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Downtown S.F. faces increased office vacancy risk over next two years

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San Francisco's downtown could see vacancy ranging from 35% to 50% in certain areas.

San Francisco started the year with a 22% of its office inventory vacant — up from a single-digit rate pre-pandemic — but that number could more than double in some areas by 2024, the city's chief economist Ted Egan said on Thursday.

The city's downtown could see vacancy ranging from 35% to 50% in certain areas, assuming that current market conditions continue and office tenants decline to renew existing leases or sign new ones in a worst-case scenario.

"Even the space that is not yet vacant, much of it's becoming vacant," Egan told the city's Planning Commission. "And if there isn't a return to office and renewal of office demand, that's going to create a problem in all of those submarkets."

Egan's projections were gleaned from real estate services firm JLL, which analyzed the amount of direct and sublease space currently available as well as leases set to expire in the coming years.

Alexander Quinn, JLL's director of research for Northern California, said that while leasing activity has not kept up with availabilities since the start of the pandemic, such a scenario is "highly unlikely" to play out, as companies have continued to lease space throughout the pandemic, albeit at a much lower rate than in the years leading up to it.

"We’ve seen leasing activity of over 1 million square feet this quarter and 6.3 million square feet last year during the depths of the pandemic," said Quinn, adding that while the market is facing unprecedented challenges, "we are not at the edge of a cliff."

The data presented to the commission on Thursday shows that Mission Bay faces an office vacancy risk of 43.1% in 2024, which is on par with Mid-Market's vacancy risk at 43.4%. The South Financial District, which roughly spans an area south of Market Street from Montgomery Street to the Embarcadero, has recorded a vacancy risk of 34.2% over the next two years, while the North Financial District, located north of Market Street, could see vacancy rise to 41.4%. Meanwhile, the North Waterfront could see vacancy rise to close to 40%.

More than half — almost 54%— of the office space in Jackson Square, a roughly five-block submarket bounded by Columbus Avenue, Sansome and Broadway streets known for its historic brick commercial buildings, could be vacant by 2024 given the absence of new lease deals or renewals.

The submarkets with the lowest projected vacancy risk are the Van Ness Corridor (23.2%), Union Square (28.2%) and Showplace Square (26.5%). The latter is home to tech giants like Airbnb Inc., which over the past year has listed much of its real estate there (more than 600,000 square feet, with some leases expiring over the next four years) for sublease.

Quinn said that year-to-date, the city has seen approximately 2.7 million square feet in leasing activity.

"Trophy buildings and buildings with meaningful waterfront views have held in pricing," said Quinn. "It shows the long-term resiliency of higher quality assets that will achieve healthy occupancy levels indefinitely."

The city is projecting that 33% of its workforce will be reduced to remote work permanently. Companies like Splunk have begun marketing entire buildings for direct leasing, while others, like the State Bar of California, are planning their exit, citing the shift to remote work.

Block, the fintech formerly known as Square, said this month that it will not renew the lease for its 450,000-square-foot headquarters in Mid-Market. The company has said previously that it is leaning toward a distributed workforce, providing employees access to offices around the Bay Area, including a significantly smaller office in San Francisco (760 Market St.). Block will also retain its 350,000-square-foot location at Uptown Station in Oakland.

That's not to say that the market hasn't had gains this year.

I first reported that Wells Fargo Bank last week signed the largest lease renewal deal of the pandemic. The bank recommitted to more than 620,000 square feet at 333 Market St., where it is consolidating much of its San Francisco workforce (the bank notably is working to offload another office building it owns and has exited a some 208,000-square-foot space it has occupied for close to 20 years at 45 Fremont).

Levi Strauss & Co.'s commitment to renewing its roughly 335,000-square-foot lease at Levi's Plaza in Jackson Square has also instilled hope in the office market's recovery, though that deal is still pending as the retailer continues to negotiate the terms of the renewal with its landlord.

Beauty company Sephora also made a splash when it subleased 286,000 square feet at 350 Mission St. from Salesforce earlier this year with plans to move its headquarters there, signing the biggest new lease since Visa's 300,000-square-foot headquarters deal at Mission Rock in late 2019.

Quinn said that the city has averaged about 1.28 million square feet of leasing activity per quarter since the start of the pandemic, even with the market virtually on hold.

Historically, the city has averaged about 2 million square feet of leasing activity per quarter since 2008, counting positive occupancy gains. The highest total annual leasing volume was recorded in 2018 at approximately 12.5 million square feet.

"If we can get back to 2 million, we would see vacancy start to go down," Quinn said.

Housing permitting slows in 2022

New construction historically ramps up when demand exceeds supply, and so it is no surprise that the pandemic has thrust the city into a new office construction drought. On the residential side, the picture is similar and perhaps more precarious as the city faces a state-mandated goal to plan for the construction of some 82,000 new homes at various income levels by 2031.

There were 4,668 units under construction at the end of the first quarter of 2021, compared to 6,748 in the first quarter of 2018. A total of 1,161 were completed in the first five months of 2022.

The city averaged about 4,000 completed units annually in recent years — predictions for 2022 show that about 2,800 units will be completed by year-end.

Egan said on Thursday that the number of units that have been permitted over the past two-and-half-years is well below 2019 trends, and has plummeted particularly hard in recent months. In 2019, it was a given to see between 250 and 300 units permitted each month, but in the early months of 2022, permits were recorded in the double-digits (in April there were just over 50).

“One of the most obvious reasons development has been slow is the decline in revenue associated with owning revenue for rental purposes or owner occupants," said Egan. Apartment rents, while having recovered some since dropping from astronomical heights in 2020, are still about 14% less than they were in 2019, according to Egan.

“So any project that was moderately feasible in 2019 now has to contend with a roughly 14% reduction in revenues, at least a rental projects," he said.

Given the current trends, Commissioner Frank Fung asked city staff whether it would be "impossible" for the city to meet its housing goals.

"(The state) set a goal of about 80 to 83,000 units over an 8-year period, that would suggest that we were going to produce over 10,000 units per year. We all know that we've never produced more than about 5,000 units per year, over the last 10 years," said Joshua Switzky, land use program manager of the Planning Department.

A total of 52,889 units are currently entitled in San Francisco, of which 6% are under construction and 49% are tied up in multiphased developments. Applications for another 14,382 units have been filed.

"There's a very large bank of projects that have been entitled and so it's a matter of getting the conditions to get them under construction," Switzky said.

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