MARKET REPORT

OFFICE

San Diego Metro Area

IPA | INSTITUTIONAL PROPERTY ADVISORS

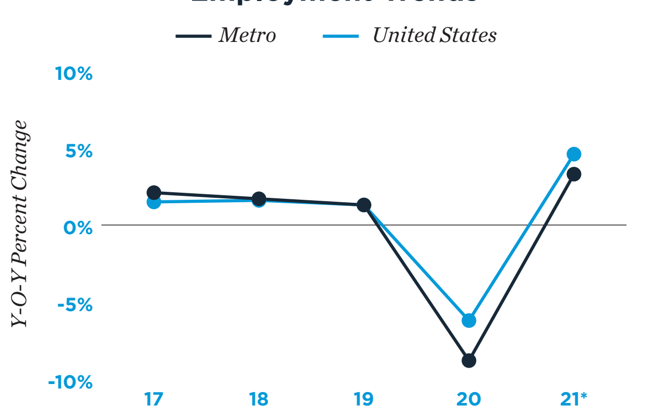
2Q/21

Life Science and Tech Expansions Serve as the Foundation for San Diego's Office Recovery

Diverse tenant base drives leasing rebound. Four straight quarters of negative absorption have pushed office vacancy in San Diego County to a nine-year high. Nevertheless, the metro is exhibiting signs of improvement that have the potential to augment office fundamentals. Preliminary leasing data from the first quarter of 2021 reveals a 40 percent rise in executions when compared with the prior three-month period, with biotech and software companies driving leasing activity for spaces larger than 10,000 square feet. Sorrento Valley/UTC/Torrey Pines is the preferred destination for these companies as Apple, Surgalign Spine Technologies, Element Biosciences and TuSimple leased a combined 200,000 square feet in the market over the past three months. Furthermore, Google announced it will occupy additional space in the area. Recent hiring by firms that traditionally use office space suggests companies are expanding and may require additional space once most professionals resume in-office work.

Downtown San Diego faces headwinds. Supported by more traditional office tenants, the metro's CBD entered April with a 26.2 percent vacancy rate. Despite the volume of space on the leasing market, a trio of speculative developments are underway that could place additional pressure on local availability. Two of these properties, 2100 Kettner and 20/6, will expand the local office inventory by 2.3 percent this year, while the 750,000-square-foot Campus at Horton is slated for 2022 delivery.

Employment Trends



** Forecast*

Sources: BLS; CoStar Group, Inc.

Office 2021 Outlook

45,000 JOBS *will be created*

EMPLOYMENT:

Business reopenings and vaccination efforts drive economic improvement, allowing San Diego to recover one-third of the positions lost in 2020. Job creation in the traditionally office-using sectors will surpass the overall rate of employment growth.

950,000 SQ. FT. *will be completed*

CONSTRUCTION:

Supply additions decrease slightly on an annual basis, yet the volume of space delivered exceeds the prior five-year average. Properties off Interstate 5 in Torrey Pines, UTC and Del Mar Heights account for 70 percent of the space to be finalized in 2021.

140 BASIS POINT *increase in vacancy*

VACANCY:

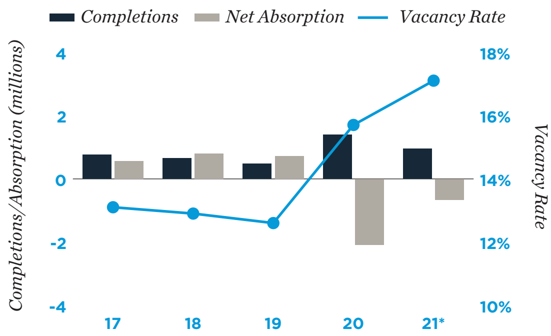
Speculative deliveries and some companies' reluctance to maintain or expand their real estate footprints will weigh on vacancy and leasing activity in 2021, pushing office availability to 17.1 percent, the highest year-end rate since 2009.

0.7% INCREASE *in asking rent*

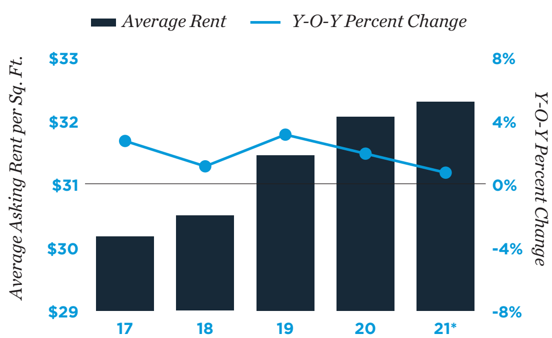
RENT:

An increase in higher-quality space available for lease allows the metro's average marketed rate to reach $32.30 per square foot. While nominal, this year's gain extends a streak of positive rent growth that began in 2012.

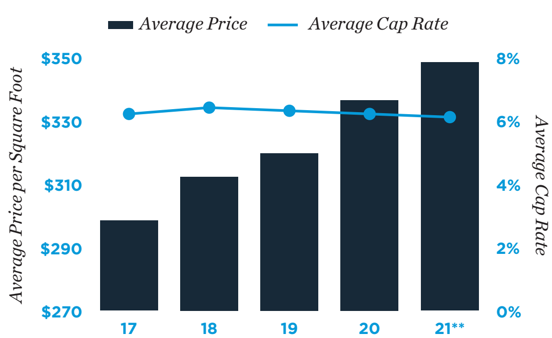
Supply and Demand



Rent Trends



Sales Trends



* Forecast ** Through 1Q

Sources: CoStar Group, Inc.; Real Capital Analytics

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1Q21 — 12-Month Period

CONSTRUCTION

1,340,000 square feet completed

- Deliveries over the past year ending in March increased office inventory by 1.3 percent. Cubic's new headquarters in Kearny Mesa and a U.S. Navy building in Downtown San Diego highlighted the list of completions.
- Entering the second quarter, construction was underway on nearly 2 million square feet of space, half of which is slated for 2021 finalization.

VACANCY

380 basis point increase in vacancy Y-O-Y

- Roughly 3.2 million square feet of suburban space entered the leasing market over the past 12 months, with 1 million square feet vacated in Downtown San Diego. This combination lifted vacancy to 16.1 percent.
- A 610-basis-point increase pushed Class A vacancy to 20.8 percent, while Class B/C availability rose 250 basis points to 13.4 percent.

RENT

0.4% increase in the average asking rent Y-O-Y

- A rise in high-quality space available for lease supported a 1 percent rent gain in the suburbs, pushing the metro's average asking rate to $32.14 per square foot. In the CBD, the mean marketed rent fell 3.4 percent.
- At 3.5 percent, North San Diego noted the largest rent gain as the volume of Class A space on the leasing market rose by 600,000 square feet.

Investment Highlights

- Sales activity returned to a pre-pandemic pace in the fourth quarter of last year and continued through the first three months of 2021. Still, deal flow over the past 12 months ending in March declined by 19 percent.
- Class A and B trades have accounted for roughly 40 percent of the transactions closed since the onset of the health crisis, driving overall pricing up 8 percent in the past year to an average of $348 per square foot. This increase lowered the mean cap rate 20 basis points to 6.1 percent.
- Within the city of San Diego, investors are most active in Sorrento Valley, where numerous life science and biotech companies occupy sizable spaces. Neighborhoods west of Balboa Park represent additional areas of interest due to their concentrations of business services firms. Outside San Diego, the higher-end market of Carlsbad and lower-priced cities including Escondido have garnered the most buyer attention.
- Investor demand for Class B/C medical office properties remains steady, with buildings trading at a high-5 percent average cap rate. Over the past yearlong span, average pricing in this office segment rose 14 percent.