

SAN DIEGO OFFICE MARKET

THIRD QUARTER 2016

Average office rental rates now at seven-year high

Office market fundamentals continue to be positive in the second half of 2016

In the third quarter, the San Diego office market reported the largest amount of quarterly net absorption in nearly nine years. This caused the total vacancy rate to drop by a full percentage point while average rental rates have increased uninterrupted for four years now. Despite these positive market fundamentals, the amount of new construction underway remains low as developers continue to focus on relatively smaller projects. However, with larger office projects planned, the local office market could be about to see the return of large-scale speculative office development for the first time in years.

ECONOMY

San Diego year-over-year job growth slows dramatically from a year ago

Total year-over-year nonfarm employment increased by 25,100 (1.8%), which is a sharp slowdown in year-over-year employment growth of 3.4% reported a year ago. In addition, total year-over-year office-using employment increased by just 6,400 (1.7%). While San Diego's unemployment rate of 5.0% is lower than the overall California unemployment rate of 5.6% in August, it appears that lower corporate earnings growth, uncertainty in overseas growth and, probably most importantly, the high cost of housing and lack of residential construction have increasingly acted as a drag on local hiring.

SUPPLY AND DEVELOPMENT

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

The San Diego office market saw no office space delivered in the third quarter. Compared to an average of 1.4 million square feet delivered annually from 2005 to 2008, new office development activity currently remains historically low and constitutes a miniscule 0.3% of the region's existing office base. However, a few high-profile proposed office projects such as Sunroad Enterprises' Centrumplace project in Kearny Mesa and Chestnut Properties' Millenia Office campuses could add over 2 million square feet to the speculative development pipeline over the next several months.

TRENDLINES

5-YEAR TREND CURRENT QUARTER

VACANCY



15.4%

Vacancy down 100 basis points from 2Q

ABSORPTION



576,179 SF

YTD net absorption over 1.1 million SF

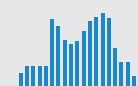
RENTAL RATE



\$2.73 PSF

Highest reported rate since 2009

UNDER CONSTRUCTION



201,635 SF

No new deliveries in 3Q 2016

CAP RATES



6.5%

Cap rates rise 50 basis points from 2Q

JOB GROWTH

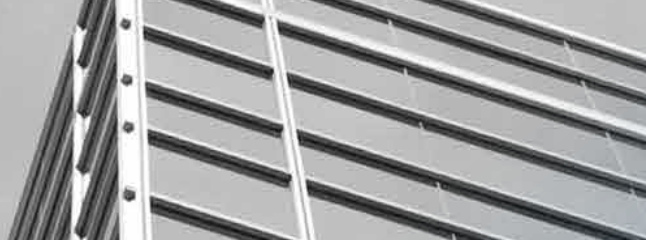


25,100 jobs

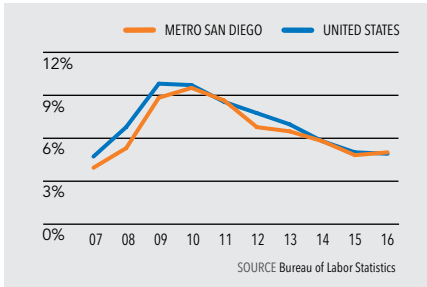
Metro job growth still outpacing the US

SAN DIEGO OFFICE MARKET

THIRD QUARTER 2016



UNEMPLOYMENT RATE

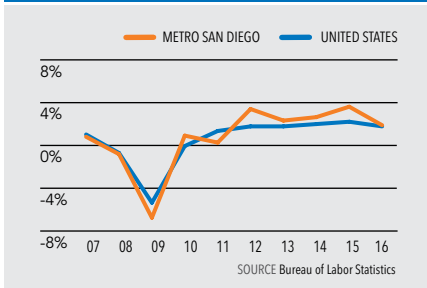


DEMAND

Net absorption bounces back in the third quarter

Demand for office space in the third quarter was 576,179 square feet, which brought year-to-date net absorption to over 1.1 million square feet (up from this time last year). Despite strong 2016 year-to-date net absorption, leasing activity in the second half of the year 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 three years.

PAYROLL JOB GROWTH

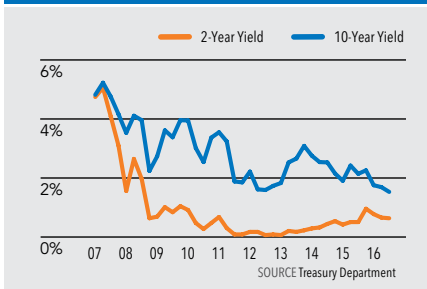


VACANCY

Total vacancy rate decreases to 15.4% although sublease vacancy rises yet again

The total vacancy rate decreased 100 basis points over the previous quarter to 15.4%, but the sublease vacancy rate increased yet again to 1.4% and should be closely watched moving forward as a gauge of softening office space demand. With vacancy levels that 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 remain lower.

TREASURY YIELDS



RENTAL RATES

Direct weighted average asking rental rate increases again

The direct weighted average asking rental rate market-wide increased to \$2.73 per square foot Full Service Gross (up 4.6% year-over-year). This is now the highest reported average asking rental rate since mid-year 2009. The highest reported average rental rate continued to be in Central County (\$2.94 per square foot) with submarkets such as Del Mar Heights/Carmel Valley (\$4.08 per square foot) and Torrey Pines (\$4.05 per square) continuing to see record rates although average rents in UTC continue to decrease slightly (\$3.37 per square foot) due to softer tenant demand. While the local economy continues to grow, the recent slowdown in leasing activity has already affected some landlords who have dropped rents in certain submarkets. As a result, expect average rental rate growth to slow over the next few months.

Metro San Diego 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	26,376,683	188,435	290,697	311,107	10.9%	1.9%	12.8%	\$3.22
Class B	33,799,424	13,200	285,482	827,932	16.5%	0.9%	17.4%	\$2.38
Metro SD Total	60,176,107	201,635	576,179	1,139,039	14.0%	1.4%	15.4%	\$2.73



INVESTMENT MARKET

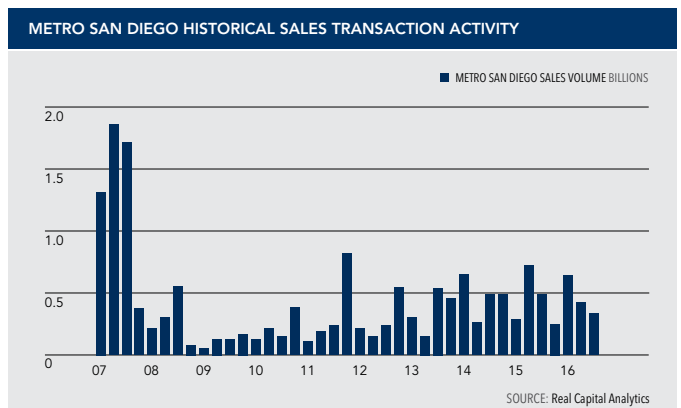
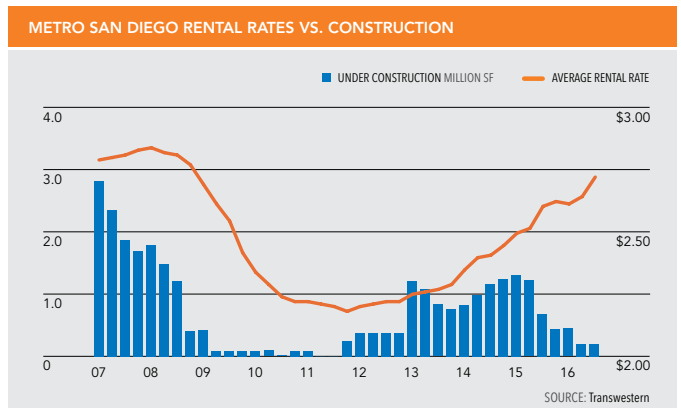
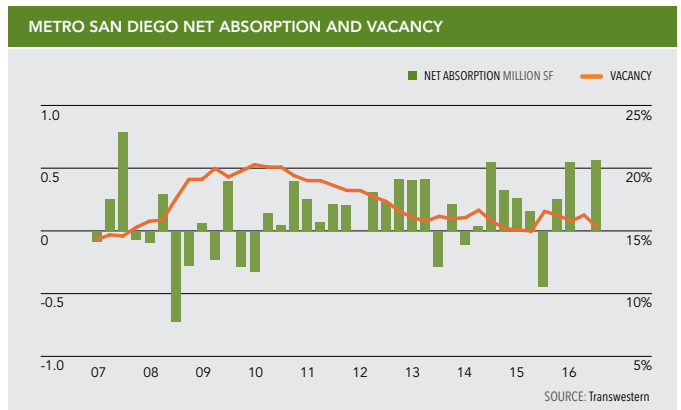
Investment sales market slows due to bid-ask spread between buyers and sellers

Approximately \$335.6 million worth of office sales transactions were reported in the third quarter, which brought year-to-date office sales volume to \$1.4 billion (down 6.7% from the first nine months of 2015). Overall, the office investment sales market has remained steady, although Class B and value-add office buildings have remained on the market longer due to the bid-ask spread between buyers and sellers. Nevertheless, expect a bump in sales activity between now and the end of the year as more properties are brought out to market for sale and seller pricing expectations come back to the market.

OUTLOOK

Office market fundamentals remains positive but employment growth slows

The San Diego office market in the second half of 2016 remains in good shape as fundamentals remain positive. While vacancy levels have dropped again and average rental rates continue to rise, the sharp slowdown in local employment growth compared to 2015 is a worrying sign for an office market that was one of the first to recover on the West Coast. Combined with the continued high cost of housing and doing business locally, it is no surprise that San Diego has seen a slowdown in employment growth as area companies increasingly look at expanding but to metro areas outside the region such as Phoenix. As mentioned in previous reports, expect more caution rather than bullishness from tenants, landlords, and investors for at least the next several months. ■



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Metro San Diego Office Market Indicators

SUBMARKET	INVENTORY	UNDER CONSTRUCTION	Q3 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Downtown San Diego	9,645,439	-	111,703	219,510	15.6%	0.6%	16.2%	\$2.62
Central County	33,937,925	188,435	273,691	268,574	14.2%	1.6%	15.8%	\$2.94
I-15 Corridor	6,372,111	-	139,854	346,308	7.7%	2.7%	10.4%	\$2.42
North County	8,062,364	-	47,228	134,500	17.5%	0.7%	18.2%	\$2.39
South Bay	1,519,569	-	1,094	130,228	12.5%	0.4%	12.9%	\$2.20
East County	638,699	13,200	2,609	39,919	1.9%	0.0%	1.9%	\$2.12
SD Office Market Total	60,176,107	201,635	576,179	1,139,039	14.0%	1.4%	15.4%	\$2.73

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
600 B St	WeWork	88,273	Class A New Lease	Downtown San Diego	Downtown San Diego
3666 Kearny Villa Rd	County of San Diego	58,222	Class B New Lease	Central County	Kearny Mesa
9860 Mesa Rim Rd	USC	40,754	Class B New Lease	Central County	Sorrento Mesa
12777 El Camino Read	Seismic Software	23,976	Class B New Lease	Central County	Del Mar Heights/Carmel Valley

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
4939 & 4955 Directors Pl (2 bldgs)	\$49,000,000	\$355	HCP, Inc.	Central County	Sorrento Mesa
401 Mile of Cars Way	\$42,750,000	\$225	Bosa Development	South Bay	National City
12396 World Trade Dr, 11545 W Bernardo Ct, 5120 Shoreham Pl (3 bldgs)	\$30,500,000	\$209	Omninet Capital	I-15 Corridor, Central County	Rancho Bernardo, Governor Park
10421 & 10431 Wateridge Cir (2 bldgs)	\$28,000,000	\$223	Angelo Gordon & Co.	Central County	Sorrento Mesa

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
9779 Towne Centre Dr	96,435	Class B Office	The Irvine Company	Central County	UTC
3420 & 3430 Carmel Mountain 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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