

SAN DIEGO OFFICE MARKET

SECOND QUARTER 2017

Office sales volume down significantly at mid-year 2017

Average direct weighted office rental rate in San Diego at highest level since 2008

In the second quarter, the San Diego office market reported quarterly sales volume of just \$163.4 million, which is the lowest level reported since 2012. While the overall regional economy remains healthy and office market fundamentals continue to be positive with higher average rental rates and construction levels, it appears that the high bid-ask spread between buyers and sellers has put a damper on sales volume at mid-year 2017. For the remainder of the year, expect a few trophy office buildings to change hands, bringing sales volume up but to a total that will be hard to surpass the \$1.8 billion in office buildings that traded hands in 2016.

ECONOMY







Unemployment rate at just 3.6% in San Diego County

The seasonally adjusted unemployment rate for San Diego County was just 3.6% in May, compared to 4.7% for California and 4.3% for the rest of country. Total year-over-year nonfarm employment increased by 20,300 (1.4%) while year-over-year office-using employment growth has grown by 8,100 (2.1%). Compared to a year ago, both nonfarm and office-using employment growth have slowed from 2.8% and 2.2%, respectively, as the regional economy nears full employment.

SUPPLY AND DEVELOPMENT

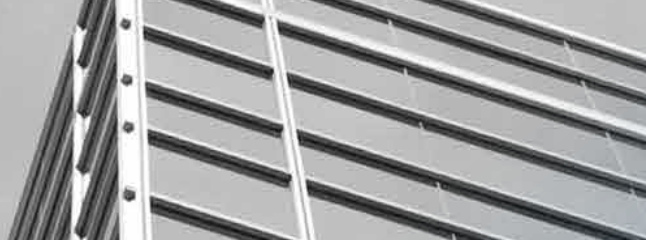
Over 1.6 million square feet of new office space now underway

The San Diego office market again saw no new office space delivered in the second quarter, while over 1.6 million square feet (2.7% of the existing office base) is now under construction. Of the 1.6 million square feet underway, 32% is pre-leased, which includes the 316,262 square foot i3 campus in UTC, 100% leased to Illumina Pharmaceuticals, as well as the 160,925 square foot Rancho Vista Corporate Center in Rancho Bernardino, which is being converted from industrial to creative office and is 100% leased to Renovate America. It should be noted that multi-tenant office development has returned to Downtown San Diego with the groundbreaking of the 63,584 square foot Block D of Makers Quarter in the East Village. This project will be closely watched to see if office building fundamentals support further spec development in Downtown San Diego moving forward.

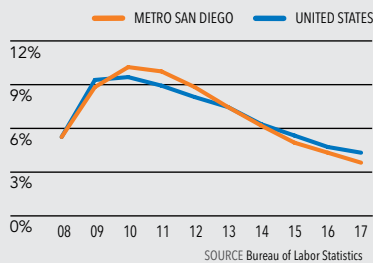
| TRENDLINES | |
|--|--|
| 5-YEAR TREND | CURRENT QUARTER |
| VACANCY  | 14.3% Vacancy up 10 basis points from 1Q |
| ABSORPTION  | -65,648 SF Givebacks in UTC lead negative absorption |
| RENTAL RATE  | \$2.79 PSF Highest reported rate in nine years |
| UNDER CONSTRUCTION  | 1.6 million SF Over 32% is pre-leased |
| CAP RATES  | 6.1% Cap rates flat from 1Q |
| JOB GROWTH  | 20,300 jobs Year-over-year growth up 1.4% |

SAN DIEGO OFFICE MARKET

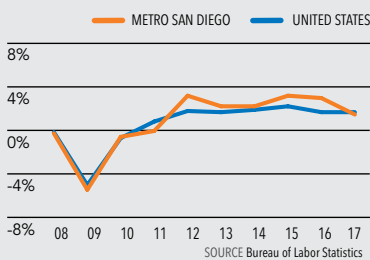
SECOND QUARTER 2017



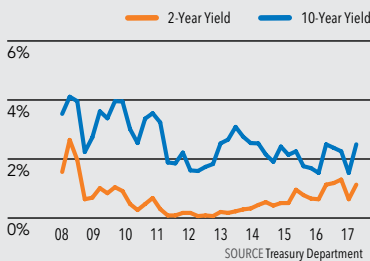
UNEMPLOYMENT RATE



PAYROLL JOB GROWTH



TREASURY YIELDS



DEMAND

Net absorption turns slightly negative, led by space givebacks in UTC

In the second quarter, office space demand turned negative at -65,648 square feet. This brought year-to-date net absorption to 186,972 square feet (down 68% from the first six months of 2016). Led primarily by space givebacks in the UTC submarket of Central County, this was the first time in six quarters that the region's office market did not report positive net absorption. In addition, leasing activity of 1.26 million square feet was the lowest reported region-wide since 2009 and is a 26% decrease from leasing activity of 1.7 million square feet reported a year ago. Due to the regional economy nearing full employment, many local firms have become much more cautious about only leasing space that they need right now, especially with increased rental rates and a focus on space efficiency.

VACANCY

Total vacancy rate ticks up to 14.3% (12.9% direct) at mid-year 2017

The total vacancy rate increased 10 basis points over last quarter to 14.3% in the second quarter. Direct vacancy increased 30 basis points to 12.9%, while sublease vacancy decreased 20 basis points to 1.4%. It should be noted that vacancy in Downtown San Diego continued to decrease to 11.9% in the second quarter as local startups have become increasingly attracted to Downtown's urban quality of life, surrounding amenities and proximity to the airport. For the remainder of 2017, expect San Diego office vacancy to hold steady with the forecast of a modest increase if projects currently underway are delivered to the market vacant.

RENTAL RATES

Direct weighted average rental rate now at \$2.79 per square foot

The direct weighted average asking rental rate market-wide increased to \$2.79 per square foot (up 5.3% year over year). This is now the highest reported average asking rental rate since 2008. Of the major office markets that make up San Diego, the highest reported average rental rate continued to be in Central County (\$3.03 per square foot), with submarkets such as Del Mar Heights/ Carmel Valley (\$4.07 per square foot) continuing to see record rates. For the rest of 2017, rents are forecasted to continue to grow, although at a slower rate relative to last year.

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 | 26,259,374 | 1,369,798 | -19,781 | -183,782 | 11.5% | 2.0% | 13.5% | \$3.23 |
| Class B | 33,326,261 | 267,316 | -45,867 | 370,754 | 14.1% | 0.8% | 14.9% | \$2.45 |
| Metro SD Total | 59,585,635 | 1,637,114 | -65,648 | 186,972 | 12.9% | 1.4% | 14.3% | \$2.79 |



INVESTMENT MARKET

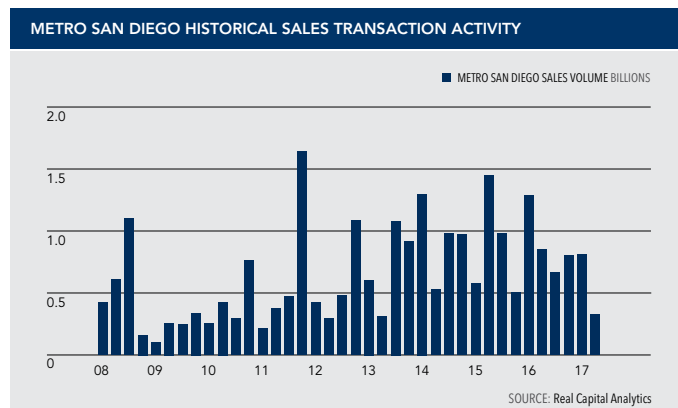
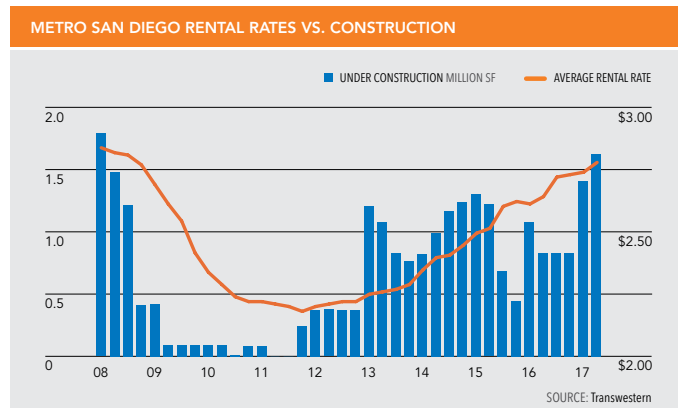
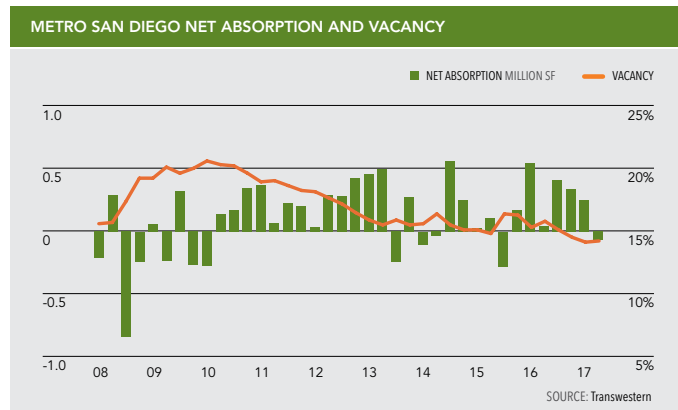
Office investment sales volume down significantly from last year

Approximately \$163.4 million worth of office sales occurred in the second quarter, which brought year-to-date sales volume up to \$571.2 million (down 47% from the first six months of 2016). As mentioned in previous reports, investor interest in the San Diego office market remains steady, but the high bid-ask spread has caused many buyers to be more cautious in their acquisition underwriting. At the same time, seller expectations of what their properties are worth remains high with very little incentive to drop asking prices right now. Nevertheless, expect a few trophy office properties to trade in the second half of the year, but it might be difficult to surpass the \$1.8 billion in office sales volume seen last year.

OUTLOOK

Hopefully slowing leasing activity and sales volume is a mid-year lull

While the San Diego office market remains relatively healthy at mid-year 2017, it is hard to explain away that leasing activity and sales volume are down significantly from a year ago. As the San Diego economy nears full employment and the investment market remains fully priced, it will be interesting to see if the slowdown in transactional volume seen in the second quarter is a quarterly blip or the start of a larger slowdown in the region's office market. On the other hand, the region's enviable life sciences sector continues to drive employment and leasing decisions. In the meantime, the San Diego office market enters the second half of 2017 in relatively good shape and, absent a larger macroeconomic shock, is expected to continue to see solid fundamentals in a slow-growth economic environment. ■



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SECOND QUARTER 2017

Metro San Diego Office Market Indicators

| SUBMARKET | INVENTORY | UNDER CONSTRUCTION | Q2 NET ABSORPTION | YTD NET ABSORPTION | DIRECT VACANCY | SUBLEASE SPACE | TOTAL VACANCY | AVERAGE RATE PSF |
|-------------------------------|-------------------|--------------------|-------------------|--------------------|----------------|----------------|---------------|------------------|
| Downtown San Diego | 9,615,944 | 63,584 | 75,597 | 334,531 | 11.5% | 0.4% | 11.9% | \$2.57 |
| Central County | 33,696,378 | 1,290,451 | -168,720 | -162,358 | 13.2% | 1.4% | 14.7% | \$3.03 |
| I-15 Corridor | 6,285,682 | 160,925 | -94,591 | -186,759 | 9.7% | 3.3% | 13.0% | \$2.50 |
| North County | 7,879,225 | 108,954 | 102,261 | 156,972 | 17.0% | 0.9% | 17.9% | \$2.39 |
| South Bay | 1,486,885 | - | 15,329 | 41,835 | 12.9% | 0.2% | 13.1% | \$2.44 |
| East County | 621,521 | 13,200 | 4,476 | 2,751 | 0.3% | 0.0% | 0.3% | \$1.94 |
| SD Office Market Total | 59,585,635 | 1,637,114 | -65,648 | 186,972 | 12.9% | 1.4% | 14.3% | \$2.79 |

MAJOR LEASE ACTIVITY

| PROPERTY | TENANT | SF | TYPE | MARKET | SUBMARKET |
|------------------------|-------------------------------------|---------|---------------------------|----------------|-------------------------------|
| 12780 El Camino Real | Neurocrine Biosciences | 140,591 | Class A Renewal | Central County | Del Mar Heights/Carmel Valley |
| 5353 Mission Center Rd | Azusa Pacific University | 48,000 | Class B Renewal/Expansion | Central County | Mission Valley |
| 10680 Treena St | Kratos Defense & Security Solutions | 26,030 | Class A New Lease | I-15 Corridor | Scripps Ranch |
| 5897 Oberlin Dr | Verimatrix | 21,200 | Class B New Lease | Central County | Sorrento Mesa |

MAJOR SALES ACTIVITY

| PROPERTY | PRICE | PRICE PSF | BUYER | MARKET | SUBMARKET |
|---------------------------------|--------------|-----------|--------------------------------|----------------|--------------------|
| 6925 & 6965 Lusk Blvd (2 bldgs) | \$26,100,000 | \$210 | HCP | Central County | Sorrento Mesa |
| 9860 Mesa Rim Rd | \$12,500,000 | \$307 | CMS Capital Holdings LLC | Central County | Sorrento Mesa |
| 5015 Shoreham Pl | \$11,200,000 | \$438 | Hanabi Shoreham LLC | Central County | Governor Park |
| 171 Saxony Rd | \$10,400,000 | \$339 | Commercial Equity Partners LLC | North County | North Beach Cities |

DEVELOPMENT ACTIVITY

| PROPERTY | SF | TYPE | DEVELOPER | MARKET | SUBMARKET |
|---|---------|--------------------|----------------------------|----------------|-------------------------------|
| Amersand - 350 Camino De La Reina - (2 bldgs) | 318,570 | Class A (Creative) | Casey Brown Company | Central County | Mission Valley |
| i3 - 4775, 4785 & 4795 Executive Dr - (3 bldgs) | 316,262 | Class A | BioMed Realty Trust | Central County | UTC |
| One Paseo (2 bldgs) | 280,000 | Class A | Kilroy Realty Corp. | Central County | Del Mar Heights/Carmel Valley |
| 16409 W Bernardo Dr | 160,925 | Class B (Creative) | Swift Real Estate Partners | I-15 Corridor | Rancho Bernardo |

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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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