

Savills Studley Report San Diego office sector

Q1 2018



SUMMARY

Market Highlights

LEASING DECREASES

Tenants have leased 4.7 million square feet (msf) in the four most recent quarters, well below the long-term average of 6.6 msf, and down by 2.1% from the last quarter of 2017, totalling 4.8 msf.

AVAILABILITY RATE DECLINES

The region's overall availability rate dipped by 60 basis points to 14.8%. The Class A rate fell by 10 basis points, starting the year at 16.7%. Overall and Class A rates both fell by approximately 200 basis points year-on-year.

RENT RISES

Overall asking rent inched up by 0.2% from the prior quarter, rising to \$2.74 (\$32.93/sf annually). Rent has fallen by 3.3% year-on-year, though.

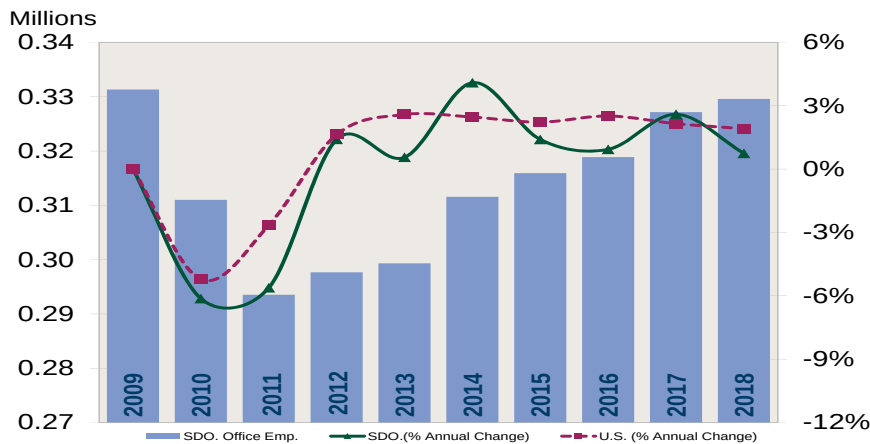
SALES INCREASE

Office property sales during the last six months (through February 2018) totaled \$1.5 billion, a 75% increase compared to the previous six-month total of \$877 million.

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"San Diego's office and economy continue on a steady growth path. Leasing has not been off the charts, but with one of the most restrained development pipelines in the nation and sustained demand from healthcare, biopharm and software firms, larger tenants seeking quality blocks of space in prime locations face challenging conditions."

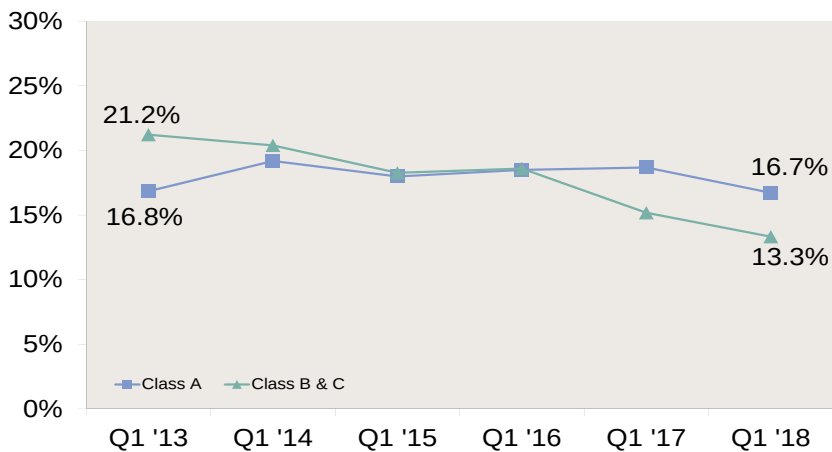
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Office-Using Employment Trends

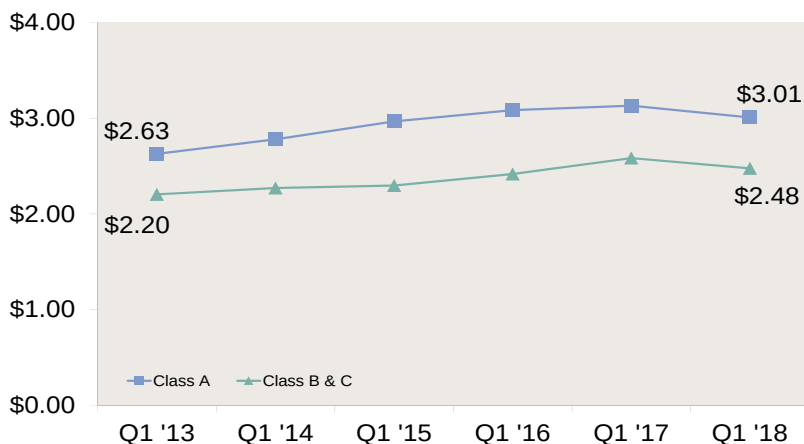


Source: Bureau of Labor Statistics^

Availability Rate Trends



Asking Rent Trends (\$/sf)



Investors and Households Flock to San Diego

San Diego's economy and office market are progressing on a steady path. In the first quarter of 2018, leasing in San Diego continued its slow but steady momentum. Deal volume fell slightly during the quarter, but leasing is often slow to start the year. A variety of mid-sized firms completed leases in the quarter, including some tech firms. AbacusNext leased 64,833 sf at 4850 Eastgate Mall. The technology-as-a-service provider to law firms and accountants will move from La Jolla Gateway to the new building developed by Irvine Company. Additionally in Scripps Ranch, TrellisWare Technologies inked a 59,527-sf deal at 10641 Scripps Summit Court. UCSD has been active over the last few quarters. This quarter it took 82,000 sf at 9305 Lightwave Ave. and 57,419 sf at 16950 Via Tazon.

Availability Pushes Lower

Availability across the San Diego market has fallen by 190 basis points during the last four quarters, declining from 16.7% to 14.8%. Conditions remain tight in North Cities. The overall availability rate in this submarket has fallen by 320 basis points from 18.7% in the first quarter of 2017 to 15.5% in the first quarter of 2018. Similarly, tenants face limited supply in Downtown San Diego's Class A market – ending the first quarter with a rate of 13.8%. The number of Class A buildings with an available big blocks over 50,000 sf dipped to 22 in the first quarter, with only one such property (450 B Street) in Downtown San Diego. Demand has been strong enough to spread beyond these two submarkets, with decreasing availability in Central Suburban and the I-15 corridor as well.

The development pipeline will not alleviate the supply shortfall any time soon. As of the end of the first quarter, there were just a handful of non-owner-user buildings under way, 60% of the 460,000 sf underway is pre-leased. Two of the biggest properties being built – Building 2 at Watermark in Scripps Ranch and Palomar Health Phase I – have significant medical office components.

Sustained leasing and controlled construction have contributed to steady rent growth in some areas. Overall average rent rose to \$2.74 (\$32.93/sf annually) in the first quarter, it just below the national average. Rent is much higher in La Jolla and Torrey Pines. Landlords pulled back slightly on concessions, curbing free rent periods in the last few quarters. Improvement allowances also dipped slightly. Even so, rent across

much of San Diego is still a bargain relative to the Bay Area or Los Angeles.

Region Gaining Households and Businesses

Net migration into San Diego exceeded 6,000 people in both 2015 and 2016. The region continues to attract households and businesses from other markets. These transplants are drawn to the high-quality of life, and reasonable cost of living and business costs. San Diego stacks up favorably on a cost basis relative to top West Coast metros – Los Angeles, San Francisco, Seattle — as well as top East Coast locations.

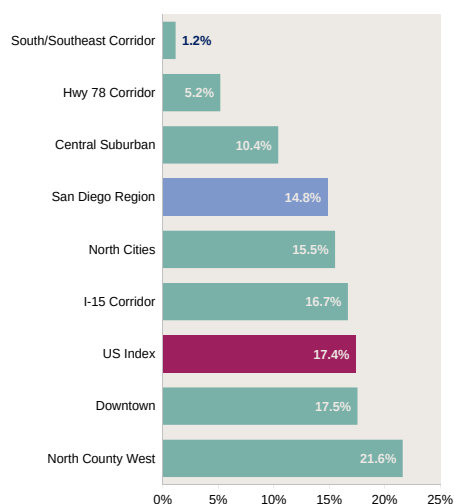
Steady population growth increases the region's workforce, another reason that expanding businesses include the market on their site selection short list. Office-using employment in San Diego has been outperforming national trends in the last few quarters. During the last 12 months, office-using employment jumped by 1.6%, more than doubling from the 0.6% growth in the prior 12 months. Some of the improvement in San Diego could be due to the relocation of businesses from higher-cost market. Office-using employment growth has accelerated, but not to the extent seen in tech centers such as Silicon Valley, Seattle and San Francisco. Office-using employment in San Francisco jumped by 4.7% year-on-year, for example, and spiked by 3.6% in Seattle.

Defense Sector Poised for Growth

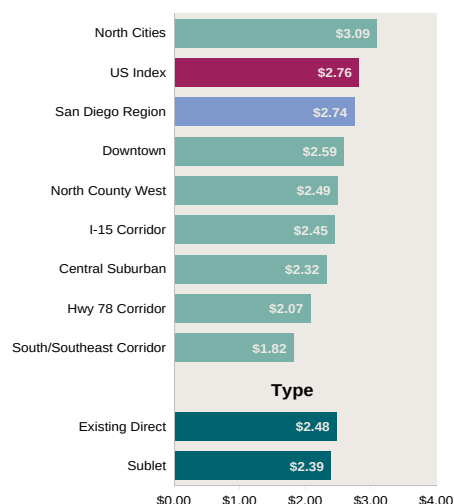
Overall employment in San Diego, which rose by 1.6% in the last 12 months, has also lagged other top tech markets. Compared to San Francisco and Silicon Valley, San Diego has a lower percentage of tech employers and a higher concentration of industries that typically grow more slowly, such as government and defense contractors. Defense contractors were already benefiting from increased funds for the Navy and cybersecurity implemented during the Obama Administration and are poised to gain even more under the new administration. Last year, Raytheon was awarded a \$87.7-million contract for ongoing engineering support services for naval ship self-defense systems. General Atomics Aeronautical Systems recently received a \$328.8-million contract from the Air Force for the support of Predator and Reaper remote controlled aircraft.

San Diego's economy is also benefitting from sustained investments in area innovators and startups. This includes many

Availability Rate Comparison



Rental Rate Comparison (\$/sf)



Major Transactions

Tenant	Sq Feet	Address	Market Area
University of California San Diego	82,000	9305 Lightwave Ave	Central Suburban
AbacusNext	64,832	4850 Eastgate Mall	North Cities
TrellisWare Technologies	59,527	10641 Scripps Summit Ct	I-15 Corridor
University of California San Diego	57,419	16950 Via Tazon	I-15 Corridor
Paylease	40,667	9330 Scranton Rd	North Cities
Avanti Workspace Executive Suites	25,065	5857 Owens Ave	North County West
Paul Hastings LLP	24,368	4747 Executive Dr	North Cities
Ostendo Technologies	21,654	6185 Paseo Del Norte	North County West
San Diego Passport Agency	20,055	401 W A St	Downtown
Henkels & McCoy	16,000	9246 Lightwave Ave	Central Suburban
Sum of Top 10 Leases	411,587		

local biotech and pharmaceutical firms. Venture capital investment in San Diego jumped to \$346 million in the first quarter of 2018, up from \$217 million in the first quarter of 2017. Biotech firm Gossamer Bio raised \$100 million from Arch Venture Partners and Omega Funds— by far the largest funding in the quarter.

Some mergers and acquisitions – such as Broadcom's proposed acquisition of Qualcomm – are once-in-a-cycle events. Broadcom ultimately withdrew its bid, but this would have been a big market mover, positioning Broadcom as the third largest chipmaker in the world. San Diego may have dodged a bullet. A merger could have spurred some job cuts at Qualcomm, which employs 13,000 people in San Diego.

Investors Target Region

Investors are also targeting San Diego's office sector. Irvine Company has enjoyed a lot of success in its Orange County portfolio and is hoping to repeat that performance in

San Diego. The developer made a significant addition to its holdings in San Diego in early 2018, paying \$105 million for the Gateway at Torrey Hills complex in Del Mar Heights. The 197,862-sf two-building park sold for \$530/sf, one of the highest prices on record. This was the second purchase for the Newport Beach-based developer in Del Mar Heights in the last several months.

Looking Forward

Tenants will face higher rent during 2018 as landlords take advantage of a limited set of quality blocks and negligible construction.

With scant quality space options and demand seemingly on a steady track, owners will maintain a tough stance. Free rent periods could fall slightly and tenants can anticipate less flexibility on lease options such as cancellation rights. Tenants are likely to find more reasonably priced space in Downtown compared to Torrey Pines and other North Cities locations.

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	13,967	1,036	400	1,452	-4.6%	1,950	10.4%	-0.5%	13.9%	\$2.32	1.9%	\$2.30
	Central Suburban - Class A	4,271	297	72	481	-10.1%	706	11.3%	-1.3%	16.6%	\$2.61	2.5%	\$2.89
2	Downtown	11,911	679	637	2,090	-1.6%	1,839	17.5%	-0.3%	15.5%	\$2.59	3.0%	\$2.62
	Downtown - Class A	6,698	493	-79	923	12.9%	915	13.8%	1.6%	13.7%	\$2.84	-0.3%	\$2.96
3	Hwy 78 Corridor	1,346	35	60	70	-3.4%	196	5.2%	-0.2%	14.6%	\$2.07	-2.4%	\$2.34
	Hwy 78 Corridor - Class A	585	12	62	29	-17.1%	98	4.9%	-1.0%	16.7%	\$2.36	-0.6%	\$2.67
4	I-15 Corridor	7,107	612	-55	1,186	-8.1%	1,459	16.7%	-1.5%	20.5%	\$2.45	1.8%	\$2.41
	I-15 Corridor - Class A	3,263	234	-234	839	3.1%	820	25.7%	0.8%	25.1%	\$2.62	1.4%	\$2.77
5	North Cities	23,447	1,928	89	3,639	-5.9%	4,340	15.5%	-1.0%	18.7%	\$3.09	0.1%	\$3.16
	North Cities - Class A	12,670	987	121	2,157	-3.6%	2,470	17.0%	-0.7%	19.6%	\$3.41	-0.4%	\$3.47
6	North County West	6,303	437	28	1,363	1.4%	1,119	21.6%	0.3%	17.5%	\$2.49	1.2%	\$2.52
	North County West - Class A	1,833	218	-2	496	-5.7%	487	27.1%	-1.7%	26.7%	\$2.69	0.0%	\$2.68
7	South/Southeast Corridor	2,065	14	23	24	16.7%	141	1.2%	0.2%	6.9%	\$1.82	4.1%	\$2.21
	South/Southeast Corridor -Class A	234	0	0	15	158.7%	11	6.6%	4.0%	4.7%	\$2.25	0.0%	\$2.57
1-7	San Diego Region TOTAL	66,190	4,740	1,181	9,822	-4.0%	11,044	14.8%	-0.6%	16.7%	\$2.74	0.2%	\$2.84
	San Diego Region TOTAL - Class A	29,552	2,241	-61	4,941	-0.6%	5,507	16.7%	-0.1%	18.7%	\$3.01	-0.1%	\$3.13

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(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.

^Unless otherwise noted, source for data is Savills Studley.

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.

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