

SAN DIEGO OFFICE MARKET

FOURTH QUARTER 2017

Office market fundamentals remain steady in San Diego

Over 1.1 million square feet of total net absorption in 2017

At year-end 2017, the San Diego office market continued to see steady market fundamentals as local economic growth remains solid. With office vacancy levels declining throughout the year, area companies have shown optimism by hiring and, in some cases, expanding. On the other hand, the industry-wide trend of occupiers becoming more efficient with regards to their real estate has affected the market this cycle due to local companies not leasing any more space than what they currently need. Looking into 2018, expect more, solid instead of spectacular, growth as the market remains healthy.

ECONOMY

Unemployment rate at just 3.3% in November

The seasonally adjusted unemployment rate for San Diego County was just 3.3% in November, which was lower than both the unemployment rate for California (4.6%), as well as the nation (4.1%). Total year-over-year nonfarm employment increased by 20,800 (1.4%) while year-over-year office-using employment growth has grown by just 5,900 (1.5%). With the local economy now operating at or very close to full employment, expect hiring to continue but at a much slower pace compared to previous years, especially with the region's high cost of living acting as a serious headwind to faster growth.

SUPPLY AND DEVELOPMENT

Just 694,881 square feet of office space is now under construction

No office space was delivered to the market in the fourth quarter and just 694,881 square feet of new office space is currently underway (28% pre-leased). As mentioned in previous reports, new office development has remained relatively low in San Diego this cycle as the region has become mostly built out and developers have either focused on smaller projects or have held off on breaking ground on larger projects due to the lack of a prelease commitment. With the cost of land and construction expected to continue to increase in 2018, expect the amount of office development in the supply pipeline to remain low for the foreseeable future unless there is a sharp increase in occupier demand.

TRENDLINES

5-YEAR TREND CURRENT QUARTER

VACANCY



13.7%

Vacancy down 40 basis points from 3Q

ABSORPTION



194,322 SF

UTC submarket leads positive absorption

RENTAL RATE



\$2.82 PSF

Highest reported rate in ten years

UNDER CONSTRUCTION



694,881 SF

Over 28% is pre-leased

CAP RATES



6.00%

Cap rates unchanged from 3Q

JOB GROWTH

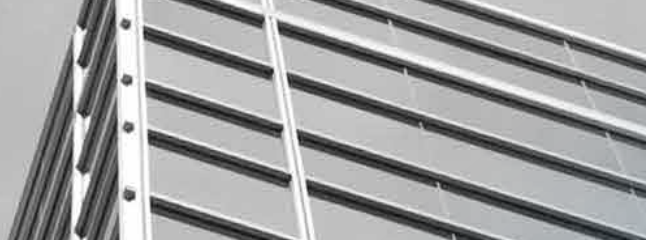


20,800 jobs

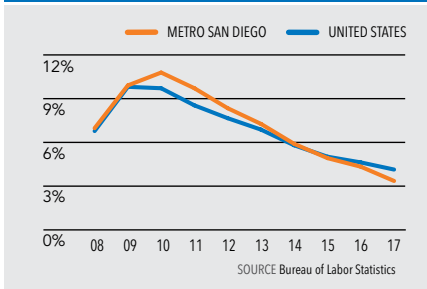
Year-over-year growth up 1.4%

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FOURTH QUARTER 2017



UNEMPLOYMENT RATE

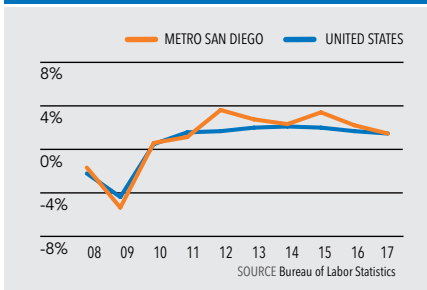


DEMAND

Total net absorption is positive for the eighth consecutive year

In the fourth quarter, net absorption was again positive at 194,322 square feet, bringing 2017 total net absorption to over 1.1 million square feet (down 15% from 2016). Led overwhelmingly by occupancy gains in the UTC submarket, Central County was responsible for 66% of all space gains in the San Diego office market in 2017. With vacancy levels continuing to decrease in the Central County submarkets along the I-5 such as UTC, Sorrento Valley, and Del Mar Heights/Carmel Valley, expect more demand in 2018 from occupiers looking in the I-15 Corridor, whose average rental rates are generally lower.

PAYROLL JOB GROWTH



VACANCY

Total vacancy rate now down to 13.7% (12.8% direct)

The total vacancy rate decreased 40 basis points over last quarter to 13.7% to end the year. Region-wide, this is the lowest year-end total vacancy rate reported in the San Diego office market since 2006. Vacancy levels ranged from just 11.1% reported in Downtown San Diego, 13.3% in Central County, 15.6% in the I-15 Corridor, and 19.2% in North County. In addition, Class A total vacancy ended the year at 14.3% while Class B total vacancy ended the year at 13.3%. For 2018, expect new office space currently under construction to be completed next year and cause an increase in office vacancy levels if they are delivered vacant.

TREASURY YIELDS



RENTAL RATES

Direct weighted average asking rental rate now at \$2.82 per square foot

The direct weighted average asking rental rate market-wide increased to \$2.82 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 continued to be in Central County (\$3.06 per square foot) with submarkets such as Del Mar Heights/Carmel Valley (\$4.14 per square foot) continuing to see historically high average rental rates. For 2018, average rents are forecasted to continue to grow, although at a slower rate relative to 2017.

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	26,762,841	615,186	-11,043	58,835	13.0%	1.3%	14.3%	\$3.26
Class B	33,547,186	79,695	205,365	1,085,749	12.6%	0.8%	13.3%	\$2.44
Metro SD Total	60,310,027	694,881	194,322	1,144,584	12.8%	1.0%	13.7%	\$2.82



INVESTMENT MARKET

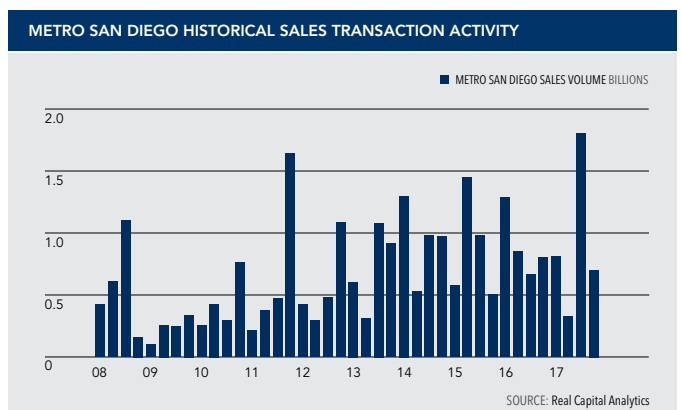
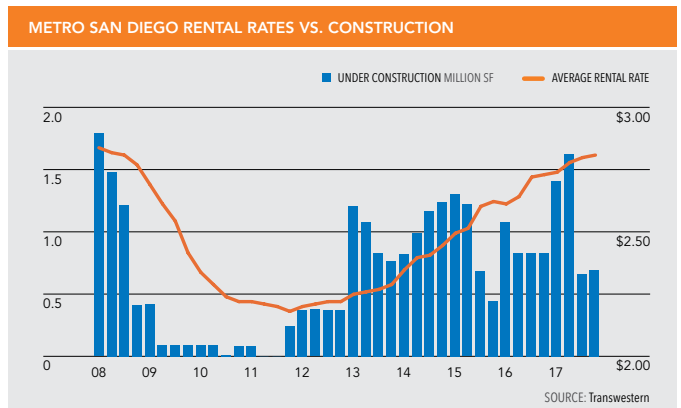
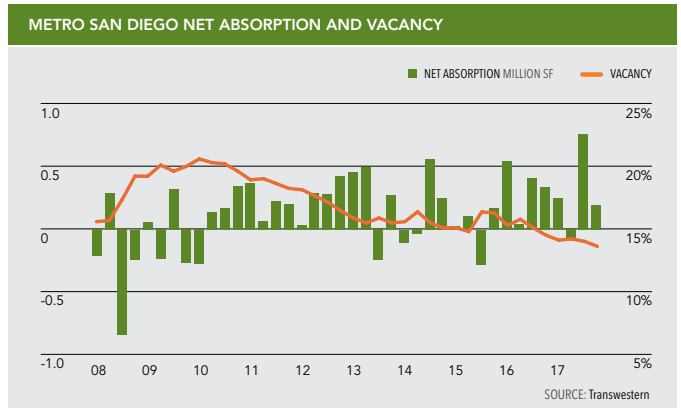
\$1.8 billion in office investment sales volume in 2017

Approximately \$352.6 million in office sales occurred in the fourth quarter, bringing 2017 total investment sales volume to \$1.8 billion, which was roughly the same as 2016. The largest sales of the quarter involved Montana Avenue Capital acquiring the 9-building Centerpark Plaza campus in Sorrento Mesa from Deutsche Asset Management for \$45.75 million (\$224 per square foot), as well Mission Federal Credit Union acquiring the 3-building Horizon Tech Center in Scripps Ranch from KBS REIT II for \$39.5 million (\$250 per square foot). Looking into 2018, expect investor interest in the San Diego office market to remain steady due to the region’s favorable pricing relative to more expensive office markets in Orange County and Los Angeles to the north.

OUTLOOK

San Diego office market enters 2018 in relatively good shape

Since peaking at 20.8% in the first half of 2010, office vacancy in San Diego has decreased dramatically, while the relative lack of speculative construction has largely kept the region from overbuilding compared to previous cycles. While most of the large leases in the region have been attributed to biotech firms in more specialized life science/ R&D buildings, the rest of the region’s office market has grown slowly but not spectacularly over the past few years. Expect the San Diego office market to continue to see slow growth in 2018 as the local economy operates at close to full employment, with the region’s high cost of housing remaining a significant headwind to higher economic and employment growth moving forward. ■



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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	9,615,944	63,584	175,172	418,337	10.6%	0.5%	11.1%	\$2.63
Central County	34,199,845	535,839	-28,008	753,320	12.3%	1.0%	13.3%	\$3.06
I-15 Corridor	6,446,607	-	82,189	-209,951	13.4%	2.2%	15.6%	\$2.65
North County	7,939,225	82,258	-68,878	105,154	18.3%	0.8%	19.2%	\$2.42
South Bay	1,486,885	-	42,942	91,785	9.4%	0.3%	9.8%	\$2.45
East County	621,521	13,200	-9,095	-14,061	2.2%	0.8%	3.0%	\$2.25
SD Office Market Total	60,310,027	694,881	194,322	1,144,584	12.8%	1.0%	13.7%	\$2.82

MAJOR LEASE ACTIVITY

PROPERTY	TENANT	SF	TYPE	MARKET	SUBMARKET
9305 Lightwave Ln	UC San Diego	82,000	Class B New Lease	Central County	Kearny Mesa
4850 Eastgate Mall	AbacusNext	63,129	Class B New Lease	Central County	UTC
10945 Vista Sorrento Pky	GreatCall	56,153	Class A New Lease	Central County	Del Mar Heights/Carmel Valley
8910 University Center Ln	WeWork	52,371	Class A New Lease	Central County	UTC

MAJOR SALES ACTIVITY

PROPERTY	PRICE	PRICE PSF	BUYER	MARKET	SUBMARKET
Centerpark Plaza (9 bldgs)	\$45,750,000	\$224	Montana Avenue Capital	Central County	Sorrento Mesa
10325, 10301 & 10343 Meanley Dr (3 bldgs)	\$39,515,500	\$250	Mission Federal Credit Union	I-15 Corridor	Scripps Ranch
5333-5353 Mission Center Rd & 7947 Mission Center Ct (3 bldgs)	\$39,275,000	\$214	Omninet Capital	Central County	Mission Valley
15255 Innovation Dr	\$21,500,000	\$314	SWK Properties LLC	I-15 Corridor	Rancho Bernardo

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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