

CONTINUED IMPROVEMENT. The San Diego Flex R&D market fundamentals continued to remain tight at the end of 2017, with low availability, strong demand, and a moderate supply in the construction pipeline. Moreover, with the steady pace of job growth in the biotech and life sciences industries that drive the Flex/R&D market in San Diego, the market should continue to grow at a slow but steady pace.

VACANCY. Direct/sublease space (unoccupied) finished the year at 7.47%, a decrease of more than a percentage point when compared with the prior year, and a decrease of more than 50% from 2010's recession high of 16.12%.

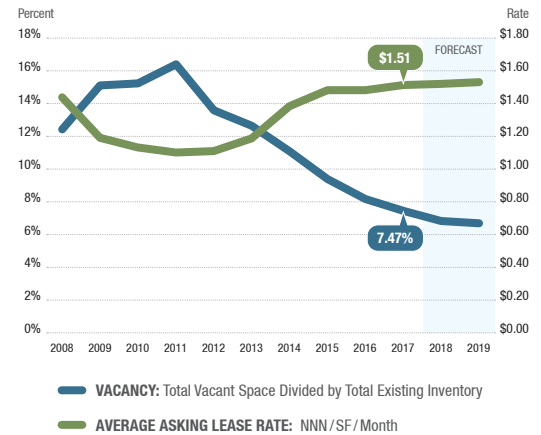
LEASE RATES. The average asking triple net lease rate per square foot per month in San Diego County was \$1.51 at the end of the fourth quarter, which is unchanged on a quarter over quarter basis. However, the average asking lease rates have risen more than forty cents since the recession lows seen in the first and second quarters of 2011, and are still continuing an upward long-term trend.

TRANSACTION ACTIVITY. The combined amount of square feet leased or sold in the fourth quarter totaled 2.1 million square feet, which is roughly equivalent to the preceding quarter's total of 2.2 million square feet. The 2017 total transaction volume was down for both sales and leasing from the previous year. This statistic can have some lag time in being reported, so look for this quarter's figures to end up somewhat higher in the next report.

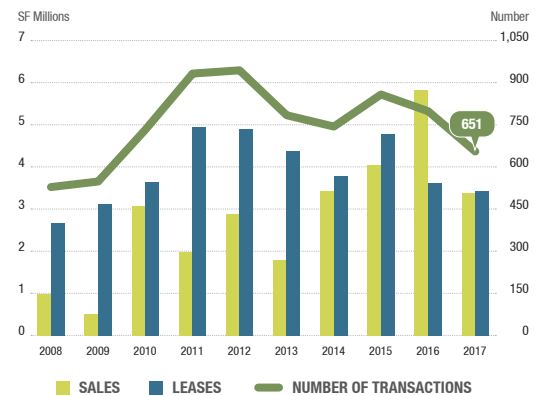
EMPLOYMENT. The unemployment rate in San Diego County was 3.3% in December 2017, unchanged from a revised 3.3% in November 2017 and below the year-ago estimate of 4.1%. This compares with an unadjusted unemployment rate of 4.2% for California and 3.9% for the nation during the same period. According to the State of California Employment Development Department, San Diego County gained 21,100 payroll jobs between December 2016 and December 2017, including 4,900 from leisure and hospitality, which reported the largest overall gain. The educational and health services sector reported a growth of 3,900 jobs, and the government sector reported an increase of 3,800 jobs.

OVERALL. The San Diego Flex R&D market had improvements in nearly all fundamentals in 2017, but the transaction volume was down. As the life science and biotech sectors continue to be major drivers in San Diego's economy, the market will continue to grow at a steady pace. Because this booming industry targets space in San Diego specifically, there will be ongoing construction and new deliveries in response to the demand, and this will contribute to the slow uptick in availability in the future.

VACANCY vs. AVERAGE ASKING LEASE RATE



TRANSACTION VOLUME & NUMBER OF TRANSACTIONS



Market Statistics

| | Change Over Last Quarter | 4Q 2017 | 3Q 2017 | 4Q 2016 | % Change Over Last Year |
|---------------------------|--------------------------|-----------|-----------|-----------|-------------------------|
| Vacancy Rate | ▲ UP | 7.47% | 6.13% | 8.18% | (8.62%) |
| Availability Rate | ▼ DOWN | 9.70% | 9.85% | 12.43% | (21.96%) |
| Average Asking Lease Rate | ▬ FLAT | \$1.51 | \$1.51 | \$1.48 | 2.03% |
| Sale & Lease Transactions | ▬ FLAT | 2,139,445 | 2,165,934 | 3,447,175 | (37.94%) |
| Gross Absorption | ▼ DOWN | 667,367 | 1,011,507 | 907,428 | (26.46%) |
| Net Absorption | ▼ NEGATIVE | (649,594) | 596,629 | 247,538 | N/A |

EMPLOYMENT. The labor market in San Diego County will continue to improve, although we anticipate job growth to slow. In 2017 there was a 1.5% increase in total employment, and a 1.6% increase is projected for 2018. 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.

CONSTRUCTION. Construction in the Flex/R&D sector has been largely concentrated in the biotech subset of properties. For the remainder of the Flex/R&D market, there has been remarkably little new construction. We expect this to change with the “creative industrial” trend migrating into the Flex/R&D market.

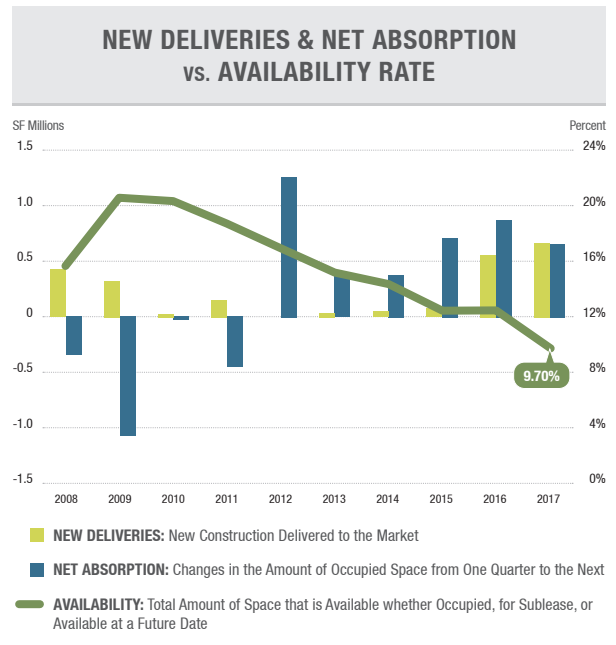
LEASE RATES. Expect average asking rates to increase by from 2–3% over the next four quarters.

VACANCY. With new deliveries hitting the market this year, we anticipate vacancy rates to tick up slightly in the coming quarters, nearing the 8% range during 2018.

CONSTRUCTION. In 2017 there was 662,935 square feet of new Flex and R&D product completed, which surpassed the annual total of every year since 2006. At the end of the year, there were 456,523 square feet under construction in San Diego County’s Flex / R&D market. Notably, all of the projects under construction are in the central county area, which is in contrast to the industrial construction which is concentrated on the edges of the county.

AVAILABILITY. Direct/sublease space being marketed was 9.70% at the end of the quarter, a nearly 22% decrease from the previous year’s rate of 12.43%.

ABSORPTION. The San Diego Flex R&D market recorded 649,954 square feet of negative net absorption in the fourth quarter of 2017. Despite the pull back in occupancy in the last quarter of the year, there was still a total of 657,942 square feet of positive net absorption for the year as a whole, and the market has seen 4.2 million square feet of positive net absorption since the start of 2012.



Significant Transactions

Sales

| Property Address | Submarket | Square Feet | Sale Price | Buyer | Seller |
|---------------------------------------------------------|-----------------|-------------|--------------|-------------------------------------------------------------------|------------------------------------|
| 16550 Via Esprillo | Rancho Bernardo | 180,946 | \$60,500,000 | Realterm US, Inc. | Greenlaw Partners |
| 6815–6885 Fladers Dr. | Sorrento Mesa | 204,028 | \$45,750,000 | Goldman Sachs Asset Management Montana Avenue Capital Partners | IPERS Centerpark Plaza I & II, LLC |
| 4940–4980 Carroll Canyon Rd. & 5451–5501 Oberlin Dr. | Sorrento Mesa | 100,600 | \$38,500,000 | BRE Moda Sorrento LLC | Lggs Sorrento, LLC |
| 10307–10309 Pacific Center Ct. | Sorrento Mesa | 103,830 | \$33,750,000 | Klein Investments Family, LP | CDCD III Pacific Center San Diego |
| 9303–9340 Chesapeake Dr., Et Al | Kearny Mesa | 131,694 | \$16,400,000 | Aardema Family Trust | Colony NorthStar |

Leases

| Property Address | Submarket | Square Feet | Transaction Date | Tenant | Owner |
|--------------------------|--------------|-------------|------------------|------------------------|--------------------------|
| 9840 Carroll Park Dr. | Miramar | 36,823 | Dec-2017 | Undisclosed | The Irvine Company |
| 4242 Campus Point Ct. | UTC | 26,605 | Oct-2017 | Signal Pharmaceuticals | Phase 3 |
| 5999 Avenida Encinas | Carlsbad | 25,038 | Dec-2017 | Undisclosed | Lincoln Property Company |
| 10628 Science Center Dr. | Torrey Pines | 24,705 | Oct-2017 | Undisclosed | Alexandria RE Equities |
| 8902 Activity Rd. | Miramar | 20,011 | Dec-2017 | Undisclosed | Rexford Industrial |

* Voit Real Estate Services Deal

| | INVENTORY | | | | VACANCY & LEASE RATES | | | | | ABSORPTION | | | |
|-------------------------------|------------------|--------------------------|-------------------|---------------------|-----------------------|---------------------|-----------------------|--------------------------|---------------------------|-----------------------|---------------------|-------------------------|-----------------------|
| | Number of Bldgs. | Net Rentable Square Feet | Square Feet U / C | Square Feet Planned | Square Feet Vacant | Vacancy Rate 4Q2017 | Square Feet Available | Availability Rate 4Q2017 | Average Asking Lease Rate | Net Absorption 4Q2017 | Net Absorption 2017 | Gross Absorption 4Q2017 | Gross Absorption 2017 |
| Central | | | | | | | | | | | | | |
| Central City | 15 | 175,224 | 0 | 0 | 9,442 | 5.39% | 9,442 | 5.39% | – | 0 | 466 | 0 | 9,731 |
| East City | 2 | 26,892 | 0 | 0 | 0 | 0.00% | 0 | 0.00% | – | 0 | 0 | 0 | 0 |
| Southeast City | 17 | 197,755 | 0 | 0 | 0 | 0.00% | 0 | 0.00% | – | 0 | 5,000 | 0 | 5,000 |
| Kearny Mesa | 204 | 5,521,694 | 156,000 | 0 | 643,346 | 11.65% | 339,625 | 6.15% | \$1.40 | (412,762) | (386,623) | 64,326 | 262,387 |
| Mission Gorge | 29 | 287,556 | 0 | 0 | 16,480 | 5.73% | 31,388 | 10.92% | \$1.63 | (1,270) | 4,445 | 720 | 18,535 |
| Rose Canyon/Morena | 38 | 609,335 | 0 | 0 | 19,590 | 3.21% | 28,863 | 4.74% | \$1.06 | (1,044) | 13,944 | 16,550 | 65,496 |
| Sports Arena/Airport | 30 | 380,720 | 0 | 0 | 7,000 | 1.84% | 7,000 | 1.84% | – | (7,000) | (5,650) | 0 | 1,350 |
| Miramar | 218 | 4,702,570 | 130,000 | 11,760 | 263,027 | 5.59% | 336,179 | 7.15% | \$1.34 | 72,244 | 75,989 | 178,199 | 471,625 |
| Sorrento Mesa | 159 | 5,931,391 | 0 | 646,000 | 549,182 | 9.26% | 721,347 | 12.16% | \$1.87 | (42,341) | 152,519 | 48,726 | 436,862 |
| Sorrento Valley | 102 | 2,353,949 | 0 | 0 | 171,371 | 7.28% | 333,680 | 14.18% | \$1.84 | 26,518 | 4,803 | 51,522 | 193,854 |
| Torrey Pines/UTC | 71 | 6,087,265 | 170,523 | 641,463 | 682,183 | 11.21% | 761,355 | 12.51% | \$3.29 | (111,363) | 481,905 | 66,307 | 472,234 |
| Central County Total | 885 | 26,274,351 | 456,523 | 1,299,223 | 2,361,621 | 8.99% | 2,568,879 | 9.78% | \$1.68 | (477,018) | 346,798 | 426,350 | 1,937,074 |
| East County | | | | | | | | | | | | | |
| El Cajon | 77 | 851,324 | 0 | 0 | 1,670 | 0.20% | 3,180 | 0.37% | \$0.85 | 920 | 16,719 | 1,440 | 34,215 |
| La Mesa/Spring Valley | 39 | 306,088 | 0 | 0 | 21,160 | 6.91% | 21,160 | 6.91% | – | (9,367) | (9,735) | 1,125 | 16,243 |
| Santee/Lakeside | 54 | 564,061 | 0 | 0 | 3,308 | 0.59% | 0 | 0.00% | – | 0 | 0 | 0 | 3,212 |
| Outlying SD County S | 20 | 78,080 | 0 | 0 | 0 | 0.00% | 0 | 0.00% | \$1.10 | 0 | 0 | 0 | 2,010 |
| East County Total | 190 | 1,799,553 | 0 | 0 | 26,138 | 1.45% | 24,340 | 1.35% | \$0.88 | (8,447) | 6,984 | 2,565 | 55,680 |
| North County | | | | | | | | | | | | | |
| Escondido | 80 | 752,671 | 0 | 0 | 17,768 | 2.36% | 23,164 | 3.08% | \$1.06 | (5,149) | 36,647 | 4,723 | 55,061 |
| Oceanside | 33 | 985,977 | 0 | 0 | 32,963 | 3.34% | 40,486 | 4.11% | – | 0 | (15,019) | 0 | 12,533 |
| San Marcos | 59 | 1,053,462 | 0 | 0 | 58,551 | 5.56% | 104,894 | 9.96% | \$1.02 | (9,367) | 20,152 | 7,152 | 78,096 |
| Vista | 62 | 1,393,694 | 0 | 0 | 49,214 | 3.53% | 97,687 | 7.01% | \$1.20 | 5,410 | 13,345 | 19,794 | 91,385 |
| Carlsbad | 251 | 6,199,617 | 0 | 231,108 | 543,708 | 8.77% | 775,810 | 12.51% | \$1.31 | (43,156) | 78,259 | 92,279 | 583,868 |
| North Beach Cities | 18 | 155,333 | 0 | 0 | 855 | 0.55% | 6,675 | 4.30% | \$1.95 | 1,737 | 25 | 2,592 | 4,072 |
| Outlying SD County North | 18 | 136,911 | 0 | 0 | 1,322 | 0.97% | 1,322 | 0.97% | – | (1,322) | 474 | 0 | 1,796 |
| North County Total | 521 | 10,677,665 | 0 | 231,108 | 704,381 | 6.60% | 1,050,038 | 9.83% | \$1.28 | (51,847) | 133,883 | 126,540 | 826,811 |
| I-15 Corridor | | | | | | | | | | | | | |
| Poway | 59 | 1,494,288 | 0 | 0 | 30,990 | 2.07% | 48,153 | 3.22% | \$1.16 | (2,459) | 75,828 | 17,957 | 176,731 |
| Rancho Bernardo | 93 | 4,529,665 | 0 | 0 | 341,474 | 7.54% | 524,709 | 11.58% | \$1.59 | (137,430) | 49,847 | 33,175 | 716,369 |
| Scripps Ranch | 27 | 713,377 | 0 | 233,741 | 21,317 | 2.99% | 23,407 | 3.28% | \$0.99 | (11,103) | 691 | 7,629 | 48,369 |
| I-15 Corridor Total | 179 | 6,737,330 | 0 | 233,741 | 393,781 | 5.84% | 596,269 | 8.85% | \$1.56 | (150,992) | 126,366 | 58,761 | 941,469 |
| South County | | | | | | | | | | | | | |
| Chula Vista | 82 | 1,476,292 | 0 | 14,960 | 21,574 | 1.46% | 157,484 | 10.67% | \$1.35 | 35,535 | 39,496 | 46,411 | 124,277 |
| National City | 22 | 300,015 | 0 | 0 | 7,768 | 2.59% | 9,061 | 3.02% | \$1.45 | 264 | (443) | 3,589 | 21,163 |
| Otay Mesa | 8 | 171,041 | 0 | 256,022 | 34,443 | 20.14% | 146,743 | 85.79% | \$0.65 | 3,151 | 6,058 | 3,151 | 6,058 |
| San Ysidro/Imperial Beach | 4 | 81,972 | 0 | 0 | 1,200 | 1.46% | 56,200 | 68.56% | – | (240) | (1,200) | 0 | 0 |
| South County Total | 116 | 2,029,320 | 0 | 270,982 | 64,985 | 3.20% | 369,488 | 18.21% | \$0.77 | 38,710 | 43,911 | 53,151 | 151,498 |
| San Diego County Total | 1,891 | 47,518,219 | 456,523 | 2,035,054 | 3,550,906 | 7.47% | 4,609,014 | 9.70% | \$1.51 | (649,594) | 657,942 | 667,367 | 3,912,532 |

Lease rates are on a triple-net basis.



San Diego Industrial: Thoughts from the Front Line

by **Josh West**

VICE PRESIDENT, SAN DIEGO

The San Diego Industrial market finished strong in 2017. With market-wide vacancy hitting a rock bottom of 3.5% and demand staying strong, the market should remain steady for 2018. Tenant demand was similar to 2016, with close to 8,000,000 square feet of gross absorption (square footage of leases signed). Net absorption, however, has dropped 41% since 2016, as expected in a tight market. As a result, many tenants are forced to renew in their existing space regardless of functionality or business needs.

Owners are benefiting from the strong market as concessions such as rental abatement have thinned dramatically and, in some cases, disappeared. Leasing activity was similar to 2016 with over 1,000 leases signed; however the total square footage leased was down by approximately 2,000,000 square feet. With rents reaching an average of \$0.86 NNN countywide and leasing velocity at an all-time high, San Diego will remain a “Landlord’s Market” for 2018.

As expected from these strong fundamentals, we are seeing speculative ground-up development in markets such as Carlsbad, Poway, and Otay Mesa. There is currently more than 2,000,000 square feet of product being developed. Developers are counting on the continuously vigorous and pent-up tenant demand for space.

The owner/user market was also strong in 2017 due to increasing rents and historically low interest rates. Values have reached an all-time high, with markets such as Poway cresting \$195 per square foot. The question for 2018 is, will an increase in interest rates have a negative effect on the overall market?

Investments have remained active, but the volume has decreased since 2016. This slowdown is mainly attributed to record low cap rates (higher pricing) and lack of available product, especially in our core market. The market remains flush with capital which will keep the investment market steady for the foreseeable future.

2018 will likely be very similar to 2017 with consistent demand across the board. While it seems this recovery may be “long in the tooth,” all signs continue to point to steady growth and strong fundamentals moving forward.

Product Type

MFG./DIST.: Flex/Research and Development (R&D) buildings can be one story, one story with a mezzanine, and two story built-out structures with a high ratio of window wall to floor area with lower ceilings. They generally have over 50% built-out office space or laboratory use, with the remaining space being utilized as light manufacturing or warehousing. In addition, the parking ratio must be at least 3 spaces or greater per 1,000 square feet.

Submarkets

CENTRAL COUNTY

Central City, East City, Southeast City, Kearny Mesa, Mission Gorge, Rose Canyon/Morena, Sports Arena/Airport, Miramar, Sorrento Mesa, Sorrento Valley, Torrey Pines/UTC

EAST COUNTY

El Cajon, La Mesa/Spring Valley, Santee/Lakeside

NORTH COUNTY

Escondido, Oceanside, San Marcos, Vista, Carlsbad, North Beach Cities, Outlying SD County North

I-15 CORRIDOR

Poway, Rancho Bernardo, Scripps Ranch

SOUTH BAY

Chula Vista, National City, Otay Mesa, San Ysidro/Imperial Beach, Outlying SD County South

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