Savills Studley Report
San Diego office sector

Q2 2017

SUMMARY

Market Highlights

AVAILABILITY FALLS

The region's overall availability rate declined by 140 basis points to 15.4%. The Class A rate dove by 200 basis points, decreasing to 16.6%, the lowest mark in more than 10 years.

RENT UP FROM A YEAR AGO

Overall asking rent has increased by 1.0% year-on-year, rising from $2.68 ($32.14/sf annually) to $2.71 ($32.47/sf annually).

LEASING REMAINS TEPID

Overall leasing in San Diego barely exceeded 1.0 msf and dropped by 26.8% quarter-on-quarter. Tenants have leased 5.6 msf in the four most recent quarters, well below the long-term average of 6.6 msf.

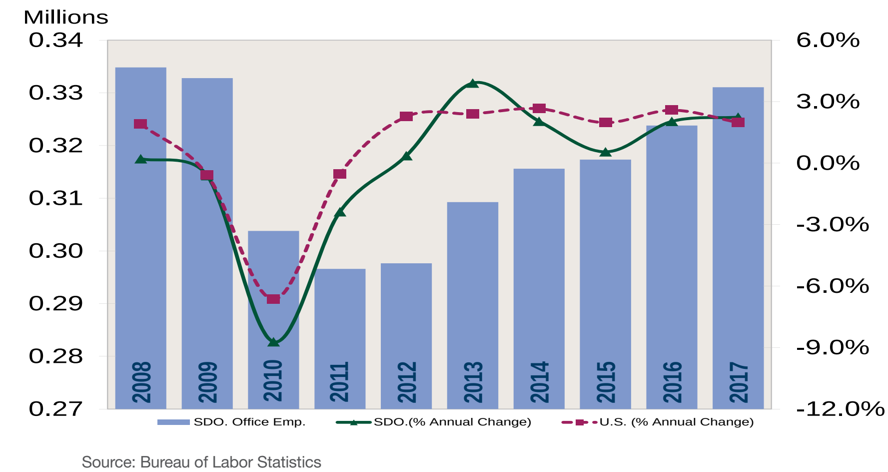
SALES SLIDES LOWER

Year-to-date office property sales totaled $525 million – falling 68.1% compared to the $1.6 billion sold during the same period in 2016.

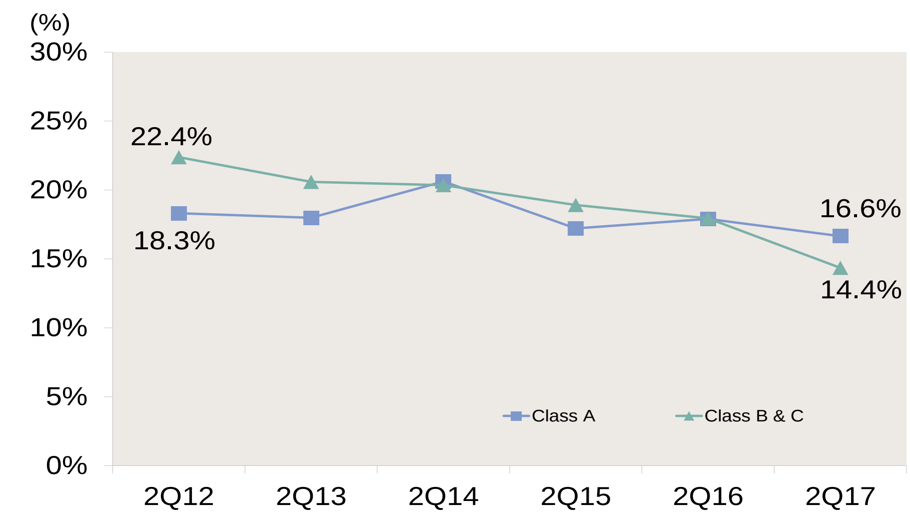
"Despite signs that hiring and leasing are losing a bit of momentum, tenants looking for quality space across San Diego face challenging conditions. Rents remain elevated in many locations, including Downtown, where steady demand from tech and creative sector firms has depleted availability."

Bridget Garwitz,
Associate Director

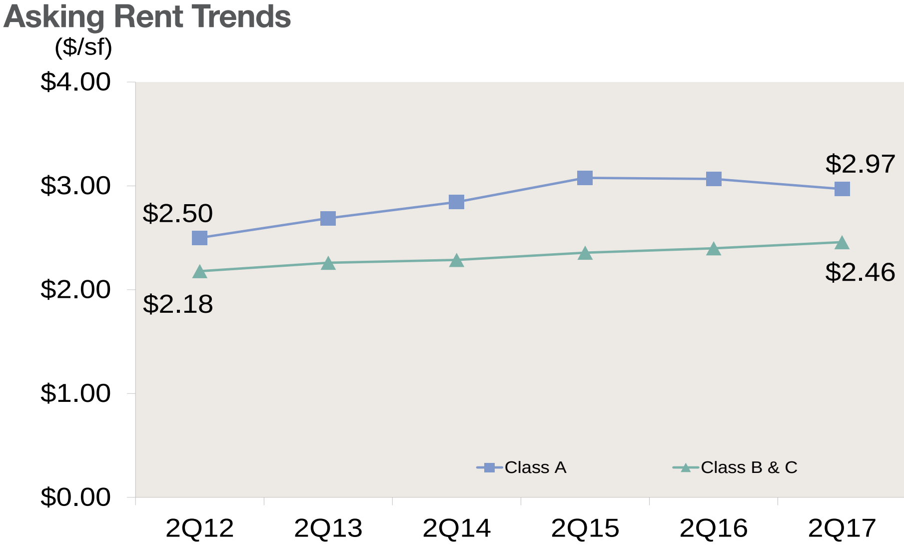
Office-Using Employment Trends



Availability Rate Trends



Asking Rent Trends



Challenging Conditions

Despite some recent signs that payroll expansion is losing momentum, tenants across much of San Diego face challenging leasing conditions. Landlords remain bullish and most will not budge off their asking rent. A few larger owners have implemented higher rent across their entire portfolio as they sense an opportunity to capitalize on tight conditions. Others have pulled the reins in on concessions.

Occupancy costs are elevated in part due to tightly controlled construction activity. Since 2013 only 2.6 msf of speculative office properties have delivered. The region has merely six buildings with a combined 480,000 sf underway. Relatively sustained demand and controlled construction have translated into lower availability rates.

Leasing and Hiring Moderating

Second quarter leasing reflects the broad cross-section of industries based in San Diego. Universities, defense contractors and architectural firms were among those completing notable leases. Azusa Pacific University signed a lease extension and expansion for 48,000 sf at Mission Office Park (5333-5353 Mission Center Road). The landlord, Kearny Real Estate Company, recently completed renovations costing $3.5 million. They updated the elevators and lobby and added a new gym. Defense contractors are anticipating increased federal funding in fiscal year 2018. Kratos Defense & Security Solutions completed a 26,000 sf lease at Scripps Plaza. Located next to the Scripps Ranch Marketplace, the building underwent renovations in 2015 including the addition of more parking, a fitness center and café.

Even with these leases, deal volume in the region remains a bit choppy and is running nearly 20.0% below its levels from a year ago. Leasing may reflect a recent cooling in hiring activity. In the 12 month period ending in April, employers added 18,200 jobs – the weakest total since early 2012, and about half the average annual hiring during the last five years. Some of the moderation may be due to a very tight labor market – particularly in sectors such as tech and healthcare. Other sectors have recently announced layoffs, including some sectors such as education that are generally quite stable. The San Diego Unified School District, recently announced that they may lay off more than 1,700 employees in 2018. Pension obligations are a contributing factor for cuts to school staffing.

Win Some, Lose Some

The region is winning some site selection battles, but losing others. San Diego is gaining from a few companies based in Northern California and Los Angeles, as well as Boston and New York City, that view San Diego as a lower-cost alternative. Retrophin (RTRX) is shutting down its Cambridge, Massachusetts offices and consolidating operations at the company's San Diego headquarters by the end of 2017. On the other hand, rising housing and business costs are pushing some local companies to make the move to lower-cost locations such as Phoenix or the Carolinas. LPL Financial, for example, is expanding its operations in South Carolina and will cut jobs based in San Diego, as well as a few in Boston.

Downtown Rising

Early on in the recovery, Downtown lagged North Cities, particularly in terms of attracting tech firms. Downtown was seen as a value-play alternative to suburban San Diego, with significant discounts in rent. This perception has changed and the rent differential has narrowed over the last two year or so. Smaller and mid-sized tech firms have come to realize Downtown's advantages: access to mass transit and a growing live/work/play setting. Companies focused primarily on recruiting younger employees consider these features essential. Gensler recently leased 21,000 sf at 225 Broadway. Already leasing space on the 16th floor at the property, they will take over NBC 7's space on the ground and second floors. The lobby, which is connected directly to the eastern plaza at the building will feature a digital interface that showcases Gensler's flooring, accessories and lighting.

Big Block Deficiency

Downtown's space options have been depleted. The inventory of large contiguous blocks of space, as well as full floors, continues to dwindle. Tenants have to get out in this market earlier than they did a few quarters ago. As of mid-year Downtown's Class A availability rate stood at 11.2% - down by 220 basis points in the last year, and its lowest mark in more than a decade. Co-working space providers are among the sectors making a dent in Downtown's vacancy.

Very few developers are building new speculative office buildings, but a fair number are buying older buildings, including some warehouses and converting them. These properties often have the large floorplates that can be redesigned with wide open space and high ceilings that creative firms covet.

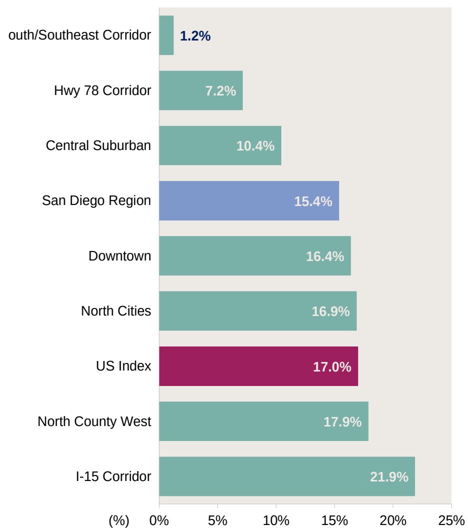
Bixby Land Company has a long track record renovating such properties. One of Bixby's latest conversions, the Oberlin (a three-building complex located in Sorrento Mesa) has had some success in leasing to tech and creative sector firms. Verimatrix, a specialist in revenue security for digital TV services, will occupy 21,200 square feet in a two-story building at 5897 Oberlin Drive. Like many of Bixby's projects, the project features a Bixby Retreat Amenity area – what they describe as an outdoor living room connecting the workspace inside to functional outdoor areas.

Robust Sales

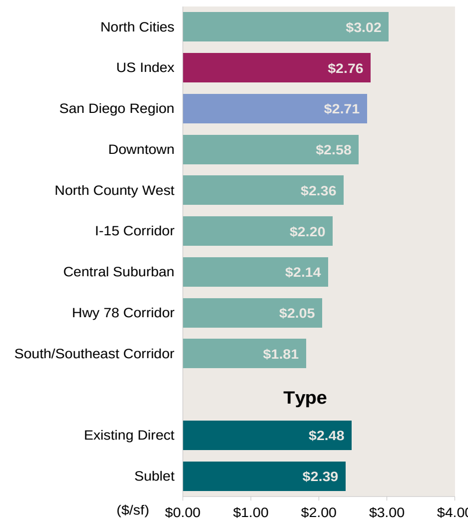
Investors pushed out of the Bay Area in California and Los Angeles by high pricing and sub – 5.0% cap rates, have set their sights on San Diego. This includes buildings in Downtown San Diego. A partnership between PCCP and Los Angeles-based Kearny Real Estate bought Emerald Plaza (402 West Broadway) for $91.7 million. The building is San Diego's newest mixed-use development and will have a 436-room hotel on lower floors with 346,000 sf of office space on upper floors.

Alexandria Real Estate Equities acquired Torrey Ridge Science Center for $182.5 million. The three-building, 291,799-square-foot campus was 87 percent leased at the time of sale. Of note, the sellers spent $55 million in improvements and renovations to common areas, signage and landscaping. New amenities were also added including a new conference center, café and fitness center. Several other smaller, but still notable properties changed hands – including the Scripps Wateridge Corporate Center. Qualcomm Inc fully occupies one of the two buildings but the other is completely vacant. HCP plans to convert it into a R&D building with office and lab space.

Availability Rate Comparison



Rental Rate Comparison



Major Transactions

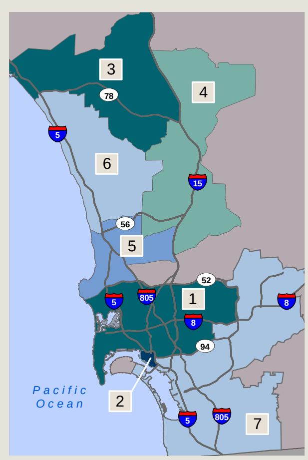
Tenant	Sq Feet	Address	Market Area
GreatCall	62,120	2200 Faraday Ave.	I-Corridor/Carlsbad
Dept. of Veterans Affairs	44,794	8880 Rio San Diego Dr	Central Suburban
Azusa Pacific University	30,846	5353 Mission Center Rd	Central Suburban
Kratos Defense & Security	26,192	10680 Treena St	I-15 Corridor
Gensler	21,000	225 Broadway	Downtown
Entercom San Diego	18,275	9665 Granite Ridge Dr	Central Suburban
Otter Products, LLC	17,315	15110 Avenue of Science	I-15 Corridor
One Reverse Mortgage	16,457	4445 Eastgate Mall	North Cities
Dokken Engineering	10,657	1450 Frazee Rd	Central Suburban
Terracosta Consulting Group	6,331	3890 Murphy Canyon Rd	Central Suburban
Sum of Top 10 Leases	**253,987**		

Map	Submarket	Total	Leasing Activity		Available SF			Availability rate			Asking rents Per SF		
		SF (1000's)	Last 12 Months	Net Absorp Last 12 Mos.	This Quarter	% Change from Last Qtr.	Year Ago	This Quarter	pp Change from Last Qtr. (1)	Year Ago	This Quarter	% Change from Last Qtr.	Year Ago
1	**Central Suburban**	13,979	1,259	380	1,460	-25.1%	2,152	10.4%	-3.5%	15.4%	$2.14	-7.0%	$2.23
	Central Suburban - Class A	4,254	319	50	492	-30.4%	652	11.6%	-5.1%	15.4%	$2.49	-13.6%	$2.85
2	**Downtown**	11,875	1,130	481	1,947	5.8%	2,341	16.4%	0.9%	19.7%	$2.58	-1.2%	$2.44
	Downtown - Class A	6,689	527	-44	747	-18.4%	899	11.2%	-2.5%	13.4%	$2.87	-3.2%	$2.79
3	**Hwy 78 Corridor**	1,346	99	76	96	-50.9%	244	7.2%	-7.4%	18.1%	$2.05	-12.5%	$2.32
	Hwy 78 Corridor - Class A	585	63	53	46	-52.4%	125	7.9%	-8.7%	21.3%	$2.26	-15.6%	$2.68
4	**I-15 Corridor**	7,100	394	79	1,553	6.5%	1,213	21.9%	1.3%	17.1%	$2.20	-8.6%	$2.25
	I-15 Corridor - Class A	3,271	118	-78	927	13.1%	618	28.3%	3.3%	18.9%	$2.54	-8.3%	$2.43
5	**North Cities**	23,222	2,163	-73	3,921	-9.7%	4,505	16.9%	-1.8%	19.4%	$3.02	-4.2%	$3.05
	North Cities - Class A	12,624	922	-158	2,265	-8.3%	2,451	17.9%	-1.6%	19.4%	$3.35	-3.4%	$3.51
6	**North County West**	6,395	468	-44	1,144	2.2%	1,209	17.9%	0.4%	19.2%	$2.36	-6.3%	$2.50
	North County West - Class A	1,826	145	-6	420	-13.7%	507	23.0%	-3.6%	27.8%	$2.69	0.7%	$2.70
7	**South/Southeast Corridor**	2,065	57	26	26	-81.9%	164	1.2%	-5.6%	7.9%	$1.81	-18.0%	$1.80
	South/Southeast Corridor -Class A	234	0	0	11	0.0%	19	4.7%	0.0%	8.0%	$2.25	-12.4%	$2.34
1-7	**San Diego Region TOTAL**	**65,981**	**5,570**	**924**	**10,146**	**-8.1%**	**11,828**	**15.4%**	**-1.4%**	**17.9%**	**$2.71**	**-4.6%**	**$2.68**
	San Diego Region TOTAL - Class A	**29,483**	**2,094**	**-181**	**4,909**	**-10.9%**	**5,269**	**16.6%**	**-2.0%**	**17.9%**	**$2.97**	**-5.2%**	**$3.07**

Please contact us for further information

Savills Studley
3579 Valley Centre Drive
Suite 100
San Diego, CA 92130
(858) 793-8600

Branch Manager
Michael Labelle,
Senior Vice President
mlabelle@savills-studley.com
License 00905261



(1) Percentage point change for availability rates.
Unless otherwise noted, all rents quoted throughout this report are average asking gross (full service) rents psf.
Statistics are calculated using both direct and sublease information.
Short-term sublet spaces (terms under two years) were excluded.

The information in this report is obtained from sources deemed reliable, but no representation is made as to the accuracy thereof. Statistics compiled with the support of The CoStar Group.