

ORANGE COUNTY OFFICE MARKET

THIRD QUARTER 2017

Office development now at its highest level in a decade

Net absorption is sharply positive as space gains are led by the Greater Airport Area

In the third quarter 2017, the Orange County office market rebounded from a slowdown in leasing activity last quarter to record its highest amount of quarterly net absorption in nearly three years. Optimism on the part of local companies has caused average rental rates to continue to increase and development activity to increase to its highest level since before the Great Recession. In addition, investment sales activity surged to \$1.1 billion, indicating that the bid-ask spread between buyers and sellers could finally be narrowing as the year rapidly comes to an end.

ECONOMY

Orange County unemployment rate at 4.2% in August

The seasonally adjusted unemployment rate for Orange County increased over the previous quarter to 4.2% in August, which is still lower than the 4.3% unemployment rate reported a year ago. Year-over-year nonfarm employment increased by just 900 (0.1%), while office-using employment increased by just 2,900 (0.6%), respectively. Compared to a year ago when both nonfarm employment and office-using employment in Orange County grew at 2.0% and 2.6%, respectively, year-over-year job growth has slowed dramatically over the past year as the local economy is now at or close to full employment.

SUPPLY AND DEVELOPMENT

Over 1.8 million square feet is now currently under construction

A little over 1 million square feet of new office space was delivered to the market in the third quarter, including high-profile projects such as The Boardwalk in the Airport Area and 400 Spectrum Center Drive in the Irvine Spectrum. In terms of space underway, over 1.8 million square feet is now under construction, of which 43% is currently pre-leased. While the current office space underway now constitutes a 10-year high, it is only comprised of three projects: Five Point Gateway and Quad at Discovery Business Center both in the Irvine Spectrum and FLIGHT at Tustin Legacy in Tustin. Compared to a decade ago when office construction averaged over 3 million square feet per quarter, most developers this cycle have been overly cautious about breaking ground on large-scale speculative projects without a pre-lease commitment from a credit tenant, and this is expected to continue moving forward.

TRENDLINES

5-YEAR TREND CURRENT QUARTER

VACANCY



12.6%

Vacancy up 10 basis points over Q2

ABSORPTION



819,376 SF

Space gains led by Greater Airport Area

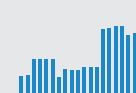
RENTAL RATE



\$2.73 PSF

Rents up 4.0% year over year

UNDER CONSTRUCTION



1.8 million SF

Development reaches new 10-year high

CAP RATES



5.7%

Cap rates remain flat from Q2

JOB GROWTH



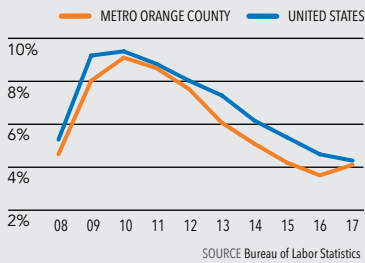
900 jobs

Year-over-year growth of just 0.1%

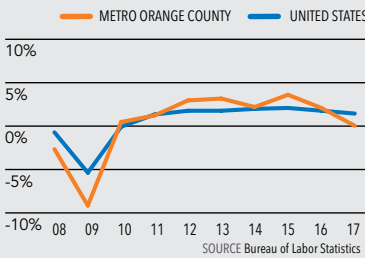
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THIRD QUARTER 2017

UNEMPLOYMENT RATE



PAYROLL JOB GROWTH



TREASURY YIELDS



DEMAND

Net absorption turns positive again in the third quarter

Net absorption in the third quarter turned positive (819,376 square feet), led mostly by the Greater Airport Area (624,123 square feet) and North County (113,909 square feet). This caused year-to-date net absorption to flip positive (740,877 square feet). Leasing activity bounced back with over 2.8 million square feet, led by large deals at Five Point Gateway in the Irvine Spectrum signed by Broadcom, Lennar, and Five Point Operating Company. For the remainder of 2017, expect leasing activity and net absorption to remain steady as the area's professional and business services sector, as well as its under-the-radar tech startup ecosystem continues to grow.

VACANCY

Total vacancy rate ticks up 10 basis points to 12.6%

The total vacancy rate increased 10 basis points to 12.6% in the third quarter mostly due to the delivery of new vacant Class A office buildings. Total available vacancy, which does not include vacant space that has already been leased, was just 10.9% in the third quarter, indicating that market fundamentals remain positive. However, sublease vacant space, an early indicator of slowing market fundamentals, again increased to 774,044 square feet, which is up 83% from a year ago and the highest level reported since 2010. In addition, with new office supply expected to be completed next quarter, expect vacancy levels market-wide to increase.

RENTAL RATES

Direct average asking rental rate now at \$2.73 per square foot

The direct weighted average asking rental rate market-wide ended the quarter at \$2.73 per square foot (up 4.0% year over year), which is the highest average office rent reported in Orange County since the beginning of 2008. At the individual market level, the highest average rental rates continue to be reported in the Greater Airport Area at \$3.01 per square foot, followed by South County at \$2.75 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. However, with new Class A office space expected to be delivered over the next two quarters, 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	Q3 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Class A	42,817,112	1,848,132	783,045	923,839	13.3%	0.9%	14.2%	\$3.08
Class B	44,527,544	-	36,331	-182,962	10.2%	0.9%	11.1%	\$2.32
OC Metro Total	87,344,656	1,848,132	819,376	740,877	11.7%	0.9%	12.6%	\$2.73



INVESTMENT MARKET

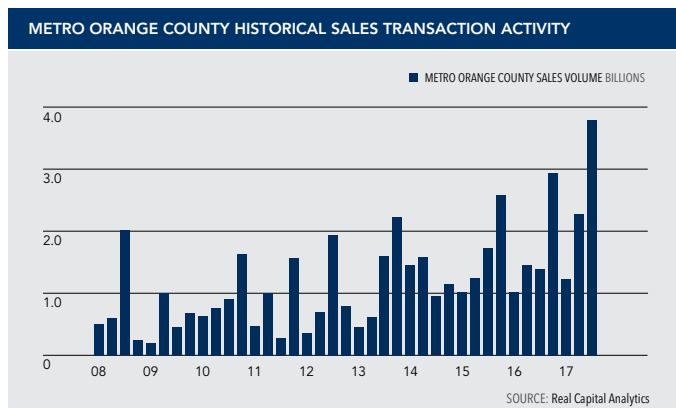
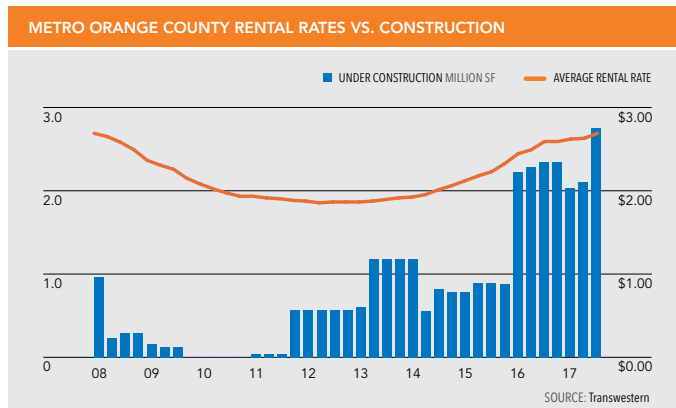
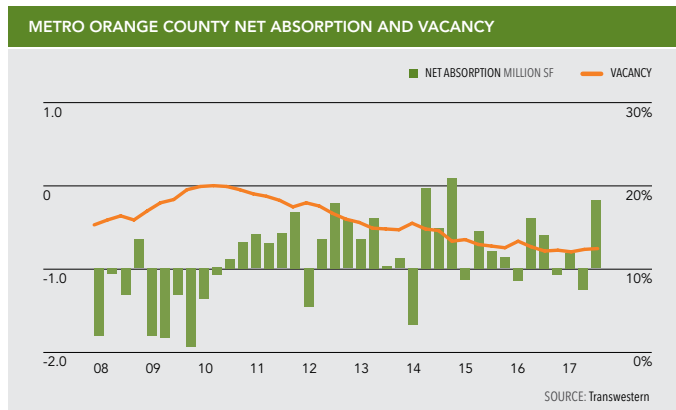
Sharp increase in sales volume pushes 2017 year-to-date volume to \$2.2 billion

Approximately \$1.1 billion of office sales occurred in the third quarter 2017, which brought year-to-date office sales volume up to \$2.2 billion (up 88% from the first nine months of 2016). The largest sale of the quarter involved Five Point Holdings LLC exercising their option to acquire the four-building Five Point Gateway campus in the Irvine Spectrum from Broadcom for \$443 million (\$426 per square foot). This was followed by The Muller Company and Cerberus Capital Management re-capitalizing a 3-building office portfolio which included 18881 Von Karman Ave, 1100 W Town & Country Rd, and 2677 N Main St for \$232.5 million (\$275 per square foot). 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. As a result, expect more sales activity before the end of the year, which is forecasted to have its highest level of office sales volume reported since 2007.

OUTLOOK

Office market fundamentals rebound in the third quarter

After what was a quarterly blip reported at mid-year, Orange County's office market fundamentals rebounded in the third quarter with a high amount of space occupancy gains and investment sales activity. On the other hand, anemic year-over-year employment growth locally shows that the Orange County economy is operating at or near full employment, leading to questions over how much more hiring local companies can do, especially with high housing and business costs acting as significant headwinds. While nobody is expecting an office market correction in the short term in Orange County, cautious optimism remains the general sentiment as 2017 quickly comes to close. ■



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MARKET	INVENTORY	UNDER CONSTRUCTION	Q3 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Greater Airport Area	42,536,668	443,284	624,123	325,846	12.5%	1.1%	13.7%	\$3.01
Central County	14,724,020	-	78,346	154,241	12.2%	0.4%	12.6%	\$2.20
North County	6,482,841	-	113,909	12,206	10.7%	1.2%	11.9%	\$2.25
South County	18,983,326	1,404,848	-1,169	196,228	10.0%	0.8%	10.8%	\$2.75
West County	4,617,801	-	4,167	52,356	11.3%	0.3%	11.6%	\$2.08
OC Office Market Total	87,344,656	1,848,132	819,376	740,877	11.7%	0.9%	12.6%	\$2.73

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
15101 & 15191 Anton Pky (2 bldgs)	Broadcom	660,893	Class A Sale-Leaseback	South County	Irvine Spectrum
15131 Anton Pky	Lennar	90,000	Class A New Lease	South County	Irvine Spectrum
15131 Anton Pky	Five Point Operating Company	44,400	Class A New Lease	South County	Irvine Spectrum
19000 MacArthur Blvd	Home Franchise Concepts	38,094	Class A New Lease	Greater Airport Area	Airport Area

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
15101, 15131, 15161 & 15191 Alton Pky (4 bldgs)	\$443,000,000	\$426	Five Point Holdings LLC	South County	Irvine Spectrum
18881 Von Karman Ave, 1100 W Town & Country Rd & 2677 N Main St (3 bldgs) - Re-capitalization	\$232,500,000	\$275	The Muller Company & Cerberus Capital Management	Greater Airport Area & Central County	Airport Area/Main Place Area
Centerpointe La Palma (10 bldgs)	\$106,100,000	\$200	Westbrook Partners & Greenlaw Partners	North County	Buena Park/La Palma
25500-25550 Commercentre Dr (5 bldgs)	\$76,200,000	\$236	Drawbridge Realty Trust	South County	Lake Forest/Foothill Ranch

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
15101, 15131, 15161 & 15191 Alton Pky (4 bldgs)	1,039,893	Class A Office	Five Point Holdings LLC	South County	Irvine Spectrum
FLIGHT at Tustin Legacy (6 bldgs)	443,284	Class A Office	Lincoln Property & Alcion Ventures	Greater Airport Area	Tustin
500, 510, 520 & 530 Technology Dr (4 bldgs)	364,955	Class A Office	The Irvine Company	South County	Irvine Spectrum

CONTACT

Michael Soto
 Research Manager, Southern California
 213.430.2525
 michael.soto@transwestern.com

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.



1630 S. Sunkist Street, Unit A
 Anaheim, California 92806

T 714.634.4664 F 714.634.2680
 www.transwestern.com/orangecounty