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San Francisco’s office investment sales, lending markets poised for reset

By Shihao Feng
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More clarity is emerging in San Francisco’s beleaguered office market, with the heavily discounted sale of 350 California Street in May and a similarly distressed sale of nearby 550 California Street providing what local investors, brokers and lenders believe is a floor for valuations in a city which has seen vacancies rise steeply as a result of the covid-19 pandemic.

The 286,000-square-foot building at 350 California Street was sold for $225 per square foot, a 75 percent drop from its last sale in 2020, according to published reports. MUFG Americas, which paid about $300 million for the property, ultimately ended up trading it for about $60 million to New York-based manager SKS Real Estate Partners.

The sale of 550 California Street, a 355,000-square-foot office building, followed a similar pattern. San Francisco-based Wells Fargo Bank, which put the property on the market in 2022 for about $160 million, eventually sold it for around $45 million, according to published reports. The bank had owned the property since 2005.

“If you look at the number of office buildings that have changed hands in San Francisco, the sample size is really small,” said Mark Mengelberg, a partner in the real estate practice at Allen Matkins, a San Francisco-based law firm. “Buyers are probably coming in with equity and not a lot of debt [on any office property that is going to change hands right now].”

Rising vacancies

According to a report from advisory Savills, the overall availability rate in the San Francisco office market hit 32.7 percent at the end of the first quarter. The city, which has roughly 86.6 million square feet of office space, had vacancies of 26.8 percent during the same period in 2022 and 11.2 percent in the first quarter of 2020.

While many owners are hoping to hold out for a brighter day, Jeremy Thornton, executive vice-president of Toronto-based Colliers International, said some properties are going up for sale due to non-performing or maturing loans.

“[Regarding] the transaction activity in the office side, [what] we’ll see this year is more lenders taking assets back as opposed to traditional buyer-seller sales,” Thornton said.

The performance of office loans on San Francisco properties securitized in commercial mortgage-backed securities deals is a good proxy for the performance of this market, market participants told *Real Estate Capital USA.* New York-based data and analytics provider Trepp tracked a steep increased in the CMBS delinquency rate for San Franciscoarea properties, with the percentage of troubled loans rising for 1.07 percent in April 2022 to 4.82 percent in May 2023.

This kind of data makes it hard for conduit lenders to consider opportunities in the city, Thornton noted. "If you look at a lot of these properties that are likely going to be defaulted in the next 12 months, it's hard for a CMBS lender to go in," he said.

Seeking Remedies

For San Francisco office owners who have loans coming in due soon, Colliers' Thornton said they can either inject additional equity to significantly pay down the existing debt and recapitalize the deal. But if a sponsor is unable to do this, it is likely a lender will foreclose an asset and appoint a receiver to manage the property until a sale can be executed.

"We've already started to see deals go into receivership," Thornton said. "It's a very similar story to what you're seeing in Los Angeles, and I would say it's probably even worse in San Francisco. Generally speaking, most lenders aren't set up to operate properties, [so] upon foreclosure [they] will immediately look to sell to an asset to cut their losses."

Still, there is innovation in the way a lender can navigate situations of distress. Thornton cited a case his firm has been working on in which a property's lender brought in a local owner to operate the office in exchange for a percentage of the equity in the property. When the property is ultimately sold in two or three years, the operator could receive equity upside in the transaction.

Conversion potential

San Francisco has been taking steps to help the recovery in its central business district.

In February, Mayor London Breed initiated a roadmap to revitalize the city's downtown office market, proposing a strategy aiming to "assess the potential for conversion of office to residential and other uses and amend the planning code to maximize the flexibility of downtown zoning."

As of July 1, Assembly Bill 2011 will provide an expedited path for developers which want to build or convert qualifying mixed-income and affordable housing projects in commercial zoning districts.

Mengelberg believes this legislation could mitigate problems of under-utilized office space and lack of available affordable housing in downtown San Francisco.

"That might have a big impact and where this is all heading," he said. He cautioned, however, that these deals don't always pencil out economically.

There is a further concern that once conversions start, the city's existing infrastructure might not be ready for a steeply higher number of residents.

"Downtown San Francisco has been developed very heavy in office, so we don't have the infrastructure, the parks, the grocery stores," he said. "Those types of amenities that would make it more desirous to live downtown."

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