

BRIEF | Future of Work

What's Next for the San Diego Office Market

The Bad News, the Good News, and the Takeaway

By Zach DiSalvo

Inflation is still rampant in the U.S, but improved supply chains, lower energy prices, and higher interest rates have curtailed demand and sent the CPI lower. The pace of recent rate hikes, the most dramatic in decades, have increased volatility in the financial markets, and companies facing the specter of decreased earnings growth in 2023 are looking to cut costs. That could help fulfill recessionary prophecies, as according to Challenger, Gray & Christmas, data shows that the current level of layoff announcements is consistent with past recessions. Office buildings, already contending with modest physical occupancy rates due to the rise of virtual work during the COVID-19 pandemic, have seen vacancies expand nationwide over the past few quarters. CBRE's Econometric Advisors reported that the trailing four quarter vacancy index grew across the U.S. by 70 basis points (bps).

The Bad News

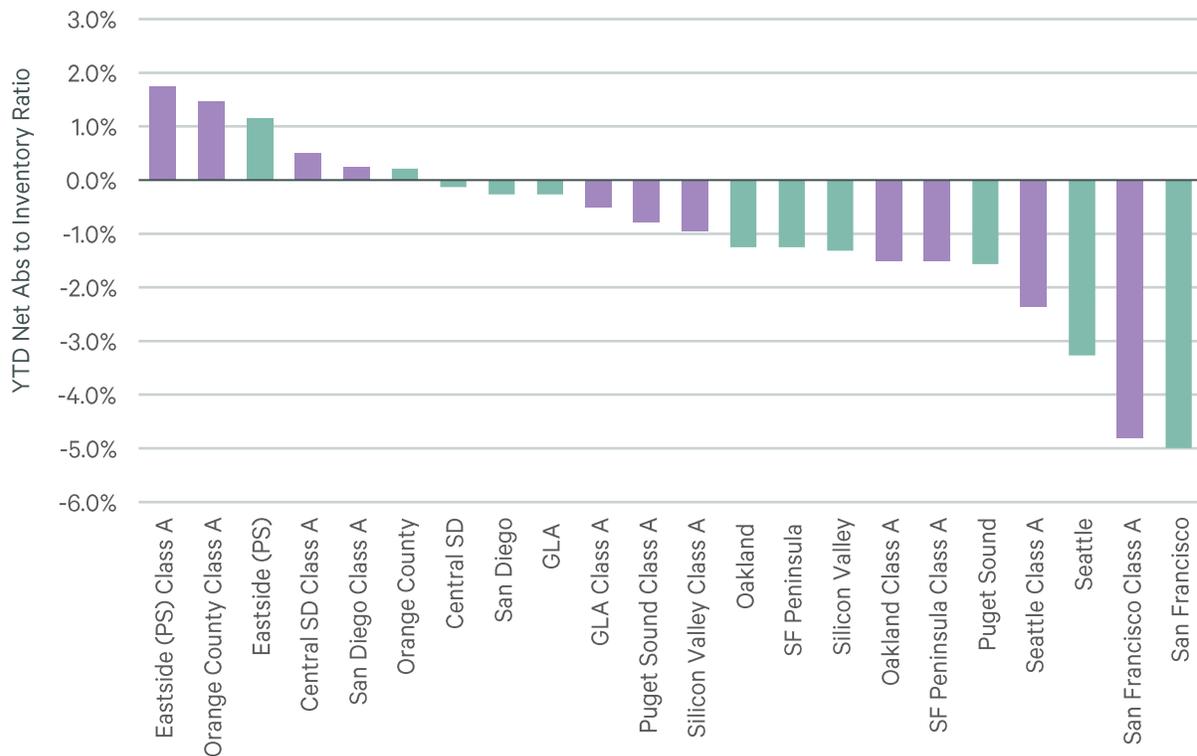
Hybrid work will likely be a permanent business model, as opposed to a temporary solution to keep businesses running during a pandemic. Office usage in the U.S. continues to stagnate, and the economic environment is accelerating companies' decision-making timeline on their long-term utilization of the hybrid workplace. If economic conditions remain uncertain, firms that lay off portions of their workforce may look to downsize their space or make it available for sublease.

San Diego and Other West Coast Markets

West Coast office markets have felt the recent economic headwinds, as San Diego, Los Angeles, the San Francisco Bay Area, and the Puget Sound Region (Seattle area) all experienced negative net absorption in 2022. Only the Eastside (Puget Sound Region), Silicon Valley, and Orange County experienced positive net absorption. However, compared to other major markets, impacts to San Diego’s office landscape were relatively minor. Amongst West coast office markets, Central San Diego currently has the second lowest Vacancy rate (11.4%) trailing only the Eastside of the Puget Sound Region (10.8%). *See Appendix: Table 3

As a percent of its overall inventory, San Diego experienced -0.3% of annual net absorption, significantly better than Seattle (-3.3%), SF Peninsula (-1.3%), and San Francisco (-5.0%). Another encouraging note is that San Diego’s Class A product joined the Eastside, Silicon Valley, and Orange County as the only markets with positive net absorption in 2022.

FIGURE 1: 2022 Net Absorption as Percent of Inventory



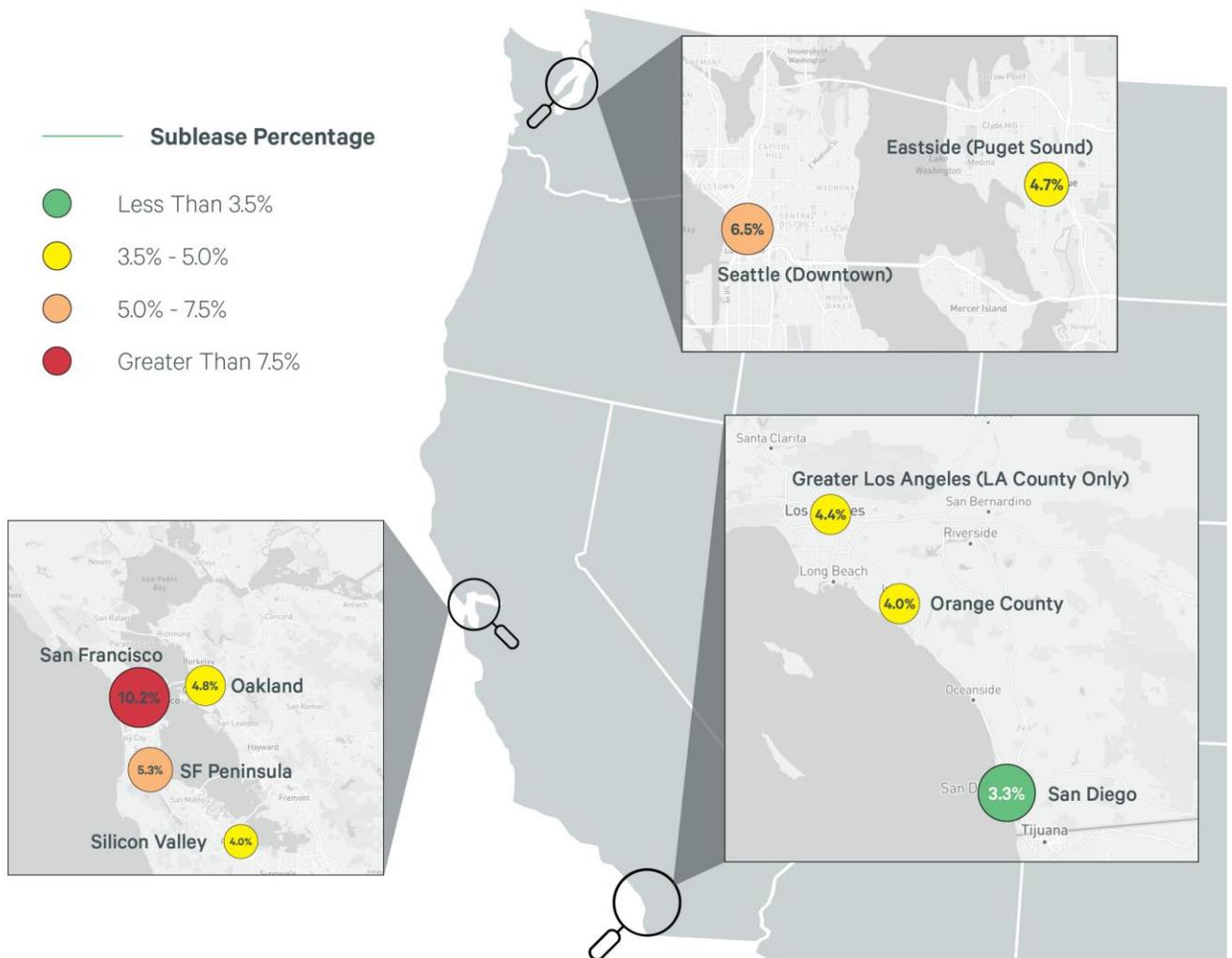
A rise in sublease space was another key indicator of the direction of office markets in the second half of 2022, and again, San Diego was impacted less dramatically than other West Coast locales: 3.3% of San Diego’s office inventory was available for sublease, the only West Coast market below 4%. Seattle, the Puget Sound Region, and the SF Peninsula each had over 5% of their inventory available for sublease, while in San Francisco, more than 10% of office space was on the sublease market.

3.3%

Inventory Available for Sublease Countywide

See Appendix Table I and II & Additional Chart

FIGURE 2: Sublease Available as Percent of Inventory



Suburban vs. Urban Office Performance

In the summer of 2022, CBRE reported that suburban office submarkets were recovering at a faster rate than downtown submarkets. According to the report, “the overall downtown office vacancy rate increased by 6.2 percentage points since Q1 2020, while the suburban office vacancy rate increased by only 3.6 percentage points. The suburban vacancy rate of 16.9% is 20 bps lower than its pandemic-era high, while the downtown vacancy rate of 16.8% is the highest in the past 20 years. The 10-bp gap between downtown and the suburbs is the narrowest it has been in more than 20 years.”

San Diego has experienced the same phenomenon, with suburban markets ending 2022 at 10.9% vacant, compared to Downtown at 22.5%. Roughly 84% of San Diego’s office inventory is in suburban submarkets, a dynamic that has likely factored into it being less impacted by the post-pandemic office trends than other downtown-dominant markets.

84%

San Diego Inventory located in Suburban Submarkets

10.9%

Vacancy Rate in San Diego Suburban Submarkets

The Good News

San Diego’s office market is experiencing economic headwinds to a much lesser extent than most of its West Coast counterparts, and recent projections indicate that a recessionary period will likely have only a minor impact on the market. CBRE’s Econometric Advisors projects a slight uptick in vacancy, followed by a recovery period with modest impacts on rents.



How We Got Here

Big Tech's Takeover

In 2018, the mega-cap tech companies collectively known as MAANG (Meta, Apple, Amazon, Netflix, and Google) occupied just over 230,000 sq. ft. of office space in San Diego, but over the past four years, that footprint has grown to nearly 3 million sq. ft. of leased space. The average lease signed by MAANG companies during that period measured 108,000 sq. ft. and played a significant role in the limited availability of 50,000 sq. ft. and larger spaces in Central San Diego submarkets. Recent layoff announcements by MAANG firms have not only had little impact on San Diego-based employees, but also their space requirements. None of these companies have given back office space in the form of subleases, and in some cases, they are still active in the market. Big Tech hiring trends have also drastically increased the number of tech jobs in the region. A 34% increase in tech talent from 2019-22 ranked San Diego as the fastest growing tech market in the country.

230K+

Office Space leased by MAANG Companies as of year-end 2018

3.0M

Office Space leased by MAANG Companies as of year-end 2022

Reduction of Office Inventory

Since the onset of the pandemic, demand for lab space has soared in San Diego, and that has spurred developers to convert older and outdated office and Industrial R&D buildings to life science uses. Nearly 3.2 million sq. ft. of office space has been converted to lab since 2015, 68% of which is in the Central San Diego submarkets of Torrey Pines, UTC, and Sorrento Mesa. An additional 1.4 million sq. ft. of space is currently planned for future conversion, brining the total reduction of office stock to approximately 4.6 million sq. ft. That planned or converted inventory has reduced Central San Diego's office footprint by 10% since 2015. Furthermore, the elimination of older and lower quality office product has had a direct impact on the region's declining vacancy rate and may continue to in the future by forcing a flight to quality.

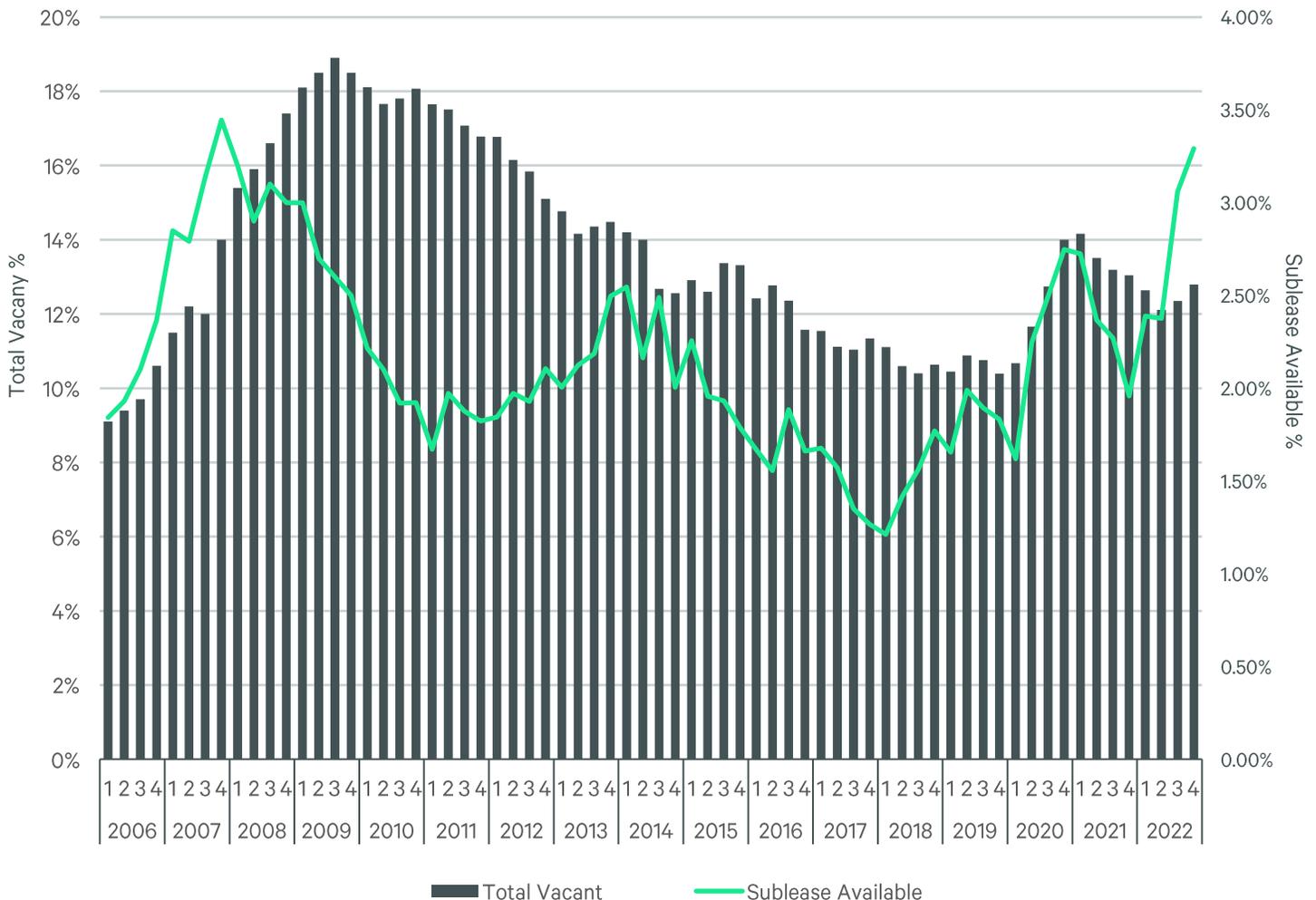
10%

Reduction of existing office inventory in Central San Diego

This is Not the Great Financial Crisis

Despite the sentiment by some that the U.S. is in a recession, real estate fundamentals in San Diego are notably stronger than during the Great Financial Crisis (GFC). In Q3 2009, San Diego's office vacancy rate peaked at 18.9%. In Q4 2022, countywide vacancies came in at 12.8%, still over 100 bps below the pandemic-era peak, recorded in Q1 2021, of 14.2%. Sublease availability in Q4 2022 was 3.3%, just below the peak we saw at the end of 2007 of 3.4%. Although an uptick in sublease space was followed by an increase in vacancy during the GFC, San Diego's strong fundamentals and shrinking office inventory due to conversion for adaptive re-use is likely to offset any uptick in vacant space.

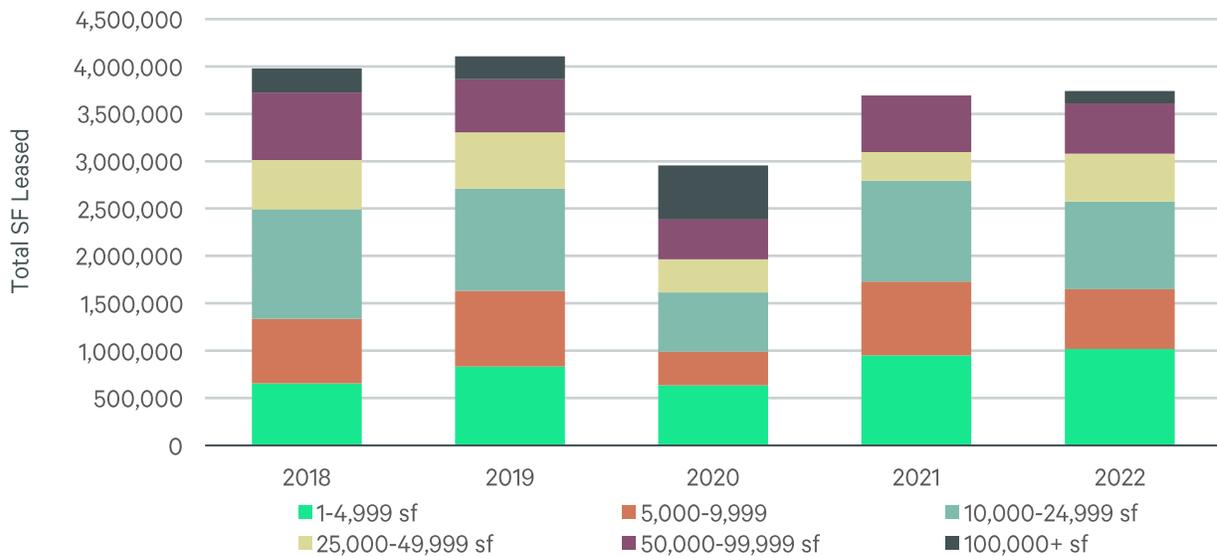
FIGURE 3: Historic Vacancy & Sublease Available Percent



Smaller Tenant Leasing Activity Unimpacted by Post-Pandemic Workplace Trends

An analysis of over 2,550 active leases signed over the past five years found that roughly 20% of leases were smaller than 5,000 sq. ft., and nearly 38% of leases were for less than 10,000 sq. ft. While some larger tenants who may have over-leased are right sizing their footprints through subleasing or downsizing, smaller tenants have largely been unaffected by the pandemic’s shift to working from home. Moreover, smaller tenants have become a larger portion of overall leasing activity coming out of the pandemic, representing 26% of leases in 2021 and 27% of leases in 2022, compared to 21.5% of leases in 2019.

FIGURE 4: Office Leases Signed by Size of Space



The Takeaway

San Diego’s office market is uniquely positioned to weather any change in office usage as work from home becomes a more permanent component of workplace trends. Life science conversions and significant leasing activity from Big Tech companies have continued to tighten the market by eliminating options for big blocks of space, while the traditional, smaller sized tenant mix in San Diego has been relatively unimpacted by working from home. Although sublease inventory has grown over the past few quarters, sublease availability and the vacating of space as a percent of total inventory has been relatively small compared to other major West Coast markets.

Appendix

Table 1: West Coast Data Comparison (All Classes)

Market	Inventory	All Classes				
		Q4 Total Vacancy	YTD Net Abs	Q4 Sublease Avail SF	Net Abs % of Inventory	Sublease Avail % of Inventory
Seattle (Downtown)	54,553,167	17.1%	(1,783,898)	3,534,706	-3.3%	6.5%
Eastside (Puget Sound)	34,253,508	10.8%	392,170	1,596,816	1.1%	4.7%
Puget Sound (1)	88,806,675	17.9%	(1,391,728)	5,131,522	-1.6%	5.8%
San Fransico	86,902,388	27.6%	(4,338,346)	8,907,302	-5.0%	10.2%
Oakland	30,380,133	18.6%	(380,106)	1,465,395	-1.3%	4.8%
SF Peninsula	41,420,643	14.1%	(544,793)	2,194,299	-1.3%	5.3%
Silicon Valley	103,468,705	14.1%	1,194,962	4,090,785	1.2%	4.0%
Greater Los Angeles (2)	220,505,659	17.3%	(592,230)	9,653,313	-0.3%	4.4%
Orange County	105,413,328	12.4%	224,296	4,200,239	0.2%	4.0%
Central San Diego	45,858,053	11.4%	(60,402)	1,953,631	-0.1%	4.3%
San Diego	77,750,001	12.8%	(206,855)	2,558,879	-0.3%	3.3%
Average		15.8%	(680,630)	4,116,990	-1.0%	5.2%

Table 2: West Coast Data Comparison (Class A Only)

Market	Inventory	Class A Only				
		Q4 Total Vacancy	YTD Net Abs	Q4 Sublease Avail SF	Net Abs % of Inventory	Sublease Avail % of Inventory
Seattle (Downtown)	41,308,743	20.2%	(976,495)	2,638,095	-2.4%	6.4%
Eastside (Puget Sound)	25,386,931	9.9%	444,637	1,462,954	1.8%	5.8%
Puget Sound (1)	66,695,674	16.2%	(531,858)	4,101,049	-0.8%	6.1%
San Fransico	58,526,015	25.0%	(2,811,458)	6,130,679	-4.8%	10.5%
Oakland	13,126,753	21.4%	(197,678)	1,016,270	-1.5%	7.7%
SF Peninsula	24,511,859	13.9%	(233,309)	1,795,013	-1.0%	7.3%
Silicon Valley	71,406,463	14.4%	1,942,051	3,488,013	2.7%	4.9%
Greater Los Angeles (2)	158,609,542	18.7%	(819,317)	8,174,246	-0.5%	5.2%
Orange County	51,952,981	14.9%	766,958	2,581,131	1.5%	5.0%
Central San Diego	19,726,359	12.4%	97,560	1,370,142	0.5%	6.9%
San Diego	31,844,108	15.3%	75,074	1,601,118	0.2%	5.0%
Average		16.6%	(203,985)	3,123,519	-0.4%	6.4%

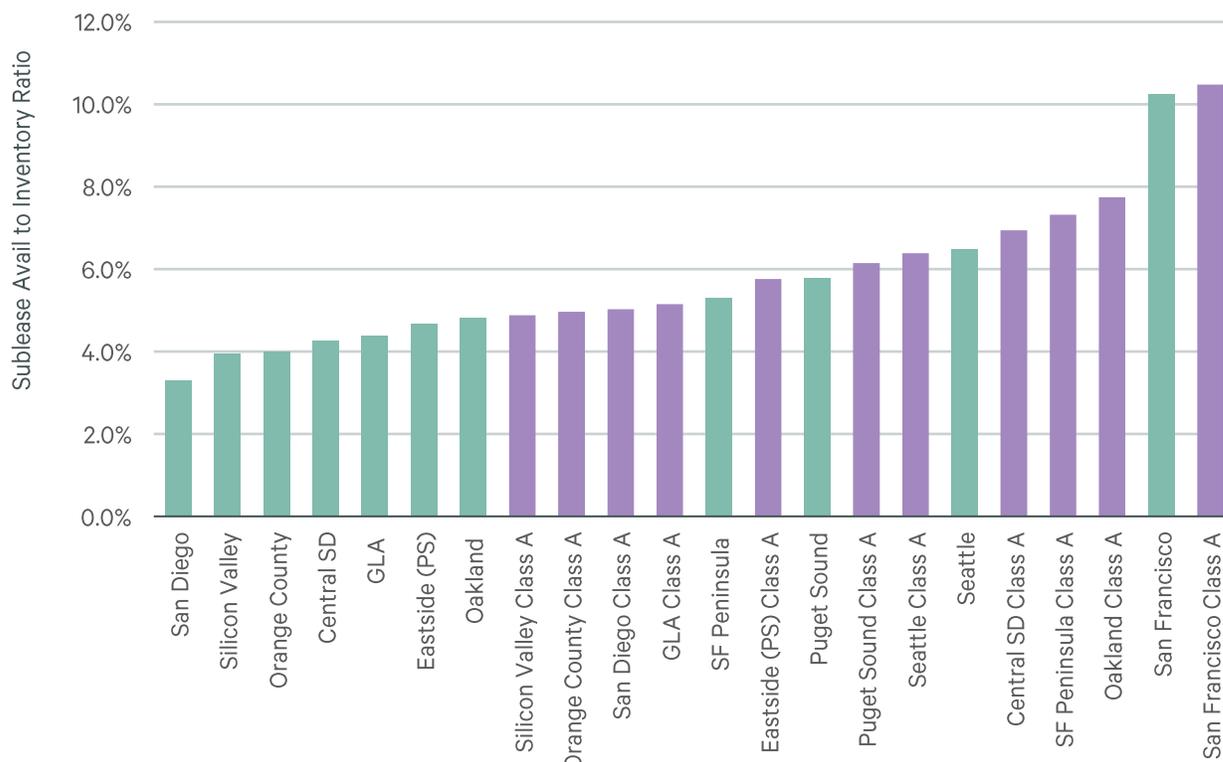
(1) Downtown Seattle & Eastside Only

(2) Los Angeles County Only

Table 3: West Coast Markets Ranked by Total Vacancy Rate

Market	All Classes Q4 Total Vacancy	Class A Q4 Total Vacancy
Eastside (Puget Sound)	10.8%	9.9%
Central San Diego	11.4%	12.4%
Orange County	12.4%	14.9%
San Diego	12.8%	15.3%
SF Peninsula	14.1%	13.9%
Silicon Valley	14.1%	14.4%
Seattle (Downtown)	17.1%	20.2%
Greater Los Angeles (2)	17.3%	18.7%
Puget Sound (1)	17.9%	16.2%
Oakland	18.6%	21.4%
San Fransico	27.6%	25.0%
Average	15.8%	16.6%

Figure 1: West Coast Data Comparison (All Classes)





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