

San Francisco Market Overview

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The San Francisco lodging industry has experienced a dramatic reversal of fortune over the last two years. In 2000, the San Francisco lodging industry was one of the hottest in the nation and posted its best performance ever. Smith Travel Research (STR) reports that San Francisco's hotels finished the year with an aggregate average rate of \$175.13 and an average occupancy of 80.8%, resulting in a RevPAR of approximately \$142. Statistics for 2001 reflect a significant downturn, with an occupancy of 66.3% and average rate of \$169.19 recorded; this resulted in a RevPAR of \$112, or a 21% decline from the RevPAR of 2001. Based upon STR statistics through May, San Francisco is the most negatively impacted metropolitan area in the country in terms of hotel demand, with room demand through the year-to-date period through May down 14%, occupancy down 16.3%, average rate down 16.2%, and rooms revenue down 27.9%. The next most impacted markets, based on year-to-date data, are Boston, with rooms revenue down 19.1%; Oahu, Hawaii, down 15.3%; and New York, New York, down 14.6%. San Francisco city has had a "triple hit" this year, with weak international and domestic leisure demand, contracted commercial demand, and a poor 2002 convention calendar. Local hoteliers hopes for recovery are tied to opening of the Moscone Convention Center expansion in Spring 2003, and robust convention calendars for the next few years. Nonetheless, most local experts expect that it will be several years before the San Francisco lodging industry returns to its normal, healthy state. The primary reason is the fallout from the collapse of numerous dot-com and Internet-related enterprises. The virtual evaporation of high-rated commercial demand from this sector is having a significant impact on average rates within the city. Unlike many cities, where commercial demand is expected to recover when the U.S. economy turns around, in San Francisco most of the high-spending, dot-com demand is now permanently gone, and more traditional sources of business will have to establish themselves before we experience a return to the robust business of the mid- to late 1990s. This is unlike the San Jose/Silicon Valley hotel market to the south, where technology-related business has diminished but is still omnipresent. The decline in San Francisco's occupancy and average rate, coupled with the high cost of hotel development and operation, will render new hotel development challenging over the next few years. Thus, after the two hotels currently under construction open, the city will see a healthy reprieve from additions to supply. San Francisco has historically enjoyed enviable strength in three market sectors: commercial, meeting and group, and leisure. In the early 1980s, many large corporations left San Francisco due to the high cost of doing business in the city. At that time the city's market mix became almost equally dependent upon the three primary lodging demand sectors, commercial, meeting and group, and leisure. In the second half of the 1990s, the economic climate changed, with San Francisco becoming the epicenter of the high-tech, Internet, e-

commerce industry. The staggering rise in office-space rental rates during those times reflected this trend. With the explosion of these industries, the city's commercial segment demand regained its strength. At the same time, while leisure and meeting and group demand were at all time highs, these lower-rated segments were often pushed outside the city by hotels seeking higher-yield demand sources. With the demise of many Internet-related businesses, some commercial demand is being replaced (again) with lower-rated sources of demand. After several stellar years for the local office market, where rents reached as high as \$80 to \$100 per square foot for class A space and the citywide vacancy rate declined to 2%, according to Grubb & Ellis Research, the San Francisco office market experienced its worst year in history in 2001. Approximately seven million square feet of negative net absorption was registered last year, which is reported to have erased all positive demand for office space since the recession of the early 1990s. Resultant vacancy rates increased dramatically from 4.0%, or 2.3 million square feet, at year-end 2000 to nearly 19.0%, or 11.7 million square feet, by year-end 2001. Average asking lease rents finished 2001 at \$37.71 for Class A and \$26.27 for Class B, which were down 51.0% and 60.0%, respectively, from the prior year. In terms of the office space market's recovery, the supply pipeline is expected to empty by year-end 2002; thereafter, a slow market recovery is expected, as approximately 16 million square feet of vacant space will need to be absorbed. High unemployment and office vacancy rates have softened hotel demand in the commercial segment. In June 2001, 22 office projects of 100,000 square feet or more were under development in the city, while as of June 2002 that number has declined to just five such buildings, as developers have placed many office projects on hold. On a positive note, many businesses that left the city in the late 1990s due to high rental rates are now returning as the business environment becomes more favorable for traditional lines of commerce. While meeting attendance dropped and events were cancelled following the events of September 11th, 2001, most groups and events were rebooked for later dates. In anticipation of the opening of the Moscone West expansion, new bookings are ramping up at the new facility. Since large meetings are typically booked far in advance, convention room night figures lag economic trends. Hotel room bookings for Moscone Convention Center events in 2003 are already 22.2% higher than the figures for 2002. The new expansion has the potential of inducing additional demand in the San Francisco lodging market, as the city positions itself to compete with other major convention cities in the region, state, and the nation as a whole. As far as tourism, the strength of the U.S. dollar in recent times has choked international leisure visitation to the country as a whole, including San Francisco. Passenger counts at the San Francisco International Airport decreased by 15.2% in 2001 from the prior year. This had a significant negative affect on the South San Francisco (airport) lodging market, which suffered a decline of 12.1 occupancy points, ending 2001 with an occupancy level of 65.2%. The decline in occupancy, combined with a 16.7% decline in average rate, resulted in a precipitous decline in revenue per available room of 29.7%. In San Francisco, supply increased by approximately 744 hotel rooms in 2001 with the opening of the 362-room Omni, the 277-room Four Seasons, and the 105-room Orchard. Additional hotels currently under construction include the Proposed 400-room Club Quarters, located in the Financial District and scheduled to open in mid-2003; the 275-room St. Regis hotel, located at Mission and Third Streets and scheduled to open in early 2004; and the Kimpton Group's historic 253-room, Argonaut Hotel in Fisherman's Wharf. It should be noted, however, that completion of the proposed Argonaut Hotel has been postponed to mid-2003 due to a fire that occurred in March 2002. Approximately 11 other projects, totaling approximately 3,200 rooms, are planned for the city of San Francisco. These projects are in various stages of development and are now being re-evaluated due to the prevailing market conditions. While, the national economy is reportedly already showing signs of a moderate economic recovery, San Francisco's recovery will lag behind those experienced by other major cities due to the weak convention calendar this year and the evaporation of many local commercial demand generators. Nonetheless, the San Francisco-Oakland-San Jose CMSA has a well-developed infrastructure and high standard of living that will attract new sources of commerce to the area. HVS International anticipates a bottoming out of the market this fall, with a rebound expected in 2003 due to a strong convention year and the opening of the Moscone

Convention Center's expansion. Gradual improvement in the commercial and leisure sectors is expected over the next several years. Despite its current challenges, San Francisco is a firmly established world-class destination and will no doubt recover to accommodate strong lodging demand in the future. Additionally, due to the hotel market's high barriers to entry and historical strength, San Francisco remains a desirable location for hotel investment.