

SAN DIEGO OFFICE MARKET

THIRD QUARTER 2017

Office sales activity up sharply in the third quarter Highest level of quarterly investment sale volume in nearly six years

In the third quarter, the San Diego office market reported quarterly sales volume of over \$906 million, which is the highest level of activity since the fourth quarter 2011. In addition, quarterly net absorption was also strong with 763,290 square feet of occupancy gains led overwhelmingly by the UTC submarket, which saw the 100% leased-to-Illumina i3 campus finally delivered in the third quarter. While market fundamentals remain mostly positive, especially in the region's booming life sciences sector, expect slow growth moving forward as the area's high cost of housing and doing business act as headwinds on faster growth.

ECONOMY







Unemployment rate now at 4.7% in San Diego County

The seasonally adjusted unemployment rate for San Diego County was 4.7% in August compared to 5.4% for California and 4.5% for the rest of country. Total year-over-year nonfarm employment increased by 19,200 (1.3%), while year-over-year office-using employment growth has grown by 8,000 (2.1%). Compared to a year ago, nonfarm employment growth has slowed from 2.4% while office-using employment has increased from 1.5%. With the area economy remaining at or near full employment, expect hiring to continue but at a much slower pace moving forward.

SUPPLY AND DEVELOPMENT

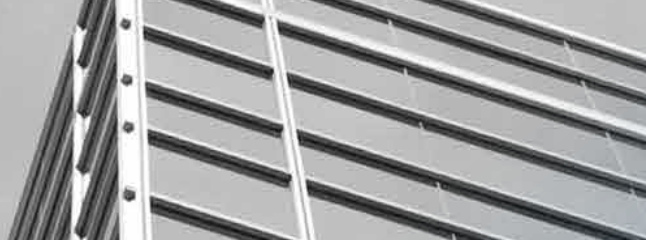
Just 661,577 square feet of new office space now under construction

In the third quarter, a total of 724,392 square feet of office space was delivered to the market. This included Biomed Realty Trust's long-awaited three-building, 316,262 square-foot i3 campus in UTC which is 100% leased to Illumina, as well as American Asset Trust's two-building, 90,770 square-foot Torrey Point project in Del Mar Heights/Carmel Valley. Just 661,577 square feet of new office space is currently underway, of which 25% is now pre-leased. Compared to previous real estate cycles, new office development has remained relatively low in San Diego as most developers either focus on smaller projects or hold off on breaking ground until they get a pre-lease commitment. This trend is expected to continue for the foreseeable future.

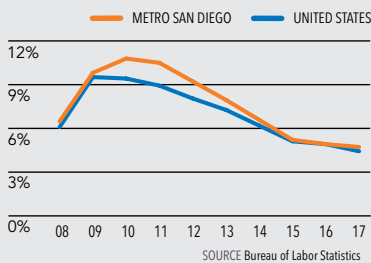
TRENDLINES	
5-YEAR TREND	CURRENT QUARTER
VACANCY 	14.1% Vacancy down 20 basis points from 2Q
ABSORPTION 	763,290 SF UTC submarket leads positive absorption
RENTAL RATE 	\$2.81 PSF Highest reported rate in nine years
UNDER CONSTRUCTION 	661,577 SF Over 25% is pre-leased
CAP RATES 	6.0% Cap rates down 10 basis points from 2Q
JOB GROWTH 	19,200 jobs Year-over-year growth up 1.3%

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THIRD QUARTER 2017



UNEMPLOYMENT RATE

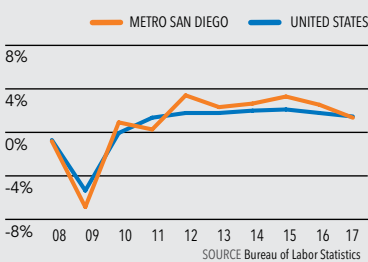


DEMAND

Net absorption turns sharply positive, led by the UTC submarket

Office space demand was sharply positive at 763,290 square feet in the third quarter. This brought 2017 year-to-date net absorption to 950,262 square feet (down 5% from the first nine months of 2016). Led overwhelmingly by occupancy gains in the UTC submarket such as Illumina moving in to their brand-new i3 campus in the third quarter, Central County is now responsible for 82% of all office net absorption in San Diego in 2017. This is expected to continue with recent large leases signed by Takeda Pharmaceuticals for 163,648 square feet in a build-to-suit project in UTC, as well as Amazon expanding their local footprint by signing a 106,874-square-foot lease at Campus Pointe also in UTC.

PAYROLL JOB GROWTH

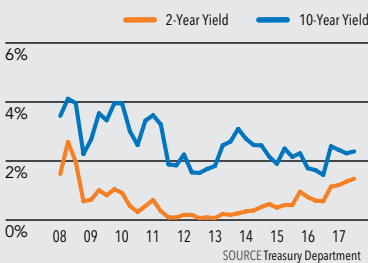


VACANCY

Total vacancy rate now down to 14.1% (12.8% direct vacancy)

The total vacancy rate decreased 20 basis points over last quarter to 14.1% in the third quarter. Direct vacancy decreased 10 basis points to 12.8%, while sublease vacancy decreased 20 basis points to 1.2%. It should be noted that the total available vacancy rate, which does not include vacant office space currently encumbered for move-in, is 12.6%, which is 150 basis points less than the reported total vacancy rate of 14.1% market-wide. For the remainder of 2017, expect San Diego office vacancy to creep down as vacant leased space eventually is absorbed.

TREASURY YIELDS



RENTAL RATES

Direct weighted average asking rental rate now at \$2.81 per square foot

The direct weighted average asking rental rate market-wide increased to \$2.81 per square foot (up 2.9% year over year). This is now the highest reported average asking rental rate since mid-year 2008. Of the major office markets that make up San Diego, the highest reported average rental rate continues to be in Central County (\$3.06 per square foot), with submarkets such as Del Mar Heights/Carmel Valley (\$4.04 per square foot) continuing to see historically high average rental rates. For the rest of 2017, rents are forecasted to continue to growth although at a slower rate relative to last year.

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	26,762,841	615,186	253,660	69,878	12.2%	2.0%	14.2%	\$3.24
Class B	33,547,186	46,391	509,630	880,384	13.3%	0.6%	13.9%	\$2.45
Metro SD Total	60,310,027	661,577	763,290	950,262	12.8%	1.2%	14.1%	\$2.81



INVESTMENT MARKET

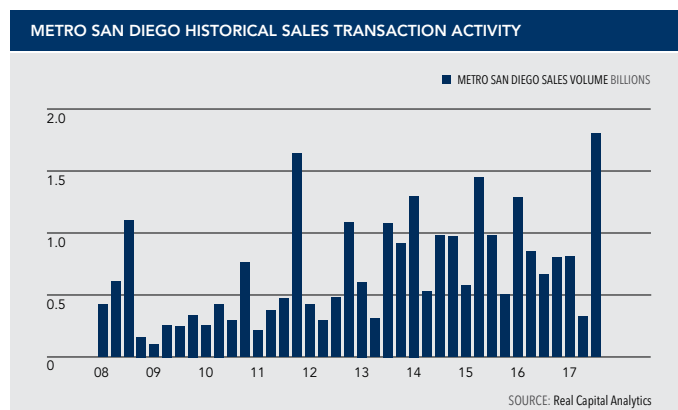
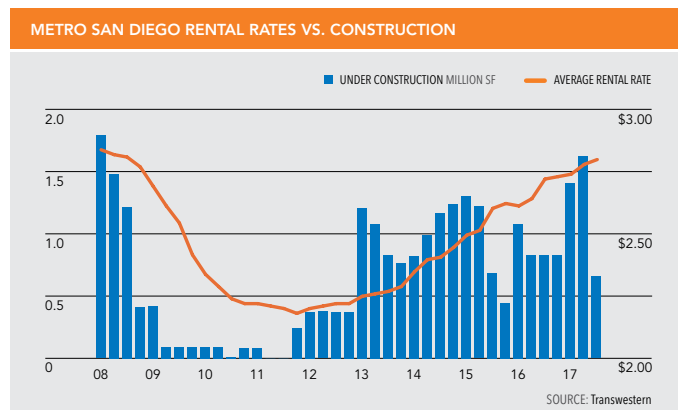
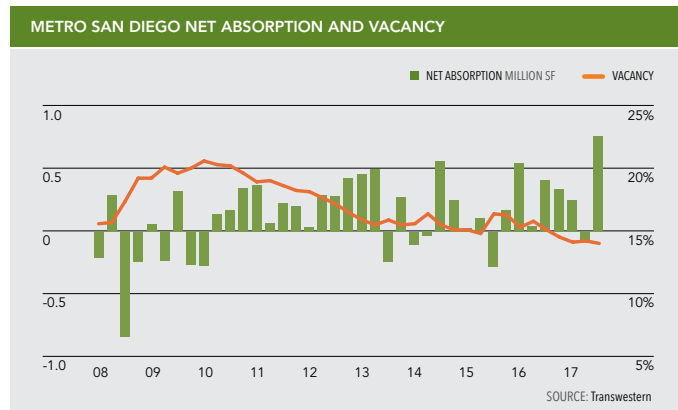
Office investment sales volume up significantly

Approximately \$906.2 million worth of office sales occurred in the third quarter, which brought year-to-date sales volume up to just under \$1.5 billion (up 4% from the first nine months of 2016). The largest sale of the quarter involved DiamondView Tower (350 10th Ave) in the East Village of Downtown San Diego being acquired by DivcoWest from a joint venture of Cruzan and CIGNA for \$207.0 million (\$678 per square foot). In addition, Canadian investor City Office REIT acquired Mission City Corporate Center in Mission Valley and Pacific Corporate Center in Sorrento Mesa from Kilroy Realty for \$174.5 million (\$261 per square foot). As mentioned in previous reports, investor interest in the San Diego office market remains steady, and, hopefully with more data points, the bid-ask spread between buyers and sellers will narrow and more trades will happen between now and year-end.

OUTLOOK

San Diego office market rebounds in the second half of 2017

After a mid-year lull in leasing and investment sales activity, the San Diego office market rebounded in the third quarter with high levels of occupancy gains and several high-profile office trades around the market. Led by only a handful of submarkets in Central County, it is no surprise that market fundamentals have been widely uneven from submarket to submarket. On the other hand, the region has come a long way from just seven years ago when the total vacancy rate was over 20% and several large corporations either downsized or left the region entirely after the Great Recession. Looking to the short-term, expect the San Diego economy in general and office market in particular to continue to see slow growth as the region's high cost of housing remains the primary headwind to more local business formation and hiring. ■



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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	9,615,944	63,584	-91,366	243,165	12.5%	0.4%	12.9%	\$2.67
Central County	34,199,845	535,839	943,686	781,328	11.9%	1.3%	13.2%	\$3.06
I-15 Corridor	6,446,607	-	-105,381	-292,140	13.9%	3.0%	16.8%	\$2.54
North County	7,939,225	48,954	17,060	174,032	17.6%	0.7%	18.3%	\$2.41
South Bay	1,486,885	-	7,008	48,843	12.1%	0.6%	12.6%	\$2.42
East County	621,521	13,200	-7,717	-4,966	1.5%	0.0%	1.5%	\$1.95
SD Office Market Total	60,310,027	661,577	763,290	950,262	12.8%	1.2%	14.1%	\$2.81

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
9625 Towne Centre Dr	Takeda Pharmaceuticals	163,648	Class A Pre-Lease	Central County	UTC
10300 Campus Point Dr	Amazon	106,874	Class A New Lease	Central County	UTC
10240 Sorrento Valley Rd	Forcepoint	64,117	Class B Renewal	Central County	Sorrento Valley
3430 Carmel Mountain Rd	Tsunami AR/VR	32,475	Class A New Lease	Central County	Del Mar Heights/Carmel Valley

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
350 10th Ave	\$207,000,000	\$678	DivcoWest	Downtown San Diego	Downtown San Diego
Mission Corporate Center & Pacific Corporate Center (10 bldgs)	\$174,500,000	\$261	City Office REIT	Central County	Mission Valley & Sorrento Mesa
600 B St	\$109,500,000	\$305	Rockwood Capital	Downtown San Diego	Downtown San Diego
12670 & 12680 High Bluff Dr (2 bldgs)	\$86,500,000	\$683	The Irvine Company	Central County	Del Mar Heights/Carmel Valley

DEVELOPMENT ACTIVITY

PROPERTY	SF	TYPE	DEVELOPER	MARKET	SUBMARKET
350 Camino De La Reina (2 bldgs)	339,000	Class A (Creative)	Casey Brown Company	Central County	Mission Valley
9625 Towne Centre Dr	163,648	Class A	Alexandria Real Estate Equities	Central County	UTC
845 15th St	63,584	Class A	Lankford Associates	Downtown San Diego	Downtown San Diego
1800 Aston Ave	48,954	Class A	Burke Real Estate Group	North County	Carlsbad

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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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