

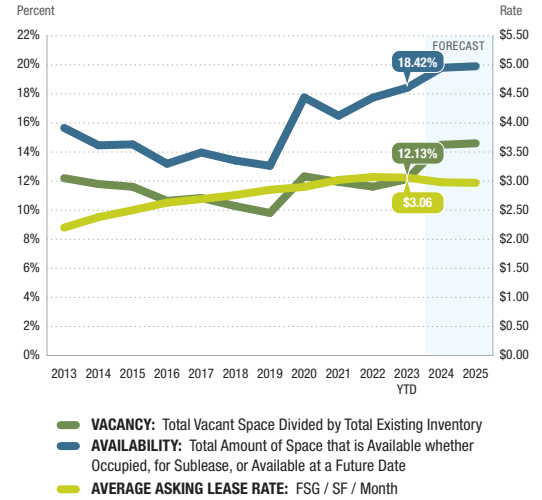
OVERVIEW. Leasing and sales volumes were depressed in the first half of 2023. The market registered negative net absorption in each of the first two quarters of the year, and a massive surge of sublease availability continues to flood the market. Rental rate increases are slowing, and office construction is historically elevated. After two years of recovery from the COVID-19 setbacks, market fundamentals are now moving in a negative direction. The largest submarket in the county, Downtown, has become the poster child for the offices that are struggling in the post-pandemic landscape.

VACANCY & AVAILABILITY. Direct/sublease space (unoccupied) finished Q2 at 12.1%, an 87-basis point increase from the level of a year ago. Available office space being marketed (regardless of occupancy status) was 18.4% of the county's inventory at the end of Q2. Among the county's major submarkets (minimum of 5 MSF of inventory), Kearny Mesa had the lowest availability, at 13.2%. Meanwhile, the availability rate in Downtown is at 39.5% and the vacancy rate there is greater than 27%. The relatively large amount of new office space that will be completed over the next couple of years will push the vacancy rate higher. Sublease availability increased by 1.5 MSF since the start of 2022, an increase of 94% over that span. The 3 MSF of available sublease space at the end of Q2 represents the largest level in at least two decades.

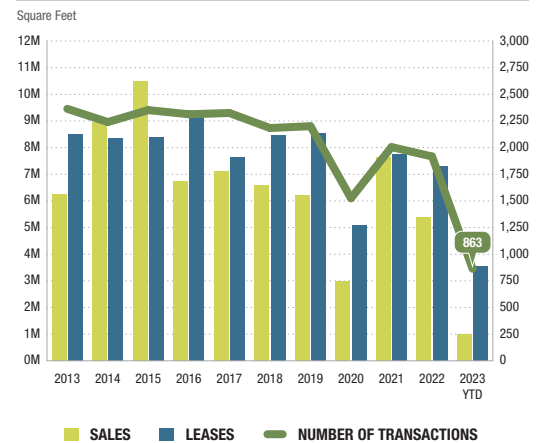
LEASE RATES. The average asking full-service-gross (FSG) lease rate per square foot per month in San Diego County was \$3.06 at the end of Q2, a two-cent increase from the prior quarter's rate, but a one-cent decrease from 4Q 2022's rate of \$3.07. The average asking rate for the county remains near an all-time high, but these recent numbers indicate the seemingly perpetual increases in asking rates may have reached a plateau. The average asking rental rate has only increased 0.66% over the past four quarters. Landlords are largely prioritizing a strong stance on starting rental rates, while taking a less stringent stance on lease concessions. But the balance of leverage varies across the county. The pipeline of new construction in the market also contributes to pushing the average rental rate for the county higher.

TRANSACTION ACTIVITY. Leasing volume levels were subdued in Q2. The total office square feet leased in Q2 dipped under 1.5 MSF for just the second time since 2020. The number of office leases recorded ticked up in Q2, exceeding 400 leases recorded for the first time in a year. Once again, one of the top leases in the quarter was a sublease, an indicator of the softening fundamentals within the office market. Office sales volume also started the year with a whimper. 28 office buildings sold in the first half of 2023, putting the pace of sales on track for the lowest annual total since 2009. Two of the top four sale transactions in Q2 were office buildings acquired by owner-users. This is an

VACANCY, AVAILABILITY & AVERAGE ASKING LEASE RATES



TRANSACTION VOLUME & NUMBER OF TRANSACTIONS



Market Statistics

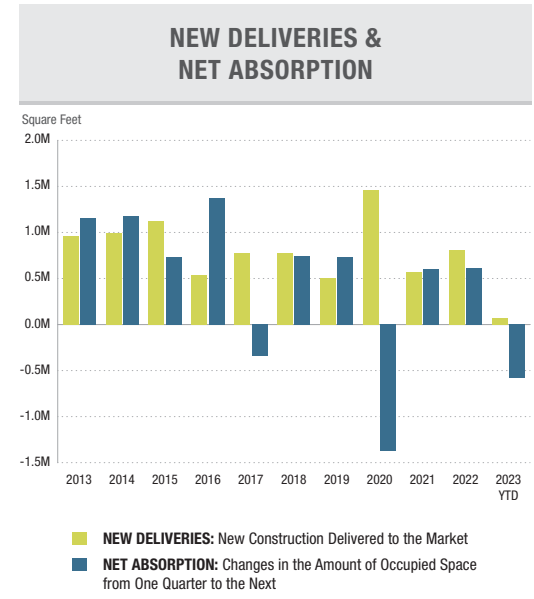
	Change Over Last Quarter	Q2 2023	Q1 2023	Q2 2022	% Change Over Last Year
Vacancy Rate	▲ UP	12.13%	11.80%	11.26%	7.71%
Availability Rate	▼ DOWN	18.42%	18.54%	16.24%	13.42%
Average Asking Lease Rate	▲ UP	\$3.06	\$3.04	\$3.04	0.66%
Sale & Lease Transactions	▼ DOWN	1,901,292	2,643,163	3,228,795	(41.11%)
Gross Absorption	▼ DOWN	1,399,363	1,841,390	2,465,396	(43.24%)
Net Absorption	▼ NEGATIVE	(377,394)	(201,748)	908,918	N/A

indication of the dearth of stabilized investment office sales. BioMed Realty's acquisition of 5670 Oberlin demonstrates that the large biotech ownership groups remain interested in opportunities for future lab conversion in the core suburban submarkets.

ABSORPTION. There were 377,394 SF of negative net absorption in Q2, bringing the total negative net absorption for the first half of the year to 579,142 SF. The pandemic-induced recession inflicted 1,374,082 SF of negative absorption on the market in 2020. In the following two years the market gained back nearly an equivalent measure of positive net absorption. Going into 2023, the local office market was affected by lower leasing volume in 2022 which led to the decrease in the tenant footprint to start the year.

CONSTRUCTION. The office market has 4 MSF under construction at the end of Q2, a figure that has remained roughly the same for the past six quarters. Prior to 4Q 2021, the last time there were more than 4 MSF of office properties under construction in San Diego County was at the end of 2006. Outside of IQHQ and Stockdale's massive projects in Downtown San Diego, the largest project under construction in San Diego at the end of 4Q was Breakthrough Properties' Torrey View project. This three-building, 520,000 SF development has its largest building preleased by medical device company BD. Overall, roughly 85% of the office space under construction remains available. Construction projects that recently completed, or are nearing completion, were begun during a period of rapid growth in the technology and life sciences sectors. Those sectors have pulled back, along with their demand for office space, leaving owners of new office buildings jockeying to capture a piece of a smaller pie.

EMPLOYMENT. The unemployment rate in San Diego County was 3.5% in May 2023, up from a revised 3.3% in April 2023, and above the year-ago estimate of 2.9%. This compares with an unadjusted unemployment rate of 4.5% for California and 3.4% for the nation during the same period. Over the 12-month period between May 2022 and May 2023, San Diego County employment increased by 42,500 jobs, an increase of 2.8%. With the normal delay in reporting from the California EDD, employment figures from June were unavailable at the time of publishing this report. For the nation as a whole, 209,000 jobs were added in June, the lowest monthly total in the past two and a half years.



Forecast

The current surge in office construction will push the vacancy rate up, and that will have the most direct impact on the market for larger tenants. For the county as a whole, we project increased vacancy in the second half of the year. On the sales side, higher interest rates and tightening conditions in the debt markets will weigh down the office sector.

Significant Transactions

Sales

* Voit Real Estate Services Deal

Property Address	Submarket	Class	Square Feet	Sale Price	Buyer	Seller
5825 Oberlin Dr.	Sorrento Mesa	B	60,518	\$36,000,000	King Street Properties	Nuveen
5670 Oberlin Dr.	Sorrento Mesa	B	20,000	\$11,250,000	BioMed Realty	South La Brea, LLC
3710 Ruffin Rd.	Kearny Mesa	B	20,060	\$7,890,000	Cabrillo Federal Credit union	Council of the Community Clinics
10717 Sorrento Valley Rd.	Sorrento Valley	C	16,126	\$7,300,000	Aroga Real Estate, LLC*	Sorrento Realty, LLC*
1011 Devonshire Dr.	North Beach Cities	C	10,007	\$6,735,000	Mkntatoma Holdings	Tata Beachside, LLC

Leases

Property Address	Submarket	Class	Square Feet	Transaction Date	Tenant	Owner
4655 Executive Dr.	UTC	A	45,706	Jun-2023	CoStar Group	Irvine Company
9808 Scranton Rd.	Sorrento Mesa	A	43,268	May-2023	Samsung	Alexandria RE Equities
12830 El Camino Real	Del Mar Heights	A	30,294	May-2023	McCarthy Building Companies	(Sublease)
4365 Executive Dr.	UTC	A	19,988	May-2023	Undisclosed	Irvine Company
15110 Avenue of Science	Rancho Bernardo	B	17,315	Apr-2023	Raytheon	Schnitzer Properties

	INVENTORY				VACANCY & LEASE RATES					ABSORPTION			
	Number of Bldgs.	Net Rentable Square Feet	Square Feet U / C	Square Feet Planned	Square Feet Vacant	Vacancy Rate Q2 2023	Square Feet Available	Availability Rate Q2 2023	Average Asking Lease Rate	Net Absorption Q2 2023	Net Absorption 2023	Gross Absorption Q2 2023	Gross Absorption 2023
Downtown													
Downtown	128	13,864,397	2,715,518	572,837	3,788,444	27.32%	6,543,856	39.47%	\$2.84	(209,129)	(313,976)	168,087	383,283
Downtown Total	128	13,864,397	2,715,518	572,837	3,788,444	27.32%	6,543,856	39.47%	\$2.84	(209,129)	(313,976)	168,087	383,283
Central													
City Heights / University	32	1,224,665	0	0	37,029	3.02%	51,059	4.17%	\$2.35	(1,306)	5,728	2,301	10,563
Coronado	4	84,540	0	0	1,610	1.90%	1,610	1.90%	\$3.25	0	0	0	0
Kearny Mesa	244	11,542,882	0	0	1,154,245	10.00%	1,523,145	13.20%	\$2.78	18,088	57,738	199,618	341,762
Mission Gorge	20	628,497	0	0	11,882	1.89%	12,707	2.02%	\$1.98	840	(5,843)	14,372	14,372
Mission Valley	128	7,423,384	0	1,130,925	1,389,345	18.72%	1,639,609	22.09%	\$2.99	(90,524)	(70,563)	152,176	351,055
Old Town / Point Loma	76	2,309,860	0	230,000	133,885	5.80%	349,635	15.14%	\$2.69	(7,969)	5,526	11,115	50,669
Park East	15	218,936	0	0	11,154	5.09%	10,263	4.69%	\$2.16	8,497	(2,657)	8,497	8,497
Rose Canyon / Morena	53	1,256,358	0	0	57,956	4.61%	122,705	9.77%	\$2.34	3,240	48,175	17,981	68,387
Uptown / Hillcrest	77	2,166,747	0	0	125,081	5.77%	212,426	9.80%	\$2.89	13,885	36,006	23,551	49,872
Central Total	649	26,855,869	0	1,360,925	2,922,187	10.88%	3,923,159	14.61%	\$2.86	(55,249)	74,110	429,611	895,177
I-15 Corridor													
Escondido	74	1,800,613	0	62,614	193,540	10.75%	404,909	22.49%	\$2.33	15,673	(16,151)	30,700	62,043
Poway	31	1,390,271	0	0	92,456	6.65%	104,152	7.49%	\$1.86	(11,175)	(8)	1,839	15,332
Rancho Bernardo	100	6,362,008	83,482	165,747	947,592	14.89%	1,190,734	18.47%	\$3.18	(29,801)	82,653	75,283	331,418
Scripps Ranch	49	2,753,182	0	356,000	428,057	15.55%	520,232	18.90%	\$2.95	21,413	40,542	69,655	152,512
I-15 Corridor Total	254	12,306,074	83,482	584,361	1,661,645	13.50%	2,220,027	17.92%	\$2.96	(3,890)	107,036	177,477	561,305
North County Coastal													
Carlsbad	163	6,972,035	0	50,000	904,772	12.98%	1,474,082	21.14%	\$2.79	(27,164)	(78,202)	90,105	181,370
Del Mar Heights / Carmel Valley	82	5,695,387	641,294	1,946,218	589,648	10.35%	1,258,252	19.86%	\$4.62	7,603	79,429	56,371	294,844
North Beach Cities	112	2,733,468	54,845	25,456	197,313	7.22%	276,871	9.93%	\$3.97	26,466	21,150	51,185	87,283
North County Total	357	15,400,890	696,139	2,021,674	1,691,733	10.98%	3,009,205	18.69%	\$3.46	6,905	22,377	197,661	563,497
North City													
Governor Park	19	769,855	0	0	82,086	10.66%	96,504	12.54%	\$2.94	(5,114)	2,508	12,637	28,687
La Jolla	46	1,353,422	0	0	187,069	13.82%	267,823	19.79%	\$3.43	(1,635)	(19,960)	41,833	50,837
Miramar	32	1,474,065	0	0	69,745	4.73%	121,826	8.26%	\$2.09	5,200	22,208	12,611	37,096
Sorrento Mesa	110	8,942,515	314,489	1,232,000	693,203	7.75%	1,295,159	13.99%	\$3.29	(21,407)	(130,102)	124,237	212,215
Sorrento Valley	23	648,616	0	0	120,260	18.54%	80,584	12.42%	\$2.80	(22,370)	(22,971)	1,775	8,385
Torrey Pines	43	3,197,075	0	309,094	185,605	5.81%	163,137	5.10%	\$4.37	1,801	(123,114)	7,056	7,056
UTC	91	9,141,100	282,851	427,000	759,917	8.31%	1,629,659	17.29%	\$4.15	(122,370)	(174,061)	84,235	193,083
North City Total	364	25,526,648	597,340	1,968,094	2,097,885	8.22%	3,654,692	13.99%	\$3.70	(165,895)	(445,492)	284,384	537,359
Southern & Eastern Areas													
Chula Vista	92	2,892,008	0	2,018,000	110,228	3.81%	162,544	5.62%	\$2.46	1,321	(11,983)	40,607	63,809
National City	16	550,315	0	0	8,323	1.51%	39,104	7.11%	\$2.16	16,198	4,004	16,198	24,438
South San Diego	13	319,824	0	0	64,873	20.28%	64,873	20.28%	\$2.70	(3,296)	(55,223)	2,200	2,200
Southeast San Diego	13	476,159	0	290,000	16,748	3.52%	16,748	3.52%	\$2.33	0	0	0	0
East County	151	3,790,747	0	61,800	130,668	3.45%	194,281	5.13%	\$2.40	29,098	13,148	38,988	79,387
Southern & Eastern Areas Total	285	8,029,053	0	2,369,800	330,840	4.12%	477,550	5.95%	\$2.39	43,321	-50,054	97,993	169,834
Highway 78 Corridor													
Oceanside	64	1,525,779	0	352,635	102,377	6.71%	137,815	9.03%	\$2.37	(3,755)	(21,783)	3,397	29,014
San Marcos	38	1,482,054	0	1,488,285	64,246	4.33%	88,289	5.96%	\$2.38	10,685	39,317	16,238	53,864
Vista	52	1,269,587	0	0	233,736	18.41%	274,602	21.63%	\$2.38	(387)	9,323	24,515	47,420
Highway 78 Corridor Total	154	4,277,420	0	1,840,920	400,359	9.36%	500,706	11.71%	\$2.37	6,543	26,857	44,150	130,298
Class A	312	40,759,259	4,008,997	8,171,770	6,879,234	16.88%	12,046,605	26.91%	\$3.50	(504,946)	(660,857)	488,236	1,278,783
Class B	1,248	51,378,342	83,482	2,524,004	5,088,893	9.90%	7,290,622	14.17%	\$2.82	100,908	103,896	768,653	1,665,864
Class C	631	14,122,750	0	22,837	924,966	6.55%	991,968	7.02%	\$2.23	26,644	(22,181)	142,474	296,106
San Diego County Total	2,191	106,260,351	4,092,479	10,718,611	12,893,093	12.13%	20,329,195	18.42%	\$3.06	9377,394	(579,142)	1,399,363	3,240,753

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



Bifurcated Office Market

by **Brandon Keith**

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Anyone who follows the commercial real estate world has no doubt seen the constant parade of national articles predicting disaster in the office market. Forthcoming issues of vacancy, rapid interest rate increases, and pending loan maturities will certainly have a significant impact on office building owners. But for the San Diego market in particular, the pain will primarily be felt in certain submarkets and certain office building types. The office sales market is in a transitional period on the investment side, while owner-user sales seem to be faring better.

The owner-user market has held up remarkably well considering SBA loan rates (and conventional financing) have gone from the upper 3% range to mid-6% range in just 18 months. Prices of offices from 5,000 SF to 30,000 SF have remained at all-time highs and purchase activity in this segment has continued to be relatively strong. The primary reason for continued owner-user purchase demand is that standard office and medical office lease rates have also increased significantly in the last few years, and these business owners are facing significant rental increases if they remain tenants. This makes record-high office purchase prices look relatively reasonable when compared with market lease rates, even with 6.25%–6.50% lending rates.

On the investment side, buyers are nervous about the office market category overall and lenders don't want to commit. As leases completed five to seven years ago continue to roll, many existing office tenants will reduce their footprint. Rates are expected to move 25–50 basis points higher in the next 6–12 months, if the Federal Reserve follows through on one or two more interest rate increases. As the economy slows and companies trim their work forces, less office space will be needed by corporate America. Meanwhile, more loans will come due, distress will mount, loans will default, property will be handed over to receivership, and the articles predicting office market and lender devastation will continue to come true.

In prior recessionary periods, lenders simply foreclosed on defaulted property, hired commercial real estate brokers to list and sell them off. Banks had to mark the value of these bad loans to market, report the loan defaults to regulators, and put money in loan loss reserves. This cycle will be different. In light of highly publicized recent bank defaults, banks covet their deposit base. When they report distressed loans, it makes their investors nervous, and they must move valuable deposits to loan loss reserves. This is a terrifying scenario for bankers. Our prediction for this cycle is that lenders will sell off their distressed loans for significant discounts, which actually puts loaned money back into their deposit base (albeit less than they had initially expected). This is nonetheless far superior to reporting the bad debts, marking their value to market, depleting their deposit base by funding loan loss reserves, covering legal expenses related to foreclosure, and suffering ongoing operational losses upon taking title. For opportunistic investors with large amounts of cash, great deals will be coming to take distressed debt off bank balance sheets.

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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.

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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, South San Diego, Southeast San Diego

HIGHWAY 78 CORRIDOR: Oceanside, San Marcos, Vista