Q2 OFFICE

market report

2023 | GALLELLI REAL ESTATE

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market overview

Market Report produced in collaboration with The Osborne Group | OSBORNE GROUP

Q2 23

△ **15.8%** Direct Vacancy Rate	▽ **(±406,415) SF** Net Absorption	▽ **$2.05** Average Asking Rate (FSG)

▽ **±56,000 SF** Under Construction	△ **3.9%** Sacramento Unemployment	△ **4.5%** California Unemployment	△ **3.6%** United States Unemployment

DARKEST BEFORE THE DAWN

As of 2023's midyear mark, office vacancy in the Sacramento region stood at 15.8%. This compares to a 15.3% reading three months ago and reflects the continued structural challenges posed to the market by the pandemic-fueled rise of remote and hybrid office work. Entering the final half of 2023, the market will continue to wrestle with those structural challenges. What is not entirely clear is the degree with which cyclical economic issues may come into play.

Since April of last year, economists have been debating whether the Federal Reserve could engineer a "soft landing" in its attempts to curb inflation, or whether a recession was simply a given. In August 2022, 72% of the members of the National Association of Business Economists (NABE) anticipated a recession by early 2023. By February of this year, 58% of NABE panelists were predicting that a downturn would still occur this year—but over the final half of the year. So far, the economy has proven to be far more resilient than expected. Both consumer spending and labor market performance have consistently defied forecasts and outperformed for more than half a year now.

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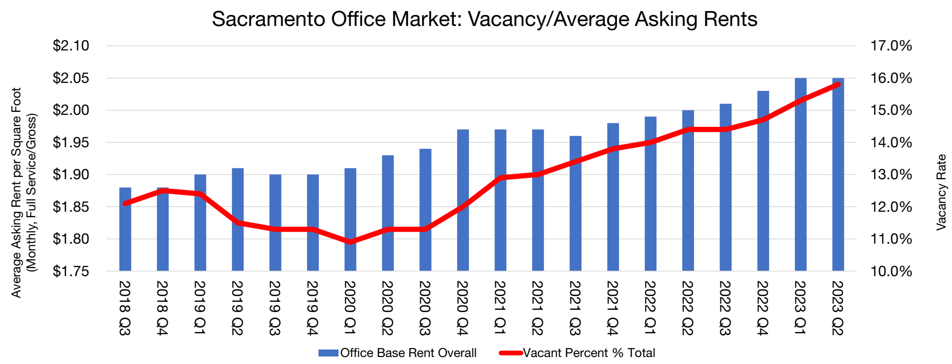
Sacramento Office Market
All Classes of Product
Q2 2023



Source: Gallelli Real Estate; Costar Group

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Sacramento Office Market
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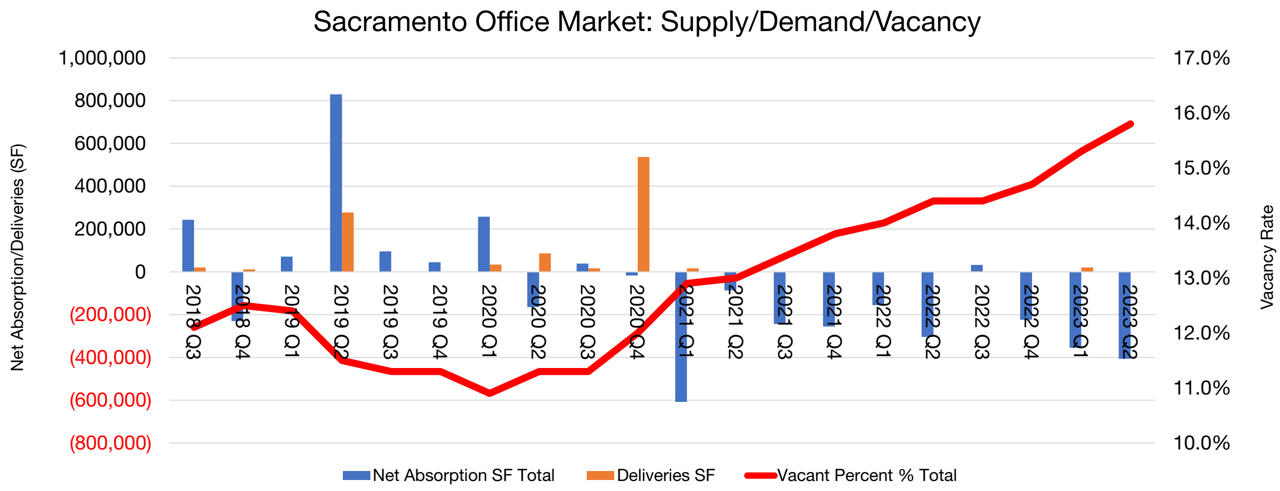

Source: Gallelli Real Estate; Costar Group

However, after two years of high inflation, consumer spending has finally been coming back to earth in recent months. Meanwhile, though a solid 209,000 jobs were created in June—this was the lowest level of employment growth the US has recorded since December 2020. While a "soft landing" scenario is still possible, most economists put the odds at greater than 50/50 that a recession is in the not-too-distant future (although most concur that if one happens, it will likely be brief and shallow).

The reality is there is a considerable lag time that occurs before the impact of interest rate hikes fully hits the economy. The Federal Reserve's current campaign to tame inflation is not just the most aggressive we have seen in 40 years; it is also the fastest—with the effective funds rate having been raised a full five percentage points in one year. We have not felt the full impacts yet—which raises the risk that the Fed will overdo it (assuming they return to rate hikes again) or that they may already have.

For the office market, the possibility of a "normal" cyclical event like a recession is particularly challenging now because the market is already dealing with structural issues. The good news for Sacramento area landlords is those structural issues have been significantly mitigated because the region's tenant base includes a strong presence from government and smaller, professional services firms—neither of which have been the primary drivers of remote/hybrid workspace givebacks. However, should the economy take a sudden turn for the worse over the next few months, more space consolidation and fewer active tenants in growth mode will be a given.

2023 THE LOW-WATER MARK OF CURRENT DOWN CYCLE

Overall vacancy within the Sacramento region currently stands at 15.8%. In Q2 2023 the market recorded negative net absorption to the tune of -406,000 square feet (SF). Year-to-date occupancy declines now stand at -761,000 and if this pace continues, the market will close 2023 with more than -1.5 million square feet (MSF) of negative net absorption. Our market statistics go back 25 years and the previous record year for occupancy declines was 2021 when 1.2 MSF of negative net absorption. Though the market is on track to set a dubious record this year, we also anticipate that this will prove to be the low-water mark of the current down cycle.

Since 2021, nearly 1.8 MSF of space has been returned to market—more than the amount of occupancy declines that occurred following the 2008 financial crisis when vacancy eventually peaked at 25.6% (Q4 2010). The key difference between then and now is that the market entered that crisis with vacancy already elevated (it stood at 16.7% in Q1 2018) and a robust development pipeline (1.7 MSF under construction). We entered this down cycle with a much healthier 10.9% vacancy rate and extraordinarily little speculative development in the pipeline. Currently, there is just 56,000 SF of new space under construction consisting of a build-to-suit and a medical condominium building—neither of which is anticipated to have a significant impact on vacancy rates. All of which means the market is still better situated for recovery than it was in 2010. The key question is when will this happen?

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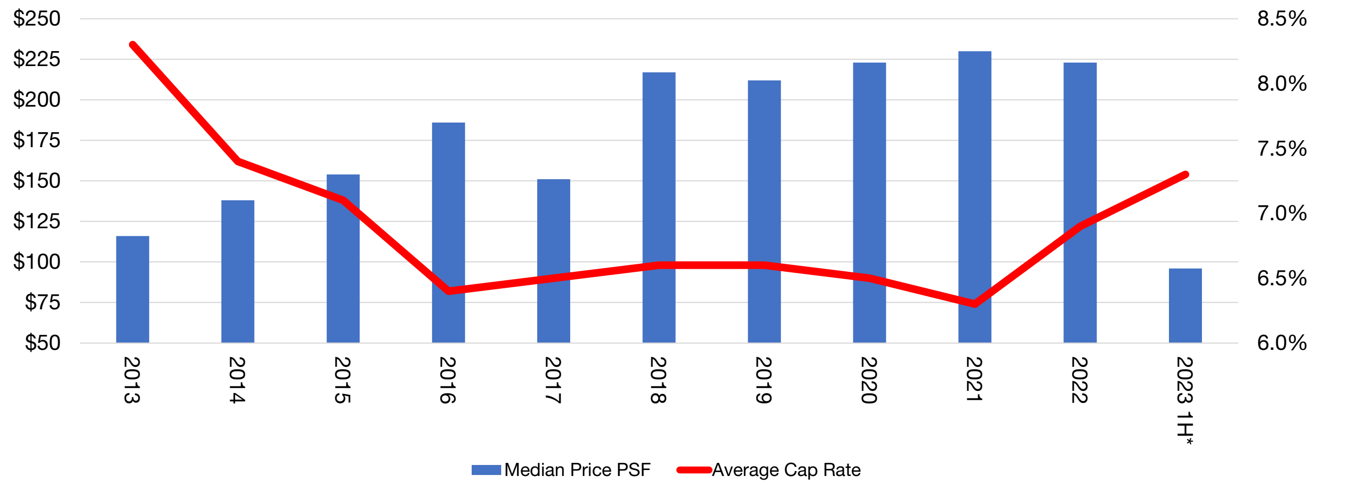
Sacramento Office Market
All Product Types
Q2 2023

Sacramento Office Market: Median Price PSF/Average Cap Rate



*The impact of interest rate hikes with uncertainty over leasing fundamentals has resulted in near record low levels of office investment activity in the first half of 2023. There have not been enough sale transactions to serve as truly reliable indicators.

Source: Gallelli Real Estate; Costar Group

THE FUTURE OF REMOTE AND HYBRID WORK

Our analysis indicates that 77% of the Fortune 100 now operate on a hybrid work schedule—the most common policy being a required three days per week in the office. Only 14% of Fortune 100 companies have declared that they do not require any office visits per week. The trend of fully remote work has already passed its peak.

Data analytics firm Morning Consult recently published its survey of 7,000 people for its annual "The State of Workers 2023" report. Their analysis indicated that the number of workers with 100% in office workweeks increased from 60% to 63% over the past year. The number of employees that reported being fully remote fell from 27% to 23%--with a mix of those workers shifting to hybrid or 100% in-person models. The most common reasons cited by those that prefer to work in-person were increased productivity, the desire to keep home and work life separate and a preference for in-person communication with coworkers. Despite stereotypes to the opposite, it is the youngest office workforce, Gen Z (ages 18 to 26) that has expressed the least enthusiasm for remote work. This makes perfect sense if you consider that people early in their careers have the most to gain from in-person work from mentoring to socialization, as opposed to older and more experienced coworkers that are more likely to be established both in their careers and in their social and family lives.

Other data sources also reflect the sharp ongoing decline in remote work. In March 2023, a Pew Research Center study found that 35% of workers with jobs that can be done remotely are currently working from home all the time—down from 43% last year. While this still compares to just 7% before the pandemic, it is important to note that employer backlash against remote work only continues to grow. The recently released 2023 Monster.com Work Watch Report found that 33% of employers that had planned to adopt a remote or hybrid model have changed their minds from a year ago.

More jarringly, Microsoft surveyed 20,000 professionals for their Work Trend Index Report last year and found that 85% of leaders say the short to hybrid work has made it challenging to have confidence that employees are being productive. Furthermore, 87% of remote and hybrid workers reported that they are productive, while only 12% of leaders believed this to be true. Productivity paranoia is real, whether it is justified or not. Though there is an immense body of research indicating that productivity paranoia is not justified, the greatest challenge to remote and hybrid work is the gravity of human psychology.

To be clear, we do not envision a future where the office work culture of 2019 returns. Hybrid and remote work simply are a greater part of the mix now. But the further the pandemic slips into our collective memory, the more organizations are going to pull back on their willingness to support those models.

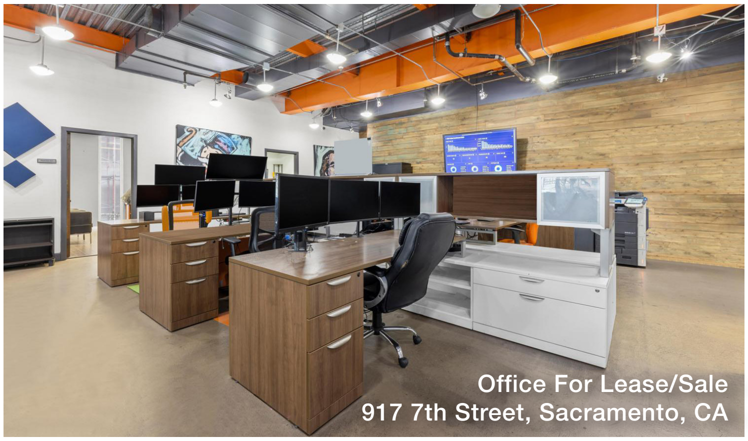
However, that movement will not be without blowback. In April, workplace design firm Unispace released the results of its global survey of 6,650 employers which found that 72% of them had mandated office returns. But here is the rub—of those firms that took a hardline stance, 42% reported a higher level of employee attrition than they had anticipated.

THE SPACE GIVEBACK PIPELINE IS EMPTYING

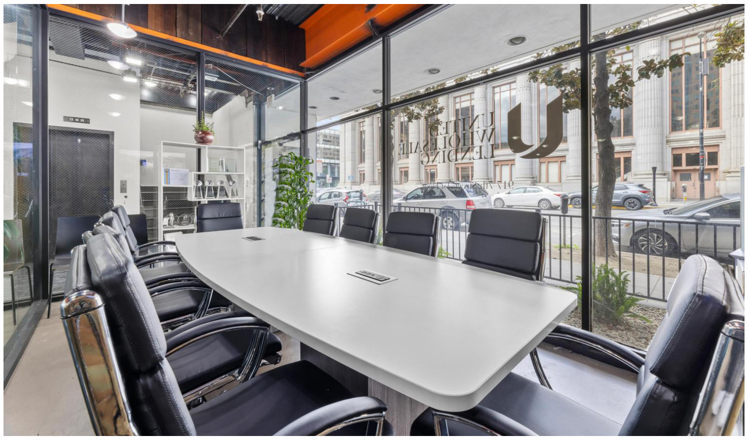
As challenging as the office leasing environment currently seems, there is cause for optimism ahead.

The current wave of tenant consolidation and space givebacks didn't truly begin until 2021. It came in two forms; increased sublease availability (typically from tenants with longer terms left on existing leases) and from tenants at the end of their lease terms that were able to downsize more easily.

First, let's look at sublease trends. There was 704,000 SF of sublease availability in Q1 2020 at the start of the pandemic. That number immediately began to climb. It peaked at 1.7 MSF last quarter and now stands at 1.6 MSF. Though successful leasing efforts accounted for half of this decline in Q2, most of it was due to sublease availability converting to direct availability as a would-be sublessor's lease term expired. It is far too soon to declare this decline in sublease availability as a trend—particularly since sublease availability usually ticks up during economic downturns. However, it is possible that sublease availability due to remote/hybrid downsizing has peaked.



Office For Lease/Sale
917 7th Street, Sacramento, CA



Where we have experienced the greatest number of space givebacks has been from tenants downsizing as their existing leases have expired. Our analysis of local lease transactions indicates that 36-month and 60-month deals account for just over half of all Sacramento region office leases. Terms longer than that account for only 20% of deals, while the rest are primarily less than five-year commitments. This means that most of the tenants that downsized in 2021 were those whose initial leases had been signed either in 2016 or 2018. Most of those that downsized in 2022 were doing so on leases initially signed in either 2017 or 2019, and so on.

Now that we are three years out from the pandemic, it means that any tenants with 36-month commitments before 2020, have now had the opportunity to renew or adjust based upon their post-pandemic realities. Tenants with 60-month commitments coming up on expirations over the final half of 2023 are those that initially inked deals in 2018. Those who signed five-year deals in 2019 will be coming up for renewal next year. What this means is that the number of local space users who have not made post-pandemic real estate decisions yet is dwindling. Though 2023 will likely set local records for space givebacks, the pipeline is emptying.

As for the question as to when to expect signs of recovery for the Sacramento office market? Assuming either a brief and shallow recession or a soft-landing scenario for the greater economy, we are looking at 2025.

Select Sacramento Region Office Leases 2023 Q2				
Address	Project Name	Submarket	SF Footage	Tenant
3830 Atherton Road	Atherton Tech Ctr.	Roseville/Rocklin	40,496	Confidential
980 9th Street	Park Tower	Downtown	15,911	CA Infrastructure & Econ. Dev. Bank
2721 Citrus Road	Stonewood Tech	Highway 50	14,679	Able Kids, Inc.
2180 Harvard Street	Harvard Square	Arden/Howe/Watt	11,368	Regus
1610 Arden Way	Point West Corporate Center	Arden/Howe/Watt	10,258	Autoaccident.com
3947 Lennane Way	Five Points	Natomas	9,520	Turning Point Programs
50 Iron Point Circle	Broadstone Business Center	Folsom	7,532	Iron Point Physical Therapy
1410 Rocky Ridge Drive	Opus Corporate Center	Roseville/Rocklin	6,683	Core Construction
100 Howe Avenue	University Park	Arden/Howe/Watt	6,380	Maternal Fetal Medicine
3200 Douglas Boulevard	Douglas Pointe	Roseville/Rocklin	6,262	Lo Duca & Avdis
2998 Douglas Boulevard	Roseville Corporate Center	Roseville/Rocklin	5,896	My Better Rate Mortgage
555 Capitol Mall	Plaza 555	Downtown	5,132	Blanning & Baker
2893 Sunrise Boulevard	Sunrise One Center	Highway 50	4,567	REV, Inc.
621 Capitol Mall	U.S. Bank Tower	Downtown	4,015	CohnReznick LLP
1180 Iron Point Road	Iron Point Business Park	Folsom	3,500	Staszak & Company
5 Sierra Gate Plaza	Sierragate Plaza	Roseville/Rocklin	3,327	John Adams Academies
500 Capitol Mall	Bank of the West Tower	Downtown	3,227	Delfino Madden
1760 Creekside Oaks	Creekside Oaks	Natomas	3,067	Sullivan & Assoc.
2150 River Plaza Drive	Gateway Oaks	Natomas	2,671	Hartman King
980 9th Street	Park Tower	Downtown	2,577	Telfer Law

OFFICE MARKET STATISTICS: *Criteria based on: 10,000 SF and above, does not include owner occupied, Existing, Under Construction, Proposed, Final Planning*

Submarket	Total Number of Buildings	Inventory	Vacant Space			Net Absorption		Current Avg Asking Rent PSF	Avg Asking Rent PSF One Year Ago	Average Asking Rent % Change Annually
			Vacancy SF	Vacancy %	Vacancy One Year Ago	Total Quarterly	Total Last Four Quarters			
Arden/Howe Watt										
Class A	8	874,770	186,854	21.4%	24.6%	35,270	28,117	$2.05	$2.14	(4.2%)
Class B	88	3,879,766	908,613	23.4%	20.8%	17,980	(100,794)	$1.82	$1.81	0.6%
Class C	97	2,682,910	366,656	13.7%	13.7%	7,159	1,934	$1.82	$1.78	2.2%
Total	**193**	**7,437,446**	**1,462,123**	**19.7%**	**18.3%**	**60,409**	**(70,743)**	**$1.85**	**$1.86**	**(0.5%)**
Auburn/Lincoln										
Class A	-	-	-	-	-	-	-	-	-	-
Class B	21	408,275	16,877	4.1%	4.6%	(336)	1,716	$1.79	$1.70	5.3%
Class C	26	479,711	39,464	8.2%	6.8%	(4,000)	(6,890)	$1.47	$1.41	4.3%
Total	**47**	**887,986**	**56,341**	**6.3%**	**5.8%**	**(4,336)**	**(5,174)**	**$1.54**	**$1.55**	**(0.6%)**
Downtown Sacramento										
Class A	21	5,664,853	1,057,008	18.7%	15.2%	(92,155)	(193,896)	$3.39	$3.38	0.3%
Class B	63	3,958,024	791,501	20.0%	18.2%	16,232	(70,975)	$2.75	$2.77	(0.7%)
Class C	85	2,534,140	185,065	7.3%	7.3%	(21,693)	(1,169)	$2.23	$2.15	3.7%
Total	**169**	**12,157,017**	**2,033,574**	**16.7%**	**14.5%**	**(97,616)**	**(266,040)**	**$3.03**	**$2.91**	**4.1%**
El Dorado Hills										
Class A	1	67,300	19,749	29.3%	7.2%	-	(14,937)	$2.00	$1.77	13.0%
Class B	32	824,829	87,095	10.6%	15.4%	1,177	40,339	$2.05	$1.81	13.3%
Class C	25	454,106	31,421	6.9%	6.2%	(5,654)	(3,259)	$1.43	$1.43	-
Total	**58**	**1,346,235**	**138,265**	**10.3%**	**11.9%**	**(4,477)**	**22,143**	**$1.94**	**$1.78**	**9.0%**
Elk Grove/South Sacramento										
Class A	6	481,431	200	-	1.4%	5,010	6,305	$2.39	$2.52	(5.2%)
Class B	70	2,143,584	133,956	6.2%	7.3%	27,193	22,430	$2.21	$2.24	(1.3%)
Class C	48	1,115,495	41,325	3.7%	3.7%	(7,893)	417	$1.40	$1.78	(4.1%)
Total	**124**	**3,740,510**	**175,481**	**4.7%**	**5.5%**	**24,310**	**29,152**	**$1.97**	**$1.46**	**(1.5%)**
Folsom										
Class A	10	856,476	99,297	11.6%	10.0%	24,095	(13,812)	$2.38	$2.47	(3.6%)
Class B	60	2,105,883	314,899	15.0%	11.4%	(7,840)	(75,385)	$2.28	$2.19	4.1%
Class C	12	321,671	8,806	2.7%	4.0%	(1,464)	3,947	$1.95	$1.86	4.8%
Total	**82**	**3,284,030**	**423,002**	**12.9%**	**10.3%**	**14,791**	**(85,250)**	**$2.31**	**$2.27**	**1.8%**
Highway 50/Rancho Cordova										
Class A	32	3,048,797	1,031,907	33.8%	20.1%	(174,329)	(417,853)	$1.90	$1.97	(3.6%)
Class B	142	7,695,796	1,658,128	21.5%	22.4%	(32,526)	64,865	$1.74	$1.76	(1.1%)
Class C	68	1,833,199	163,941	8.9%	11.3%	(1,104)	43,375	$1.26	$1.29	(2.3%)
Total	**242**	**12,577,792**	**2,853,976**	**22.7%**	**20.2%**	**(207,959)**	**(309,613)**	**$1.73**	**$1.75**	**(1.1%)**
Midtown/East Sacramento										
Class A	4	465,701	5,811	1.2%	2.8%	-	7,313	$2.89	$2.94	(1.7%)
Class B	56	3,424,870	212,514	6.2%	9.3%	(2,969)	106,758	$2.50	$2.33	7.3%
Class C	41	789,085	140,799	17.8%	10.8%	(21,575)	(55,305)	$2.07	$1.84	12.5%
Total	**101**	**4,679,656**	**359,124**	**7.7%**	**8.9%**	**(24,544)**	**58,766**	**$2.44**	**$2.29**	**6.6%**
Natomas										
Class A	38	3,931,519	650,182	16.5%	14.8%	(10,447)	(66,832)	$2.23	$2.22	0.5%
Class B	51	2,003,446	411,247	20.5%	14.3%	(17,432)	(108,324)	$1.82	$1.82	-
Class C	16	569,839	77,777	13.6%	9.7%	416	(22,311)	$1.44	$1.18	22.0%
Total	**105**	**6,504,804**	**1,139,206**	**17.5%**	**14.2%**	**(27,463)**	**(197,467)**	**$2.00**	**$1.99**	**0.5%**
Northeast Sacramento										
Class A	1	79,163	-	-	-	-	-	-	-	-
Class B	40	1,281,678	196,260	15.3%	16.9%	(2,718)	20,141	$1.53	$1.63	(6.1%)
Class C	65	1,523,774	164,054	10.8%	13.8%	41,509	45,826	$1.52	$1.39	9.4%
Total	**106**	**2,884,615**	**360,314**	**12.5%**	**14.8%**	**38,791**	**65,967**	**$1.52**	**$1.49**	**2.0%**
Roseville/Rocklin										
Class A	40	3,518,212	701,863	19.9%	16.1%	34,476	(136,381)	$2.33	$2.28	2.2%
Class B	145	5,055,887	695,036	13.7%	13.0%	(153,041)	(39,980)	$1.67	$1.72	(2.9%)
Class C	51	1,079,776	147,441	13.7%	15.7%	9,214	22,376	$1.42	$1.41	0.7%
Total	**236**	**9,653,875**	**1,544,340**	**16.0%**	**14.4%**	**(162,843)**	**(153,985)**	**$1.91**	**$1.86**	**2.7%**
Yolo County										
Class A	7	706,467	86,200	12.2%	3.5%	-	(61,313)	$2.25	$2.30	(2.2%)
Class B	46	1,691,626	162,417	9.6%	10.3%	(9,605)	12,591	$2.07	$2.05	1.0%
Class C	38	794,479	37,790	4.8%	5.8%	(5,873)	8,487	$1.65	$1.51	9.3%
Total	**91**	**3,192,572**	**286,407**	**9.0%**	**7.7%**	**(15,478)**	**(40,235)**	**$2.01**	**$1.95**	**3.1%**
Totals	**1554**	**68,346,538**	**10,832,153**	**15.8%**	**14.4%**	**(406,415)**	**(952,479)**	**$2.05**	**$2.00**	**2.5%**
Class A	**168**	**19,694,689**	**3,839,071**	**19.5%**	**15.1%**	**(365,597)**	**(863,289)**	**$2.49**	**$2.44**	**2.0%**
Class B	**814**	**34,473,664**	**5,588,543**	**16.2%**	**15.8%**	**(29,860)**	**(126,618)**	**$1.90**	**$1.89**	**0.5%**
Class C	**572**	**14,178,185**	**1,404,539**	**9.9%**	**10.2%**	**(10,958)**	**37,428**	**$1.67**	**$1.62**	**3.1%**

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