

ORANGE COUNTY OFFICE MARKET

SECOND QUARTER 2017

Office market show signs of slowdown at mid-year 2017

Leasing activity sees its slowest quarter in nearly eight years as vacancy levels rise

In the second quarter 2017, the Orange County office market saw a sharp slowdown as reported leasing activity was at its lowest level since 2009. While area companies have been in expansion mode for the past few years, the Orange County economy is nearing full employment, which has caused most local firms to once again become cautious about taking more space than they need. Combined with an emphasis on space efficiency, it is no surprise that occupiers are right-sizing their office space footprints, especially with the high run-up in average rental rates over the past two years.

ECONOMY

Unemployment rate falls to its lowest level in a decade to 3.2% in May

The seasonally adjusted unemployment rate for Orange County decreased to just 3.2% in May, which is the lowest unemployment rate reported locally since 2006. However, year-over-year nonfarm employment increased by just 3,800 (0.2%) while office-using employment increased by just 4,100 (0.8%), respectively. Compared to a year ago when both nonfarm employment and office-using employment in Orange County grew at 2.7% and 2.5%, respectively, year-over-year job growth has slowed dramatically over the past year as the area economy nears full employment.

SUPPLY AND DEVELOPMENT

Over 1.4 million square feet is currently under construction

No new office space was delivered to the market in the second quarter, while over 1.4 million square feet of office space is now under construction, of which only 9.4% is currently pre-leased. As mentioned in previous reports, compared to a decade ago when office construction averaged over 3 million square feet per quarter, developers this cycle have mostly been cautious about breaking ground on large-scale speculative office projects without a pre-lease commitment from a credit tenant. Nevertheless, expect high-profile projects such as The Boardwalk near John Wayne Airport (0% pre-leased) and 400 Spectrum Center Dr in the Irvine Spectrum (29% pre-leased) to deliver in the second half of the year largely vacant.

TRENDLINES

5-YEAR TREND CURRENT QUARTER

VACANCY



12.5%

Vacancy up 30 basis points over Q1

ABSORPTION



-264,483 SF

Space losses led by Greater Airport Area

RENTAL RATE



\$2.67 PSF

Rents tick up slightly from Q1

UNDER CONSTRUCTION



1.4 million SF

Development reaches new nine-year high

CAP RATES



5.7%

Cap rates rise 10 basis points

JOB GROWTH



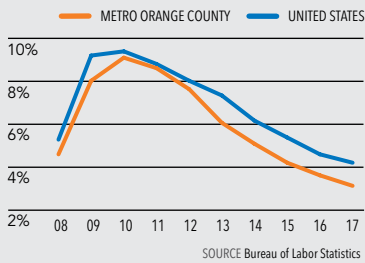
3,800 jobs

Year-over-year growth of just 0.2%

ORANGE COUNTY OFFICE MARKET

SECOND QUARTER 2017

UNEMPLOYMENT RATE

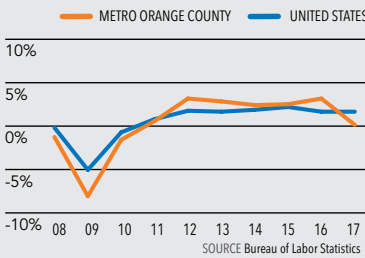


DEMAND

Net absorption turns negative, led by the Greater Airport Area

Net absorption in the second quarter turned negative (-264,483 square feet), led mostly by the Greater Airport Area (-417,807 square feet) and North County (-119,771 square feet). This caused year-to-date net absorption to also turn slightly negative (-78,499 square feet), which is a sharp reversal from the first six months of 2016, which saw 454,951 square feet of office space absorbed. Leasing activity saw its weakest quarter in over eight years with just under 2.0 million square feet of leases signed, although the largest new lease of 2017 so far involved Cylance taking 133,324 square feet at 400 Spectrum Center Dr in a future relocation from the Airport Area down to the Irvine Spectrum.

PAYROLL JOB GROWTH

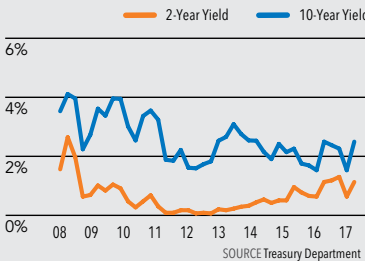


VACANCY

Total vacancy rate increases 30 basis points to 12.5%

The total vacancy rate increased 30 basis points to 12.5% in the second quarter. Led mostly by expected move-outs from Zenith Education and Broadcom, the total vacancy rate rose to 14.0% in the Greater Airport Area. It should be noted that sublease vacant space, which is an early indicator of slowing market fundamentals, increased to 707,986 square feet, which is up 50% from a year ago and the highest level reported since 2010. In addition, with new office supply expected to be completed in the second half of 2017, expect vacancy to continue to increase as most of the office development underway is delivered to the market unleased.

TREASURY YIELDS



RENTAL RATES

Direct average asking rental rates now up to \$2.67 per square foot

The direct weighted average asking rental rate market-wide ended the quarter at \$2.67 per square foot (up 5.5% year over year) which is the highest average office rent reported in Orange County since 2008. At the individual market level, the highest average rental rates continue to be reported in the Greater Airport Area at \$2.93 per square foot followed by South County at \$2.58 per square foot. While landlords have been aggressive in pushing rents over the past two years, it appears that rental rate growth is beginning to slow at mid-year 2017. However, with new Class A office space expected to be delivered in the second half of the year, expect the increase in average rents to continue as more expensive space hits the market for lease.

Metro Orange County Office Market Indicators

PROPERTY CLASS	INVENTORY	UNDER CONSTRUCTION	Q2 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Class A	41,813,158	1,373,722	94,600	140,794	13.1%	0.9%	14.0%	\$3.02
Class B	44,379,615	37,929	-359,083	-219,293	10.3%	0.7%	11.1%	\$2.31
OC Metro Total	86,192,773	1,411,651	-264,483	-78,499	11.7%	0.8%	12.5%	\$2.67



INVESTMENT MARKET

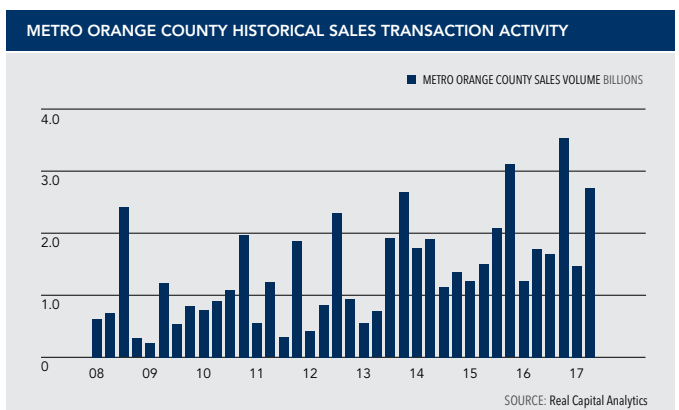
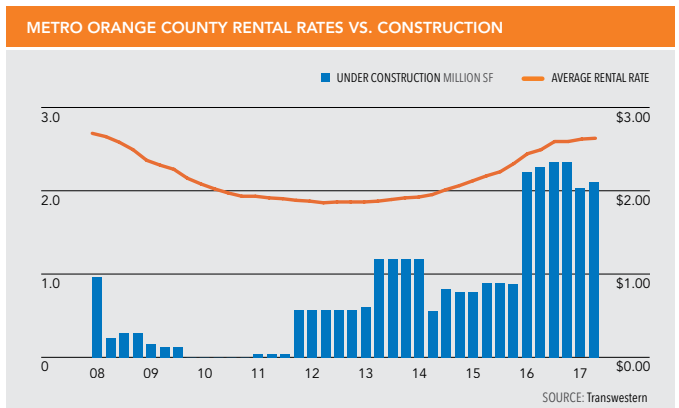
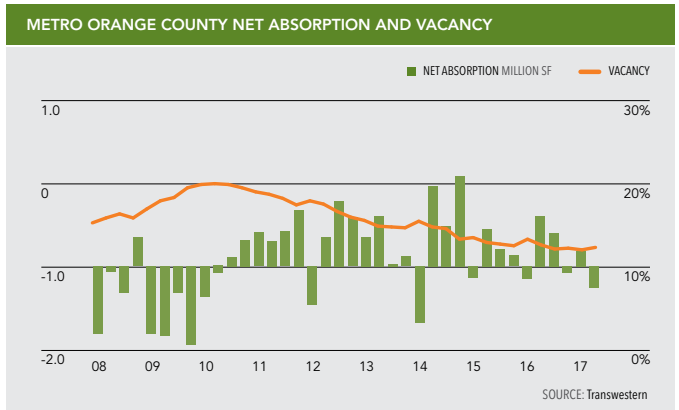
OC office investment sales volume sharply increases in the second quarter

Approximately \$685.1 million worth of office sales occurred in the second quarter 2017, which brought office sales volume up to \$1.05 billion in the first six months of the year (up 40% from the first six months of 2016). The largest sale of the quarter involved Emmes Group acquiring 1920 & 2010 Main St in Irvine from Shorenstein Properties for \$200 million (\$325 per square foot). As mentioned in previous reports, investor interest in the Orange County office market remains high as many buyers feel they can get better value and deal with less competition, especially from overseas buyers, than what is currently on the market for sale in adjacent Los Angeles. While expected increases in interest rates are expected to put an end to cap compression and cool down the market, investors remain highly attracted to Orange County’s diversified business ecosystem, growing tech sector, and increasingly high barriers to entry on the supply side.

OUTLOOK

Slowing market fundamentals could be a quarterly blip or a sign of things to come?

At mid-year 2017, it appears that the Orange County office market is seeing slowing fundamentals. While Orange County reported healthy fundamentals to begin the year, a slowdown in leasing activity combined with higher vacancy and slowing rental rate growth begs the question of whether this is a quarterly blip or a sign of a further slowdown as the local economy nears full employment? Despite these underlying questions, investment activity remains high as investors continue to seek out yield. Looking into the second half of 2017, it will be very interesting to see if the office market rebounds amidst a increasingly slow-growth local and national economy. ■



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Metro Orange County Office Market Indicators

MARKET	INVENTORY	UNDER CONSTRUCTION	Q2 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Greater Airport Area	41,889,410	537,258	-417,807	-298,277	13.0%	1.0%	14.0%	\$2.93
Central County	14,724,020	-	29,987	75,895	12.7%	0.4%	13.1%	\$2.25
North County	6,482,841	-	-119,771	-101,703	12.4%	1.2%	13.7%	\$2.29
South County	18,478,701	874,393	230,032	197,397	7.6%	0.8%	8.4%	\$2.58
West County	4,617,801	-	13,076	48,189	11.4%	0.2%	11.7%	\$1.98
OC Office Market Total	86,192,773	1,411,651	-264,483	-78,499	11.7%	0.8%	12.5%	\$2.67

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
400 Spectrum Center Dr	Cylance	133,324	Class A New Lease	South County	Irvine Spectrum
2600 Michelson Dr	Zillow	60,099	Class A Renewal	Greater Airport Area	Airport Area
7555 Irvine Center Dr	Accurate Background	34,612	Class A New Lease	South County	Irvine Spectrum
18200 Von Karman Ave	Americor Funding	21,742	Class A New Lease	Greater Airport Area	Airport Area

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
1920 & 2010 Main St (2 bldgs)	\$200,000,000	\$325	Emmes Group	Greater Airport Area	Irvine Business Complex
18301 Von Karman Ave	\$85,800,000	\$380	Greenlaw Partners, Rodney Sacks & Hilton Schlosberg	Greater Airport Area	Airport Area
2400 E Katella Ave	\$76,925,000	\$294	CBRE Global Investors	Central County	Anaheim Stadium Area
200 W Center St	\$58,900,000	\$307	Greenlaw Partners	Central County	Greater Anaheim

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
The Boardwalk (Jamboree & Dupont)	537,258	Class A Office	Trammell Crow	Greater Airport Area	Airport Area
400 Spectrum Center Dr	466,696	Class A Office	The Irvine Company	South County	Irvine Spectrum
500, 510, 520 & 530 Technology Dr (4 bldgs)	369,768	Class A Office	The Irvine Company	South County	Irvine Spectrum
3 Burroughs	37,929	Class B Creative Office	Harbor Associates	South County	Irvine Spectrum

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METHODOLOGY

The information in this report is the result of a compilation of information on office properties located in the Orange County metropolitan area. This report includes single-tenant and multi-tenant office properties 10,000 SF and larger, excluding condo and medical office facilities and those properties owned and occupied by a government agency.



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