

ORANGE COUNTY OFFICE MARKET

FOURTH QUARTER 2017

Strong end to 2017 seen in the Orange County office market

Total investment sale volume finishes up 40% over previous year

In the fourth quarter 2017, the Orange County office market ended the year with more space gains, causing total net absorption to finish at its highest level since 2014. Led by a resurgence in leasing activity mostly in the Irvine Spectrum, the direct weighted average asking rental rate overall is now at a level last seen in 2007. Finally, total investment sales volume of nearly \$2.9 billion shows that many investors continue to look favorably on the Orange County office market due to its high-quality workforce, quality of life, and relative discount to sky-high valuations currently being seen in adjacent Los Angeles.

ECONOMY

Orange County unemployment rate down to just 2.8% in November

The seasonally adjusted unemployment rate for Orange County decreased to a miniscule 2.8% in November, led by year-over-year gains in the leisure & hospitality, as well as construction sectors. Year-over-year nonfarm employment increased by 13,800 (0.9%) while office-using employment increased by 4,100 (0.8%), respectively. Compared to a year ago when both nonfarm employment and office-using employment in Orange County grew at 1.5% and 2.5%, respectively, year-over-year job growth has slowed dramatically over the past year as the local economy is now operating very close to full employment.

SUPPLY AND DEVELOPMENT

Over 1.4 million square feet is now currently under construction

A total of 554,299 square feet of new office space was delivered to the market in the fourth quarter, while over 1.4 million square feet is now under construction, of which 42% is currently pre-leased. As mentioned in previous reports, development levels have steadily increased over the past few years; developers, however, have been mostly cautious this cycle about breaking ground on larger speculative office projects with just four projects underway. Looking into 2018, expect relatively restrained office development levels as we head into the latter stages of this real estate cycle.

TRENDLINES

5-YEAR TREND CURRENT QUARTER

VACANCY



13.6%

Sublease vacancy and deliveries drive rate

ABSORPTION



249,400 SF

Space gains led by Irvine Spectrum

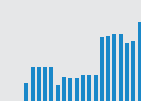
RENTAL RATE



\$2.74 PSF

Rents up 4.1% year over year

UNDER CONSTRUCTION



1.4 million SF

42% of developments is pre-leased

CAP RATES



5.65%

Cap rates remain flat from Q3

JOB GROWTH



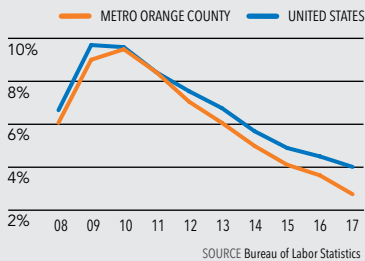
13,800 jobs

Year-over-year growth of just 0.9%

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FOURTH QUARTER 2017

UNEMPLOYMENT RATE

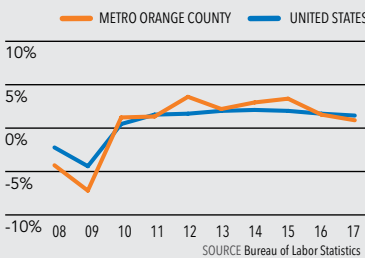


DEMAND

Net absorption mostly led by South County again in the fourth quarter

Led by large space gains in the Irvine Spectrum, net absorption in the fourth quarter totaled 249,400 square feet, which brought 2017 total net absorption to end at 990,277 square feet (up 27% from 2016). However, 2017 total leasing activity of 9.5 million square feet was a decline of 6% in 2016 as many local companies remain focused on “right-sizing” their real estate footprints and using their office space more efficiently. For 2018, expect office space demand to remain steady, although there could be headwinds for local companies concentrated in certain industries such as semiconductors and medical devices that have recently seen some consolidation.

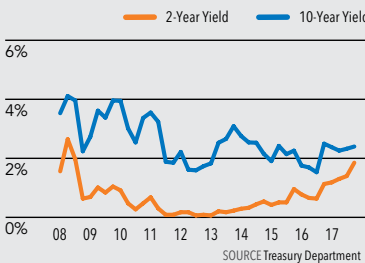
PAYROLL JOB GROWTH



VACANCY

Total vacancy rate at 13.6% due to new vacant supply delivered Despite positive net absorption market-wide, the total vacancy rate increased to 13.6% at year-end due to the recent completion of The Boardwalk in the Airport Area, as well as two buildings at Five Point Gateway in the Irvine Spectrum. As mentioned previously, office space demand remains healthy; however, sublease vacant space, which is an early indicator of slowing market fundamentals, was up again for the sixth consecutive quarter to 879,868 square feet. This is up 106% from a year ago, and the highest level reported since 2010. While the overall market has seen vacancy come down significantly since 2010, any slowdown in leasing activity could result in rising vacancy market-wide, especially with new supply expected to be delivered in 2018.

TREASURY YIELDS



RENTAL RATES

Direct average asking rental rate now at \$2.74 per square foot

The direct weighted average asking rental rate market-wide ended the year at \$2.74 per square foot (up 4.1% year over year), which is the highest average office rent reported in Orange County since year-end 2007. While Orange County year-over-year office rental rate growth was in the double digits at year-end 2016 and year-end 2015, it appears that rental rate growth has slowed in 2017 due to the softening in office space demand in 2017. However, with new Class A office space expected to be delivered in 2018, expect the increase in the average rental rate to continue as more newly-completed higher-priced space is delivered to the market.

Metro Orange County Office Market Indicators

PROPERTY CLASS	INVENTORY	UNDER CONSTRUCTION	Q4 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Class A	43,551,411	1,285,465	127,164	1,051,003	15.0%	1.2%	16.2%	\$3.07
Class B	44,527,544	155,000	122,236	-60,726	10.3%	0.8%	11.2%	\$2.34
OC Metro Total	88,078,955	1,440,465	249,400	990,277	12.6%	1.0%	13.6%	\$2.74



INVESTMENT MARKET

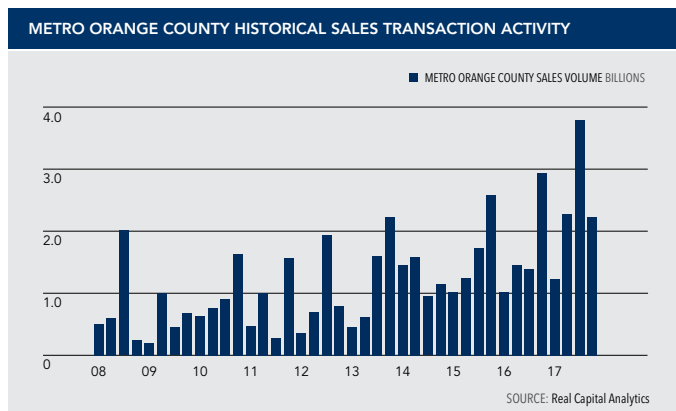
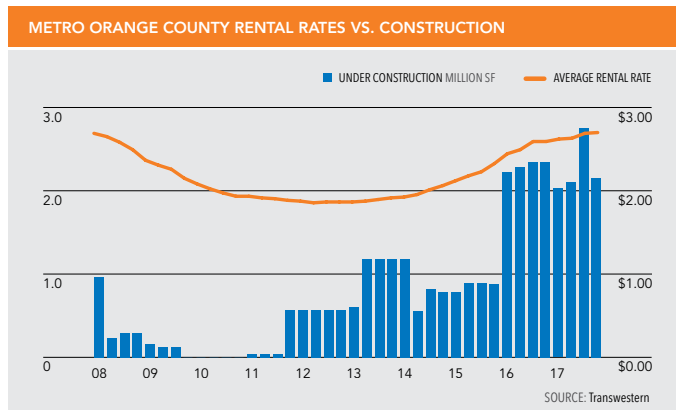
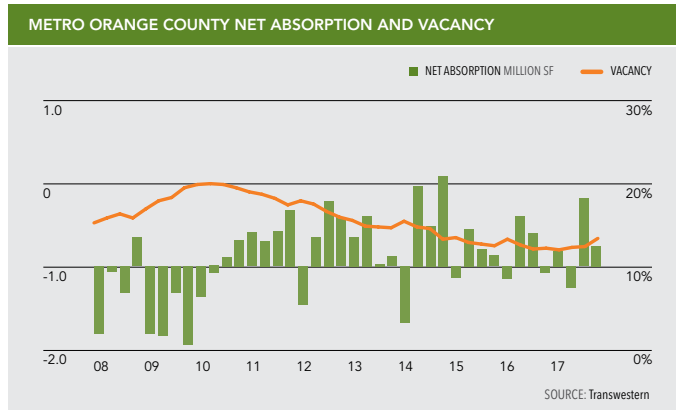
Total investment sales volume at highest level since 2007

Approximately \$672.2 million of office sales occurred in the fourth quarter 2017, which brought 2017 total office sales volume to \$2.9 billion (up 40% from 2016). The largest sale of the quarter involved Hines and Goldman Sachs acquiring 4000 MacArthur Blvd in Newport Beach from Hines and Oaktree Capital for \$176.5 million (\$444 per square foot). This was followed by 2600 Michelson Dr in Irvine being acquired by CBRE Global Investors from Ocean West Capital and Dune Real Estate for \$126 million (\$386 per square foot). As mentioned in previous reports, investor interest in the Orange County office market has increased in 2017 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. Expect these market conditions to continue in 2018.

OUTLOOK

Office market fundamentals remain healthy in Orange County going into 2018

After what was a quarterly blip reported at mid-year, Orange County office market fundamentals continue to be healthy going into 2018. While space demand has slowed in 2017, it has been due to the overall economy now operating at full employment rather than a national or local market correction. In addition, occupiers remain focused on greater space efficiency and flexibility which has caused “right-sizing” within the market. As mentioned in previous reports, very few people are expecting a market correction over the next 12 months but cautious optimism remains the general sentiment moving into 2018 with rental rates and sale prices so high. ■



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Metro Orange County Office Market Indicators

MARKET	INVENTORY	UNDER CONSTRUCTION	Q4 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Greater Airport Area	42,536,668	598,284	-56,942	268,904	13.7%	1.4%	15.1%	\$2.98
Central County	14,724,020	-	-2,376	151,865	13.3%	0.3%	13.6%	\$2.25
North County	6,662,841	-	-24,328	-12,122	10.9%	1.0%	11.9%	\$2.27
South County	19,537,625	842,181	274,229	470,457	11.0%	0.9%	11.9%	\$2.83
West County	4,617,801	-	58,817	111,173	10.0%	0.3%	10.3%	\$2.08
OC Office Market Total	88,078,955	1,440,465	249,400	990,277	12.6%	1.0%	13.6%	\$2.74

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
510 & 520 Technology Dr (2 bldgs)	Vyair Medical	184,886	Class A Pre-Lease	South County	Irvine Spectrum
3450 E Miraloma Ave	Pacific Sunwear	180,000	Class A Sale-Leaseback	Central County	Greater Anaheim
3347 Michelson Dr	Incipio	70,000	Class A New Lease	Greater Airport Area	Airport Area
18200 Von Karman Ave	American Advisors Group	64,405	Class A New Lease	Greater Airport Area	Airport Area

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
4000 MacArthur Blvd (2 bldgs)	\$176,500,000	\$444	Hines & Goldman Sachs	Greater Airport Area	Airport Area
2600 Michelson Dr	\$120,000,000	\$386	CBRE Global Investors	Greater Airport Area	Airport Area
500 N State College Blvd & 3600 W Orangewood Ave (2 bldgs)	\$92,500,000	\$285	Lincoln Property Company & Cadre	Central County	Anaheim Stadium Area
3450 E Miraloma Ave	\$27,000,000	\$150	Hines & Oaktree Capital	Central County	Greater Anaheim

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
15101 & 15131 Alton Pky (2 bldgs)	477,226	Class A Office	Five Point Gateway 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
2722 Michelson Dr	155,000	Class B (Creative Office)	LBA Realty	Greater Airport Area	Airport Area

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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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