



Office Report

Q3 2017
GALLELLI REAL ESTATE MARKET REPORT

Overview

The Sacramento office market experienced another quarter of notable occupancy growth, with vacancy falling to its lowest level in 11 years. Office leasing activity also saw an uptick, with a number of larger deals being signed during the quarter. Asking rental rates are also on the rise and are currently at their highest level in seven years.

Market Trends

- The market saw a notable uptick in net absorption, as the region recorded just over 215,000 square feet of occupancy growth in Q3. A number of large move-ins hit the market in the last three months, including the Office of Statewide Health Planning & Development, who occupied 124,340 square feet at 2020 W El Camino in Natomas; Centene Corp occupying 55,192 square feet at 10811 International Drive in Highway 50; and Growth Public School who occupied 40,252 square feet at 9320 Tech Center Drive, also in Highway 50.
- Quarterly market vacancy fell from 13.8% to 13.5%, which is the lowest vacancy rate the local office market has seen in 11 years. Year-over-year vacancy is also down – one year ago, local vacancy stood at 14.4%.
- Activity across the submarkets was largely positive, with the majority of trade areas recording positive growth. The largest growth was seen in the Downtown submarket, which recorded ±90,000 square feet of positive net absorption during the quarter. Vacancy in Downtown



Sacramento currently stands at 12.1%, which is the lowest vacancy rate this submarket has seen since 2010. Other submarkets that saw notable occupancy growth include Midtown (±64,000 square feet), Highway 50/Rancho Cordova (±60,000 square feet), Northeast Sacramento (±58,000 square feet), and Roseville/Rocklin (±55,000 square feet).

- The average asking rate for office space saw another uptick during Q3, increasing from \$1.79 per square foot to \$1.84 per square foot, which is the highest asking rate the market has seen since 2010. Though rents are up over 5.0% year over year, they are still 5.6% below their peak of \$1.95 per square foot during 2008. Office space in the Downtown/CBD market is currently averaging \$2.32 per square foot, while Suburban markets are commanding \$1.74 per square foot on average.
 - Regionally, Class A space is currently asking \$2.26 per square foot; Class B is going for \$1.82 per square foot; and Class C space is asking \$1.42 per square foot.
 - Downtown/CBD Class A space is asking \$2.90 per square foot; Class B space is asking \$2.26; and Class C space is commanding \$1.80 per square foot. Overall Downtown/CBD asking rents have increased 5.5% over the last 12 months.
 - Suburban Class A rents are currently going for \$2.16 per square foot; Class B is asking \$1.73 per square foot; and Class C is asking \$1.34 per square foot on average. Overall Suburban asking rents are up 5.2% on a year-over-year basis.

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Office Q32017

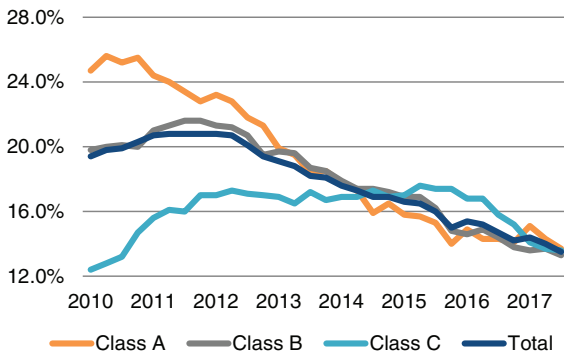
The absence of any notable Class A transactions led to a decline in investment sales volume during Q3.

Vacancy 13.5% ▼	Net Absorption 215,368 _{SF} ▲	Avg. Asking Rate \$1.84 _{PSF} ▲
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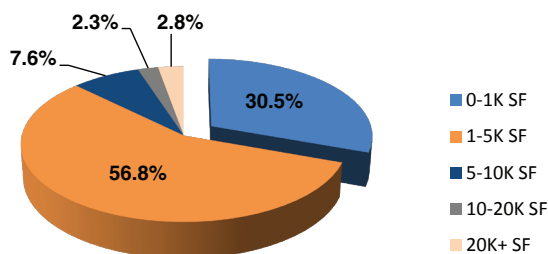
Investment Trends

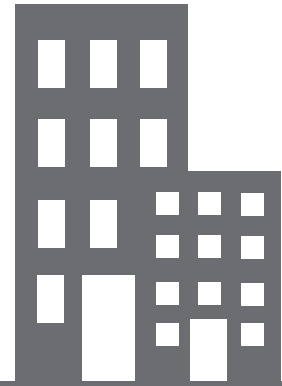
- The absence of any notable Class A transactions led to a decline in investment sales volume during Q3, as the market recorded 18 investment transactions totaling \$86.8 million in total volume. This number is significantly declined over Q2, which recorded \$340.4 million in total volume. This marks the first time in the last 12 months that quarterly office investment volume has fallen under \$100 million.
 - Suburban transaction volume saw a significant decline from Q2, with the market recording \$65.6 million in total volume compared to \$232.9 million. Year-over-year sales volume has also declined – one year ago, the market recorded \$160.9 million in total sales volume.
 - Downtown/CBD sales volume decreased during Q3 - the market recorded 4 investment transactions totaling \$21.1 million compared to \$107.5 million in Q2. However, Q2 saw the sale of 980 9th Street, which accounted for \$97.5 million of the \$107.5 million in total sales volume. Taking this sale out of the equation, investment volume downtown has actually increased over the last two quarters, as Q1 recorded \$3.1 million in total volume. Year-over-year volume is down, however, as sales volume fell from \$39.3 in Q3 2016 to \$21.1 million in Q3 2017.
- Year-to-date, all classes of Suburban office space have averaged \$156 per square foot, while Downtown/CBD space has averaged \$169 per square foot. This is primarily attributable to the lack of Downtown Class A transactions during the year.
- The two largest investment sales of the quarter included:
 - Placer Town & Country Village, a 9-building, 135-970-square-foot office portfolio in Roseville that sold for \$17.1 million, or \$126 per square foot.
 - City Gate Plaza, a 105,003-square-foot, Class B building located in Natomas. This project sold for \$15.5 million or \$147.85 per square foot.

Historical Office Vacancy by Class



Q3-2017 Office Leasing Volume by SF





Construction
671,292^{SF}
 ▲

Sacramento Unemployment
4.5%
 ▼

US Unemployment
4.1%
 -

Spotlight On: Sacramento's Shot at Amazon's HQ2

Amazon is currently in the midst of completing the largest industrial development in more than a decade in the Sacramento region - their 855,000-square-foot distribution facility will complete in Q4 and hiring for the center's 1,500 jobs kicked off in July. This quarter, Amazon announced its intention to build a second headquarters outside of Seattle, and Sacramento is throwing its hat into the ring. The question is, however - does Sacramento have a realistic shot at landing Amazon's second national headquarters? Unfortunately, the answer is complicated.

In the region's favor, the Sacramento area has numerous sites that could potentially accommodate a large Amazon campus. Amazon is looking to occupy 500,000 square feet by 2019 and have the ability to expand up to 8 million (non-contiguous) square feet by 2027. Sites that could accommodate this include Metro Air Park, where Amazon already exists; the former Sleep Train Arena site in Natomas; the Railyards site in Downtown; and a 160-acre, city-owned vacant land site in West Roseville. The Greater Sacramento Economic Council's bid for Amazon included 12 potential sites. The Sacramento area also has a highly educated, younger, and more diverse workforce which could also work in the region's favor. Sacramento's proximity to Sacramento State, UC Davis, and UC Berkeley provides great access to top talent and highly qualified workers.

Alternatively, California is unfortunately known as a notoriously bad state for business. Higher taxes, heavy regulations, and an increasingly expensive cost of living could deter Amazon from choosing Sacramento or any other location in California, for that matter. States such as Texas, North Carolina, or Colorado may have a better shot at landing the Amazon headquarters due to their lower costs of living and more business-friendly climates.

Ultimately, whether or not Amazon lands in Sacramento depends on what kind of incentive package the region and state can offer the company and whether or

not that package is attractive enough to beat out the competition. Proposals for the new headquarters will be submitted as of the time of this writing, with final site selection to be completed in 2018.

Outlook

Sacramento's office market continues to tighten, as vacancy has returned to pre-recession lows and rents continues to see incremental increases and are currently at their highest level in seven years. Tenant demand in the region remains high, especially in popular submarkets such as Downtown, Midtown, and Roseville/Rocklin. Though rents are on the rise, new speculative office construction remains limited. Considering the cost of new construction and the fact that rents are far below levels needed to support new speculative construction, future office competition is still years away. Investors continue to be drawn to the region, due to the tightening marketplace, affordability and attractive gap between acquisition prices and replacement costs. Barring any unforeseen circumstances, Sacramento's office market will see much of the same strong momentum through 2018, as vacancy continues to fall and rental rates rise.



Office Q32017

Submarket	Inventory	Direct	Available Space Sublease	Total	Vacancy Q3-17	Net Absorption		Avg. Asking Rate (NNN)
						Q3-17	Q3-16	
Arden/Arcade								
Class A	265,552	18,200	0	18,200	6.9%	2,473	595	\$2.10
Class B	3,846,458	766,606	5,774	772,380	20.1%	(52,571)	(20,455)	\$1.83
Class C	1,755,334	273,238	0	273,238	15.6%	1,655	59,992	\$1.50
Total	5,867,344	1,058,044	5,774	1,063,818	18.1%	(48,443)	40,132	\$1.81
Auburn/Lincoln								
Class A	-	-	-	-	-	-	-	-
Class B	446,395	18,827	3,000	21,827	4.9%	10,435	6,396	\$1.46
Class C	500,296	40,305	0	40,305	8.1%	(6,302)	9,938	\$1.19
Total	946,691	59,132	3,000	62,132	6.6%	4,133	16,334	\$1.33
Downtown Sacramento								
Class A	5,782,533	747,122	5,513	752,635	13.0%	30,324	(15,020)	\$2.90
Class B	4,651,819	508,853	14,579	523,432	11.3%	32,795	76,219	\$2.05
Class C	2,914,994	344,112	1,670	345,782	11.9%	27,049	9,742	\$1.78
Total	13,349,346	1,600,087	21,762	1,621,849	12.1%	90,168	70,941	\$2.24
El Dorado Hills/Folsom								
Class A	727,607	96,468	975	97,443	13.4%	(402)	(1,214)	\$2.27
Class B	2,802,119	545,302	13,082	558,384	19.9%	(38,418)	28,481	\$1.75
Class C	745,960	87,111	0	87,111	11.7%	(34,570)	11,882	\$1.45
Total	4,275,686	728,881	14,057	742,938	17.4%	(73,390)	39,149	\$1.82
Highway 50/Rancho Cordova								
Class A	-	-	-	-	-	-	-	-
Class B	11,113,976	1,802,779	121,264	1,924,043	17.3%	94,158	2,421	\$1.71
Class C	745,960	87,111	0	87,111	11.7%	(34,570)	11,882	\$1.45
Total	11,859,936	1,889,890	121,264	2,011,154	17.0%	59,588	14,303	\$1.58
Midtown/East Sacramento								
Class A	329,289	1,020	0	1,020	0.3%	1,093	0	-
Class B	3,230,056	121,189	0	121,189	3.8%	57,690	3,818	\$2.47
Class C	1,251,784	205,437	150	205,587	16.4%	4,868	16,065	\$1.82
Total	4,811,129	327,646	150	327,796	6.8%	63,651	19,883	\$2.15
Northgate/Natomas								
Class A	2,266,209	215,543	41,660	257,203	11.3%	108,885	(4,738)	\$2.04
Class B	3,493,845	546,505	12,714	559,219	16.0%	(114,519)	(55,779)	\$1.74
Class C	499,503	133,589	0	133,589	26.7%	0	2,801	\$1.22
Total	6,259,557	895,637	54,374	950,011	15.2%	(5,634)	(57,716)	\$1.67
Northeast Sacramento								
Class A	79,163	0	0	0	0.0%	0	0	\$0.00
Class B	1,746,704	418,806	5,504	424,310	24.3%	21,579	33,829	\$1.48
Class C	2,993,395	378,273	0	378,273	12.6%	36,040	12,998	\$1.17
Total	4,819,262	797,079	5,504	802,583	16.7%	57,619	46,827	\$1.33
Roseville/Rocklin								
Class A	2,313,961	165,562	6,341	171,903	7.4%	20,482	(486)	\$2.16
Class B	6,103,513	579,425	19,444	598,869	9.8%	27,054	112,975	\$1.63
Class C	1,302,214	214,828	0	214,828	16.5%	7,299	7,881	\$1.17
Total	9,719,688	959,815	25,785	985,600	10.1%	54,835	120,370	\$1.65
South Sacramento								
Class A	358,498	0	0	0	0.0%	1,496	(4,570)	\$2.40
Class B	1,979,156	285,978	0	285,978	14.4%	(3,494)	37,052	\$2.05
Class C	1,422,898	217,229	0	217,229	8.1%	7,489	(74)	\$1.20
Total	3,760,552	503,207	0	503,207	13.4%	5,491	32,408	\$1.88
Yolo County								
Class A	553,592	21,376	0	21,376	13.0%	0	42,123	\$1.98
Class B	1,623,424	108,362	0	108,362	11.3%	8,690	(1,630)	\$1.88
Class C	830,622	51,919	0	51,919	11.9%	(1,340)	12,413	\$1.67
Total	3,007,638	181,657	0	181,657	6.0%	7,350	52,906	\$1.84
Totals	68,676,829	9,001,075	251,670	9,252,745	13.5%	215,368	395,537	\$1.84
Class A	12,676,404	1,265,291	54,489	1,319,780	10.4%	164,351	16,690	\$2.26
Class B	41,037,465	5,702,632	195,361	5,897,993	14.4%	43,399	223,327	\$1.82
Class C	14,962,960	2,033,152	1,820	2,034,972	13.6%	7,618	155,520	\$1.42