The Weekly Take

Down by the Bay: AI and the future of San Francisco real estate

6.18.2024

Spencer Levy
Fun fact: San Francisco is where CBRE was founded more than a century ago. Beyond that, it's a market with a deep history of social and political movements, as well. A place that makes waves in many ways. On the business front, its best known industry, technology, has made an impact that's being felt worldwide, starting in the city's own real estate. On this episode, we go west for a look at a new kind of tech: the rise of artificial intelligence and what it means for labor, lifestyle, and leasing in the City by the Bay.

Glenn Gilmore
What AI is doing now for this city in a very short order, and what we'll see as the trend, is it is bringing people home. If you are in venture capital, you have an office here.

Spencer Levy
That's Glenn Gilmore, founder of Brick and Timber Collective, a boutique office landlord with assets across San Francisco, including in some of the city's cool, reemerging historic neighborhoods and similar districts in other markets such as the Wynwood section of Miami and more.

Mike Taquino
It's a tremendous influx of capital, which is going to continue to create growth in the office sector, which we think is hugely positive for this market.

Spencer Levy
And that's Mike Taquino, an Executive Vice President who runs CBRE's Capital Markets platform in the Bay Area. Mike specializes in San Francisco proper and the wider region of Northern California. Coming up, a San Francisco treat. A look at this capital city of tech and some things that might surprise you, including a pocket of strength in the office sector. How and why the new, new thing known as AI is making an impact on real estate. I'm Spencer Levy, and that's right now on The Weekly Take.

Spencer Levy
Welcome to The Weekly Take, and I'm delighted to be here with Glenn Gilmore, founder, Brick and Timber Collective. Glenn, thanks for coming out.

Glenn Gilmore
Thanks for having me.

Spencer Levy
And thanks for hosting us in one of your spaces here. Beautiful building.

Glenn Gilmore
You're welcome.

Spencer Levy
And then we have Mike Taquino. Mike, thanks for coming out.

Mike Taquino
Appreciate you having me.

Spencer Levy
Well great to have you here today. Let's just start with the hot two letters that are stated out there: AI, and how it's influencing the market. One of our dear friends and colleagues Colin Yasukochi, who works in our offices, wrote a report and said that 75 out of every 100 cents for AI is going to the San Francisco market. Is that true and how is it influencing the market?

Mike Taquino
Yeah, I think from our statistics, about 60% of all the venture capital funding going to AI is in San Francisco. And from what we've heard, that's going to increase to 90% by the end of the year. It's a tremendous influx of capital, which is going to continue to create growth in the office sector, which we think is hugely positive for this market.

Spencer Levy
Glenn, you're here in an area, the tenant in this building. A beautiful space, a venture capital firm. This seems like a mini venture capital hub here in San Francisco. There are other neighborhoods that I would call a tech area. This is more venture capital. Is that intentional?

Glenn Gilmore
I think it is, Spencer. If we go back before the pandemic, before work from home, before the problems here, and we look historically at San Francisco and we look historically at San Francisco and technology, the story of San Francisco is one of very, very powerful network effects. And the way these companies get off the ground, there's two very important pieces of that. One is you need well-capitalized venture capital firms to identify the best and the brightest. But then you also need the network of engineers, and you need the talented people with the ideas. And so those don't really coalesce very well remotely. And so as a result, what AI is doing now for this city in a very short order, and what we'll see is the trend, is it is bringing people home. If you are in venture capital, you have an office here. If you're serious about AI and if you're serious about venture capital, you're serious about AI. So to some extent, the thought was, in this

town, if you're very serious about your tech startup, this is before AI, if you have a serious tech startup, you would move it to San Francisco for these network effects. I think that theory got a bit disjointed and broken in Covid, frankly, and a lot of people were able to have a great time, frankly, live their best lives. Second house, third house, whatever it is, and do the zooms and we've all seen it. But now that there's this energy back, it's changing and it won't fully change. In some respects, people will be able to do what they want to do. But for those that are super opportunistic and want to be part of this new value creation technology, this is the place.

Mike Taquino
I think it is an example of history repeating itself. After the GFC, we saw a lot of the companies that are in massive spaces in San Francisco now, like Twitter and Uber, were founded in small startups, and they grew throughout that period. I think we're seeing that again. Neighborhoods like the Dogpatch of the Mission are where most of this AI innovation is happening. They're starting small, the money is pouring in, they're starting to expand. So last year, there was probably a million square feet of net positive absorption, primarily from AI tenants. Leading the charge was obviously OpenAI and Anthropic, taking roughly 800,000 square feet. If you're looking at the tenants in the market right now, we're back to almost pre-COVID levels with about 6.7 million feet in the market, 14% of that, roughly 27 tenants, is represented by AI. So albeit, a million square feet of net positive absorption is taking a small chunk of our overall vacancy. It is a tremendously positive green shoot as we see it for the real estate industry itself. When investors are coming back to a market where the headlines are hugely negative, it's really impactful to see A, you've got a tremendous amount of venture funding coming back into the city, and B, this is where AI is. And so I see history repeating itself, where a new technology is going to blossom and continue to lift our market back up.

Spencer Levy
I know we're not talking tech here, we're talking real estate here. But there is concern that this is going to eliminate jobs, eliminate demand for space. What's the talk in the market?

Mike Taquino
I think it's a TBD discussion. I think most people believe that AI is going to be an ancillary benefit to most companies that hopefully will provide growth within that company. Sure, they're going to be back office operations, or maybe people on phones in different countries that are replaced by AI. It's definitely a discussion. But I don't think anybody's certain yet. I think Glenn might have some more perspective on that, but...

Glenn Gilmore
I think it's a complete coin flip and the venture capitalist, if you talk to them, of which they think which way they think that's going to go. But I think that pessimism always sounds smarter than optimism. So, I think that people will generally be pessimistic professionally, because studies have shown that that proves that you sound more intelligent if you're pessimistic versus optimistic. So it takes a lot of courage to be optimistic in a place like this and a time like this. Doesn't mean one or the other is right.

But generally, if we look at the past as a guide, new technologies that were supposed to disrupt everything, make everything so productive that nobody would need all these people have usually not proven to do that. They've usually proven to just maybe disrupt jobs in certain classes and add them in others. So I would be on the optimistic side, which is why I won't sound as intelligent as my pessimistic friends, but it's a 50/50 coin flip.

Spencer Levy
We have to talk about the negative headlines about San Francisco and look, they're extraordinarily negative. I looked at some of the office data. The vacancy rate is as high as I've ever seen it. I saw 36, 37%. I mean, it's a pretty staggering number right now. So let's start with you, Glenn, what do you say to those folks that are down on San Francisco?

Glenn Gilmore
History is the best guide for the future in all of this. We forget this every time, which is why opportunities arise. AI is the latest in a many generation, many waves of technology changes that come to this city, that give the city a huge, huge shot in the arm. We know that AI is going to be a ubiquitous technology. Every single industry, every single business, is going to be touched by it in some way. We don't know who the winners and losers are, but we already know where they're going to be, so that's enough for me. It may not be enough for others, but I think that those that can believe in that and understand that have one of the great real estate opportunities of a generation here.

Mike Taquino
Look, I grew up in the Bay Area. I made my career in San Francisco. San Francisco has been great to me. I think from the perspective of anyone who's worked in this city, we've been on the defensive for the past 3 or 4 years. The negative headlines have been impactful. And again, part of it's true. You can watch the news and see some pretty dramatic scenes that most people from the outside world think has become all of San Francisco. And to your point, we have a tremendous amount of investors coming into our office weekly, given this new established value in the office market. New trades are happening, so people are coming to the office. And one of the most common themes we hear from people, whether it's New York or around the world, that step into our offices, it's not anything like we see on the news. It's much better. And I think that is the narrative. I mean, perception is reality. So if you keep being inundated with these negative images, you're going to believe it. Once you get here, real estate is location, location, location. And you being here, you look out the window, we've got the bay right outside, we've got beautiful weather, we've got Napa up north, we've got Carmel down south. I still believe it's one of the best locations to start a company and raise a family in the United States. So from that perspective, I'm hugely bullish on the rebound that we're going to see in San Francisco.

Spencer Levy
And I think it's fair to say by looking at history, to use your term, Glenn, and I agree with you, by the way, San Francisco has been a volatile market historically, but I think the biggest challenge we have here today, putting aside perception and, is the RTO, return to office, challenge. I heard a statistic the other day from one of the largest office owners in the US, said New York Tuesday to Thursday, basically 100% back in the best buildings. Boston, 75% and San Francisco around 50%. Are those numbers right? Or do they feel right? And what do we do to turn that around?

Glenn Gilmore
I believe the right, first of all. To back up, also, if we talk about the workweek, there really hasn't been a, hadn't been a real shift in office hours or workweek hours since the dawn of the internet, right? And so we now take home our work with us 24/7. We have iPhones, we have all these things. And people were still expected to be in office and in person five days a week, 9 to 5, generally speaking. I think that Covid probably gave a pause to that in a reflection of people's personal time and other things too, because we are connected. So there might have been a necessary shift culturally in this country to a bit of less work. I mean, I know that Mike Taquino's never worked on a Friday afternoon, but not everybody enjoys that kind of leisure in their work world. So maybe there is some of a reset that's necessary. I think also, there's a bit of an entitlement that came with this that made life a little bit more pleasant and a little bit more easy. But at the end of the day, businesses are about profits. And I think what we're going to find out, over time, is the proof will be in the pudding and people will go where the profits go. I don't want to get people angry with me when they say I'm trying to take away their work from home. But at the same time, I think that most people in their careers are going to go where it's most profitable for them. And I think we're going to see that companies that are spending time iterating together are going to outperform those that don't. I don't think there's a lot of people that really disagree with that from a guttural level. That being said, our workforce, I wouldn't call it a problem, but it has become entitled to that right. And so you're definitely taking something away from a certain group of the workforce who value that time more than they do that in office.

Mike Taquino
I would agree wholeheartedly with Glenn. And I think before the pandemic, there was never really a shift. And I think the office on Fridays in the Bay Area, for example, was always kind of optional. So I don't think that's a huge shift.

Glenn Gilmore
That wasn't just you.

Mike Taquino
Yeah, it wasn't just me. There was other people taking Fridays. But, you know, during Covid, it was a novelty. Everyone said, wow, we can actually work from home. We've got Zoom. We've never used Zoom before. This is pretty efficient. Well, that begin to wear pretty thin, especially for my team. And if me and my partners are the heads of the Bay Area capital markets, we have to be in the office, we have to be seen, we have to

be connecting with our leasing brokers, we have to mentor the young people. That cannot be done remotely. And so our team is in every day, Monday to Thursday, most times Friday. And I don't say this jokingly, but you get so much more done in person. It's just a reality. New ideas come up, new conversations happen. So to Glenn's point, I think there is a standoff right now, especially in the Bay Area where lifestyle seems to trump work style. And I understand that. Look, I live in the suburbs. Most people my age that have kids have come to a realization that being home with their kids and coaching has been fantastic. And if they live in Orinda and have to drive all the way to the valley, that's a two hour commute every day. They like that. So there's got to be some median, though, of coming back, because I think to Glenn's point, if you're going to move up and you're following the money, I think to live in the Bay Area, you're going to have to come back to the office.

Spencer Levy
Mike, given that you helped lead the capital markets effort here in the Bay Area, what's going on in the capital markets here in the Bay Area? What's selling and what's not? What types of capital is active?

Mike Taquino
Yeah, I think it's pretty common across the United States right now that, for most transactions to occur, you're seeing high net worth and private capital come into the market. Institutional capital as it relates to office is fairly redlined. You take office to IC, they're not believing this story yet. So just like in the GFC when we saw a major correction in values, in San Francisco right now, we're seeing anywhere from call it 60 to 85% deterioration in value. We're seeing a new floor set. Deals that were trading north of $1,000 a foot are trading anywhere from $100 to $300 a foot right now. And that's kind of our barometer. And I think what's really happened in this market, cap rates are kind of out the door. It's not net operating income. It's cash flow. There's no leverage to buy office right now. So every dollar you're putting in you need a return. So I think the return on cost metric has become much more prevalent. Cash flow has become much more prevalent, and basis is becoming the biggest thing people are looking at. So when you have these high net worth and family offices coming in, they're not IRR driven per se. They're looking at basis. And I think the beauty of San Francisco is you can always point to the fact that in the height of the market, you were north of a thousand a foot. People are seeing deals traded $1 to $300 a foot. That feels like a tremendous value. And again, the non-institutional buyers don't necessarily need to see the trends happening to come in. This is when the bets are made. Once we get to the third or fourth or fifth inning and there's some momentum, institutional players will come back in, hopefully coupled with a functioning debt market, because again, right now we have no functioning debt market for office, unless it's single tenant leased.

Spencer Levy
So Glenn, I guess it is the best of times as a buyer, as an existing owner, you see some diminishing in value. But I haven't seen opportunities like this since the early 1990s to be direct about it, when we saw assets trading in the same values. How do you see it?

Glenn Gilmore
I couldn't agree more. I mean, we're very active in the market right now looking at opportunities. We're tracking everything that comes out and we're a net acquirer. Our portfolio here is, I'm happy to say we've kept it during the pandemic leased. We're 100% leased in San Francisco. The only challenge we have or not, the only the biggest challenge we have on our portfolio is debt, is areas where we can’t recycle our debt, because the debt markets. But we've enjoyed pretty good relationships with our lenders and keep those things alive, keep those things moving, and they are all making money. But the values, if we had to trade them right now, we'd be in rough shape. It wouldn't be wouldn't be right. So I do think that if you're on the market here and selling an asset, there's no doubt that it's a distressed sale, no matter what you want to call it or no matter how you want to package it. Because those that are able to keep their properties right now will. There's no reason to test the markets unless you absolutely can't do it. So I think it's a tremendous buying opportunity. We have a fund together to take advantage of this. And we've been actively, like I said, pursuing opportunities. We haven't found the first one yet but we're getting closer on a few things.

Spencer Levy
So what I've heard from a few entrepreneurial buyers is that there are certain types of assets they're looking for. They're different than your profile, though. You seem to have a very different model here. Glenn, this building, I think, is exhibit A: historic buildings need a lot of value-add looking for entrepreneurial venture capital type tenants, which necessarily brings you to a different part of the city, not the traditional CBD. This is sort of on the outskirts of the CBD. Is that a fair way to characterize your optimal asset?

Glenn Gilmore
I think it's a completely fair way to characterize what we've been known for and what we've done. I think in the future, we will likely expand to other office. I hate to call it a commodity office product, but we definitely want to be on the luxury office side. Like I don't like the term creative office. Creative office sounds to me like just open space, you know. I think what we are is a luxury office player, but I think that a lot of our fit outs and a lot of the design we've done are what people are trying to do now. And we were doing this before the pandemic, because we see the office as a different kind. We're not trying to maximize density in our office. We've never done that anywhere. And what we've done is try to maximize the experience and the aesthetic so that people have a good sense when they come into the office, and don't feel like it's such a slog. So I think that that model is going to continue to work, and we're seeing it everywhere. We're seeing it in Miami, we're building it there. But we've enjoyed pretty good success down multiple places, building office this way and finding the kind of tenants that appreciate it and are willing to pay a market rate for it.

Mike Taquino
Glenn, I would argue, was ahead of his time in San Francisco. He came into a market that had no shortage of tenants, demand or rents. But he still said, I'm going to go and spend the money to build out tremendous space. Now, where that is advantageous in this market, when he loses a tenant, he's got space that doesn't need $250 of TIs. So

what he's competitively positioned against are these groups that are coming in to buy buildings. TI dollars are now more expensive on a price per foot than the buildings actually are. So to think that somebody is actually going to buy a building and put that amount of capital in to match Glenn's buildings is tough in this environment. Glenn, values may be down, but when his tenants roll, he's still getting premium rents. And that's pretty interesting. I think everyone is trying to do this model, but I think it's going to be economically tough.

Spencer Levy
So let's talk this through. And this is the math warning portion of today's show, because we're going to talk a little math here. Because I think that when I look at this space that we're in here today, you bought this building corn shell. It needed everything. And before you had a tenant in hand, did you do everything and everything? And this is not a visual show. I'm looking out the window at natural wood, a cross laminated timber, I presume. I'm looking at natural light. I'm looking at exposed ceilings. You don't have to give the exact number, but this fitout is probably in that north of that $250 a foot range. And you did that as base building. Is that a fair way to put it?

Glenn Gilmore
Yeah, it's exactly right.

Spencer Levy
And by doing it that way, when you get a tenant like here today, they pay whatever they pay in base rent. But you don't have to give them a TI package, or did you have to give them a TI package to be able to…?

Glenn Gilmore
No. Absolutely not. It was already done. There was nothing to give a TI package for. They just needed to move in their furniture. The benefit of that, if you can figure out in your cap stack how to do that, so that you're not waiting for the tenant to wait for the fit out, you get a lot of benefits. The negative benefits put all the cash out front without any security that you're going to find that tenant. But if you do it right and you and you hit it right, a couple things are going to happen. One, you're going to have no downtime. You're going to collapse your downtime of just waiting with nothing happening in the project, right? Once we launch one of these projects to the market, we typically have at least within a week or two. So even today, I can tell you we do that today. So ready to go space in this condition will lease very fast. And there's not a lot to negotiate because you're not negotiating 50 pages of a dream and what the cost and who's going to pay for what. It's done. Just move in. Here's your rent. Now, what's the challenge about that negotiation is that rent needs to be fairly significant, right. Because we already put the capital up, and you're not having to put up your own TI dollars. And it's worth a lot. And I think that's where brokers in the market can do a better job educating their tenants on how valuable that really is and what the real costs are, because you're saving the tenant coming out of pocket a tremendous amount of money. And almost every time in this market, because our construction is way overpriced. And I'd like to talk about that a little bit too, but, is that a landlord gives an allowance that's woefully short. Everybody wants

to make a deal. They say, well, we think you can get…. And they tell the tenant who has nothing to do with construction, nothing to do with office landlord, probably never done a lease before. And they come in and they say, well, we're funded or where this or where that and that sounds like a fair deal. And they kind of rely on their broker to tell them, okay, yeah, you're going to be.... And then all of a sudden when they're fully inked up, they realize that it's not 2 million we need from you, it's 6 million. It's 8 million. And they go, holy moly, you know, like we now are…. But you know what? This is not what we do. We'll take the hit this year. We'll make the office great. We'll make the business a success and we'll make it back in our business. And that's great. And so the pain of that sort of transaction kind of gets forgotten. And then the next guy gets it and the next guy gets it and the next guy gets it. And I think that we do need to be smart. And one of the things that's terrible about office investing is how many times we redo the same space which is unnecessary, but we need to be looking to do spaces that can be reused and recycled, and that means doing them right the first time. And I think that, in our perspective, we are so much happier when we are very involved in the build with that tenant and the design and not left sort of landlords stay away, let us do it, we got this. Because usually when our tenants do build outs, there's some cringe spots in there where we're like, oh, that's going to need to be redone and that's not going to be reusable, versus having something that we're so proud of that we know that every tenant will like it. Does that make sense?

Spencer Levy
It makes perfect sense. Do you even have a demolition clause here?

Glenn Gilmore
No.

Spencer Levy
Remarkable. People don't realize that when you are a typical tenant in a typical building, not only you got to pay upfront, you got to pay on the way out the door for demolition.

Mike Taquino
Yeah, there's some restoration clauses here and there, but it's a tenant market right now. And I would tell you there's two different business plans happening in San Francisco as relates to office acquisitions. You effectively got groups coming in and buying into really low bases and saying, we're going to do cheap and cheery, and what that means is limited TIs, have the lowest rent in the market, drive tenant demand. Because what we were seeing throughout Covid was asking rents in San Francisco never moved, and that was primarily dictated by the fact that there were no tenants in the market. Now we're back to 6.7 million tenants, square feet of tenants, in the market. We're going to really start to see this play out. You've got groups that buy cheap. Want to throw a little TIs, who are the economically driven tenants. And the other end of the spectrum, you've got groups like Glenn and a couple other building owners who are buying buildings and saying, I understand that model, but I'm also going to go build the Taj Mahal, the Four Seasons of an office building, get the highest rents, and we will see those two models play out. But there's two different opinions going on in San Francisco

right now. We're going to watch and see. You know, I think both will probably be successful in their own right.

Spencer Levy
Glenn, I want to go back to two basic points you made about adaptive reuse. One is the spec suite. The second is sustainability. And the spec suite concept, or we used to call it in New York City, maybe this is a bad term, but we call it a vanilla box. And that was we built it for you and you're moving right in. And I look at this, this is anything but a vanilla box. But nevertheless that's the term they use. But spec suites would be a fundamental shift in the office business. What's your point of view on using and what is your term for spec suites rather than my term? And does this work in a larger project?

Glenn Gilmore
I think it depends on the floor plate size, clearly. I think it's more of a challenge to do spec suites when we're starting to talk about greater than, say, 10,000 foot plates is where it starts to get a little bit uncomfortable, because now you're making a lot of decisions for larger companies and that's kind of hard to do. I don't think it's impossible. I think people will generally figure out how to do it. I think if we go backwards a little bit into what the market wants and what the tenants want, what they're really clamoring for is shorter term leases. And it's much to the chagrin of landlords. But I think the ten year leases is just a hard commitment. Companies are either growing or shrinking in that time. The only way to do leases that are going to be shorter than ten years with the build costs is going to be to have reusable space. But I think if you could also deliver something where somebody can get in and try it out for three years, you have a great opportunity to then grow that tenant in that building and take on additional floors that already look the same, or look in a similar fashion or style. Recently in Wynwood, Miami, we did the top two floors of The Cube building, which we own. We spec those out and those are 10,000 feet each, but we made them so they could be demised. We did something very clever with the kitchen, where you can actually have the plumbing on either side of a wall. So now we can have either two 10,000 foot suites or a seven and a three on either floor. And so then depending on what the market brings us, we can lease that way. It was super effective. I think there's some risks there, but I think that we're solving a market need and we're listening to our tenants. I don't think we can do office the way we've always done office. I think office needs to become a little bit more like the Marriott. The economy moves fast, companies move fast. There are still going to be big financial companies and law firms that are going to do the ten year lease, the traditional stuff. But when you're talking tech and these other groups that the businesses just have a velocity that doesn't really work for, let's wait two years while we build this out. Let's spend all this money on a ten year plan. Just doesn't work.

Mike Taquino
I just want to make one note of why this is very tough in this environment, right? If you're an owner, are you going to go spec a 50,000 foot space right now? And I think the answer's probably no. And if you look at the market, there's 8.9 million square feet on the sublease market. 78% of that is tech space. Oftentimes that space is built out already. So not only are you competing against sublease space that's built out in

probably short term, like Glenn said. If you've got, I don't know, 100,000 feet and you're competing against all this sublease space in which for you to put $250 a foot of spec money into the building, you need X rent, you're not going to get it. And so I think that's a really tricky equation for a lot of these owners, coupled with the fact that a lot of these buildings are saddled with debt that is probably above market.

Spencer Levy
Shorter term leases. And I've looked at that concept in other asset types, particularly retail. I call it the new rent and it's a story for another day. Mike, how do you handle shorter term leases?

Mike Taquino
It's a great question. I mean, I think from an institutional and maybe a foreign entity perspective, if they're coming into San Francisco, they want long term leases and they want basis. Now, Glenn's got an interesting point on the short term basis, because if you're buying a deal right now, all equity, no debt, you have to assume that there's an exit three, five years down the road when you have a functioning debt market. So is it better to have short term leases if you believe the market's down right now and you can sell into an upswing market where a new buyer can come in that's readily available, and you get to mark to market a tremendous amount. It's TBD right now. There's not a lot of long term core buyers right now, but the ones that do show up long term, groups are coming in opportunistically, like Glenn, are probably trying to position their assets that they can move in a fairly liquid way should the debt markets come back in. And having short term leases in a rising market is typically a good spot to be.

Glenn Gilmore
It's a tough leasing market. I think you need to meet the tenants where they're at right now, and you bring up a good point about debt. The hardest part about doing spec building is obviously lenders. They don't want to give you that good news money until they have a tenant on the line. And we've had some challenges in the past with even when we had buyouts from tenants, the lenders won't let us use that buyout money to spec the space. But in my core belief of how to run an office building, probably much like how to run a movie theater, you got to get butts in seats. And the quicker and the faster, the more velocity we can do to have that and get rent paying tenants and get activity in a building, the better that building is. So maybe your first deals are shorter term, but then you can hold out towards the end and start improving those terms and improving it because people want to be in that building because that building has cachet. That building has the right tenant mix. That building does what I wanted to do. So everything is a toss up. It's not like I'm right, you're wrong. I think that there's probably multiple ways to, you know, there's tortoise and the hare discussions here. But my personal opinion has just been, and where we've been successful has been, get the tenants in the space, get them working. And generally they don't leave in three years.

Spencer Levy
So, Mike, let's talk a little bit about the broader San Francisco market. We talked about Silicon Valley before. And again, it's fair to say that there are parts of this market that

are a lot softer than others. We're sitting here in Glenn's neighborhood, and it's 100% leased. So nobody knows that there is a neighborhood in San Francisco with this kind of…

Glenn Gilmore
Well, I didn't say the neighborhood was 100%.

Spencer Levy
Your buildings are 100%.

Glenn Gilmore
Yes, yes. But the neighborhood's doing quite well, too.

Spencer Levy
Okay, there you go. Well, close enough. Thank you, Glenn. But there are some neighborhoods that are nowhere as near. That I saw the vacancy rates overall. I actually looked at our statistics prior to today's meeting and looked at the highest rent districts and the lowest rent districts, and there wasn't that much of a difference between the vacancy rates. How do you see it, Mike?

Mike Taquino
Well, interestingly enough, the largest tranche of vacancy in San Francisco was historically the hottest market in San Francisco, and that's the South of Market. The South of Market, if you're familiar with San Francisco, the blocks are twice as long as they are in the North of Market. So what that provided were much larger floor plates, which was kind of what all the tech tenants wanted. So do the last run up post GFC, we saw that South of Market absolutely explode. And I remember the glass ceiling of when a Brick and Timber building, which we don't necessarily call it that, but Brick and Timber crested $1,000 a foot. That was a big deal because historically speaking, a South of Market Brick and Timber building was never going to trade more than a North of Market building. And we saw that. That's because the rents down south hit an astronomical trajectory. Right now that is the largest amount of vacancy. So it's quick how that happens. You go down to South of Market. It's not bad. It's just empty. And talking to a lot of the tenant rep brokers, I mean, the interesting story that you're seeing in every major market is the discrepancy between best in class office and second tier office. Best in class is outperforming everything. And the question we always ask is okay, if big tech wakes back up, are they going to go to a high rise class A tower? Maybe. But I think they also probably expand back into Soma where you've got the cool, creative bigger floor plate vibe. But that hasn't happened yet and that's our largest vacancy. I mean, Mid-Market's pretty terrible as well. But that's got a whole other set of issues.

Spencer Levy
Given the modern tenant preference for larger floor plates, having everybody on one floor or all contained in the same space, has hype been devalued? You see the market changing as preferences for these lower slung, older buildings, adaptive reuse overall, or were those still be a need, want, tenant demand for CBD towers?

Mike Taquino
It's pretty clear right now that the towers in the view space are dictating the high watermarks in the market. I think you can look at the lower stacks of these buildings and there's effectively no activity. So at this given point, whether it's private equity or venture capital or law firms or maybe some growing tech companies, they are paying a premium for those high floors and water views. That may change again once tenants start to move again and economically are driven and will take lower rent space. But right now, I think the story is consistent with New York, where if you look at our ultra premium set, the vacancy is much less than call it the whole class B tranche in the market. So there is a premium still for view space in higher floors right now.

Spencer Levy
Well, let's go back to Wynwood for a moment. And as we were walking in here today, I said, you don't know how many times I've mentioned Wynwood as the emerging neighborhood in Miami because it is got the Art Basel festival there. It's a cool neighborhood with basically looks like this neighborhood, low slung building. Kind of looks like the arts district in LA. I could point to the districts in America that look just like this and Wynwood is one of them. Is that how you chose it, and are there other districts in America that you might be sticking your toe in the water?

Glenn Gilmore
It is how we chose it. I mean, when the pandemic hit here, we knew, I shouldn't say we knew, we had a feeling that San Francisco might not be attractive for investors for a while. Just given how, and I don't want to get political about it, but just given how we were treating Covid here and how seriously or ridiculously, depending on how you look at it, they took some of the measures here. We also had quite a bit of investors say, hey, we've been in a bunch of deals with you in San Francisco. Like, I don't want to be all San Francisco. I'd like to look out. And so a lot of our investors moved to places like Austin and places like Miami. So we kind of took a search on both markets, and we liked Miami more, and we specifically liked Wynwood, because what we saw there was a creative vibe and the ability–you know, I love going to Brickell. I love eating there. I love everything about it. I like all the different areas of Miami, to be honest. But Wynwood just kind of felt like us, and it felt like our kind of tenants and it kind of was. And there's a lot of people within our network that relocated out there that are now our tenants. And so I think that when you're doing real estate, the more you can kind of create focus and stick to a focus, the better you're going to do, because you're constantly iterating on your business, on things that you can learn from one another. So our Wynwood business has informed some of our San Francisco business, some things we did there. In fact we, on the back of The Cube, which we bought, we have Jeremy Fish did the mural there, which is a giant 100 foot mural. It's gorgeous. It's got the California bear and the Florida Panther on it. It's one of the biggest murals in Wynwood. Jeremy Fish is one of the great living artists here in San Francisco. He's a North Beach guy. I'm having dinner with him on Thursday. He's a good friend. We had so much fun with him there that we are naming one of our other buildings, 900 Kearny after him,

naming the fish building. He designed the wallpaper in the lobby. We put original art of his on the building. We're going to put more art of his in the building. So that's a very Wynwood thing. It's not a San Francisco thing, but we learned that there and we thought, that's fun. We can do more of that here in San Francisco. We can have fun with these buildings in a way that I think is great for our tenants and great for the artists, and great just to kind of bring the community together. So I do think the neighborhoods are very similar.

Spencer Levy
Mike, let's talk about the future. And here we are. 2024, mid-year, capital markets are still a significant headwind. Reputational risk in San Francisco, still a headwind for many investors. Where will we be this time next year? This time five years from now in San Francisco?
Mike Taquino
It's a great question. And if I told you I had the answer, I'd be far wealthier than I am. But I think we're extremely optimistic. San Francisco continues to shine as a beacon in the United States for attracting venture capital and new innovation. And with new innovation comes talent. And I think young people that are looking for, quote unquote, the next revolution or gold rushing in kind of tech, they're going to come out here for AI. That's going to translate to tremendous growth in the office market. Albeit we do have a steep hill to climb with all the vacancy we have, but I think next year we'll see, I would imagine, more leasing velocity, probably some more discovery on pricing. And in five years we can only hope that the debt markets are functioning again in combination with institutional capital coming back into the market and reestablishing San Francisco as one of the great cities it's always been.

Spencer Levy
Glenn, same question for you. The future: San Francisco, one year from now, five years from now.

Glenn Gilmore
I would start with studying the past, but I don't know if you guys are aware, do you guys know what the original flag of San Francisco is? It's the Phoenix. And actually our city's flag still has the Phoenix on it. But the original flag is the Phoenix. This city has been through way worse than this. I think if you go back in the past to 1906, to the crashes in the 1800s here, to the fires, to all those, and by the way, most people think that Phoenix is from the 1906 fire. It's not, it was actually from 50 years before that where they had nothing but calamities here and then things come back. So I think history should have taught us this, and it didn't teach us once or twice. It's taught us this in this town maybe a dozen times. And I don't think this one is actually that bad. So I think in a year, as soon as we see some debt loosening up, I think you'll see the institutions are right about to roll in here. They're coming. Because I do think that institutions do have to take advantage of low basis plays, too. They can only sit on the sidelines so long because if they're wrong, they're I think they're going to not look competitively good. They're going to have to have some exposure to this. So I think you'll see that happen. I think you'll

see the business continue to expand. And I think in five years we may not be back to 2019, but we might be like to a 2015. So that'd be my prediction.

Spencer Levy
So a couple things there. First, I'm proud to say that CBRE as an organization was founded after, I believe, the 1906 San Francisco fire right here in San Francisco, in part to help the city rebuild.

Mike Taquino
You know a fun fact about that?

Spencer Levy
No.

Mike Taquino
Arthur Banker is my wife's great grandfather.

Spencer Levy
Oh, is that right?

Mike Taquino
Yeah. So to your point…

Spencer Levy
One of the founders of CBRE.

Mike Taquino
Correct. And again, they started the company because when the fire happened, all the deeds were burned. There was no, you know, records. And they started CBRE. So.

Glenn Gilmore
So is Bank of America, which was the Bank of Italy at the time. And their first customer was a guy by the name of Rosenberg. And he was helping sweep up glass in the streets and everything. And he had the first business bank, a checking account number was number one. And that company came to be ABM, which is one of the great American janitorial and building companies. So a lot's come out of this little town, and I don't think that changes.

Spencer Levy
Terrific. What a great discussion of San Francisco, artificial intelligence, adaptive reuse and so many other things. And I'd like to really thank Glenn Gilmore, founder of Brick and Timber Collective, for not only being a great guest, but hosting us in this beautiful space.

Glenn Gilmore
You're welcome. Thanks for having me.

Spencer Levy
I then want to thank my friend and colleague, Mike Taquino, Executive Vice President, CBRE, for making this happen. Nice job Mike.

Mike Taquino
Thanks, Spencer. Always great to see you.

Spencer Levy
For more, please visit our website CBRE.com/TheWeeklyTake. We've got related content and more on the ways that tech and innovation are making an impact on real estate. We'll keep our eye on the tech ball with upcoming shows on smart cities and the future of urban real estate in the weeks to come, so tune in for that and more, and loop in your network, too. You can share the episode on your podcast platform of choice, and make sure to subscribe to the show and send us your feedback, as well. Thanks for joining us. I'm Spencer Levy. Be smart. Be safe. Be well.