the Bay Area preclude profitable development of low-finish industrial buildings. Finished industrial land prices are highest in Emeryville and Berkeley, at $20 per square foot, followed by the San Mateo
Figure 12. San Francisco-Oakland Metropolitan Area Industrial Building Permits, 1979-88E (Value in Millions of 1982 Dollars)

E Salomon Brothers Inc estimate.
Source: U.S. Bureau of the Census.
Peninsula, at $13-$17 per square foot. Land is $7-$9 per square foot in Oakland and San Leandro and $5-$7 in Hayward, Union City and Fremont. Consequently, industrial sites are increasingly developed as research and development or flex space and older industrial properties are frequently redeveloped for higher rent uses.

Although the northern and central California vacancy rate remains above the national average, the Bay Area’s most close-in submarkets are tighter (see Figure 13). The composite vacancy rate also masks a lower rate in warehouse space, which we estimate at 8%-10% in the Bay Area, and a considerably higher rate in research and development/flex space, estimated at 25%.

Because most of the Bay Area’s submarkets have good highway access, the cost of space is a prime factor in competition between locations, and rents generally fall moving eastward and northward from the Bay. Consistent with the national trend, industrial users continue to relocate to outlying areas as industrial sites shift to higher uses. In the late 1970s, as San Francisco’s office market expanded to the south of Market Street area, many industrial users moved to South San Francisco and San Mateo. More recently, East Bay users, lured by less expensive space as well as lower wages, relocated from the I-880 Corridor to the I-680 Corridor. Rising costs in Contra Costa County are now making the North Bay locations of Napa, Fairfield and Vacaville and the Central Valley locations of Stockton and Tracy more attractive for warehouse and distribution operations.

Strong institutional demand for quality warehouse and
Figure 13. Northern and Central California\textsuperscript{a} versus United States Industrial Vacancy Rate,\textsuperscript{b} 1979-2Q88 (Quarterly Data)

\textsuperscript{a} Defined as San Francisco, San Mateo, Santa Clara, Alameda, Contra Costa, Sacramento, San Joaquin, Stanislaus, Merced, Fresno, Tulare, Yolo, Yuba, and Placer counties and portions of Solano and Sutter counties.

\textsuperscript{b} Includes both traditional industrial space and high-finish research and development space.

Source: Coldwell Banker.
distribution and light manufacturing product in recent years has driven capitalization rates down to 7.5% on the Peninsula and 8.5% in most other Bay Area locations.

Alameda County

Alameda County’s 110-million square foot distribution, warehouse and light manufacturing inventory is 5%-6% vacant, except for a 10% vacancy rate in the 20-million square foot high-cube distribution sector of the Hayward/Union City market. This is the only Alameda County submarket where rent concessions are common, and the typical deal is for two or three months free rent on a five-year lease. With about two million square feet of high-cube space under construction, vacancy rates and rent concessions are expected to increase in those cities. Oakland has a 31-million square foot inventory of light manufacturing and distribution space, but lacks the high-quality modern distribution space available in the nearby 22-million square foot San Leandro market. Quoted rents are $0.25-$0.35 per square foot per month, triple net.

Hayward/Union City’s 4.5-million square foot research and development/flex space market is 35% vacant, reflecting overbuilding in recent years and the large supply of competitive space in nearby Fremont (7.5 million square feet) and Silicon Valley. By contrast, the one-million square foot San Leandro market and the smaller markets in Emeryville and Berkeley are 15%-20% vacant. Emeryville’s proximity to the University of California, Berkeley, its support of redevelopment activity and its political neutrality relative to Berkeley have made it,
rather than Berkeley, a biotechnology center, with firms such as Cetus Corp. This traditional industrial enclave is being transformed largely by the Martin Group, which is developing the multi-use Emery Bay project, as well as by the conversion of older industrial buildings. In Alameda, two master planned developments, Marina Village and Harbor Bay, are also attracting biotechnology and high technology office/research and development tenants and owner/users. The latter features an advanced telecommunications network in conjunction with Bay Area Teleport.

Quoted rents range from $0.45-$0.55 per square foot per month, triple net for flex space in Hayward/Union City and Fremont to $0.75-$1.25 for higher-finish research and development space in Emeryville, Berkeley and Alameda. Space in the southern Alameda County markets is typically leased with a concession of two months free rent per a year of lease term.

San Mateo County

About half of San Mateo County's 42-million square foot industrial inventory is located in the north county areas, including South San Francisco, Brisbane, Daly City, and San Bruno. The northern part of the county contains half of the inventory and has a 7% vacancy rate.

The central part of the county, including Burlingame, Foster City and San Mateo, has six million square feet with a vacancy rate of 8%. Another 15 million square feet is located in the south county cities of Redwood City, San Carlos, Belmont, and Menlo Park, with a vacancy rate below 3%. Traditional warehouse
and light manufacturing space leases for $0.25-$0.65 per square foot per month, triple net in the northern county area and $0.35-$0.70 in the central and southern parts of the county. For space that is 40% or more improved, rents range from $0.60-$0.90 in the northern markets to $0.75-$1.15 in the southern markets. Rents in new research and development/flex space run $0.05-$0.15 higher.

The flex space market contributes an additional four million square feet to the countywide inventory. Despite an approximately 35% vacancy rate, half a million square feet are under construction in the northern and southern parts of the county. Because of high land costs, development in recent years has shifted to these single-story, 16-foot floor-to-ceiling structures with low-profile truck loading facilities. Extensive glass finish, as well as parking ratios and landscaping comparable with garden office product, accommodate a variety of tenants from electronics manufacturers and research and development companies to administrative and general office users. The majority of absorption is generated not from the relocation of Santa Clara County tenants, but rather, from expansion and movement of tenants within the county, frequently from more expensive midrise office space. As industrial sites have been developed and converted to higher uses, large warehouse users have relocated to less expensive facilities in Alameda and Solano counties.

Contra Costa County

The 17-million square foot Contra Costa County industrial market stretches along I-680. The market traditionally served a
warehouse and distribution function, but as a result of population and office market growth, it now predominantly supports small, local sales/service and incubator/warehouse functions. Many of the buildings completed in the past three years have been of the latter type, some with office buildouts as high as 30%-50%, glass fronts, parking ratios similar to office product, and campus-style settings. Livermore, in eastern Alameda County, is one of the last locations for warehouse/distribution development on the I-680 Corridor, and one million square feet of speculative space are under construction. Although new development has put downward pressure on Livermore rents in the past couple of years, absorption has been strong recently, with 600,000 square feet leased in the first seven months of 1988. Rents range from $0.28-$0.35 per square foot per month, triple net for warehouse and distribution space in Benicia (Solano County) and Livermore to about $0.55 for light industrial/incubator space in Concord. Distribution space is approximately 15% vacant, while the vacancy rate in the higher-finish product resembles that of the Corridor’s overbuilt office market, at 20%-25%.

On the I-880 Corridor, the Richmond market has 11.5 million square feet of warehouse space with a 10% vacancy rate. Rents range from $0.20-$0.50 per square foot per month, triple net. The area’s proximity to Berkeley and Emeryville has encouraged the development of research and development space, now approaching half a million square feet with a 25% vacancy rate.
San Francisco

San Francisco’s 27-million square foot industrial market runs from the south of Market Street business district to the San Mateo County line. In addition to warehouses, the south of Market/Showplace Square area accommodates the city’s high-fashion wholesale design center, sales and service, outlet stores, office support services, and restaurants and entertainment in converted and renovated industrial buildings.

Traditional waterfront tenants include wholesale distributors, manufacturers and port-related users, but most new tenants provide office support services. Further from the central business district core, the India Basin/Bayview area serves import-export operations and the building trades. Rents range from $0.20-$0.65 per square foot per month, triple net, depending on the type of building and size of lease. New developments tend to be high-finish research and development projects with asking rents of $1 per square foot per month.

RETAIL MARKET

The San Francisco Bay Area has the highest per household effective buying income and per household retail sales among the nation’s five largest areas of dominant influence (ADIs)\(^7\), ahead of New York, Chicago, Los Angeles, and Philadelphia. San Francisco also ranks first in department store sales per household and is second only to New York in apparel and accessories store sales per household. However, slower population
growth and high housing costs -- which limit discretionary income -- are eroding sales growth in the region to a greater extent than in other major California metropolitan areas and the state overall (see Figure 14). In 1987, total taxable sales grew by 5.1% in the San Francisco-Oakland metropolitan area, compared with 8.2% statewide and 9.5% in the Los Angeles-Orange-Riverside-San Bernardino metropolitan area.

The Bay Area retail property market is healthy and relatively balanced overall, with generally low vacancies, high sales productivity and average square footage per capita. The estimated 60-million square foot retail inventory equates to 17 square feet per person, compared with the national average of 15 square feet. Of the total inventory, approximately six million square feet are in downtown San Francisco and more than 20 million square feet are located in 23 regional shopping centers. Twelve of these centers are superregional centers containing more than 800,000 square feet of gross leasable area and at least three full-line department stores. This tally includes Stanford Shopping Center in Palo Alto, but otherwise excludes Santa Clara County, which has eight other regional malls.

San Francisco

San Francisco -- unlike Los Angeles -- is unusual in that it has a vibrant downtown shopping district comparable with New York’s Fifth Avenue. The Union Square district achieves exceptional sales per square foot: In 1987, Ann Taylor recorded sales of $1,286 per square foot; Tiffany & Co., $2,000 (1986); Macy’s $293; and Nordstrom projects sales will exceed $350 per
Figure 14. San Francisco-Oakland Metropolitan Area versus California Taxable Retail Sales Growth, 1981-88E

E Salomon Brothers Inc estimate.
Sources: Association of Bay Area Governments and California Board of Equalization.
square foot in its first year. This high sales productivity is supported by tremendous regional drawing power, heavy conventioneer and tourist traffic and the concentration of office employment. The district is bounded by Nob Hill, the prestigious residential and hotel district to the north, the Financial District to the east, and Market Street, which connects the district to the region via the BART stations at Montgomery and Powell streets, to the south (see Figure 9).

The selling space in Union Square’s five major department and specialty store anchors totals more than two million square feet. The district houses the largest Macy’s outside of New York City, the flagship I. Magnin store, Neiman-Marcus, Saks Fifth Avenue, and The Emporium. Four of these stores face Union Square, a square-block public plaza with an underground parking garage, which provides a focal point for the shopping area.

Rents for space fronting the plaza reached $150 per square foot per year for street-level shops and $24-$30 per square foot for second-floor space with the 1987 opening of One Union Square. Tenants include Hermes, Gucci and North Beach Leather. Off Union Square, on Post Street from Stockton to Kearny, street-level rents average $80-$100 per square foot. One block north of the plaza on Sutter Street from Powell to Kearny, rents drop to $60-$85 per square foot. Only stores with very high sales productivity can afford these aggressive rental rates. Store turnover has accelerated recently, and space availability has significantly increased, especially on the northern periphery. These conditions signal a cyclical peak in rents, yet rents remain resistant to downward pressure, because most landlords
prefer to wait for a strong tenant.

The prime retail addresses are beginning to encompass shops nearer to Market Street, as exemplified by new leases to FAO Schwarz and the Limited's northern California flagship store at Stockton and O'Farrell Streets. San Francisco Centre, the one-million square foot, eight-story vertical mall at Fifth and Market Streets across from the Powell Street Cable Car Turnaround, is testing the elasticity of the district's boundaries. The mall's impressive opening in October of this year marked the entry of Nordstrom to the Union Square market, with the chain's largest store at 312,000 square feet. The critical questions to the center's success are whether shoppers will cross the physical and psychological barrier of busy Market Street, whether they will bypass the spiral escalators designed to lure them into the mall shops on the lower three levels en route to Nordstrom, and whether interior shops can generate sufficient sales to support rents similar to those in prime street-level locations.

The retail component of downtown office towers can be far more significant than a convenience-oriented amenity. Embarcadero Center traverses four blocks on three levels and maintains virtually full occupancy. Second-level rents are $50-$60 per square foot per year, and street-level rents average $80 -- nearly double typical street-level rents in the area. The smaller enclosed Galleria at Crocker Center has had less success capturing the office worker trade.

The city's successful tourist-oriented retail is concentrated in the Fisherman's Wharf area and includes the
renown Ghirardelli Square, the country’s first major urban adaptive reuse project. Trendy, upscale neighborhood shopping and eating and drinking districts include Union Street, Chestnut Street, Fillmore Street, and Sacramento Street. Vacancies are quickly filled on these streets, and net rents average $24-$48 per square foot per year.

The growth of tourism, encouraged by the expanding convention center and hotel market, will fuel the growth and vitality of San Francisco retailing. However, rent growth will be constrained until sales catch up to the record-high rent levels. The trend toward Market Street area locations will continue with the focus of recent office development in the south of Market Street area and the early 1990s opening of the retail promenade in Olympia & York’s Yerba Buena Development.

Oakland

In sharp contrast to San Francisco, the Oakland area is one of the largest underserved retail markets in California. The area lacks a regional mall to serve the substantial high-income population in the Berkeley-Oakland Hills. Concerns about crime have hindered the downtown’s ability to attract after-five activity. The key issue for the success of Oakland retailing is whether it can overcome the city’s historically poor image and attract upscale shoppers and evening and weekend traffic.

In 1986, downtown Oakland had a low capture rate of about 12% of the estimated $1.1-billion comparison goods expenditure potential of the trade area, encompassing the Berkeley-Oakland
Hills and extending from El Cerrito to San Leandro. Apparel sales averaged $208 per square foot downtown, substantially less than the average of $233 per square foot achieved in neighborhood shopping districts such as Montclair Village ($273) and Grand Avenue ($328), which have evolved to serve the region partially. Rents in downtown Oakland and Berkeley average $10-$12 per square foot per year, compared with $24-$36 per square foot in strong neighborhood locations and on Telegraph Avenue near the University of California, Berkeley campus. The only commercial rent control ordinance in the nation, which covered the Elmhurst District on College Avenue, was preempted by state legislation banning commercial rent control effective January 1, 1988.

Several retail developments are seeking to tap Oakland's potential by sharing the costs and risks with the City Redevelopment Agency and the Port of Oakland. The stalled Rotunda office/retail project underscores these risks. In the next year, Jack London Square, the waterfront collection of restaurants and destination-oriented retail will add 140,000 square feet of midprice, local regional shops as well as office space. Cost Plus and Pier I imports have attained exceptional sales productivity, but boutique shops have performed poorly in this isolated area. The Old Oakland mixed-use renovation near the Hyatt Hotel, and Oakland Convention Center also suffers from a lack of foot traffic, but the office worker-oriented retail recently completed at City Center is apparently succeeding. A key event to watch for will be confirmation by Nordstrom of its intent to anchor the Rouse Company's proposed regional shopping center on Broadway
from 17th Street to 20th Street.

**Suburbs**

Suburban shopping center construction accelerated on the Peninsula and in the East Bay in the past three years, approaching 1980 peak levels (see Figure 15). Construction has slowed overall in 1988, but we expect continued near-term construction growth in Contra Costa outside of downtown areas and in southern Alameda, fueled by greater land availability and population growth than in the closer-in areas. Land values average $20-$30 per square foot in San Mateo, compared with $12-$15 in Walnut Creek, $7-$9 in Fremont and Milpitas and $6-$8 in outlying areas of Contra Costa.\(^{11}\)

The last wave of suburban regional mall construction pushed this market to its saturation point — except for the Greater Oakland area — for at least the next decade (see Figure 1). For example, Fremont’s Hub Shopping Center lost its primary draw, a Mervyn’s store, to NewPark Mall subsequent to its 1980 opening one mile away. On the Peninsula, Fashion Island mall opened in Foster City in 1981, within a ten-minute drive of Hillsdale Shopping Center, one of the Bay Area’s first regional malls. The new center lost the competition for Nordstrom to the established center and subsequently suffered the closing of two of its anchors, Liberty House and Bullocks, as a result of corporate restructurings. With an approximately 30% vacancy, the renamed Island is struggling to find a merchandising mix, which includes the first mall location of Berkeley-based Whole Earth Access, the
Figure 15. Peninsula and East Bay\textsuperscript{a} Shopping Center Construction Contracts, 1972-88E (Square Feet Indexed: 1972=100, Annual Data)

\textsuperscript{a} San Mateo, Alameda and Contra Costa counties.

Salomon Brothers Inc estimate.

Source: Construction and Real Estate Information Service. Reproduction or dissemination of this data in any form prohibited without prior written permission by Dodge/DRI, McGraw-Hill, Inc.
electronics and home general store, in a market that cannot support another regional mall.

Stoneridge Mall established a monopoly in the rapidly growing Tri-Valley and southern Contra Costa market when it opened in 1980 at the junction of I-580 and I-680. The planned addition of Nordstrom to this center and the chain's opening in the Stonestown Galleria, which reopened with a classic marble interior in 1988 in the southwestern section of San Francisco, demonstrate the trend for major retailers to expand by adding stores at existing centers rather than by anchoring new suburban malls. The Hahn Company recently withdrew plans for an 800,000 square foot mall in Novato (Marin County), and the proposed Starr Center Mall in Union City (Alameda County) has not attracted anchors.

Suburban development is now focused on strip centers in upscale communities and promotional centers in infill locations. Recent completions include Terranomics's successful 280 Metro Center, which includes a Marshall's, a Federated and a Nordstrom's Rack, located south of San Francisco across I-280 from Serramonte Center; and the reconstructed Caterpillar Plant in San Leandro, with major leases to Costco, Home Depot and Breuner's.

Suburban mall rents average $17-$30 per square foot for 5,000 square foot or more leases and $30-$55 for less than 1,100 square foot leases. Average mall tenant sales per square foot vary significantly between centers, ranging from $160 to more than $300. Despite lower sales productivity, Stoneridge and Sun Valley on the I-680 Corridor achieve comparable rents to
Stanford, perhaps the most upscale regional shopping center in northern California. With the exception of The Island, malls on the Peninsula are near full occupancy. We estimate an average 5% vacancy rate in East Bay malls.

As in downtown San Francisco, suburban strip center rents are testing the limits of affordability for retailers, and as a result, the potential for near-term rent growth is limited. In bustling downtown Walnut Creek, the scarcity of parking is limiting sales growth in prime locations around Broadway Plaza, and the growth-restrictive policies of the city and neighboring Pleasant Hill and Concord give retailers pause. Strip center rents are in the $12-$24 per square foot range per year, but asking rents can exceed $30 in Palo Alto, Burlingame and Menlo Park. Vacancy rates range from a low of less than 3% in San Mateo to a high of 8%-10% in Contra Costa, with the greatest availability in the retail components of the I-680 Corridor’s new office projects and in fringe locations.

Indicative capitalization rates for well-leased regional malls serving middle- to upper-income trade areas are 5.5%-6.5%. Limited regional mall investment opportunity supports strong demand for smaller retail properties. Neighborhood centers anchored by major food and drugstores have traded at 7.5%-8% capitalization rates, and well-located strip centers have traded at 8.5%-9%. In fringe locations, capitalization rates are reportedly in the 9%-10% range.
APARTMENT MARKET

There are more than 850,000 multifamily units in the Bay Area region, including more than 175,000 in Santa Clara County. Demand for rental housing in the Bay Area is underpinned by the high and accelerating cost of homeownership. The median-priced Bay Area home requires an estimated monthly mortgage payment of $1,613 -- more than double the median advertised rent for a two-bedroom apartment.

The high cost of housing, rapid population growth and sluggish construction in the late 1970s and early 1980s created a tight rental market (see Figure 16). Then the post-recession pickup in construction accelerated to a rental unit building boom in 1984-86. Multifamily construction overtook single-family construction, supported by the Bay Area market’s strong fundamentals, liberal tax write-offs for investors, falling interest rates, and a large increase in the statewide ceiling on tax-exempt financing. In 1987, changes in the tax law sharply curtailed syndication and public financing. Multifamily construction in the Bay Area mirrored the national contraction, dropping by 27% to 12,254 units in 1987 from 16,898 units in 1986. In 1988, multifamily permits have declined by 50% from the comparable period in 1987. The decline has been most dramatic in Contra Costa County, where heated construction activity in the previous two years created a temporary glut. By contrast, in the adjacent Tri-Valley area, construction rebounded in Pleasanton, which rezoned land and exempted developments with affordable housing from its annual growth limit.
Figure 16. San Francisco-Oakland Metropolitan Area Multifamily and Single-Family Housing Permits, 1975-88E (Units in Thousands)

E Salomon Brothers Inc estimate.
Sources: U.S. Bureau of the Census, The WEFA Group and Salomon Brothers Inc.
In San Francisco, city and state subsidies have helped to maintain multifamily completions above 1,300 units in four of the past five years. About 27% of the 9,167 units completed in the 1980-87 period were low- and moderate-income housing units. This total is less than half of the 20,000 new housing units voters supported for completion in the 1980-85 period, and the shortage of affordable housing persists. Construction activity is concentrated in one- and two-bedroom apartments in subsidized developments in the south of Market, Mission and downtown districts. Approximately 7,000 units are planned with a 20-year buildout at Santa Fe Pacific Realty Company’s Mission Bay redevelopment, which is undergoing an extensive review and approval process.

Although apartments are still frequently built to condominium standards, conversions have declined precipitously in the past three years throughout the Bay Area. Since 1983, San Francisco has restricted conversions to buildings with six or fewer units and tenant-initiated projects and has limited the citywide total to 200 units per year. In the city, luxury condominiums have sold slowly, and middle-market units have only sold well with financing incentives.

As the need for affordable housing has become acute, residential development has spread to outlying areas in Sonoma, Solano and Napa counties to the north and San Joaquin County to the east. On I-580 near Tracy (San Joaquin) and I-80 around Vallejo and Fairfield (Solano), the median home prices are little more than half of the Bay Area median, and rents are $200-$300 lower than in the East Bay. The availability of land has allowed
these areas to become overbuilt. According to the Federal Home Loan Bank (FHLB) of San Francisco's most recent survey of both owner-occupied and rental multifamily units, the vacancy rate is 6.2% in the Vallejo-Napa-Fairfield area and 4.9% in San Joaquin County. Vacancy generally runs significantly higher in rental units than in for-sale dwellings.

Strong household growth, combined with land constraints and growth controls, ensured a historically low rental vacancy rate in most Bay Area markets (see Figure 17). Higher vacancy rates have persisted in the wake of recent construction activity. Among the five inner Bay Area counties, Contra Costa has the highest vacancy rate, at 5.3%, as measured by the FHLB of San Francisco's September 1987 survey. San Francisco has the lowest vacancy rate at 1.6%, followed by Alameda (2.3%), Marin (3.0%) and San Mateo (3.2%).

Rents in available units are 75%-90% higher than 1980 levels throughout the region, but have been flat to declining in the past three years. This softening resulted from both greater availability and lower interest rates, which enabled more renters to become homeowners. San Francisco has the highest median advertised rent, at $900 per month for a two-bedroom apartment, followed by San Mateo County ($795) and Marin County ($755). Median rents are lower across the bay in southern Alameda County ($600) and the Oakland area ($595) and decline further east in Central Contra Costa ($550) and northeast in Fairfield ($425). New luxury units achieve higher rents: 700 square foot one-bedroom/one-bath apartments are leasing for $690-$740 in southern
Figure 17. Multifamily Housing\textsuperscript{a} Vacancy Rates in San Francisco, Alameda and Contra Costa Counties, 1980-87 (Sep Data)

\textsuperscript{a} Includes both owner- and renter-occupied units.
Source: FHLB of San Francisco.
Alameda County, $770-$800 in Walnut Creek and Pleasant Hill and $765-$840 in prime San Mateo locations.

The rental component of the Consumer Price Index (CPI) for the San Francisco-Oakland metropolitan area has grown at a compound annual rate of 7% since 1982, outpacing the overall CPI, which grew at a 3.6% rate. Percentage changes in the rental component of the CPI tracked changes in the advertised rents in the early 1980s, but have lagged the decline in advertised rents beginning in 1984. Because the CPI survey includes occupied units and existing, as well as new units, the discrepancy may indicate that the substantial additions to the stock in the past three years have not improved the affordability in older units in the middle and lower tiers of the market.¹⁴

San Francisco, Oakland and Hayward have moderate rent control ordinances. New construction is exempted from each city's ordinance, and none include the controversial provision in San Jose's law, which would deny rent increases that would cause a hardship to a particular tenant.¹⁵ Stringent rent control in Berkeley has contributed to a virtual zero vacancy rate. San Francisco may move toward Berkeley-type control if a ballot provision that would eliminate the practice of allowing vacated apartments to revert to market rents passes in November. Passage of this measure would create many negative dynamics in the San Francisco housing market.

The Bay Area apartment market is a seller's market, with capitalization rates generally in the 7%-8.5% range. Although low for apartments, yields are 0.5%-1.5% higher than in the pretax reform, syndication-driven era. Rising interest rates are putting
some upward pressure on yields, but strong demand should maintain low yields for quality product, because high land costs limit production. In prime suburban locations, land averages $20,000-$25,000 per unit, and total construction costs for luxury garden-style apartments are $80,000-$90,000 per unit. Well-located large, institutional quality properties have recently sold for $100,000-$110,000 per unit with indicated capitalization rates below 7%. Preferred locations are high-income infill sites, such as Burlingame, San Mateo and Menlo Park and, in the East Bay, have excellent BART access, such as Sunnyvale and the Pleasant Hill BART Station area. In fringe locations such as Livermore, Antioch and Martinez, land costs drop to $13,000-$15,000 per unit.

Development fees, especially growth impact fees, have ballooned in the 1980s and now comprise a significant component of the cost of new housing, estimated at 10%-15% of the cost of a starter home. Growth impact fees are intended to pay for new or improved infrastructure and public facilities, thereby maintaining the same level of service despite population growth. The dramatic rise in these fees is the response of local governments to slashed property tax revenues since the passage of California’s Proposition 13 in 1978 and less Federal and state support in the 1980s.

Greater development opportunity is beginning to arise around certain BART stations. The system was envisioned as a catalyst for development of suburban downtown centers with high-density housing, but antigrowth sentiment led to the downzoning of areas
around stations in several cities. Faced with the need to provide more housing and combat traffic congestion, most local governments are now encouraging residential development linked to mass transit, and the Bay Area Council estimates that 6,750-7,600 housing units are planned, approved or under construction within walking distance of East Bay BART stations. During the next decade, sites for higher-density housing should become available around most of the 10 stations proposed in San Mateo, Alameda and Contra Costa counties.

CONCLUSION

The San Francisco Bay Area is experiencing some of its strongest economic growth of the decade in 1988. San Jose is showing a substantial recovery, and the city of San Francisco is recovering from the corporate restructurings and moveouts of the mid-1980s. Oakland/East Bay continues to show the strongest economic growth in the region. The Bay Area’s high quality of life and importance as a center of higher education and research, combined with the scarcity of affordable housing, portends an increasingly white collar work force. The future of the Bay Area does not lie in attracting many existing Fortune 500 companies to relocate here, but in its entrepreneurial culture that creates new Fortune 500 corporations. Because the Bay Area comprises the fourth-largest market area in the United States, it will continue to attract sales and service offices. Its ports will sustain its role in international trade and support its role in international finance. Interactions with Pacific Rim countries will become even more critical to the region’s future.
Our concern is that San Francisco may stifle its economic growth by not relaxing development restrictions before its supply of available space is absorbed. If the growth cap remains in place through 1993, the costs of occupancy could reach levels that may outweigh the benefits of a San Francisco location for many large tenants and may place an excessive burden on expanding young enterprises. Corporate decision makers need assurance from San Francisco's political leadership that their expansion needs will be met by quality space at competitive rents. Because suburban office markets have an average two to three years supply of available space, if employment growth outside of San Francisco is constrained, it will be attributable more to the high cost of housing than to a lack of office space.

In this environment, premier financial district office buildings offer strong, nonreproducible investment values. Well-leased, regional shopping centers in upper middle- and high-income locations and warehouse and distribution product on both sides of the Bay, like premier office buildings, are priced aggressively. We believe that the outlook is bright for institutional quality apartment buildings and upscale neighborhood shopping centers in infill locations, although traffic congestion and high housing costs will constrain retail sales growth overall. Relatively high vacancy rates will persist in research and development space.

In sum, institutional investors will find a mature market with solid fundamentals and sellers in a strong position. The negative perceptions of San Francisco, while perhaps correct in
the 1984-86 period, have not yet reversed to reflect the improving fundamentals. Although the political climate still presents some risks, the economic and demographic climate has improved substantially.
FOOTNOTES


2 Population statistics compiled by the Center for Real Estate and Urban Economics at the University of California, Berkeley.

3 There is approximately 14 million square feet of Class C space.


5 Santa Clara County has the largest concentration of research and development space in the greater Bay Area, with more than 70 million square feet.

6 All industrial inventory, vacancy and rent data provided by Grubb & Ellis, Coldwell Banker, San Mateo County Economic Development Association, Reynolds & Brown, and Lincoln Property Company.

7 ADI is a market term for the counties in which local television stations have a dominant share of the viewing audience. These market definitions are used in newspaper advertising sales. See Survey of Buying Power Data Service, 1986, published by Sales and Marketing Management Magazine, New York, New York; and San Francisco Newspaper Agency.

8 San Francisco retail data provided by Blatteis Realty Company, Jones Lang Wooton and Edward Plant Company.

9 Nordstrom reportedly grossed $1.7 million in sales on its opening day.


11 Suburban retail market data primarily provided by Coldwell Banker, Terranomics Development Corp. and Taubman Companies.

12 In addition to explicitly cited sources, Marcus & Millichap, Essex Property Corp., Lincoln Property Company, BRE Properties, Inc., Coldwell Banker and the Center for Continuing Study of the California Economy provided apartment market information.

13 Assumes a mortgage principal equal to 80% of value, a 10.75% interest rate, and a 30-year term. In addition, the purchaser would need a $43,200 down payment, loan fees of approximately 2.5 points or $4,000, and monthly real estate tax payments.
14 See *Bay Area Housing Data: Rent Levels*, The Bay Area Council, March 1987.

15 The United States Supreme Court upheld San Jose’s rent control law in an early 1988 ruling without taking a position on the hardship clause.

16 See *Taxing the American Dream: Development Fees and Housing Affordability* in the Bay Area, Bay Area Council, May 1988.