

**AT THE PEAK.** The second quarter of 2017 continued to show trends of a tight market, with vacancy rates near a post-recession low of 10.56%, down from 2016 year end's vacancy which came in at 11.1%. Overall, vacancy continues its gradual downward trend for the first half of the year, while lease rates are continuing on a fairly stable path at some of the highest rates this market has seen—\$2.78 at the end of the quarter. Leasing volume recorded one of the lowest numbers in the past ten years, reflecting the tight market and lack of available space.

**VACANCY.** Direct/sublease space (unoccupied) finished the quarter at 10.56%, a 30 basis point increase from the previous quarter, but a 1.1 percentage point decrease the second quarter 2016. Kearny Mesa posted the lowest vacancy rate of any submarket (minimum of five million square feet of inventory) at 7.03%.

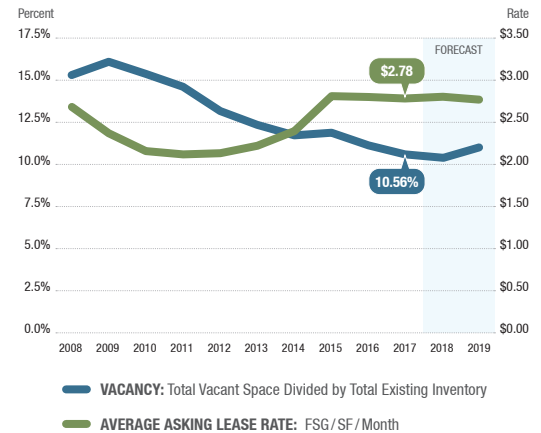
**LEASE RATES.** The average asking full-service gross (FSG) lease rate per square foot per month in San Diego County was \$2.78 at the end of the quarter, no change from last quarter's rate, but a notable increase from 2016's second quarter rate of \$2.64. The record asking rate stands at \$2.81, showing the market remains near record high asking rates.

**TRANSACTION ACTIVITY.** Sale and lease transactions totaled 2.2 million square feet in the second quarter, a sharp decrease from the previous quarter's 3.34 million square feet. This statistic can have some lag time in being reported, so look for figures to end up somewhat higher in the next report.

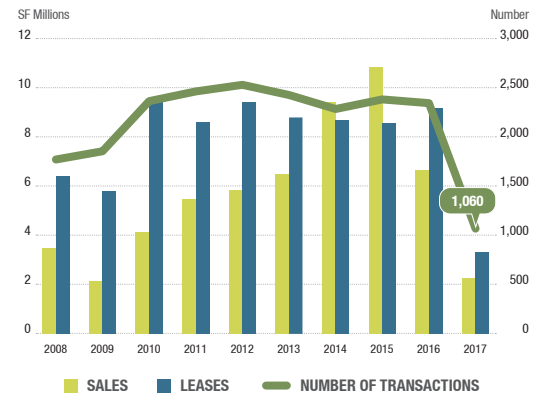
**EMPLOYMENT.** The unemployment rate in San Diego County was 3.6% in May 2017, down from a revised 3.8% in April 2016 and below the year-ago estimate of 4.3%. This compares with an unadjusted unemployment rate of 4.2% for California and 4.1% for the nation during the same period. According to the State of California Employment Development Department, San Diego County gained 20,300 payroll jobs between May 2016 and May 2017, including 6,000 from government services, which reported the largest overall gain. The construction sector reported a growth of 5,000 jobs, and the educational and health services reported an increase of 3,900 jobs.

**OVERALL.** The San Diego office market is steady for now and still showing definite signs of growth, but we are starting to see a slight shift in market fundamentals as we are in the latter stages of the current recovery. Construction levels of new office product remain relatively low compared to 2005–2008, as developers continue to focus on repositioning projects. Unemployment rates have continued to trend downward since the peak in January 2010. The stable trend of the increase in jobs and minimal speculative construction will help set the San Diego office market on firm footing in the coming year.

### VACANCY vs. AVERAGE ASKING LEASE RATE



### TRANSACTION VOLUME & NUMBER OF TRANSACTIONS



### Market Statistics

	Change Over Last Quarter	2Q 2017	1Q 2017	2Q 2016	% Change Over Last Year
Vacancy Rate	▲ UP	10.56%	10.26%	11.69%	(9.67%)
Availability Rate	▲ UP	14.36%	13.75%	14.40%	(0.28%)
Average Asking Lease Rate	▬ FLAT	\$2.78	\$2.78	\$2.64	5.30%
Sale & Lease Transactions	▼ DOWN	2,174,787	3,338,083	3,660,294	(40.58%)
Gross Absorption	▼ DOWN	1,818,058	2,509,304	2,029,934	(10.44%)
Net Absorption	▼ NEGATIVE	(354,350)	697,129	(212,597)	N/A

**EMPLOYMENT.** The labor market in San Diego County will continue to improve although we anticipate job growth to slow to 1.8%, or 25,000 jobs, over the year. With an expected growth in tourism and local economy in general, look for sectors like leisure and hospitality to lead the way for employment gains, followed by health care and biotech, and government employment.

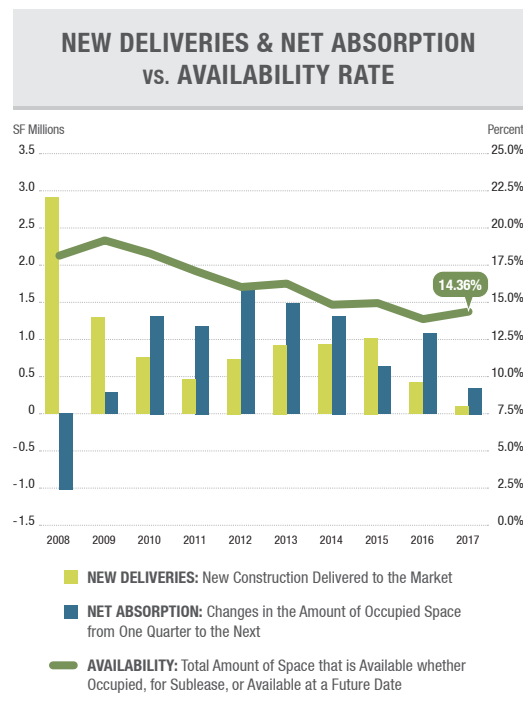
**LEASE RATES.** Expect the average asking lease rate to increase by a marginal 1% over the next four quarters, and smoothing into the same range for the year.

**VACANCY.** We anticipate vacancy to continue to remain in the 10–11% range in the coming quarters, but look out for slight upticks toward the end of the year, resulting in a vacancy of approximately 11% by the end of 2017.

**CONSTRUCTION.** Office deliveries have averaged 825,000 square feet a year over the past five years, but last year’s deliveries were below average, at approximately 400,000 square feet, and 2017 is expected to follow in the same trend, with only another 400,000 square feet by year end. This low rate of construction for two consecutive years has contributed to the significant reduction in vacancy. There are currently seven properties, for a total of 303,000 square feet, under construction due to complete in 2017. To augment the new office construction, there has been an increasing trend towards property being extensively renovated and repositioned to creative office use, e.g., IDEA1, a mixed-use project in downtown San Diego that includes a very modern outlook on residential, retail and creative office, estimated to complete in the fall of 2017.

**AVAILABILITY.** Direct/sublease space being marketed was 14.36% at the end of the quarter, an increase from the 13.75% availability rate of the previous quarter, and practically flat compared to the 14.40% rate of second quarter 2016.

**ABSORPTION.** The San Diego office market posted 354,064 square feet of negative net absorption in the second quarter, but still has a total of 320,701 square feet of positive net absorption for the first half of the year. There has been approximately 9 million square feet of positive net absorption for the overall San Diego market since the start of 2010.



## Significant Transactions

### Sales

Property Address	Submarket	Class	Square Feet	Sale Price	Buyer	Seller
North Coast Medical Plaza	Carlsbad	B	49,580	\$30,050,000	Montecito Medical Real Estate	Foley Properties
Torrey Hills Medical Plaza	Carmel Valley	A	44,156	\$28,500,000	Coast Income Properties, Inc.	Torrey Pines Enterprises, LLC
Scripps Wateridge Corporate Center	Sorrento Mesa	B	124,303	\$26,100,000	HCP	Colony Northstar
9860 Mesa Rim Rd.	Sorrento Mesa	B	40,755	\$12,500,000	CMS Capital Holdings, LLC	Washington Capital Management
5015 Shoreham Pl.	Governor Park	B	25,600	\$11,200,000	Persnickety Painters Inc.	Locale Advisors

### Leases

Property Address	Submarket	Class	Square Feet	Transaction Date	Tenant	Owner
401 Mile of Cars Way	National City	B	44,000	Apr-2017	Undisclosed	Bosa Development
10101 Old Grove Rd.	Scripps Ranch	B	38,210	Jun-2017	Undisclosed	Samuelson Partners
5353 Mission Center Rd.	Mission Valley	B	30,846	May-2017	Azusa Pacific	Kearny Real Estate Company
10680 Treena St.	Scripps Ranch	A	26,192	May-2017	Kratos Defense	Cypress Office Properties
10052 Mesa Ridge Ct. – Renewal	Sorrento Mesa	B	23,906	Apr-2017	Golden Hour Data Systems	Mesa Ridge Center, LLC

	INVENTORY				VACANCY & LEASE RATES					ABSORPTION			
	Number of Bldgs.	Net Rentable Square Feet	Square Feet U / C	Square Feet Planned	Square Feet Vacant	Vacancy Rate 2Q2017	Square Feet Available	Availability Rate 2Q2017	Average Asking Lease Rate	Net Absorption 2Q2017	Net Absorption 2017	Gross Absorption 2Q2017	Gross Absorption 2017
<b>Downtown</b>													
Downtown	131	12,928,011	0	3,744,560	1,435,847	11.11%	2,099,046	16.24%	\$2.63	16,151	264,876	276,471	813,065
Downtown Total	131	12,928,011	0	3,744,560	1,435,847	11.11%	2,099,046	16.24%	\$2.63	16,151	264,876	276,471	813,065
<b>Central</b>													
City Heights / University	29	1,058,511	0	0	33,130	3.13%	41,088	3.88%	\$0.00	7,348	16,923	16,707	26,282
Coronado	6	124,831	0	0	17,349	13.90%	17,349	13.90%	\$0.00	(2,138)	(5,788)	0	0
Kearny Mesa	235	10,622,522	0	690,000	746,800	7.03%	1,017,747	9.58%	\$2.12	20,084	138,981	171,001	444,836
Mission Gorge	25	572,926	135,228	0	29,242	5.10%	30,982	5.41%	\$1.06	1,197	10,978	1,197	12,258
Mission Valley	130	7,253,371	0	0	935,157	12.89%	1,104,180	15.22%	\$2.60	(339,434)	(43,227)	162,583	356,339
Old Town / Point Loma	64	2,097,302	0	0	123,209	5.87%	138,363	6.60%	\$1.11	2,313	17,450	32,055	77,564
Park East	8	155,884	0	0	5,516	3.54%	5,516	3.54%	\$0.00	0	(750)	0	0
Rose Canyon / Morena	53	1,202,150	0	0	43,669	3.63%	67,206	5.59%	\$0.00	8,178	8,323	18,604	36,469
Uptown / Hillcrest	101	2,615,941	0	28,500	191,558	7.32%	253,594	9.69%	\$2.86	(6,598)	(687)	17,931	77,933
Central Total	651	25,703,438	135,228	718,500	2,125,630	8.27%	2,676,025	10.41%	\$2.27	(309,050)	142,203	420,078	1,031,681
<b>I-15 Corridor</b>													
Escondido	91	1,911,473	0	46,614	155,895	8.16%	221,321	11.58%	\$1.47	(24,758)	(20,762)	14,032	39,439
Poway	30	1,324,065	0	160,000	72,845	5.50%	100,228	7.57%	\$1.89	41	3,997	19,870	37,773
Rancho Bernardo	108	6,991,432	0	2,103,595	619,306	8.86%	1,147,488	16.41%	\$2.34	(85,647)	(64,029)	91,923	228,362
Scripps Ranch	51	2,715,218	0	409,994	415,214	15.29%	689,235	25.38%	\$2.35	(189,247)	(190,694)	33,236	285,492
I-15 Corridor Total	280	12,942,188	0	2,720,203	1,263,260	9.76%	2,158,272	16.68%	\$2.14	(299,611)	(271,488)	159,061	591,066
<b>North County Coastal</b>													
Carlsbad	155	6,340,347	79,586	147,764	1,176,782	18.56%	1,541,636	24.31%	\$0.00	98,249	168,937	222,819	454,635
Del Mar Heights / Carmel Valley	74	4,663,787	370,770	660,000	785,340	16.84%	1,420,989	30.47%	\$3.57	78,338	(27,652)	142,105	248,407
North Beach Cities	110	2,604,195	0	19,933	141,222	5.42%	195,172	7.49%	\$2.85	2,943	(9,656)	35,432	67,358
North County Total	339	13,608,329	450,356	827,697	2,103,344	15.46%	3,157,797	23.20%	\$3.31	179,530	131,629	400,356	770,400
<b>North City</b>													
Governor Park	20	890,160	0	0	83,871	9.42%	100,833	11.33%	\$3.05	(14,662)	(26,359)	6,150	13,739
La Jolla	48	1,404,107	0	0	117,440	8.36%	155,285	11.06%	\$3.91	5,280	(63,619)	38,341	57,099
Miramar	33	1,609,700	0	0	165,014	10.25%	235,701	14.64%	\$2.50	(3,586)	(25,664)	32,237	74,925
Sorrento Mesa	121	9,496,814	0	2,096,063	1,181,548	12.44%	1,426,687	15.02%	\$2.45	41,115	5,992	103,176	298,918
Sorrento Valley	31	838,908	0	0	73,389	8.75%	178,022	21.22%	\$1.40	9,757	10,467	34,242	40,036
Torrey Pines	39	2,470,705	0	0	91,647	3.71%	169,483	6.86%	\$4.05	4,068	9,272	4,068	9,272
UTC	89	8,452,828	96,435	453,124	1,102,255	13.04%	1,518,167	17.96%	\$3.48	1,618	129,348	194,226	465,877
North City Total	381	25,163,222	96,435	2,549,187	2,815,164	11.19%	3,784,178	15.04%	\$3.41	43,590	39,437	412,440	959,866
<b>Southern &amp; Eastern Areas</b>													
Chula Vista	91	2,924,678	0	1,545,100	286,383	9.79%	320,946	10.97%	\$2.00	11,672	11,155	50,666	78,485
East County	151	3,705,533	13,200	61,800	123,069	3.32%	176,552	4.76%	\$1.78	9,293	7,605	38,350	59,558
National City	14	508,388	0	0	48,156	9.47%	2,306	0.45%	\$0.00	6,169	18,766	10,180	26,507
Otay Mesa	13	318,004	0	0	12,177	3.83%	12,177	3.83%	\$0.00	(678)	3,396	0	5,174
Southeast San Diego	9	381,826	0	0	60,650	15.88%	60,650	15.88%	\$0.00	0	0	0	0
Southern & Eastern Areas Total	278	7,838,429	13,200	1,606,900	530,435	6.77%	572,631	7.31%	\$1.80	26,456	40,922	99,196	169,724
<b>Highway 78 Corridor</b>													
Oceanside	63	1,356,320	0	335,249	161,065	11.88%	188,432	13.89%	\$1.44	7,123	19,307	29,355	68,788
San Marcos	36	1,315,278	60,000	1,991,538	104,262	7.93%	136,602	10.39%	\$3.87	271	3,859	5,821	24,552
Vista	50	1,246,435	11,800	0	242,306	19.44%	225,789	18.11%	\$1.69	(18,810)	(50,044)	15,280	23,933
Highway 78 Corridor Total	149	3,918,033	71,800	2,326,787	507,633	12.96%	550,823	14.06%	\$1.59	(11,416)	(26,878)	50,456	117,273
Class A	276	35,528,995	516,159	10,780,503	3,950,254	11.12%	5,436,634	15.30%	\$3.24	(254,746)	(185,179)	643,734	1,657,795
Class B	1,233	51,352,782	250,860	3,713,331	5,598,541	10.90%	7,744,809	15.08%	\$2.32	(90,410)	470,860	957,362	2,302,173
Class C	700	15,219,873	0	0	1,232,518	8.10%	1,480,354	9.73%	\$1.84	(9,194)	35,020	216,962	493,107
<b>San Diego County Total</b>	<b>2,209</b>	<b>102,101,650</b>	<b>767,019</b>	<b>14,493,834</b>	<b>10,781,934</b>	<b>10.56%</b>	<b>14,661,797</b>	<b>14.36%</b>	<b>\$2.78</b>	<b>(354,350)</b>	<b>320,701</b>	<b>1,818,058</b>	<b>4,453,075</b>

This survey consists of buildings greater than 10,000 square feet. Lease rates are on a full-service gross basis.



## Amenities, Tech, and Life Science Driving Office

by **Greg Kipnis**  
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In the San Diego office market, product boasting on-site amenities continues to attract tenants and incur less down time when compared with office projects with minimal amenities. Gyms, locker rooms, recreational areas, and cafes are becoming the standard. Office users are looking for these amenities and landlords are feeling the pressure to keep pace with the desires of the millennial generation.

With the demand in the market, landlords are continuing to see a rise in TI costs. Building to code and in compliance with Title 24, plus the cumbersome permitting process all contribute to the increased cost of tenant improvements. TI costs are now between \$25–\$40 per square foot for second generation space and \$65–\$75 per square foot for shell space. These high cost for improvements, combined with low vacancy, are compelling landlords to heavily scrutinize tenant financials.

Overall, the office market remains on a slow but steady course. Vacancy rates countywide are currently hovering right around 10–11%. There is heavy activity among users under 5,000 square feet while larger occupiers are being forced to consider multiple markets due to the limited supply of buildings over 100,000 square feet.

San Diego's unemployment continues to be among the nation's lowest as it continues to dip towards 3.5%, compared with California's unemployment which continues to be at 4.2%. This spring the San Diego Economic Development Council reported 133,445 unique job postings. The largest number of job postings were with Lyft Inc., Scripps Health, and UCSD.

We are seeing San Diego's tech and life science community continue to build momentum as these industries have been the quickest developing sector, growing at an annual rate of approximately 9% since 2011. Some highlights from the second quarter include:

- \$79 million in venture capital put into San Diego start-ups this past quarter.
- 5,700 different requirements for registered nurses (the most demanded job) this quarter.
- Approximately \$1.7 billion in foreign investment in life science companies based in San Diego over spring.

The most notable office sale taking place was the purchase of Scripps Wateridge Corporate Center for \$209.97 per square foot by HCP Life Science REIT Inc from Colony Northstar, Inc. out of Boston. HCP plans to convert the two class B office buildings consisting of approximately 125,000 square feet to Class A lab space. A strong disconnect currently exists between buyers and sellers of office product, and a number of assets have been pulled from the market as seller expectations are not met.

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## Product Type

**CLASS A:** Most prestigious buildings competing for premier office users with rents above average for the area. Buildings have high-quality standard finishes, state-of-the-art systems, exceptional accessibility and a definite market presence.

**CLASS B:** Buildings competing for a wide range of users with rents in the average range for the area. Building finishes are fair to good for the area, and systems are adequate. However, Class B buildings cannot compete with Class A buildings of the same price.

**CLASS C:** Buildings competing for tenants requiring functional space at rents below the area average.

## Submarkets

**DOWNTOWN:** Downtown

**CENTRAL:** City Heights/University, Coronado, Kearny Mesa, Mission Gorge, Mission Valley, Old Town/Point Loma, Park East, Rose Canyon/Morena, Uptown/Hillcrest

**I-15 CORRIDOR:** Escondido, Poway, Rancho Bernardo, Scripps Ranch

**NORTH COUNTY COASTAL:** Carlsbad, Del Mar Heights/Carmel Valley, North Beach Cities

**NORTH CITY:** Governor Park, La Jolla, Miramar, Sorrento Mesa, Sorrento Valley, Torrey Pines, UTC

**SOUTHERN & EASTERN AREAS:** Chula Vista, East County, National City, Otay Mesa, Southeast San Diego

**HIGHWAY 78 CORRIDOR:** Oceanside, San Marcos, Vista