

SAN DIEGO OFFICE MARKET

SECOND QUARTER 2016

Office vacancy levels increase in San Diego at mid-year 2016

Weighted average asking rental rate increases but growth is slowing

In the second quarter, the San Diego office market reported an increase in vacancy and a slowdown in leasing activity. Despite these reported figures, average rental rates continued to increase region-wide although certain submarkets have seen rent decreases. New construction remains relatively low as developers continue to focus on relatively smaller projects and creative office conversions. While market fundamentals remain steady, the general feeling is that the office market is beginning to slow as employment growth has decreased compared to last year.

ECONOMY







San Diego year-over-year job growth slows from the first quarter

The seasonally adjusted unemployment rate for San Diego decreased to 4.2% in May, which is the lowest unemployment rate seen in the region since late 2007. Total year-over-year nonfarm employment increased by 32,200 (2.3%) while year-over-year office-using employment increased by just 8,600 (2.3%), respectively. While still growing faster than the national average of 1.7%, local employment growth has slowed since the beginning of the year as concerns remain over lower corporate earnings growth, weaker overseas growth especially in the wake of the UK's decision to leave the EU and the continued high cost of housing and doing business locally.

SUPPLY AND DEVELOPMENT

Just 201,635 square feet of new office space currently under construction

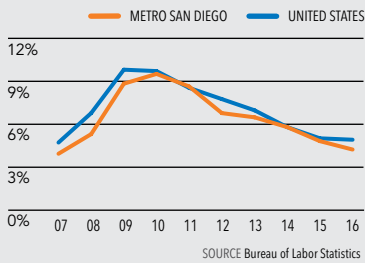
The San Diego office market saw a total of 359,842 square feet delivered in the second quarter. Compared to an average of 1.4 million square feet delivered annually from 2005 to 2008, new office development activity remains historically low. The largest projects under development include The Irvine Company's 96,435-square-foot Eastgate Terrace project in UTC, as well as American Asset Trust's 2-building, 92,000-square-foot Torrey Point project in Carmel Valley. As reported previously, expect new office construction to continue to be low as developers remain mostly focused on smaller build-to-suit projects and creative office conversion opportunities.

TRENDLINES	
5-YEAR TREND	CURRENT QUARTER
VACANCY 	16.4% Vacancy up 50 basis points from 1Q
ABSORPTION 	7,164 SF Leasing activity slowing in the region
RENTAL RATE 	\$2.65 PSF Highest reported rate since 2009
UNDER CONSTRUCTION 	201,635 SF Development remains historically low
CAP RATES 	6.0% Cap rates down 60 basis points from 1Q
JOB GROWTH 	32,200 jobs Metro job growth still outpacing the US

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SECOND QUARTER 2016

UNEMPLOYMENT RATE

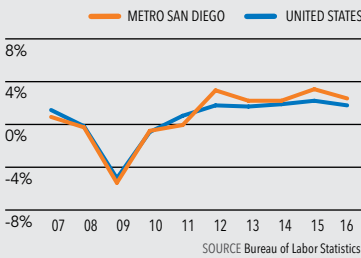


DEMAND

Net absorption was essentially flat in the second quarter

Demand for office space in the second quarter was just 7,164 square feet, which brought year-to-date net absorption to 562,860 square feet. Compared to the first six months of 2015 when 430,380 square feet was absorbed around the region, current net absorption is outpacing last year despite the second quarter slowdown. However, leasing activity has slowed from a year ago as area companies have become more cautious amid mixed economic data and rising average rental rates across the region. As a result, expect the San Diego office market to continue to see positive fundamentals although they might not be as strong as what has been seen over the past 2-3 years.

PAYROLL JOB GROWTH



VACANCY

Total vacancy rate jumps to 16.4% due to newly delivered vacant office projects

The total vacancy rate increased 50 basis points over the previous quarter to 16.4% in the second quarter. Due to the completion of 359,842 square feet of new speculative office space delivered vacant in the second quarter, the overall vacancy in San Diego increased despite essentially flat net absorption. Compared to vacancy levels which touched 20% just five years ago, steady leasing activity and the relative lack of new construction has resulted in a vacancy decrease for much of the past few years. However, expect vacancy levels to increase again if leasing activity and net absorption continue to remain lower as area companies once again consolidate and become efficient with regards to their real estate footprints.

TREASURY YIELDS



RENTAL RATES

Direct weighted average asking rental rate increases again

The direct weighted average asking rental rate market-wide increased to \$2.65 per square foot Full Service Gross (up 5.2% year over year). This is now the highest reported average asking rental rate since mid-year 2009. The highest reported average rental rate was in Central County (\$2.82 per square foot), with submarkets such as Del Mar Heights/Carmel Valley (\$4.07 per square foot) and Torrey Pines (\$4.05 per square foot) continuing to see record rates, although average rents in UTC have decreased from last quarter (\$3.40 per square foot) due to softer tenant demand. While the local economy continues to grow, the

Metro San Diego 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	26,376,683	188,435	-219,200	20,410	11.8%	2.1%	13.9%	\$3.18
Class B	33,799,424	13,200	226,364	542,450	17.5%	0.8%	18.3%	\$2.32
Metro SD Total	60,176,107	201,635	7,164	562,860	15.0%	1.4%	16.4%	\$2.65



slowdown in leasing activity at mid-year 2016 is already affecting some landlords who have gotten out in front of the market by dropping rents in certain submarkets. As a result, average asking rental rates region-wide are forecasted to flatten between now and year-end.

INVESTMENT MARKET

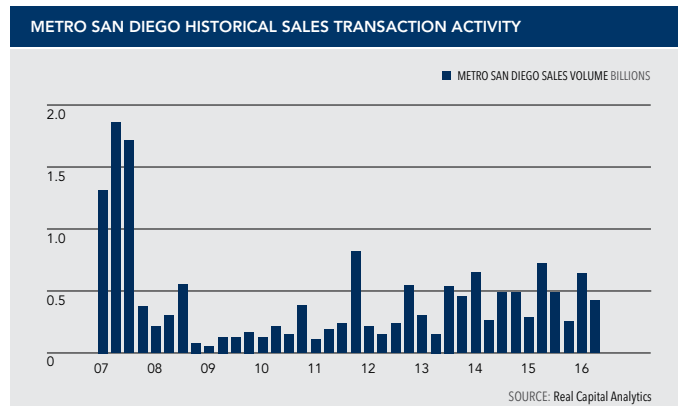
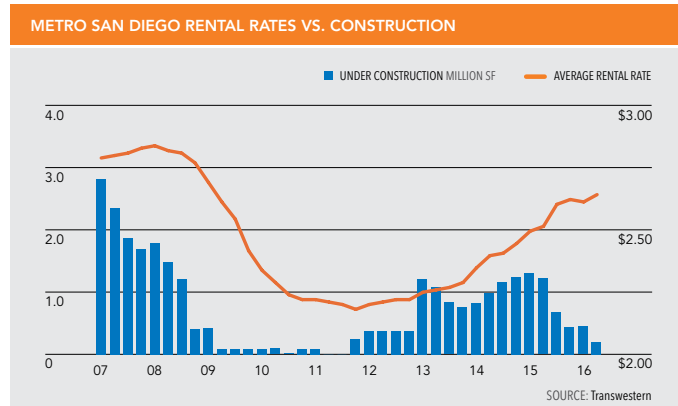
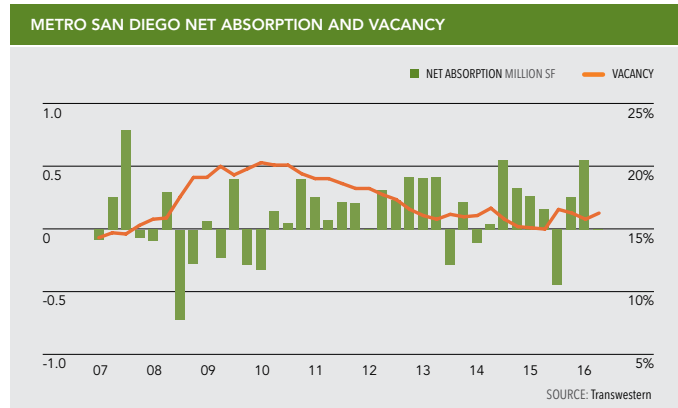
Investment sales market continues to see solid activity in the second quarter

In the second quarter, approximately \$427.8 million worth of office sales transactions were reported, bringing year-to-date office sales volume to \$1.07 billion (up 5% from the first six months of 2015). The largest office sale was UCSD acquiring the 5-building Torrey Pines Court from a joint venture of Rockwood Capital and The Muller Company for \$135,150,000 (\$620 per square foot). The office investment market has remained steady despite Class B and value-add office buildings remaining on the market longer due to the pricing disconnect between buyers and sellers. Nevertheless, expect a few Class A trophy assets around the market to trade in the second half of the year, although pricing may be cooling as buyers continue to underwrite to less aggressive assumptions relative to last year.

OUTLOOK

San Diego office market fundamentals mixed as employment growth slows

The San Diego office market at mid-year 2016 remains in relatively good shape although vacancy levels have begun to increase again. While this increase was primarily due to the delivery of vacant office projects, net absorption was worryingly flat. Combined with a lower amount of leasing activity market-wide relative to the past several quarters, it could be that the San Diego office market might be on the verge of a correction, especially after the past three years when the average rental rate increased nearly 20%. For the remainder of 2016 expect more caution rather than bullishness from tenants, landlords and investors. ■



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SUBMARKET	INVENTORY	UNDER CONSTRUCTION	Q2 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Downtown San Diego	9,645,439	-	79,796	107,807	16.9%	0.5%	17.4%	\$2.55
Central County	33,937,925	188,435	-223,897	-5,117	15.0%	1.6%	16.6%	\$2.84
I-15 Corridor	6,372,111	-	113,677	206,454	9.4%	3.2%	12.6%	\$2.40
North County	8,062,364	-	41,126	87,272	18.4%	0.4%	18.8%	\$2.39
South Bay	1,519,569	-	2,923	129,134	12.6%	0.4%	13.0%	\$2.11
East County	638,699	13,200	-6,461	37,310	2.3%	0.0%	2.3%	\$2.11
SD Office Market Total	60,176,107	201,635	7,164	562,860	15.0%	1.4%	16.4%	\$2.65

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
8925 & 8945 Rehco Rd (2 bldgs)	Scripps Health	89,488	Class B New Lease	Central County	Mira Mesa/Miramar
9577 Chesapeake Dr	City of San Diego	51,000	Class B New Lease	Central County	Kearny Mesa
5887 Copley Dr	Guild Mortgage	38,244	Class A New Lease	Central County	Kearny Mesa
9985 Pacific Heights Blvd	LE Technology	12,570	Class B New Lease	Central County	Sorrento Mesa

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
Torrey Pines Court (5 bldgs)	\$134,150,000	\$620	University of California	Central County	Torrey Pines
9360 & 9390 Towne Center Dr (2 bldgs)	\$55,000,000	\$381	BioMed Realty Trust	Central County	UTC
610 W Ash St	\$55,000,000	\$310	Gemini Rosemont	Downtown San Diego	Downtown San Diego
1010 2nd Ave	\$54,400,000	\$168	Hammer Ventures	Downtown San Diego	Downtown San Diego

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
9779 Towne Centre Dr	96,435	Class B Office	The Irvine Company	Central County	UTC
11965 & 12025 Sorrento Valley Rd (2 bldgs)	92,000	Class A Office	American Assets Trust	Central County	Del Mar Heights/Carmel Valley
9400 Grossmont Summit Dr	13,200	Class B Office	SDCRE	East County	La Mesa

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METHODOLOGY

The information in this report is the result of a compilation of information on office properties located in the San Diego 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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