

SAN DIEGO OFFICE MARKET

FOURTH QUARTER 2016

SD office market ends year with lowest vacancy since 2007

Direct weighted average rental rates now at their highest level in eight years

The San Diego office market ended the fourth quarter with strongly positive market fundamentals as occupier demand continued to cause the total vacancy rate market-wide to drop to levels last seen in mid-2007. With new office development remaining historically low, vacancy has decreased from over 20% reported in 2010 to just 14.5% now. As a result, average rental rates have continued to climb around the region, which could result in the return of large-scale speculative office development again.

ECONOMY




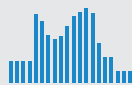


San Diego year-over-year job growth remains steady

Total year-over-year nonfarm employment in November increased by 30,900 (2.2%) while total year-over-year office-using employment increased by 9,400 (2.4%). This brought San Diego's unemployment rate down to 4.3%, which was lower than both the unemployment rate for California (5.3%) as well as nationally (5.1%). According to the state Employment Development Department, Leisure and Hospitality (7,300) saw the most employment growth year over year, followed by Government (6,500) and Education and Health Services (5,200). Growth is expected to remain steady into 2017; however, the region's high cost of housing and doing business will remain headwinds moving forward.

SUPPLY AND DEVELOPMENT

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

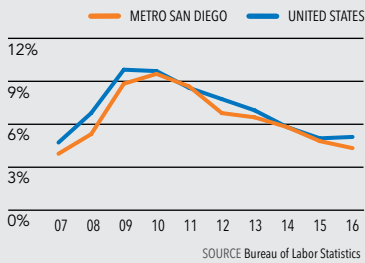
The San Diego office market again saw no new office space delivered in the fourth quarter. A total of only 201,635 square feet or 0.3% of the existing office base remains under construction. For the most part, speculative office development has been restrained for most of the past few years as developers have either focused on creative office renovations of existing industrial buildings or smaller scale projects under 100,000 square feet. With vacancy levels continuing to decrease and average rents continuing to increase, 2017 could see long-proposed projects such as Centrumplace in Kearny Mesa and Millenia in Chula Vista finally start construction.

TRENDLINES	
5-YEAR TREND	CURRENT QUARTER
VACANCY 	14.5% Vacancy down 90 basis points from 3Q
ABSORPTION 	526,793 SF 2016 net absorption over 1.6 million SF
RENTAL RATE 	\$2.74 PSF Highest reported rate since 2009
UNDER CONSTRUCTION 	201,635 SF No new deliveries in 4Q 2016
CAP RATES 	5.8% Cap rates drop 80 basis points from 3Q
JOB GROWTH 	30,900 jobs Metro job growth still outpacing the US

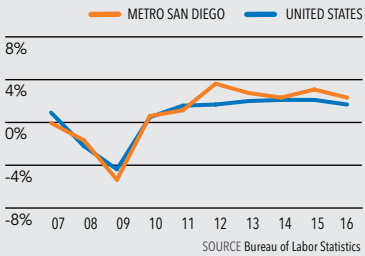
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UNEMPLOYMENT RATE



PAYROLL JOB GROWTH



TREASURY YIELDS



DEMAND

Net absorption ends year on a strong note as area companies expand

Office space demand in the fourth quarter was 526,793 square feet, which brought total net absorption for 2016 to over 1.6 million square feet (up from just 245,567 square feet in 2015). With regards to submarkets, Downtown San Diego saw the most positive net absorption in 2016 with 301,598 square feet, followed by Sorrento Mesa (294,312 square feet) and Kearny Mesa (291,957 square feet). With steady employment growth, net absorption has remained positive with demand coming from the region's government, and professional and business services sectors. In addition, area tech and life sciences companies have been expanding, which further bodes well for the San Diego office market going into 2017.

VACANCY

Total vacancy rate of 14.5% now the lowest seen in the region since mid-2007

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.

RENTAL RATES

Direct weighted average asking rental rate increases again

The total vacancy rate decreased 90 basis points over the previous quarter to 14.5% at year-end. In Downtown San Diego, total vacancy decreased yet again to 15.4% while Central County (14.2%) and the I-15 Corridor (9.8%) reported large drops in vacancy in 2016. With such low levels of new office supply forecasted to be delivered to the market next year, expect office vacancy to continue to decrease market-wide with some submarkets dropping below 10%.

Metro San Diego 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	26,376,683	188,435	5,369	316,476	11.2%	1.6%	12.8%	\$3.22
Class B	33,799,424	13,200	521,424	1,349,356	14.7%	1.2%	15.9%	\$2.40
Metro SD Total	60,176,107	201,635	526,793	1,665,832	13.2%	1.4%	14.5%	\$2.74



INVESTMENT MARKET

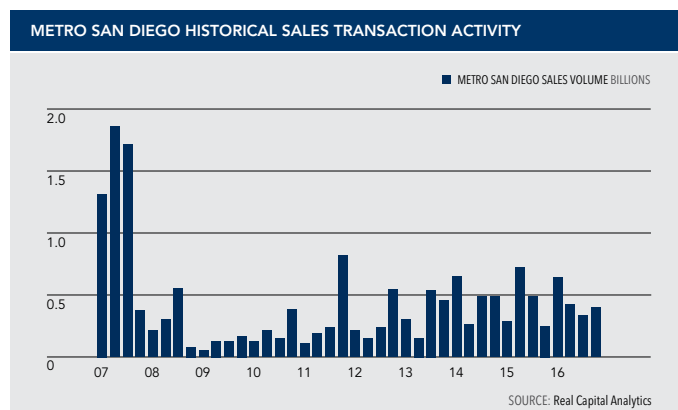
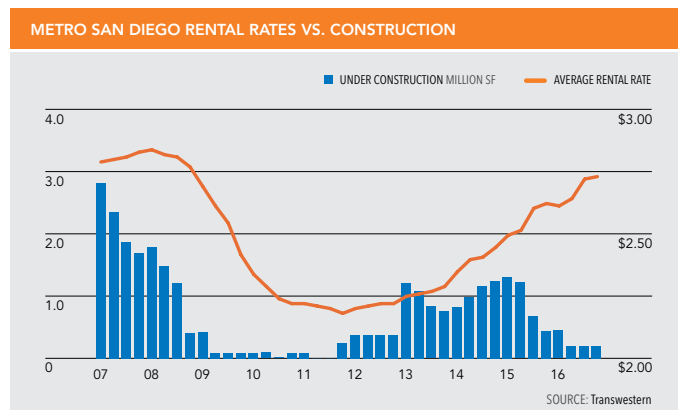
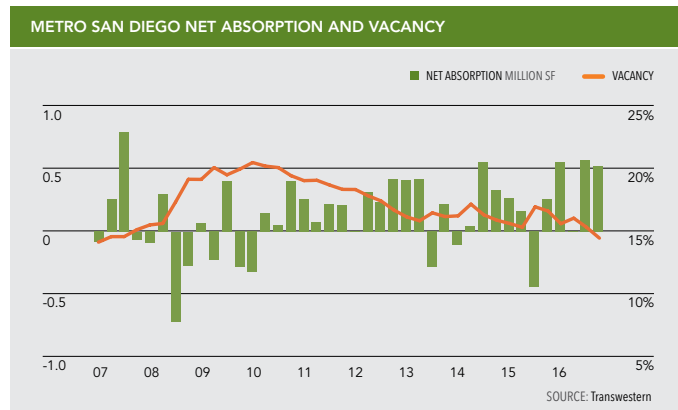
Investment sales market ends year on solid footing after slowdown last quarter

Approximately \$403.4 million worth of office sales transactions were reported in the fourth quarter, which brought total 2016 office sales volume to \$1.8 billion (up 2.8% from \$1.7 billion reported in 2015). Overall, the office investment sales market has remained steady with investors increasingly looking at the San Diego market for good relative value compared to more expensive office markets to the north in Orange County and Los Angeles, respectively. Looking into 2017, expect sales volume to remain steady, but a correction in pricing is likely due to widely expected increased interest rates next year.

OUTLOOK

Office market remains in good shape headed into 2017

The San Diego office market at year-end 2016 remains in good shape as fundamentals have remained positive. While regional year-over-year job growth of 2.2% is above the national average of just 1.6%, it still is a sharp slowdown from year-over-year job growth that was 2.9% at the same time a year ago. As mentioned in previous reports, the region's high cost of housing and doing business locally has been a major headwind to faster employment growth, but for the most part, the regional economy and office market go into 2017 in the healthiest shape in over a decade. ■



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Metro San Diego Office Market Indicators

SUBMARKET	INVENTORY	UNDER CONSTRUCTION	Q4 NET ABSORPTION	YTD NET ABSORPTION	DIRECT VACANCY	SUBLEASE SPACE	TOTAL VACANCY	AVERAGE RATE PSF
Downtown San Diego	9,645,439	-	82,088	301,598	15.1%	0.2%	15.4%	\$2.64
Central County	33,937,925	188,435	556,477	825,051	12.7%	1.5%	14.2%	\$2.94
I-15 Corridor	6,372,111	-	35,090	381,398	7.2%	2.6%	9.8%	\$2.38
North County	8,062,364	-	-113,657	20,843	18.2%	1.4%	19.6%	\$2.40
South Bay	1,519,569	-	-40,820	89,408	15.2%	0.4%	15.6%	\$2.41
East County	638,699	13,200	7,615	47,534	0.7%	0.0%	0.7%	\$1.90
SD Office Market Total	60,176,107	201,635	526,793	1,665,832	13.2%	1.4%	14.5%	\$2.74

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
101 Ash St	City of San Diego	315,000	Class A New Lease	Downtown San Diego	Downtown San Diego
2200 Faraday Ave	GreatCall, Inc.	61,772	Class B Sublease	North County	Carlsbad
401 W A St	Psyonix	39,762	Class A New Lease	Downtown San Diego	Downtown San Diego
4242 Campus Point Ct	Heron Therapeutics	28,275	Class A New Lease	Central County	UTC

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
10578, 10614 & 10628 Science Center Dr (3 bldgs)	\$182,500,000	\$625	Alexandria Real Estate Equities	Central County	Torrey Pines
402 W Broadway	\$91,700,000	\$252	Kearny Real Estate	Downtown San Diego	Downtown San Diego
2550 5th Ave	\$71,500,000	\$443	Manchester Financial Group	Central County	Uptown West/Park West
Hewlett-Packard San Diego Campus (8 bldgs)	\$69,000,000	\$88	Swfit Real Estate Partners	I-15 Corridor	Rancho Bernardo

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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