

# tWO

## Citywide Economic and Development Context

Over the last quarter of the 20th century, San Francisco experienced several cycles of economic boom and bust. During periods of growth, the planning process must respond to high levels of private investment and job growth, and guide the growth so that it is beneficial for the City. During periods of decline, the planning process must respond to the reduction of jobs and focus on business retention. With lower development pressures and a less active market, these slow periods also provide the opportunity to plan for the next cycle of growth.

During the period of economic decline beginning in the mid-1980s San Francisco's employment dropped and the local economy slowed down. The economy recovered by the late 1980s and by 1989 employment grew to 555,900. (Figure 2.1.1) In 1990, the total number of San Francisco jobs peaked at approximately 560,000. Subsequently, it began to decline as part of the national and statewide recession that started in the mid to late 1990s. The Bay Area's high technology industry helped to delay the City's decline for several years. The number of jobs in San Francisco ultimately dropped to 521,500 in 1993. This reduction of jobs in San Francisco increased office vacancy rates to 14 percent between 1987 and 1993, as described further in this section, while many other U.S. cities had office vacancy rates as high as 25 percent due to over-construction.

## Strong Economic Growth

The City's most recent period of growth was spurred on by the strong regional, domestic and international economy and San Francisco's role as a regional center for financial services and information-based activities. The hotel, restaurant, and related tourism industries benefitted by San Francisco's position as a favorite city to visit for both domestic and international travelers. The City's convention facilities drew large numbers of national and international convention-attendees. Conventions generated increased employment in the hotel and hospitality sectors, as well as the business sectors that support them.

Between 1994 and 2000, San Francisco experienced a period of sustained growth and added over 86,000 jobs. The City attracted 17.3 million tourists and visitors in the year 2000. Figure 2.1.1 shows that employment in San Francisco reached 591,196 in 1998, and 608,340 in 2001.

Corresponding to the job growth in San Francisco, office vacancy rates rapidly declined to five percent in 1997 and to two percent in 1999 and 2000. Monthly asking rents for office space rose

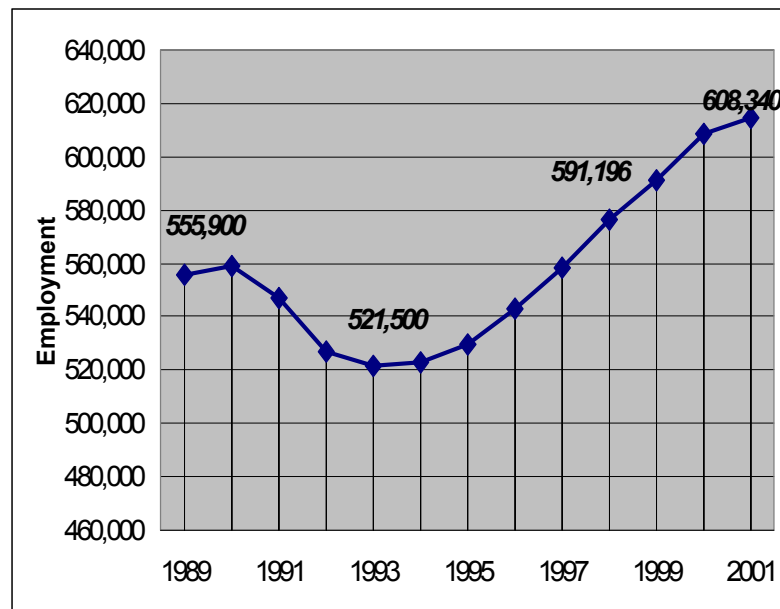


Figure 2.1.1 Total Employment in San Francisco

from approximately \$20.00 per square foot from 1987 to 1995 to about \$75.00 per square foot by 1999. These low vacancies and higher rents were aggravated by the limited office space available in the mid 1990s. New office space only became available starting in 1997.

Many warehouses in the Eastern Neighborhoods, including South Park and other areas South of Market were converted from production, distribution and repair (PDR) uses to Internet and web companies and the area took on the moniker iMultimedia Gulch. Along with this growth and conversion of warehouse space to high-tech and other office uses came the loss of space available to more traditional PDR businesses.

## Growth in High-Tech Companies

In the mid-to late 1990s, San Francisco's rapid employment growth was linked to the City's position as a regional center, its close proximity to Silicon Valley, and its diverse and highly skilled labor force.

In the mid-1990s, San Francisco began to experience a new phenomenon; it became a center for the emerging multimedia industry. These new tech companies took advantage of the resources of the existing artist community in South of Market, the technical expertise of Silicon Valley and the availability of appropriate space. Internet companies were often started informally. Company principals did not need or want traditional office space, nor initially, could they afford it. The new high-tech multimedia companies started to lease low cost space in warehouses South of Market. Because of the low rental costs and the large open warehouse floor plates, these businesses had the flexibility needed to respond to rapid employment growth and the ability to wire and rewire computer hardware easily.

San Francisco and the Bay Area acted as an incubator as new companies started to grow. While Internet and other high-tech companies started out as small businesses, many of them began

to attract funding. In 1996, venture capital (VC) companies provided about \$10 billion to Internet and other high-tech start-up companies in San Francisco. Funding continued at about that level until 1998, when the funding rose 20 percent to \$12 billion, even though many of the companies were not generating any profit. (Figure 2.1.2) The amount of venture capital funding continued to rise and many new high-tech companies started to grow very rapidly, hiring staff and leasing more office space. In 1999, VC funding rose to \$40 billion. In 2000, the last year for which we have complete information, VC funding exceeded \$50 billion for start-up companies in San Francisco. This funding allowed the expansion of the high-tech office space. The reported leasing activity increased from about 0.5 million square feet to 4.25 million square feet.

In San Francisco, as in Silicon Valley and other parts of the country, there was a boom in the incubation and development of high-tech companies. Given the limited supply of warehouse space and the growing demand for office space conversions for high-tech companies, rents began to increase significantly.

Historically, warehouses were used for storage, light and heavy industrial uses and also storage related to maritime uses. However, beginning in the mid 1990s, office vacancy rates throughout the City started to fall as a result of the fast growth of professional services as well as high-tech and multimedia businesses. As the multimedia companies started to grow, they were often

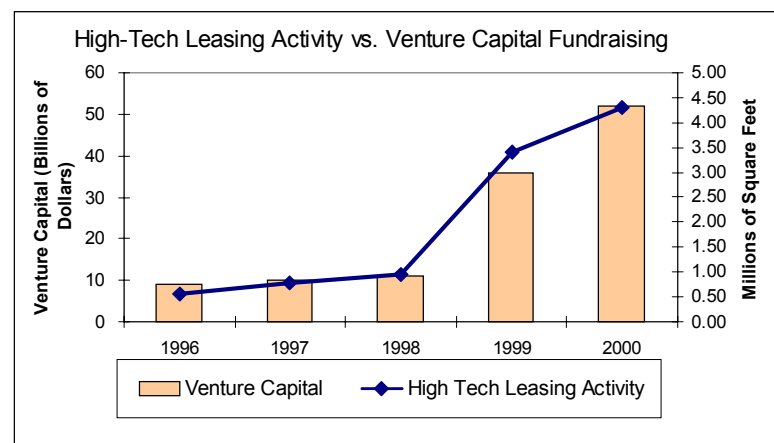


Figure 2.1.2 High Tech Leasing Activity vs. Venture Capital Funding

able to outbid PDR companies for warehouse spaces. As a result, many PDR companies were forced to move to other districts, leave San Francisco or they were forced to close down.

## Office Development

Beginning in 1986, Prop M established an annual limit for new office space. This limit allowed for the annual approval of 475,000 square feet of new office space per year through 1998, and 950,000 square feet per year thereafter. The 950,000 square feet total is split between small and large projects. In a given year, 75,000 square feet is allotted to small office projects between 25,000 and 50,000 square feet. For large office projects 50,000 square feet or greater, a total of 875,000 square feet is allotted per year. Between 1995-2001, the City approved 22 small office projects and 34 large office projects. Ten of the small and 11 of the large office projects have been approved in eastern neighborhoods outside of the downtown districts.

## Live/Work Boom

Many live/work units have been constructed in San Francisco over the last decade. Initially, the live/work designation was created in the Planning and Building Codes to provide affordable spaces in which artists could live and work. It permitted artists the opportunity to legalize their live/work spaces. These structures were located primarily in industrial districts. Many of these spaces had been converted from vacant warehouse structures, but they could not meet the residential requirements of either the Planning or Building Codes. The original intent of the live/work designation was to allow the consideration of these affordable units as convenient rather than residential use so that they would be legal.

The year 1989 marked the beginning of a very strong period of live/work development. (Figure 2.1.4) The live/work units are concentrated in the Eastern Neighborhoods. (Figure 2.1.3) In the 1990s, developers began to construct new live/work projects on

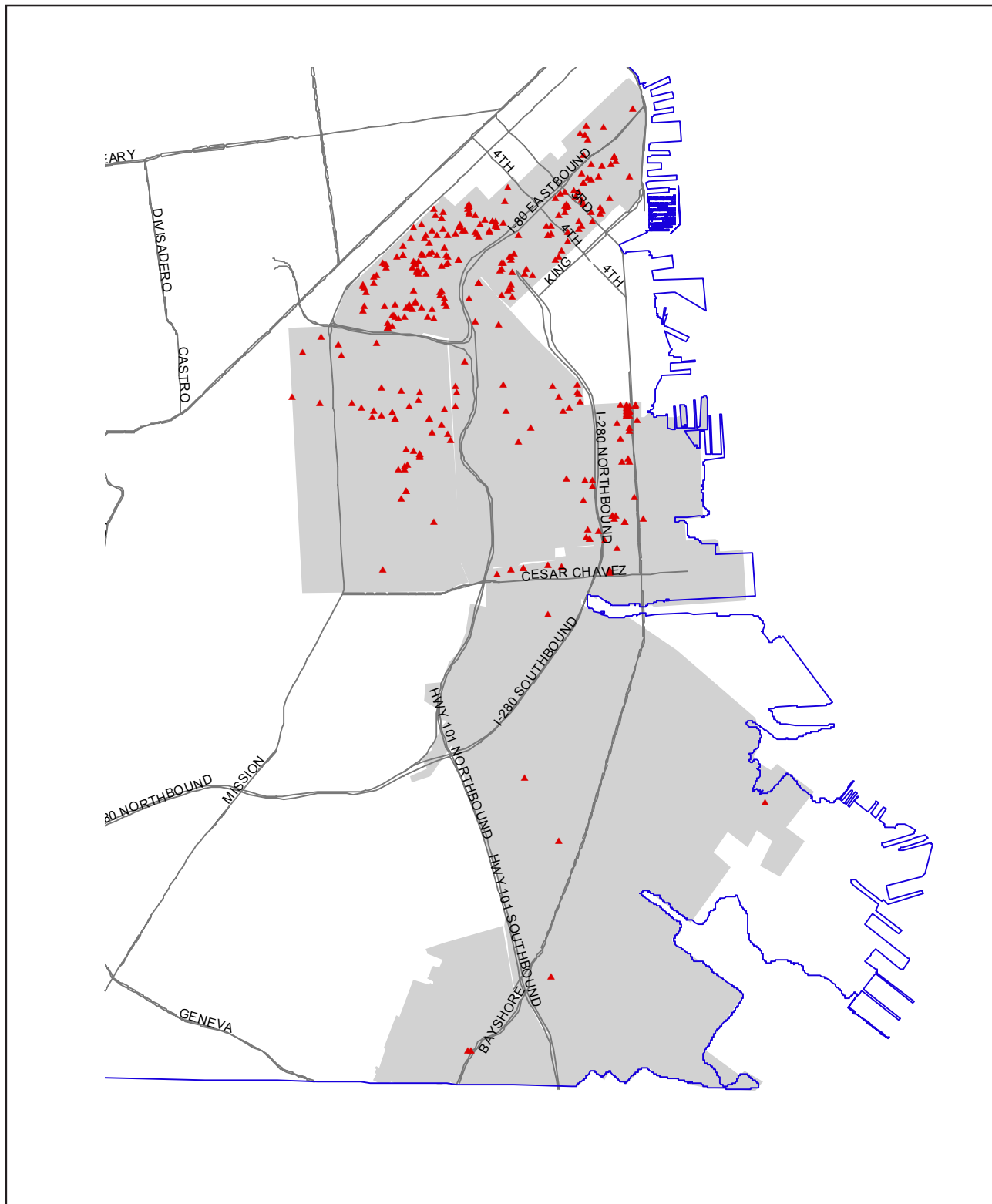


Figure 2.1.3 Location of Live/Work Units

vacant lots, or demolish structures and construct new live/work units throughout the Eastern Neighborhoods. By 2001, 1,860 units were constructed or converted and 2,314 additional units were approved but not yet constructed. Assuming all units for which permits have been issued are constructed, a total of 4,174 live/work units may be constructed throughout all industrial areas in the City (Figure 2.1.3). Most of these units have been built or may be constructed in the South of Market, the Inner Mission and in the Central Waterfront districts. Many of them do not house working artists and most are not considered affordable by a majority of San Francisco residents.

Often construction of live/work units has come at the cost of losing land for other uses. This includes industrially zoned land, which has supported PDR uses. In addition, new loft residents are often at odds with their PDR neighbors. PDR companies may create noise, emissions and require truck loading and unloading at odd hours.

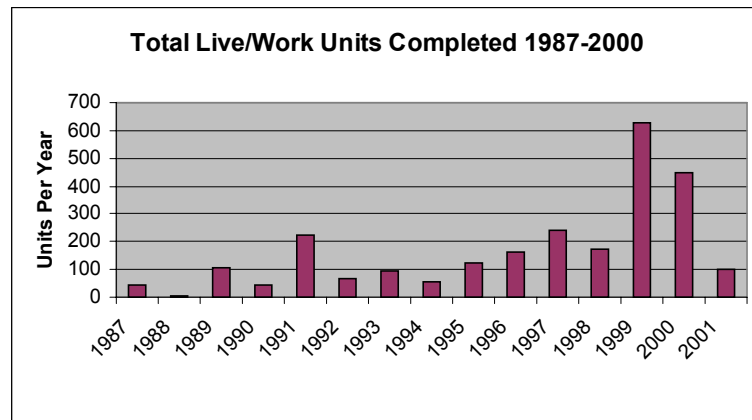


Figure 2.1.4 Total Live/Work Units Completed 1987-2000

## Increase in Overall Housing Production, but Limited Affordable Housing

Since 1981, there has been a net increase of 22,592 housing units in San Francisco, with the greatest amount of housing constructed in a single year in 1989, when there was a net gain of 2,345 units. The City has issued building permits for 31,460 housing units and from 1981 until the present, 25,205 housing units have been constructed.

Most of the existing housing stock and new housing constructed in San Francisco is not affordable to the majority of people who reside in the city. While some affordable units have been constructed in San Francisco and will continue to be constructed, the majority of residential units will be offered at market rate.

The State Office of Housing and Community Development (HCD) and the Association of Bay Area Governments (ABAG) set housing production targets for San Francisco for both affordable housing and market rate housing. (Figure 2.1.5) San Francisco's actual housing production is below the 1999 and 2000 targets, for affordable housing, while the goal for above moderate was exceeded. The target for total housing production in 1999 and 2000 was 5,433 units. Only 2,887 units were actually constructed, the vast majority of which (2,515) were at market rate levels, primarily for residents earning more than 120 percent of the area median income. The construction of units meeting the needs for Very Low, Low, and Moderate Income levels varied between 6.3 percent and 14.5 percent of production targets for 1999-2000. In order to meet the overall 1999-2006 production targets for housing at all income levels, a significant number of affordable residential units must be constructed.

<b>ABAG/HCD Housing Needs Determination and Actual Housing Production 1999 - 2000</b>			
	<b>HCD/ABAG HOUSING NEEDS DETERMINATION</b>	<b>ACTUAL HOUSING PRODUCTION</b>	
<b>Income Level</b>	<b>2 Year Production Targets (1999 &amp; 2000)</b>	<b>1999 &amp; 2000</b>	<b>Percentage of Targets Achieved</b>
Very Low (50% of AMI)	<b>1,398</b>	203	14.5%
Low (80% of AMI)	<b>567</b>	75	13.2%
Moderate (120% of AMI)	<b>1,504</b>	94	6.3%
Above Moderate (Market Rate)	<b>1,963</b>	2,515	128.1%
<b>TOTALS</b>	<b>5,433</b>	<b>2,887</b>	<b>53.1%</b>

Figure 2.1.5 ABAG/HCD Housing Needs Determination 1999-June 2006

## Recent Downturn in National and Local Economy

After a period of sustained growth from the mid 1990s through 2000, the local economy abruptly reversed its course. In the spring of 2001, the economic bubble burst. Many of the Internet companies depended on constant inflow of venture capital for company growth and development. A number of dot-com companies went out of business as their costs continued to rise, but not their funding. Initially the impact focused on the high-tech sector. Many high-tech company stock valuations on the New York and Nasdaq stock markets fell. Drops in market values affected individual and institutional investors.

The economic downturn expanded to other sectors, affecting broad segments of the national and international economy.

Major corporations started to lay off employees, and the nation's unemployment rates grew. Finally, The National Bureau of Economic Research, on November 26, 2001, reported that the US Economy had fallen into recession and had actually been in a recession since March 2001. The recession ended the nation's 10-year period of exceptional growth.

San Francisco's unemployment rate grew from 4.2 percent in May 2001 to 6.1 percent in November 2001. While in the late 1990s, San Francisco's unemployment rate was below that of the State and regional levels, the City's unemployment rate now exceeds the State's 5.8 percent unemployment rate and the nation's 5.7 percent unemployment rate. In addition, the job growth rate projected for 2000 through 2010 is lower than the 1995 to 2000 period. Since Spring 2001, profits have declined and many companies have increased layoffs. The steepness of the downturn continued to increase in the fourth quarter of 2001.

Another major blow to San Francisco's economy was the September 11, 2001 terrorist attacks in New York and Washington, D.C. These and related events have further eroded business and leisure travel to San Francisco. Tourism is one of the City's largest economic engines, this slowdown is reducing hotel, restaurant, and related industry income and municipal taxes.

## Higher Office Vacancy Rates

As a result of higher unemployment rates and office closures, San Francisco has experienced an increase in office vacancy rates and a corresponding decrease in asking rents. The average vacancy rate for both Class A and Class B office space by the end of the third quarter of 2001 was almost 12 percent and the average rent decreased from a high of about \$75.00 in 2000 to \$45.83. The dramatic changes began in the third quarter, and the increased vacancies and decreased rents are expected to become steeper. In the third quarter of 2001, office vacancy rates

were estimated at 14 percent for downtown Class A office space and up to 18 percent for Class B office spaces outside of the downtown. (Figure 2.2.1)

On December 28, 2001, the San Francisco Chronicle Business Section quoted Grubb and Ellis statistics for the cost of rents and the vacancy rates for office space in the Central Business District and the SoMa areas. According to this article, the Central Business District of San Francisco experienced a 51 percent drop in cost per square foot and an increase in vacancy from four percent in December 2000 to 16 percent in December 2001. An even more dramatic change in cost and vacancy took place in the SoMa. Grubb and Ellis reported a 67 percent decline in rents and a rise from ten percent to 46 percent vacancy for the SoMa during the same time period. Unlike the falling prices and the rising number of vacancies for office space in the City, the vacancy rate and cost per square foot for PDR has remained stable during this same time period. (See discussion in Chapter 4)

## Decline in Building Permit Applications for Major Projects

Another indicator of the change in the local economy that can be measured is building permit activity in San Francisco. The table below (figure 2.2.2) shows a significant reduction in building

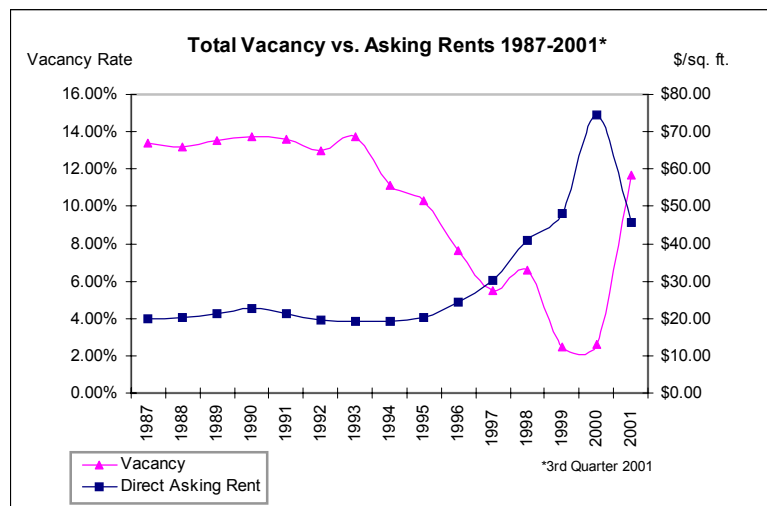


Figure 2.2.1 Vacancy Rates vs. Asking Rents for Office Space

permit activity in the City for the six-month period of April to October 2000, compared to the same period in 2001. This period was selected because the economic slowdown started in March 2001. The selected period reflects the economic shift in the local economy.

The largest reduction in building permit application activity in this period was for new office construction. The total number of building permit applications for office developments decreased dramatically, down 75 percent, in the period from April to October 2000 compared to the same period in 2001. While there was a reduction in building permit applications for residential construction, it was significantly less than office. Housing construction is not as effected as office construction, in part because of the pent-up demand for housing in San Francisco, the strong market, and a reduction in interest rates. (Figure 2.2.2)

## Home Sale Prices

After a long period of growth, home prices in the nine Bay Area Counties have started to come down. Average home prices went from a median sale price of \$386,000 in March 2001, to a median price of \$366,000 in October, 2001. In San Francisco, prices remained relatively stable during the same period. They actually

	April - October 2000	April - October 2001	Percent Change
<b>Office Buildings</b>			
Building Permit Applications	24	6	- 75
Estimated Construction Cost	\$297 million	\$39 million	- 86
<b>Residential Units</b>			
Building Permit Applications	186	133	-28
Estimated Construction Cost	\$210 million	\$79 million	-15

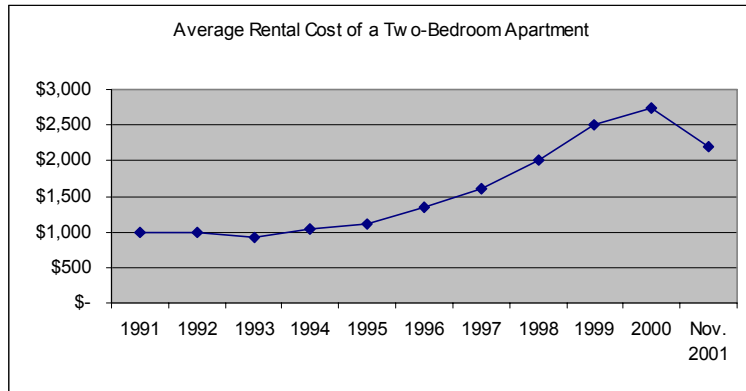
Figure 2.2.2 Building Application Submittals for Large Office Projects and Residential Projects

increased 0.2 percent from \$489,000 to a median price of \$490,000. While there is a regional trend for home prices to drop, there may be a lag in San Francisco and some other Bay Area cities.

### Apartment Rental Cost

During the late 1990s and into 2000, the average cost to rent an apartment in San Francisco skyrocketed. Average rent for a two-bedroom apartment rose by 20 percent from 1998 to 1999 and 25 percent from 1999 to 2000. (Figure 2.2.3)

What is surprising is that after the year 2000, for the first time in years, rental vacancy rates have increased, rents have dropped and potential tenants can negotiate with landlords over the terms of their tenancies. Metro Rent reported a reduction in apartment rental costs in San Francisco over the last year even though the rate of housing production had remained stable in the same period. (Figure 2.2.4)



<sup>1</sup> Source: METRO Rent, San Francisco, 11/1/01 ñ 11/30/01

Figure 2.2.3 Average Rental Cost of a Two-Bedroom Apartment

Apartment Size	Average Rent. Nov. 2000	Average Rent Nov. 2001	Rent Reduction from Nov. 2000 (Percent)
Studio	\$1,367	\$1,131	- 17
One Bedroom	\$2,128	\$1,660	- 22
Two Bedroom	\$2,692	\$2,197	- 18
Three Bedroom	\$3,320	\$2,770	- 17
All Sizes Average Rent	\$2,377	\$1,940	- 18

<sup>1</sup> Source: METRO Rent, San Francisco, 11/1/01 ñ 11/30/01

Figure 2.2.4 Reduction in Rental Costs for Apartments in San Francisco