
3Q23

Orange County Office Market Overview



NEWMARK

Market Observations

Economy

- Local unemployment increased for the fourth consecutive month, reaching 3.9% in August. This is slightly higher than the U.S. average of 3.8%.
- Local office-using employment totals 478,500 jobs, a record high. Strong white-collar employment historically fosters healthy demand for office space, but not so in a post-COVID-19 world: Hybrid work models are leading to space reductions.
- A still-high interest rate environment, paired with ongoing slowing in the general economy, also continues to weigh on most businesses. Reducing costs is the focus for most tenants.
- Leasing activity will be subdued in the quarters ahead.

Major Transactions

- This quarter's largest lease was Boot Barn's sublease at 17100 Laguna Canyon Road, an Irvine Company property from the Spectrum Terrace development. The sublessors were Kajabi and Alteryx.
- In one of the largest office sales the market has seen in two years, MGR Real Estate acquired Canvas in Costa Mesa for \$92.5 million. The property was 62% occupied at the time of sale and sold at a 30% discount, when factoring in the prior sale of the property and renovation work since from the seller.
- Yet another office property is slated for a multifamily conversion after Watermarke Properties acquired Hutton Centre in Santa Ana. The apartment investor purchased the two office buildings for \$36.3 million, a 31% discount to its prior sale in 2017. Last quarter, the same buyer acquired an office building in Orange to convert to housing.

Leasing Market Fundamentals

- Quarterly net absorption was positive (79,994 SF) after Anduril's occupancy of its R&D extension at The Press (190,000 SF) was levied against move-outs throughout the market. Year-to-date net absorption is negative 1.2 MSF.
- Nothing is presently under construction in the market for the first time since the Global Financial Crisis in 2008.
- 35% of Orange County's office inventory consists of buildings with sub-80% occupancy. Buildings with lower occupancy thresholds tend to struggle to generate positive NOI, which, in turn, makes it difficult to support debt (assuming debt is present on a given building).

Outlook

- Only 12% of aspiring Orange County home buyers can afford a median-priced home (currently \$1.25 million). Tearing down or converting a portion of the metro's surplus office inventory to apartments makes sense, in cases where the numbers pencil out.
- Leasing brokers will closely evaluate the debt situation of a given building before touring a client. This is especially true for properties with low occupancy averages and a CMBS loan coming due; a CMBS loan default usually triggers immediate transfer to a special servicer. It is harder to transact (e.g., get T.I. dollars) in such instances.
- Tenants in the market generally fall into one of two camps: 1) those wishing to retain an office presence at the lowest possible rental rate and 2) those seeking trophy-grade space in amenity-rich areas, as they reduce footprints. The latter grouping is using top-shelf space to lure workers back to the office.

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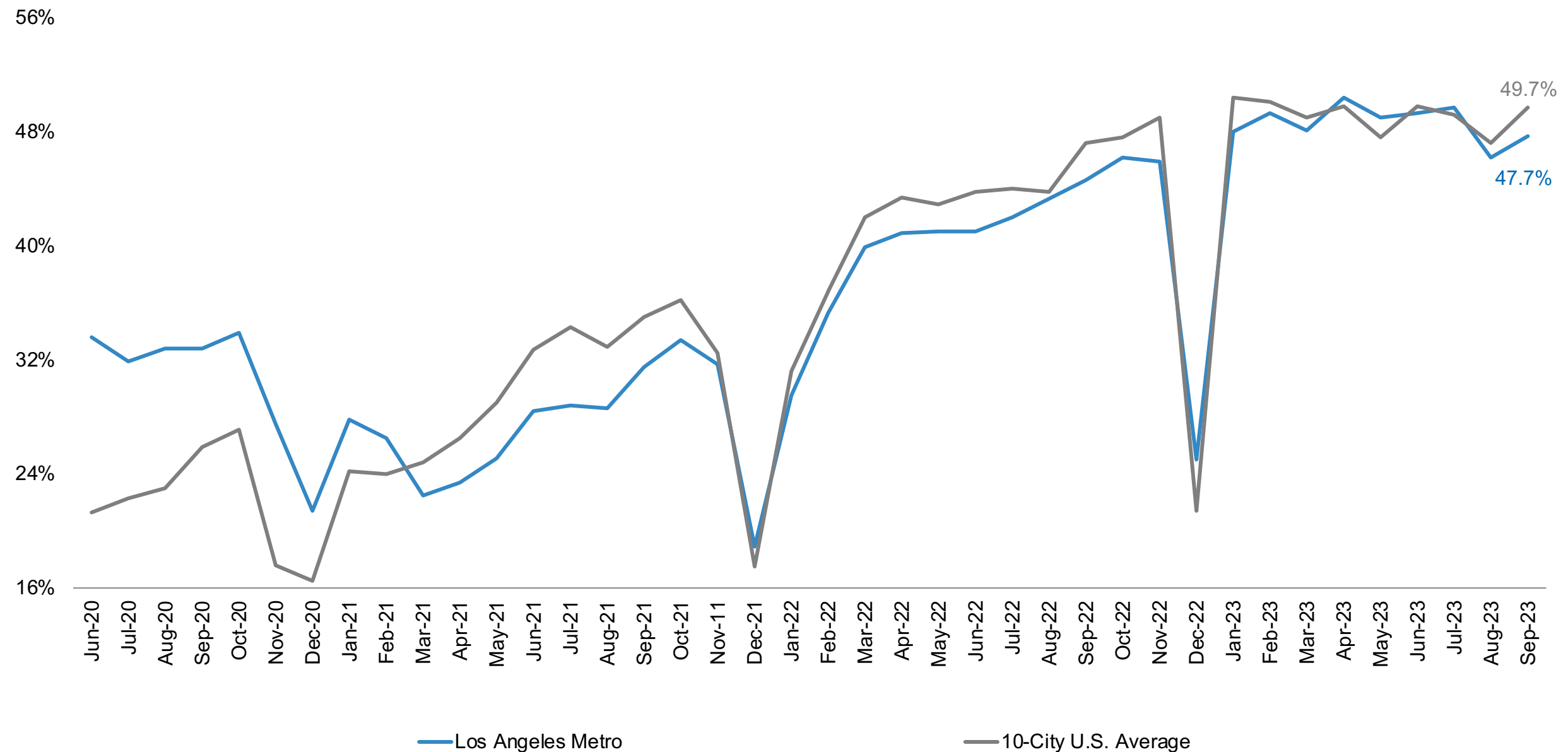
Economy



Local Office Utilization is Up since 2020, but Remains Sub-50%

The winter holidays aside, local utilization has generally hovered in the upper 40s since September 2022 as most companies continue to rely on hybrid work schedules. The labor market is generally healthy, and most companies are not strictly enforcing work-from-office expectations. Some tech and media companies – with notable layoffs in recent months – are less lenient.

Los Angeles Metro Office Utilization Rates | Kastle Systems Return to Work Data Based on Key FOB Swipes

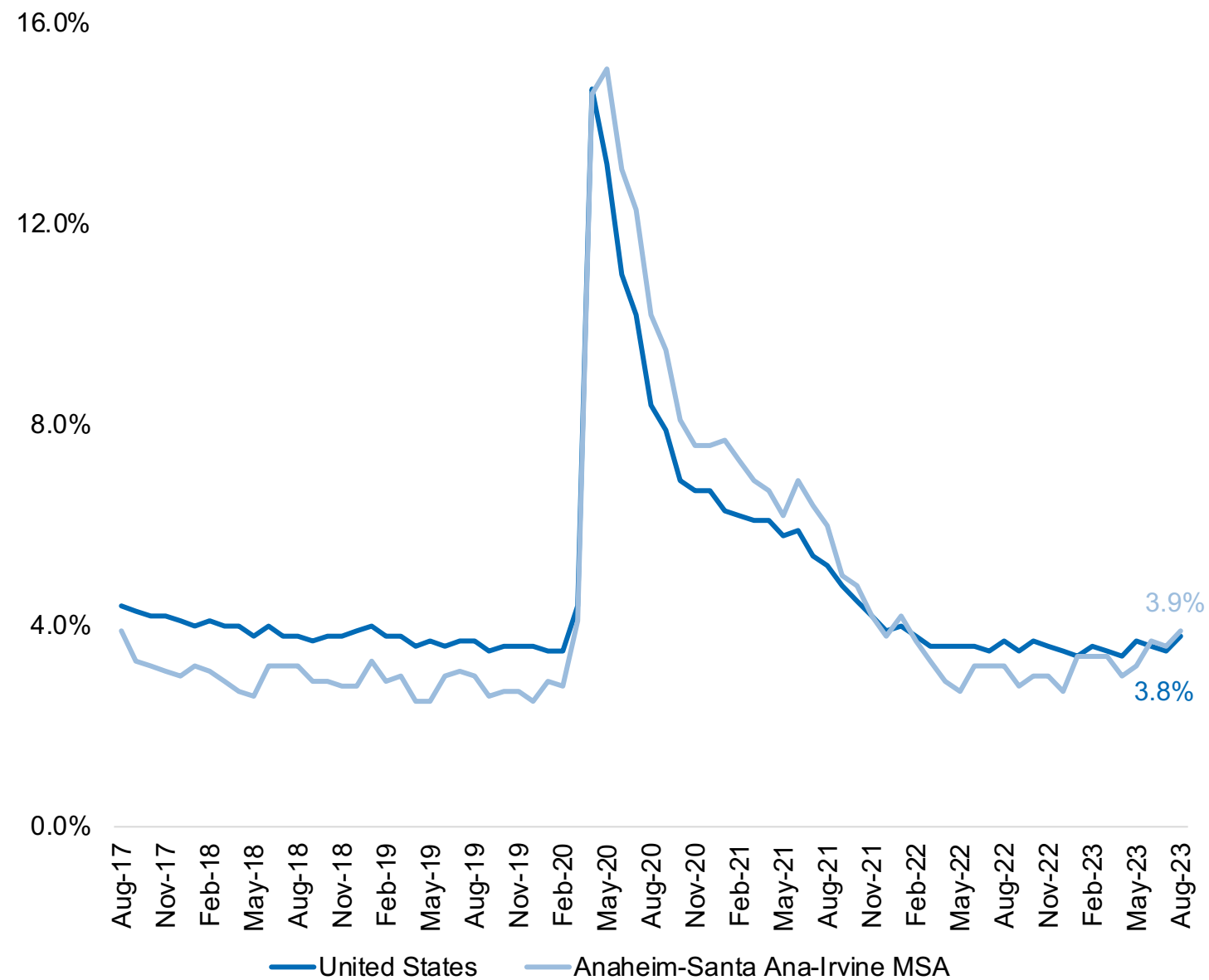


Source: Newmark Research, Kastle Systems (Each month's percentage reflects the average of its final week).

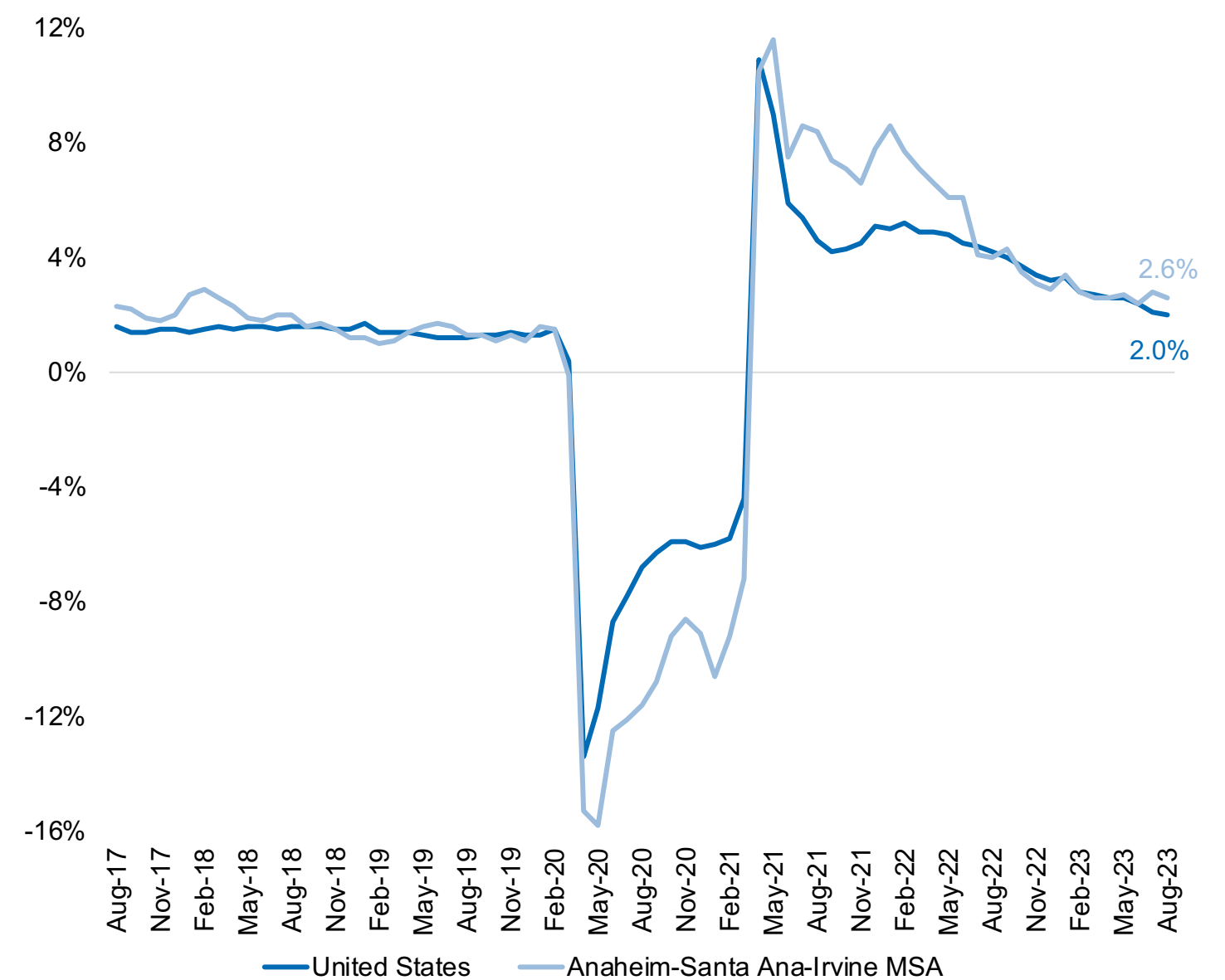
Local Unemployment Overtakes National Average

Orange County unemployment has been steadily increasing over the last four months, going from 3.0% in April to 3.9% in August. The growth can be attributed to cooling in the economy and cost-cutting measures, such as hiring freezes, enacted by companies in a still-high interest rate environment.

Unemployment Rate, Seasonally Adjusted



Nonfarm Payroll Employment, Non-Seasonally Adjusted, 12-Month % Change

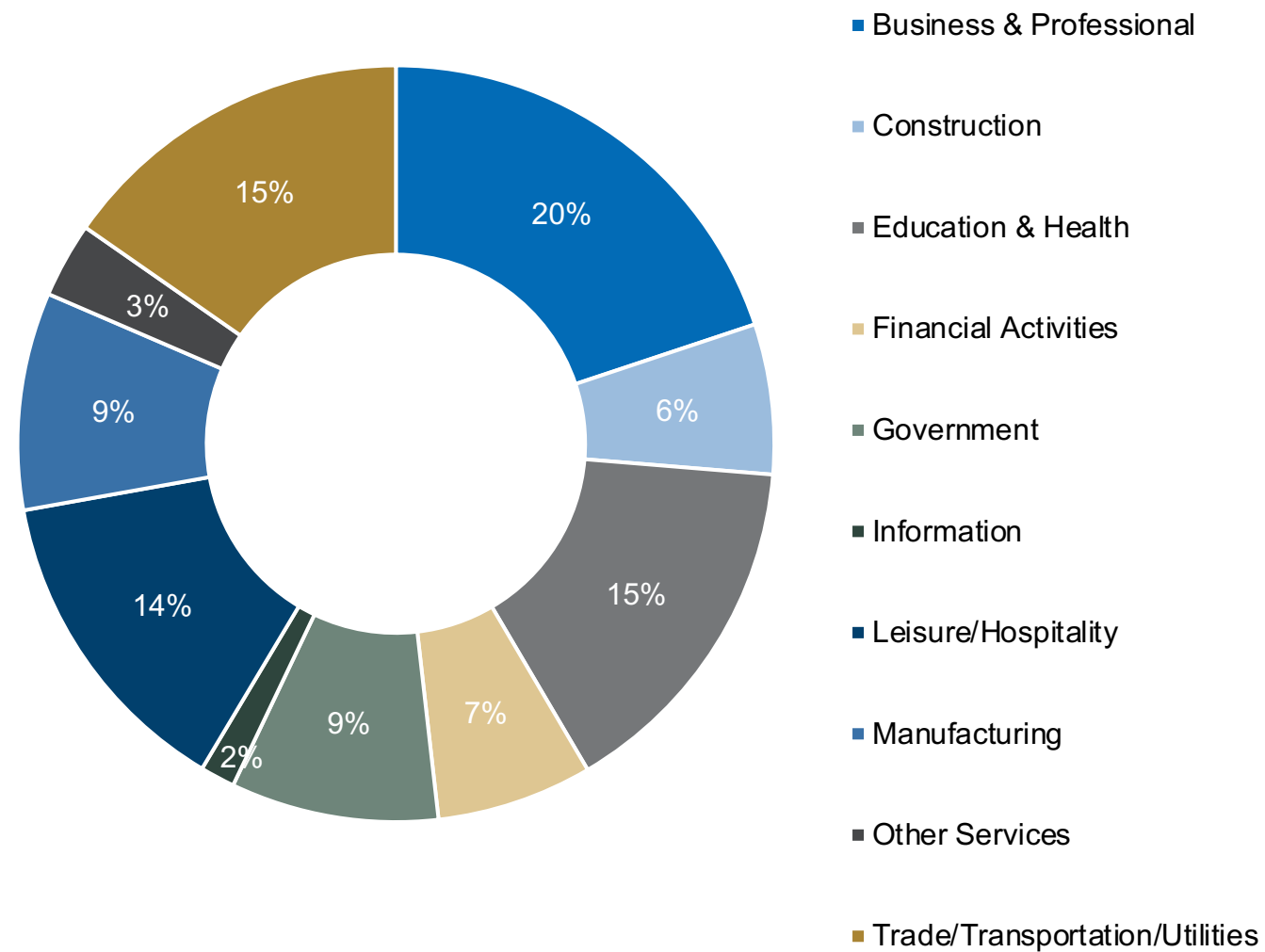


Source: U.S. Bureau of Labor Statistics, Anaheim-Santa Ana-Irvine, CA
 Note: August 2023 data is preliminary

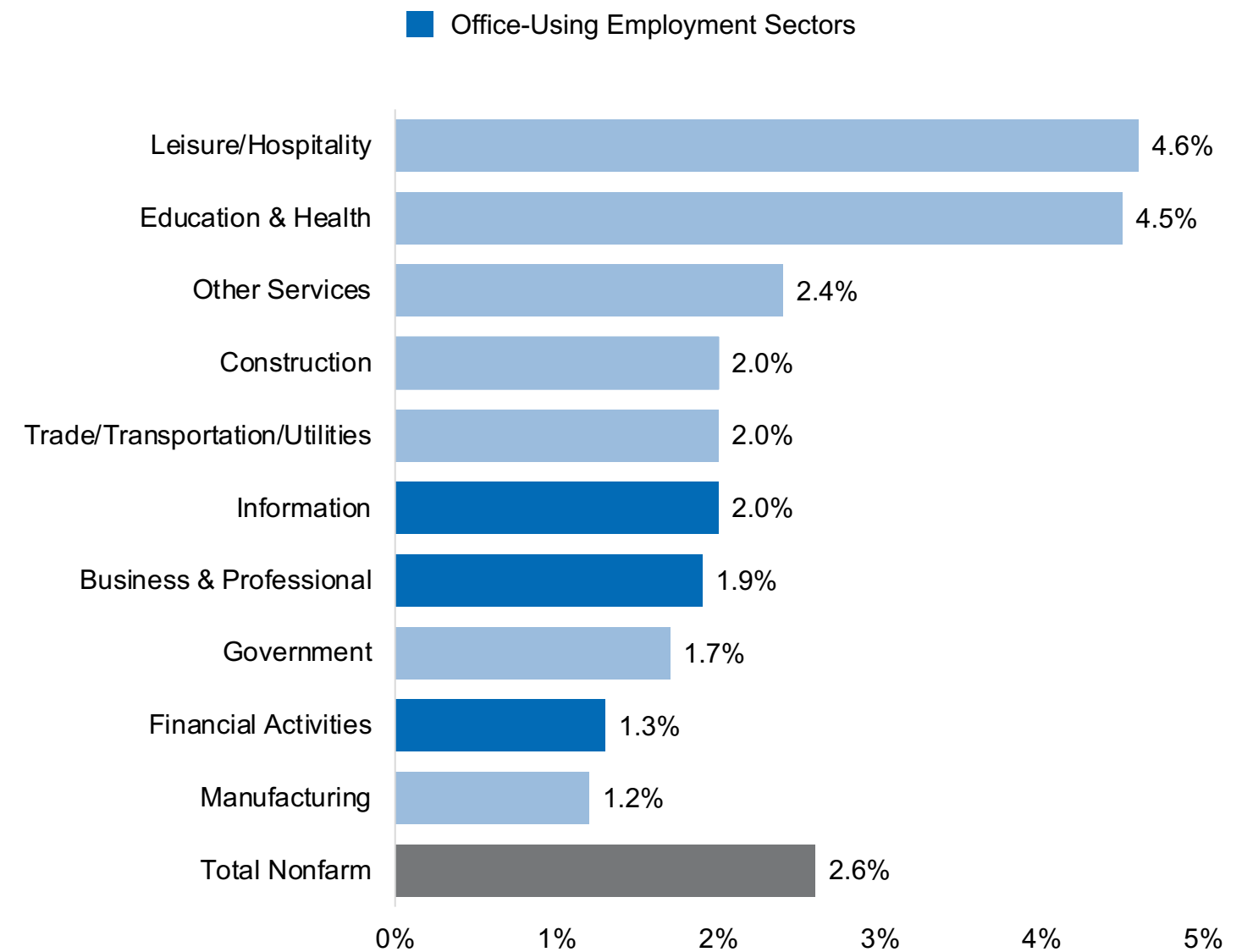
All Employment Industries Posted Job Gains

While this is favorable news it is worth noting that gains are decelerating. Business and professional jobs, for instance, grew by 1.9% from August 2022 to August 2023. Compare this to 3.7% growth from August 2021 to August 2022.

Employment by Industry, August 2023



Employment Growth by Industry, 12-Month % Change, August 2023

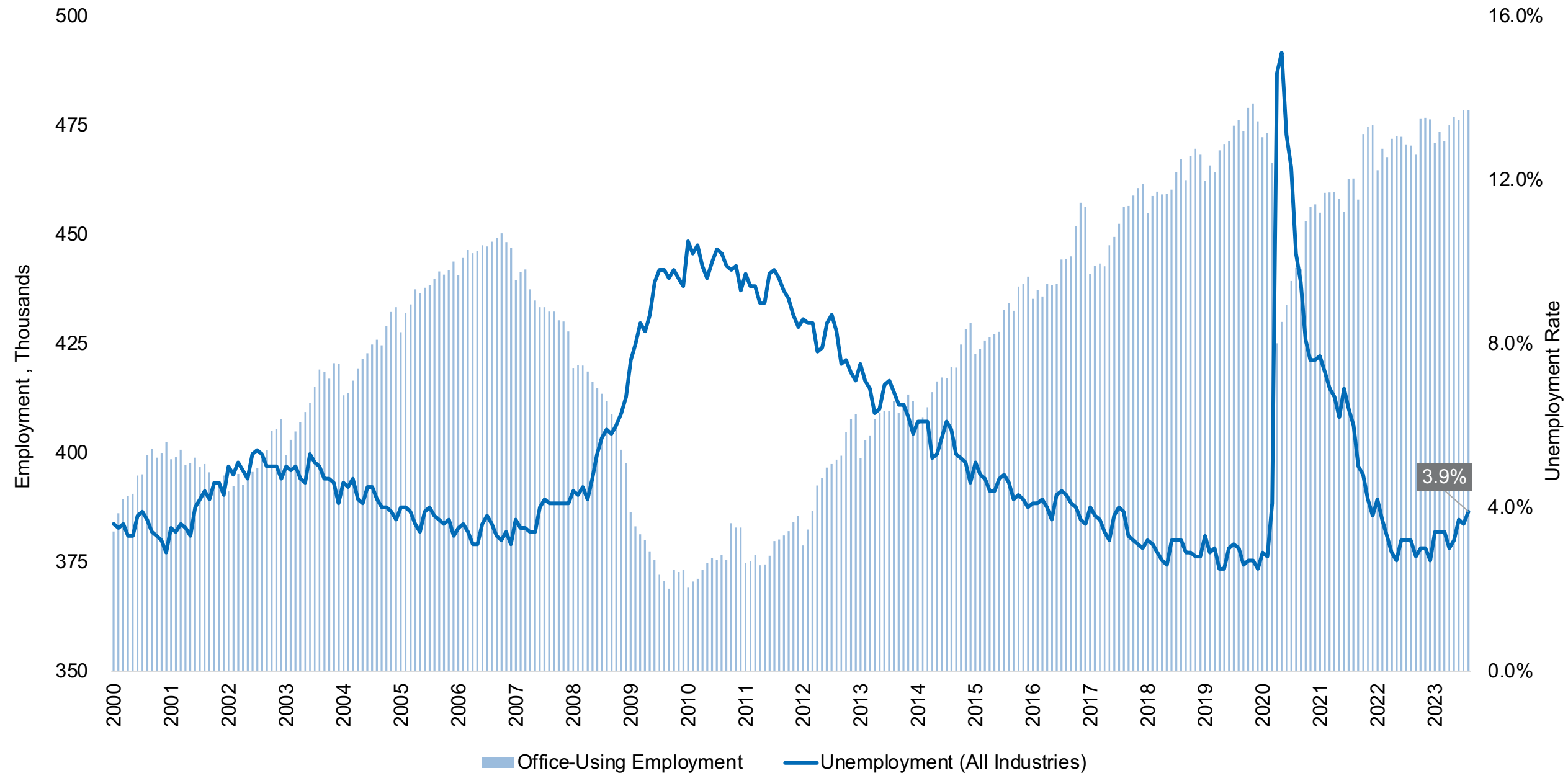


Source: U.S. Bureau of Labor Statistics, Anaheim-Santa Ana-Irvine, CA
 Note: August 2023 data is preliminary

Office-Using Employment Grows Despite Increase in Unemployment

Office-using employment experienced gradual growth since the beginning of this year, reaching its highest level since the onset of the pandemic. Future job growth is expected to remain modest as employers await softening market conditions.

Office-Using Employment* and Unemployment Across All Industries



Source: U.S. Bureau of Labor Statistics, Anaheim-Santa Ana-Irvine, CA

Note: August 2023 data is preliminary.

*Office-using employment includes employment in the following industry sectors: Professional & Business Services, Financial Activities and Information.

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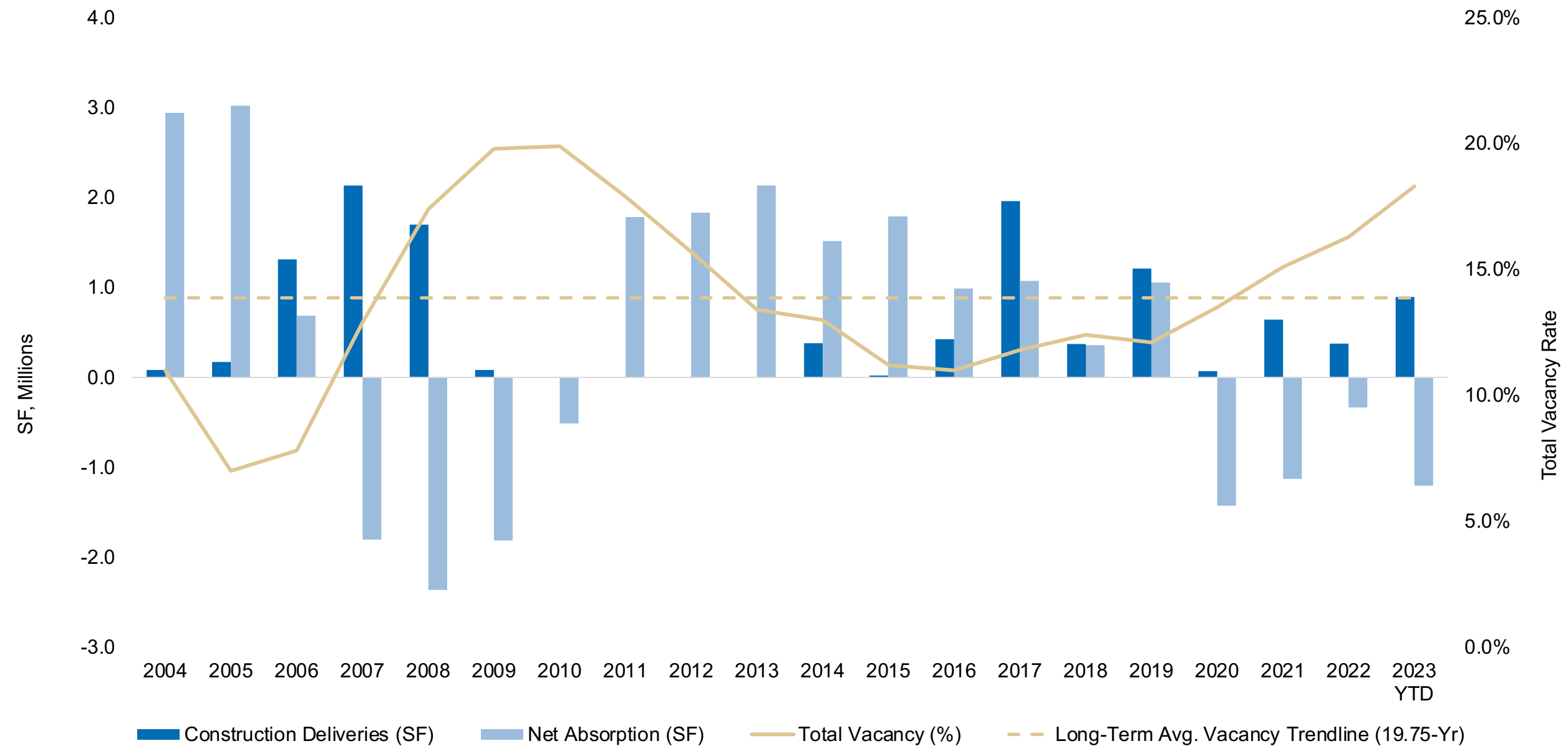
Leasing Market Fundamentals



Vacancy on the Rise

Total vacancy reached 18.3% this quarter, up from the 18.2% average from the second quarter of 2023. Tenants are either opting for smaller spaces at new, low-rise developments or seeking the most affordable option on the market. A growing vacancy rate and increased net absorption losses are expected over the next few quarters as the market navigates declining demand. It is very likely that vacancy will eventually top the Global Financial Crisis' peak average of 20.6%.

Historical Construction Deliveries, Net Absorption, and Vacancy

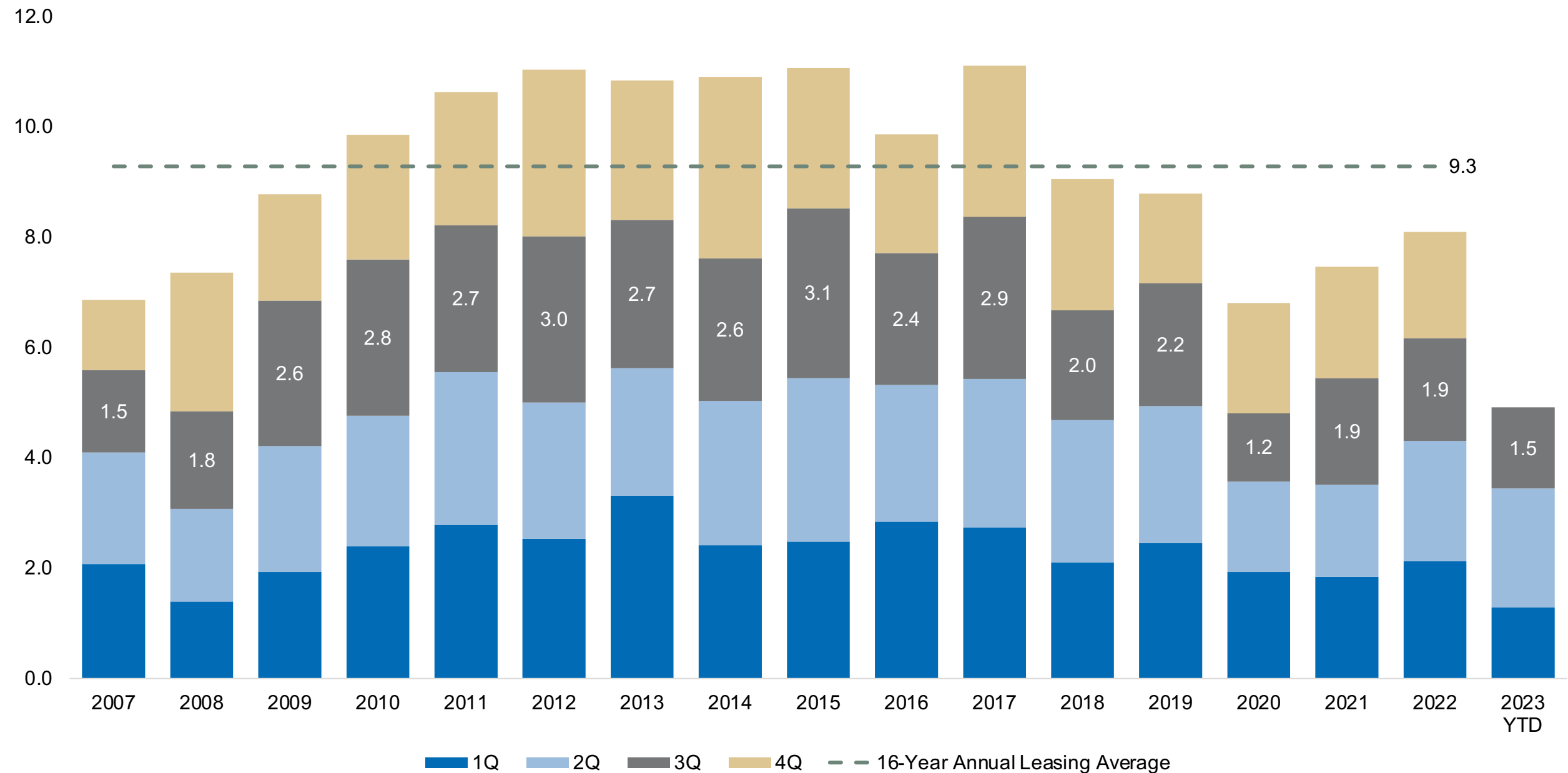


Source: Newmark Research

Year-to-Date Leasing Activity Falling Behind

Hybrid work models and a cloudy economic outlook are accelerating ongoing space reductions, while hampering overall leasing activity. Based on current momentum, leasing activity this year is expected to fall short of 2022's total.

Total Leasing Activity (MSF)



Source: Newmark Research, CoStar

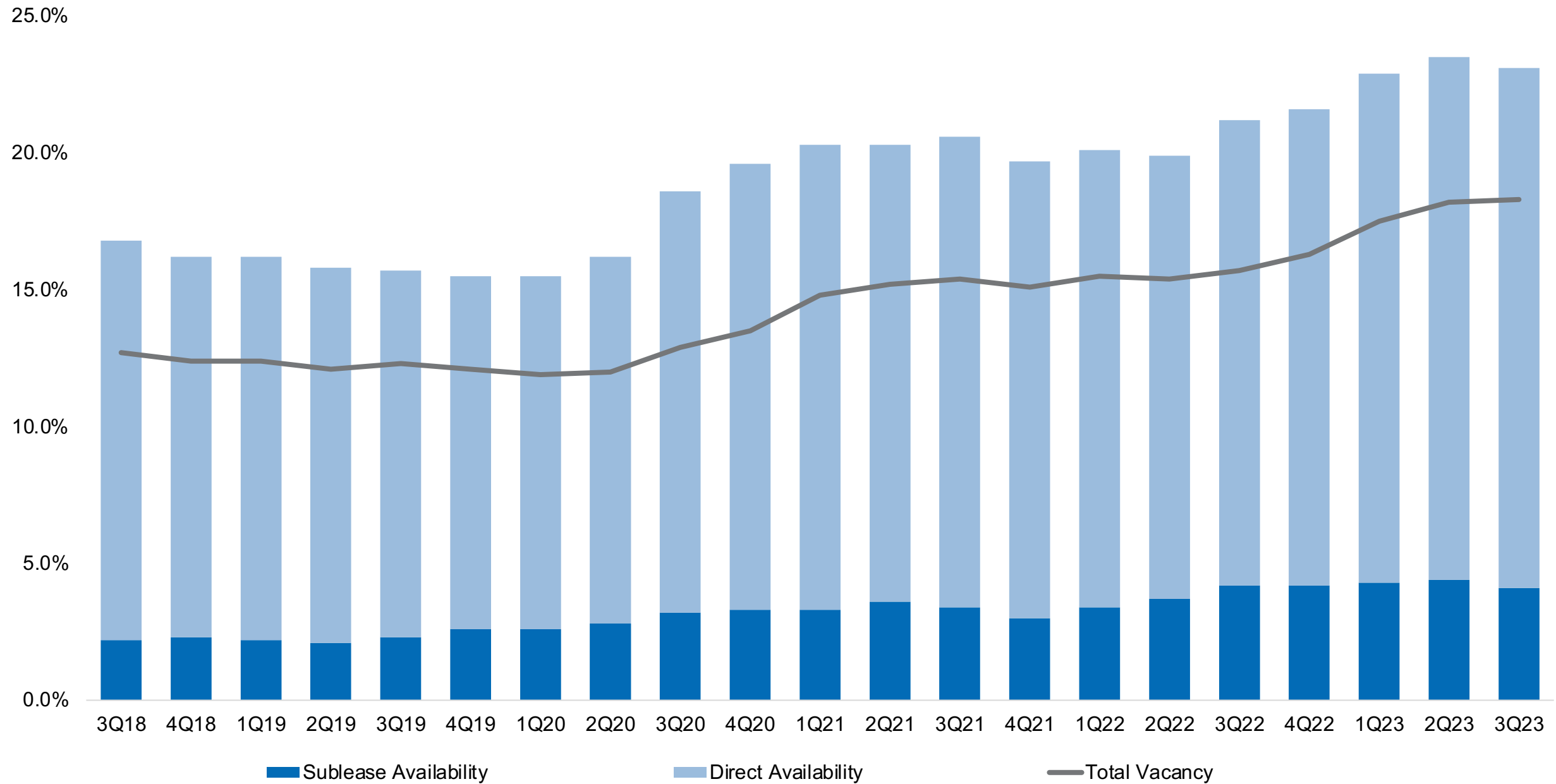
Decline In Leasing Activity Across All Submarkets

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Sublet Availability Softened Following Several Sublease Deals

Tenants seeking quality spaces at lower rents committed to a few subleases this quarter. This caused overall sublet availability to decrease to 2.0% of existing inventory, down from last quarter's average of 2.1%.

Available Space as Percent of Overall Market



Source: Newmark Research

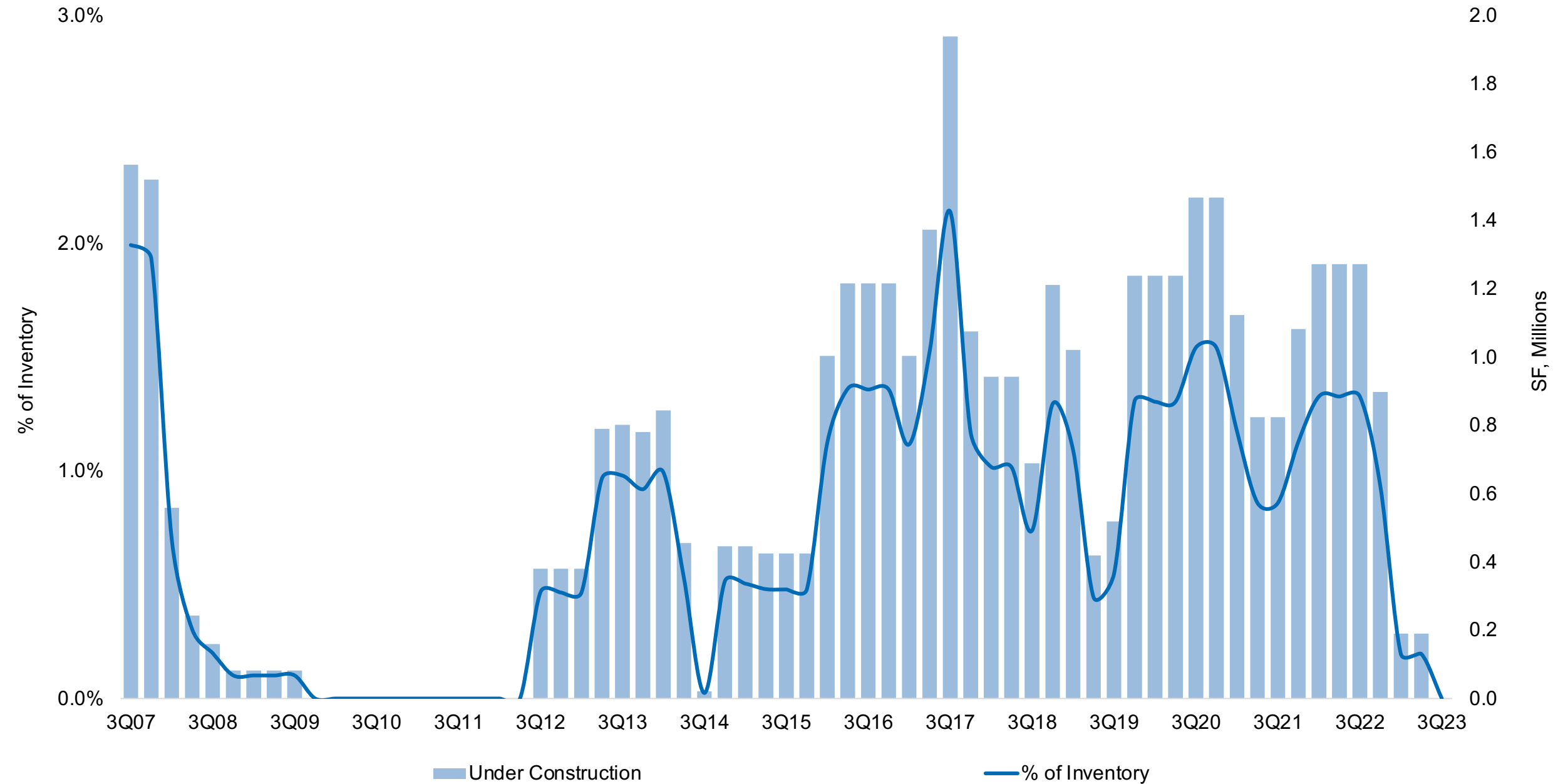
Airport Area has the Bulk of the Metro's Availability

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Nothing is Present Under Construction

Anduril's 190,000-SF expansion at The Press delivered this quarter, bringing under-construction activity to zero for the first time since 2010. It is unlikely a new speculative project will break ground over the next 12 months, based on current market dynamics.

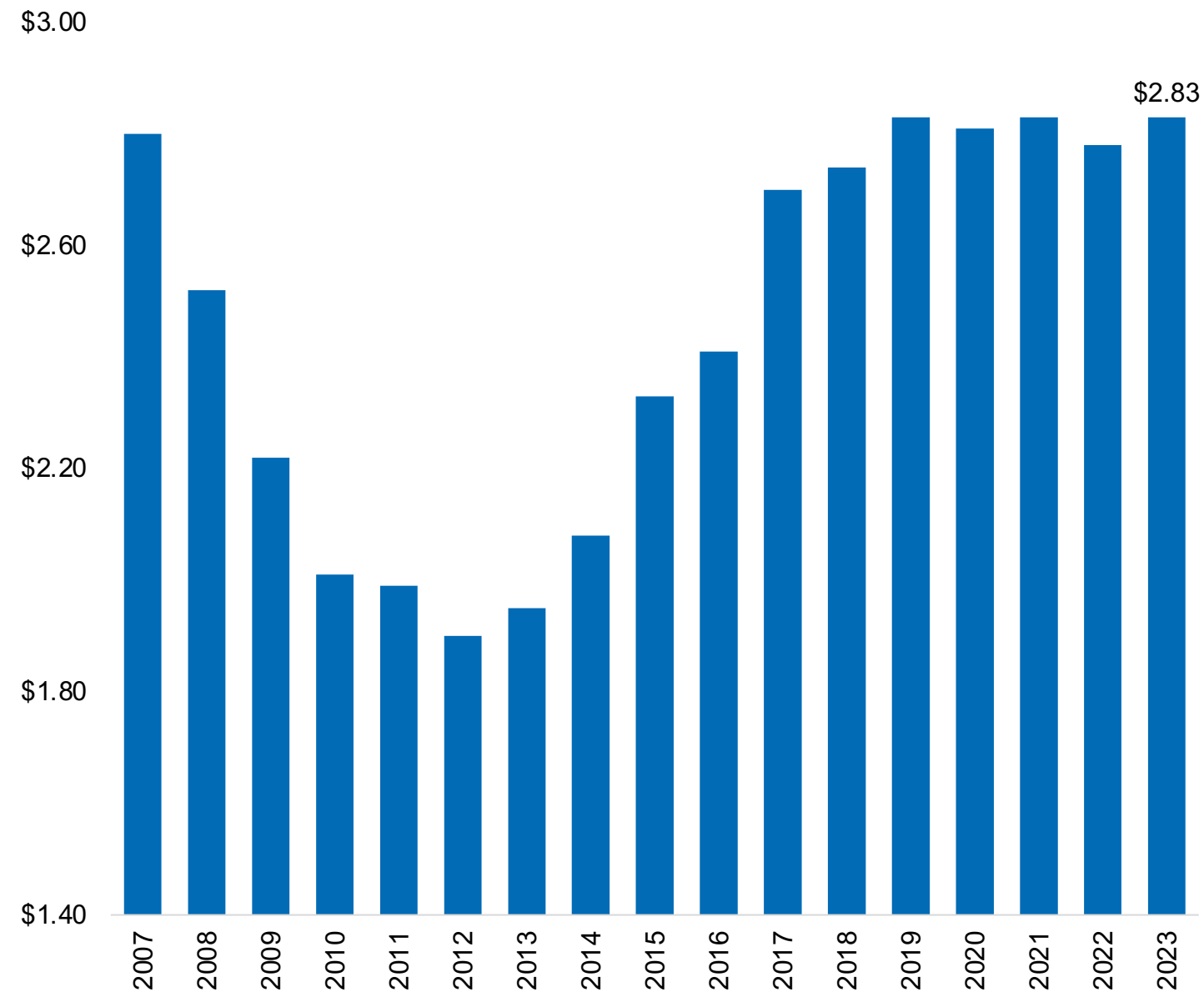
Office Under Construction and % of Inventory



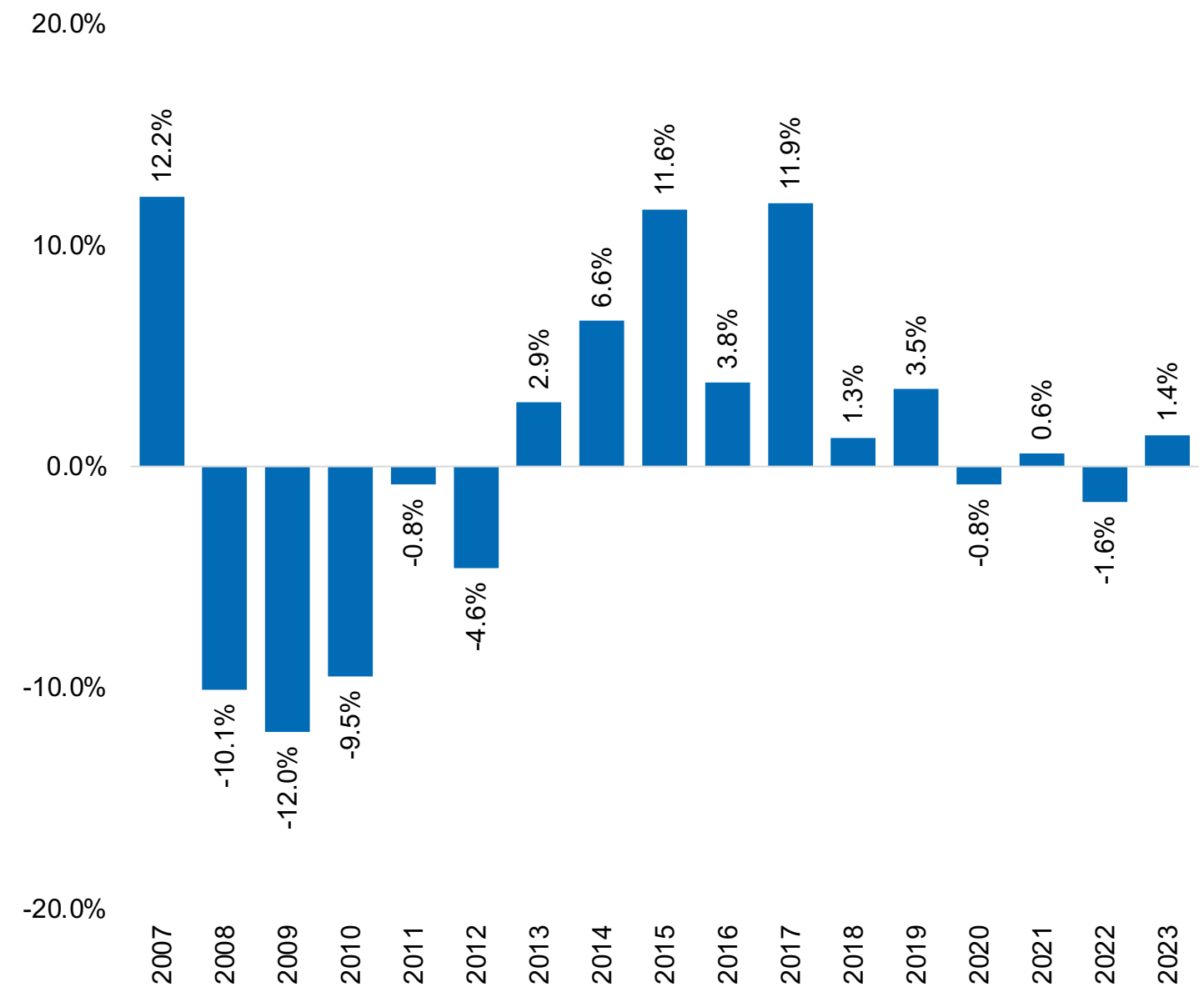
Asking Rents Hold Steady

Leasing activity may be subdued relative to recent quarters, but this has yet to impact average asking rents. Much of this can be traced to newer Class A listings presently on the market, in addition to inflation, which is keeping tenant improvement allowances elevated.

Office Average Asking Rent (\$/SF/Month, FS)



Year-over-Year Asking Rent Growth Rate



Source: Newmark Research

South County Rents Increase Following Delivery of Spectrum Terrace

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Major Sublease Deal in Irvine Spectrum Tops 3Q23's Leases

Notable 2Q23 Lease Transactions

Tenant	Building(s)	Submarket	Type	Square Feet
Boot Barn	17100 Laguna Canyon Road	South County	Sublease	116,261
<i>The new tenant subleased the entire Spectrum Terrace building from two previous occupiers- Kajabi and Alteryx.</i>				
Panasonic Avionics	3345 Michelson Drive	Airport	Expansion	25,911
<i>The in-flight entertainment systems developer relocated its corporate headquarters from Lake Forest to Irvine in 2020.</i>				
Ducommun	600 Anton Boulevard	Airport	Direct Lease	22,466
Kimball, Tirey & St. John LLP	2040 Main Street	Airport	Renewal	20,753
Me & My Big Ideas	6261 Katella Avenue	West County	Direct Lease	15,045

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Office-to-Residential Conversion and Distress



Home Ownership is Out of Reach for 88% of Buyers; Good News for the Rental Market

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35% of the Office Market Obsolete or Unable to Service Debt

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Some Underperforming Office Properties Will Find New Life

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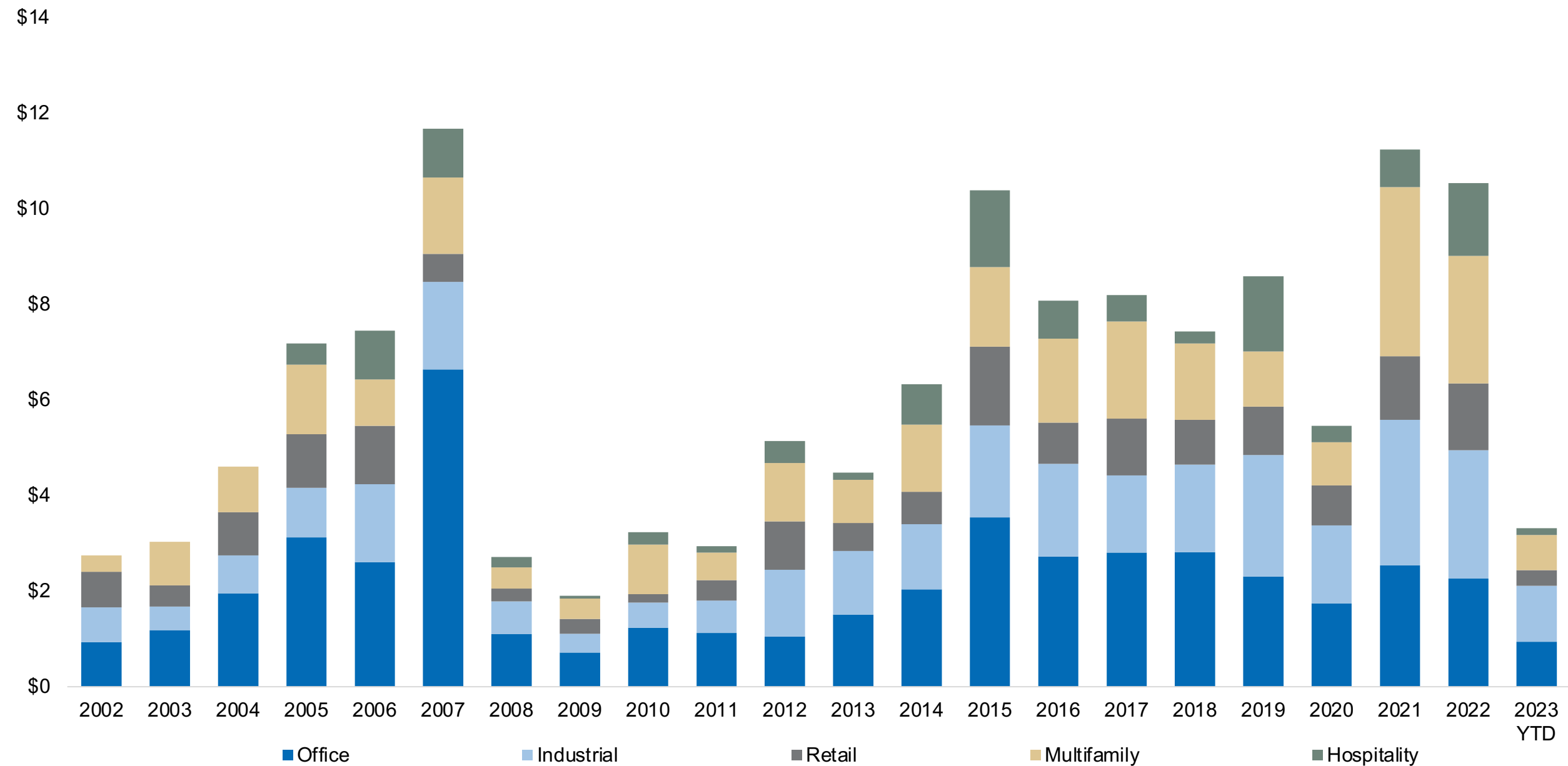
Sales Activity



Office Comprised 21.5% of Total Sales Volume in 2022

This is a noticeable decline from the 34.1% average in 2015. Structural shifts in leasing dynamics since the onset of COVID-19 remains an ongoing challenge for the property segment. This is in contrast to other asset classes, such as industrial and multifamily, which have experienced heated rent growth amid high demand in recent years.

Orange County: Sales Volume Across Commercial Property Segments (\$ in Billions)

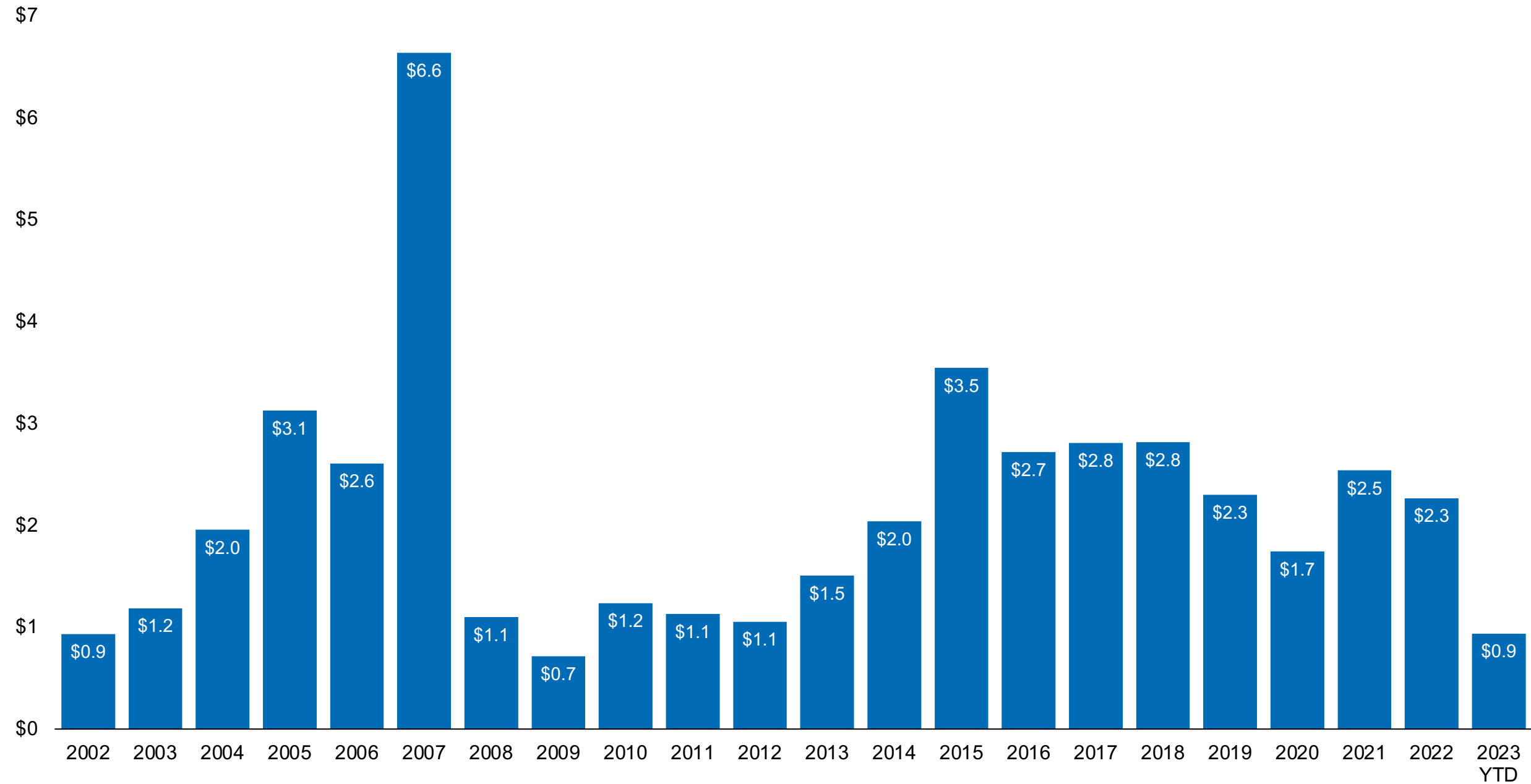


Source: MSCI Real Capital Analytics, Newmark Research
 Note: Preliminary data is cited for the third quarter of 2023.

Office Sales Volume: Up Close

Office sales volume totaled just \$936.8 million in the first nine months of 2023. Economic headwinds, concern regarding long-term adoption of hybrid work models, rising vacancy, looming debt maturities and a higher interest rate environment have most investors taking a wait-and-see approach to the asset class.

Orange County: Office Sales Volume (\$ in Billions)



Source: Newmark Research, MSCI Real Capital Analytics
Note: Preliminary data is cited for the third quarter of 2023.

Pricing is Decreasing, While Cap Rates Will Increase

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Office Trades: Private, Opportunistic Buyers Are Active; Institutions Less So

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Opportunistic Buyers Are Taking Advantage of Discounted Pricing

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Submarket Snapshots



Airport



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North County

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South County

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Orange County Office Submarket Map and High-level Statistics | 3Q23

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