

HOLDING STEADY. The office market continues to show a balance in availability and demand. The overall availability rate of 14.14% is flat, unchanged over the first half of the year. Lease rates continue to press upward at a modest rate, and speculative office construction is minimal.

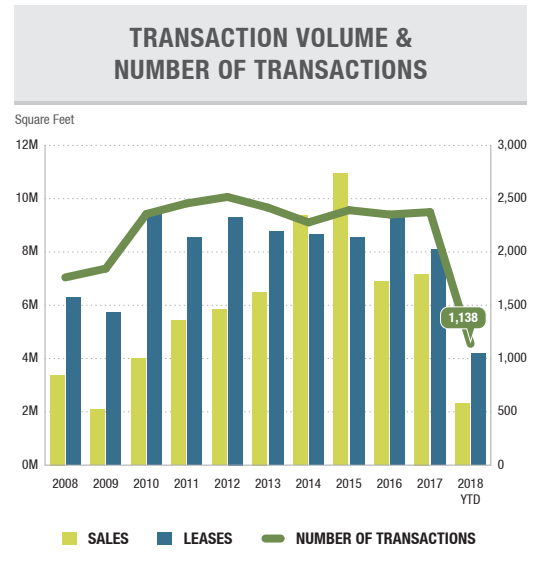
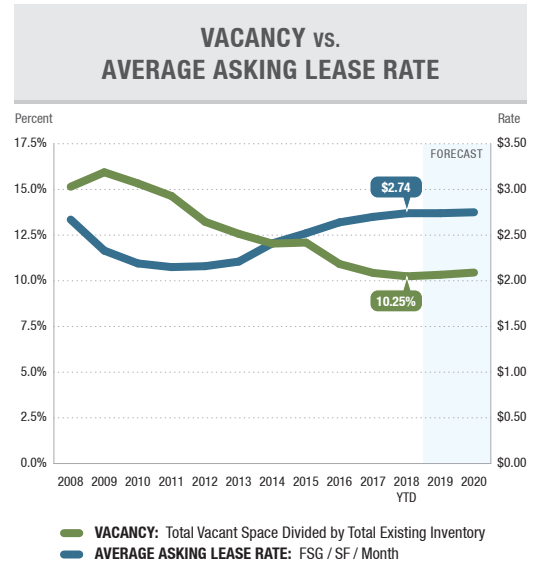
VACANCY. Direct/sublease space (unoccupied) finished the quarter at 10.25%, 75 basis points lower than a year prior in 2Q 2017. Kearny Mesa posted the lowest vacancy rate of any major submarket (minimum of four million square feet of inventory) at 5.78%.

LEASE RATES. The average asking full-service gross (FSG) lease rate per square foot per month in San Diego County was \$2.74 at the end of 2Q, a two cent increase over the previous quarter's rate, and an annual increase of 2.6% from 2Q 2017's rate of \$2.67. The overall average asking rate in San Diego County has increased 27% since 2011.

TRANSACTION ACTIVITY. Sale and lease transactions totaled 3.7 million square feet in 2Q, a significant increase from the 2.7 million square feet which transacted in 1Q. Leasing volume has started the year on pace to exceed 2017's total, while office sales volume is down. The transaction activity statistic can have some lag time in being reported, so look for figures to end up even higher in the next report.

EMPLOYMENT. The unemployment rate in San Diego County was 2.9% in May 2018, unchanged from a revised 2.9% in April 2018, and below the year-ago estimate of 3.7%. This compares with an unadjusted unemployment rate of 3.7% for California and 3.6% for the nation during the same period. According to the State of California Employment Development Department, San Diego County gained 32,500 payroll jobs between May 2017 and May 2018, including 15,500 from professional and business services, which reported the largest overall gain. The construction sector reported a growth of 5,200 jobs, and the manufacturing sector reported an increase of 4,600 jobs.

OVERALL. The San Diego office market is steady for now, but it's been a fairly flat start to the year, as we are in the latter stages of the current recovery. Construction levels of new speculative office product remain low, 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



Market Statistics

	Change Over Last Quarter	2Q 2018	1Q 2018	2Q 2017	% Change Over Last Year
Vacancy Rate	▼ DOWN	10.25%	10.61%	11.00%	(6.83%)
Availability Rate	▲ UP	14.14%	13.89%	13.90%	1.66%
Average Asking Lease Rate	▲ UP	\$2.74	\$2.72	\$2.67	2.62%
Sale & Lease Transactions	▼ UP	3,754,287	2,716,852	2,693,415	39.39%
Gross Absorption	■ FLAT	1,825,669	1,957,205	1,803,103	1.25%
Net Absorption	▲ POSITIVE	253,956	(239,099)	(565,485)	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 1.2% increase in total employment, and a 1.0–1.5% increase is projected for 2018. With the local stalwarts of defense and biotech remaining strong, look for these sectors to lead the way for employment gains, followed by healthcare, and hospitality and leisure.

LEASE RATES. Expect the average asking lease rate to increase by a modest 2.0–2.5% over the next four quarters.

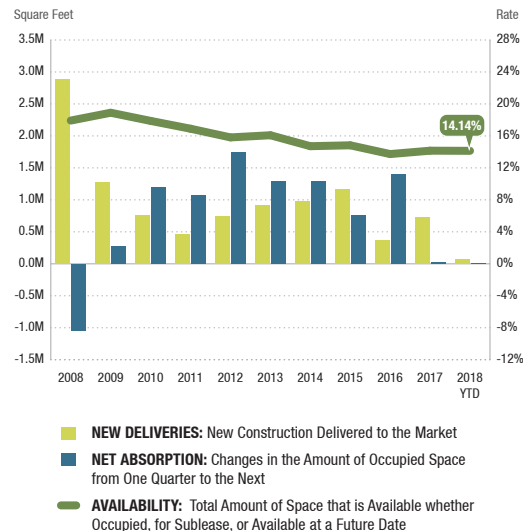
VACANCY. While landlords were happy to see hundreds of thousands of square feet absorbed by co-working companies in the past 12–18 months, these new operators in the market will be competing for tenants, and could act as a headwind to future occupancy gains. We anticipate the countywide vacancy to remain relatively stable around the 10–11% range.

CONSTRUCTION. New office development has picked up a bit, with more than a million square feet under construction, but the majority of this total is from build-to-suit projects. MedImpact has 160,000 square feet under construction in Scripps Ranch, and there is 357,000 square feet under construction for ViaSat in Carlsbad. More new office space is coming to market via extensive renovations and the repositioning of older projects. The most notable current example of this is AMP&RSAND, the 340,000 square foot former Union-Tribune headquarters, which is being converted into a creative office project.

AVAILABILITY. Direct/sublease space being marketed was 14.14% at the end of 2Q, a 1.7% decrease from the 13.9% availability rate from one year ago in 2Q 2017.

ABSORPTION. The San Diego office market has recorded just 14,857 square feet of positive net absorption for the first half of the year. The market saw 253,956 square feet of positive net absorption in 2Q, completely reversing the 239,099 square feet of negative net absorption in 1Q. There has been approximately 9 million square feet of positive net absorption for the overall San Diego market since the start of 2010.

NEW DELIVERIES & NET ABSORPTION vs. AVAILABILITY RATE



Significant Transactions

Sales

Property Address	Submarket	Class	Square Feet	Sale Price	Buyer	Seller
9635–9665 Granite Ridge Dr.	Kearny Mesa	A	327,234	\$100,300,000	Pendulum Property Partners	TIAA-CREF
8910–8980 Villa La Jolla	UTC	B	196,940	\$97,100,000	Goldstein Planting Investments	La Jolla Village Prof. Ctr. Associates
1450 Frazee Rd.	Mission Valley	B	140,476	\$33,050,000	DRA Advisors, LLC	Menlo Equities
10920 Via Frontera	Rancho Bernardo	A	110,110	\$31,200,000	Harbor Associates, LLC	Muller Company
3444 Kearny Villa Rd.	Kearny Mesa	B	38,665	\$20,000,000	MBRE Healthcare	Genesis Healthcare Partners

Leases

Property Address	Submarket	Class	Square Feet	Transaction Date	Tenant	Owner
13480 Evening Creek Dr. N.	Rancho Bernardo	A	153,559	May-2018	General Atomics	Kilroy Realty Corporation
4350 La Jolla Village Dr.	UTC	A	136,000	May-2018	Bofl Federal Bank	The Irvine Company
9645 Scranton Rd.	Sorrento Mesa	B	115,732	May-2018	Undisclosed	Locale Advisors
10221 Wateridge Cir.	Sorrento Mesa	A	107,356	Apr-2018	American Specialty Health	Parallel Capital Partners
10241 Wateridge Cir.	Sorrento Mesa	A	81,157	Apr-2018	Healthyroads.com	Parallel Capital Partners

	INVENTORY			VACANCY & LEASE RATES						ABSORPTION			
	Number of Bldgs.	Net Rentable Square Feet	Square Feet U / C	Square Feet Planned	Square Feet Vacant	Vacancy Rate 2Q2018	Square Feet Available	Availability Rate 2Q2018	Average Asking Lease Rate	Net Absorption 2Q2018	Net Absorption 2018	Gross Absorption 2Q2018	Gross Absorption 2018
Downtown													
Downtown	124	12,606,514	60,000	3,821,649	1,488,233	11.81%	2,501,600	19.84%	\$2.63	(36,091)	19,810	149,509	400,478
Downtown Total	124	12,606,514	60,000	3,821,649	1,488,233	11.81%	2,501,600	19.84%	\$2.63	(36,091)	19,810	149,509	400,478
Central													
City Heights / University	31	1,216,139	0	0	60,810	5.00%	54,648	4.49%	\$2.10	497	(16,278)	8,765	10,540
Coronado	6	124,831	0	0	13,025	10.43%	13,025	10.43%	\$3.65	1,624	2,186	1,624	5,274
Kearny Mesa	234	10,699,897	0	690,000	618,115	5.78%	927,326	8.67%	\$2.37	9,340	(27,138)	115,245	313,144
Mission Gorge	19	436,208	0	0	13,102	3.00%	2,999	0.69%	\$1.65	(1,249)	945	0	4,852
Mission Valley	127	7,109,041	163,000	0	701,722	9.87%	1,058,092	14.88%	\$2.54	24,470	(34,586)	150,114	280,515
Old Town / Point Loma	81	2,507,578	0	230,000	165,115	6.58%	195,555	7.80%	\$2.53	(22,963)	(21,194)	43,320	87,649
Park East	17	273,122	0	0	8,258	3.02%	9,533	3.49%	\$2.17	(1,992)	(1,992)	0	0
Rose Canyon / Morena	53	1,202,150	0	0	58,111	4.83%	87,662	7.29%	\$1.95	(18,235)	(17,198)	12,435	27,726
Uptown / Hillcrest	78	2,210,058	0	0	138,892	6.28%	178,405	8.07%	\$2.72	(17,403)	(29,986)	33,430	57,593
Central Total	646	25,779,024	163,000	920,000	1,777,150	6.89%	2,527,245	9.80%	\$2.45	(25,911)	(145,241)	364,933	787,293
I-15 Corridor													
Escondido	90	1,913,813	76,400	46,614	163,561	8.55%	270,537	14.14%	\$1.94	(9,138)	(4,999)	18,897	42,134
Poway	30	1,324,065	0	160,000	49,010	3.70%	88,438	6.68%	\$2.16	6,859	22,445	20,669	51,295
Rancho Bernardo	106	6,869,818	0	2,128,747	921,170	13.41%	845,427	12.31%	\$2.89	111,416	(81,324)	165,389	418,613
Scripps Ranch	51	2,718,108	158,994	137,000	341,088	12.55%	535,033	19.68%	\$2.54	(15,862)	24,906	28,093	114,698
I-15 Corridor Total	277	12,825,804	235,394	2,472,361	1,474,829	11.50%	1,739,435	13.56%	\$2.61	93,275	(38,972)	233,048	626,740
North County Coastal													
Carlsbad	157	6,413,360	411,646	80,000	1,262,454	19.68%	1,527,846	23.82%	\$2.52	93,973	55,669	274,271	415,022
Del Mar Heights / Carmel Valley	76	4,751,052	0	960,266	726,379	15.29%	1,011,789	21.30%	\$4.18	38,080	18,044	160,246	248,886
North Beach Cities	111	2,548,154	24,000	85,389	182,846	7.18%	230,497	9.05%	\$3.65	(4,089)	(31,587)	46,115	91,117
North County Total	344	13,712,566	435,646	1,125,655	2,171,679	15.84%	2,770,132	20.20%	\$3.27	127,964	42,126	480,632	755,025
North City													
Governor Park	20	889,275	0	0	71,294	8.02%	125,351	14.10%	\$2.67	3,027	(734)	33,522	37,275
La Jolla	48	1,409,395	0	0	113,596	8.06%	177,099	12.57%	\$3.16	7,190	(1,736)	13,402	34,263
Miramar	34	1,590,751	0	0	134,782	8.47%	215,934	13.57%	\$1.83	15,253	27,060	35,956	80,914
Sorrento Mesa	122	9,634,836	0	1,971,063	1,184,145	12.29%	1,540,068	15.98%	\$2.77	46,413	59,885	164,856	297,877
Sorrento Valley	30	808,908	0	0	40,510	5.01%	99,570	12.31%	\$2.51	22,064	26,085	32,866	45,115
Torrey Pines	41	2,698,845	0	0	90,889	3.37%	262,481	9.73%	\$3.69	1,484	28,867	1,484	34,122
UTC	92	8,608,039	150,000	303,124	1,027,407	11.94%	1,258,271	14.62%	\$3.34	18,059	(30,809)	217,524	470,571
North City Total	387	25,640,049	150,000	2,274,187	2,662,623	10.38%	3,678,774	14.35%	\$2.87	113,490	108,618	499,610	1,000,137
Southern & Eastern Areas													
Chula Vista	90	2,905,034	0	1,545,100	250,468	8.62%	322,812	11.11%	\$2.53	2,576	2,657	25,739	42,713
National City	15	528,472	0	0	2,294	0.43%	994	0.19%	\$2.69	4,920	13,967	6,120	15,167
Otay Mesa	13	319,824	0	0	3,373	1.05%	37,753	11.80%	\$2.06	0	7,971	0	7,971
Southeast San Diego	13	479,269	0	290,000	66,568	13.89%	66,568	13.89%	\$2.44	2,000	2,000	2,000	2,000
East County	151	3,663,071	17,654	61,800	119,981	3.28%	172,466	4.71%	\$1.82	(12,921)	2,014	24,184	65,188
Southern & Eastern Areas Total	282	7,895,670	17,654	1,896,900	442,684	5.61%	600,593	7.61%	\$2.30	(3,425)	28,609	58,043	133,039
Highway 78 Corridor													
Oceanside	62	1,349,948	0	335,249	151,432	11.22%	191,510	14.19%	\$2.00	(23,408)	(12,991)	4,413	14,830
San Marcos	37	1,375,278	0	1,991,538	107,008	7.78%	132,178	9.61%	\$2.37	13,898	18,765	17,684	34,539
Vista	50	1,209,379	0	0	215,697	17.84%	332,630	27.50%	\$1.84	(5,836)	(5,867)	17,797	30,793
Highway 78 Corridor Total	149	3,934,605	0	2,326,787	474,137	12.05%	656,318	16.68%	\$2.03	(15,346)	(93)	39,894	80,162
Class A	279	35,364,221	965,394	10,971,410	4,531,271	12.81%	6,240,167	17.65%	\$3.26	26,222	(263,889)	611,830	1,362,812
Class B	1,251	52,272,560	96,300	3,866,129	5,052,790	9.67%	7,105,820	13.59%	\$2.51	268,695	301,024	1,067,814	2,051,879
Class C	679	14,757,451	0	0	907,274	6.15%	1,128,110	7.64%	\$2.02	(40,961)	(22,278)	146,025	368,183
San Diego County Total	2,209	102,394,232	1,061,694	14,837,539	10,491,335	10.25%	14,474,097	14.14%	\$2.74	253,956	14,857	1,825,669	3,782,874

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



Running at a Slow but Steady Pace

by **Jon Boland**

SENIOR VICE PRESIDENT / PARTNER, SAN DIEGO
858.458.3312 · jboland@voitco.com · Lic. #00999843

The San Diego office market continued to show positive signs at mid-year 2018. Vacancy continued to decline and sits at 10.25%, the lowest level in years, while net absorption showed the largest gain compared with the previous 4 quarters—253,956 square feet of positive net absorption. Another notable data point is the average lease rate for office space has now matched the historic high water mark, as of this quarter. The tightening of the office market is in parallel with the declining unemployment rate which is 2.9%, compared with 3.7% at the end of 2016. This is the lowest unemployment level in the county since 1999.

Notwithstanding the tightening of the office market, tenants are still able to secure some concessions such as free rent and an above-standard tenant improvement allowance. Landlord appetites for giving TI allowances has remained generally steady the past couple years, but the actual costs continue to rise. With the rise in construction costs and taking Title 24 requirements into account, tenant improvement cost are \$65–\$70 per square foot. In addition, landlords are working towards annual rent increases in excess of 3%.

There has been very little speculative office development during this period of recovery. In the past 18 months, only a handful of low-rise offices have been delivered. In the UTC submarket, The Irvine Company's recent construction of Eastgate Terrace (Q1 2017) remains completely available (96,435 SF). American Assets REIT completed Torrey Point, a Class A, two-building project (89,452 SF) within Torrey Reserve West, and the project remains 82% vacant a year later. The somewhat soft demand for new office product has kept developers mostly cautious on building new office buildings.

We should continue to see positive job growth and positive net absorption through the end of 2018. The national economists are forecasting robust growth, resulting from continued benefits of the lower corporate tax structure, future infrastructure investment and the rollback of regulations. If these aspirations play out with the result intended, then the economy should thrive and remain strong. However, if they are unsuccessful, then the road ahead will be foggy.

In the investment arena, we are in the latter stages of this cycle, and because of that, investors are really sharpening their pencils and underwriting deals with a lot of scrutiny. However, sellers have high expectations on pricing, because prices have been steadily moving upward for such a prolonged period. This has caused a gap in expectation between buyers and sellers in the market. User sales have been slow to start the year as well, with only four Central County sales in the 5,000–30,000 square foot range, a pace of less than half of the amount of user sales seen in each of the last five years.

We are now approaching year ten of the recovery and while optimistic, we are proceeding with caution.

Please Contact Us for Further Information

Josh Brant
Regional Director of Research
jbrant@voitco.com

Anaheim, CA
714.978.7880

Carlsbad, CA
760.517.4000

Inland Empire, CA
909.545.8000

Irvine, CA
949.851.5100

Los Angeles, CA
424.329.7500

San Diego, CA
858.453.0505

This survey consists of properties representing both single tenant and multi-tenant buildings. The lease rates are based on a full-service gross basis. The information contained in this report is gathered from sources that are deemed reliable, but no guarantees are made as to its accuracy. This information is for Voit Real Estate Services' use only and cannot legally be reproduced without prior written consent from the management of Voit Real Estate Services. ©2018 Voit Real Estate Services, Inc. License #01991785.

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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