Q3 OFFICE

market report

2023 | GALLELLI REAL ESTATE

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market overview

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

Q3 23

△ **16.0%** Direct Vacancy Rate	▽ **(±218,000) SF** Net Absorption	— **$2.05** Average Asking Rate (FSG)

— **±20,000 SF** Under Construction	— **4.5%** Sacramento Unemployment	— **4.6%** California Unemployment	— **3.8%** United States Unemployment

SURVIVE ‘TIL 25

As of the close of Q3 2023, office vacancy in the Sacramento region stood at 16.0%, the highest level recorded locally since Q2 2015 when the market was still in recovery mode following the Great Financial Crisis (GFC) when vacancy peaked at 20.3% in the aftermath of the most challenging recession since the Great Depression. The impact of the pandemic and its acceleration of remote and hybrid work has not proven as disruptive to the Sacramento region in terms of vacancy as that crisis was, nor has it been as challenging in terms of space givebacks as what has been experienced by most other major American office markets. It is important to note that when the GFC hit in Q4 2008, Sacramento’s office vacancy rate was already elevated at 17.1%. The ***cyclical economic*** pressures of that period resulted in 836,000 square feet (SF) of space being returned to the market between Q4 2008 and Q2 2012 when the market finally returned to consistent growth. By comparison, the ***structural challenges*** have been far more challenging in terms of occupancy growth. Since Q2 2020 (when lockdowns first began to impact the office market), Sacramento has recorded -2.8 million square feet (MSF) of negative net absorption, or more than three times the amount of space that was realized following the GFC. The primary difference is that vacancy stood at just 10.5% in Q1 2020 when the pandemic hit.

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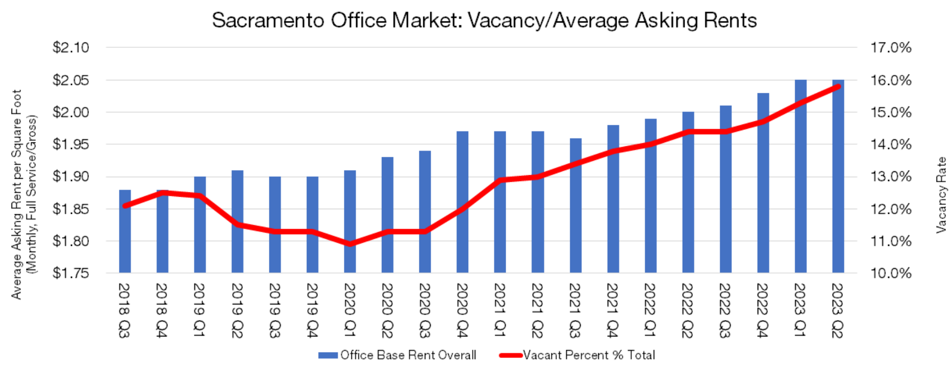
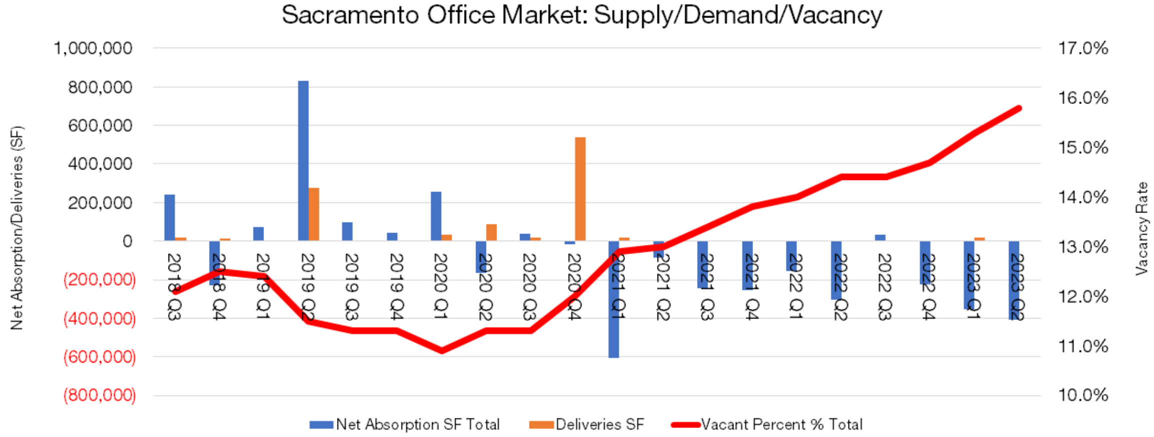
Sacramento Office Market
All Classes of Product
Q3 2023



Source: Gallelli Real Estate; Costar Group

Sacramento Office Market
All Classes of Product
Q3 2023



Source: Gallelli Real Estate; Costar Group

Today's vacancy rate of 16.0% compares to last quarter's reading of 15.7% and the 14.4% rate of exactly one year ago. In Q3, Sacramento experienced -218,000 SF of negative net absorption. This reflects the lowest level of space givebacks in one year (the market posted -336,000 SF of negative net absorption in both the first two quarters of the year and over -223,000 SF of negative growth in Q4 2022).

Q3 was also notable for the stark differences that emerged locally in terms of individual submarket performance. The Highway 50 trade area remains the most challenged of the region's submarkets in terms of vacancy; it recorded -318,000 SF of negative net absorption over the past three months as vacancy climbed from 22.3% to 24.8%. No other Sacramento region trade area posted negative gains that were even close.

El Dorado Hills submarket experienced givebacks to the tune of 34,000 SF as its vacancy hit 11.5%, and Natomas recorded -25,000 SF of negative net absorption that drove its vacancy rate to 17.8%. However Elk Grove/South Sacramento, El Dorado Hills and Auburn/Lincoln all posted modest declines of less than 5,000 SF.

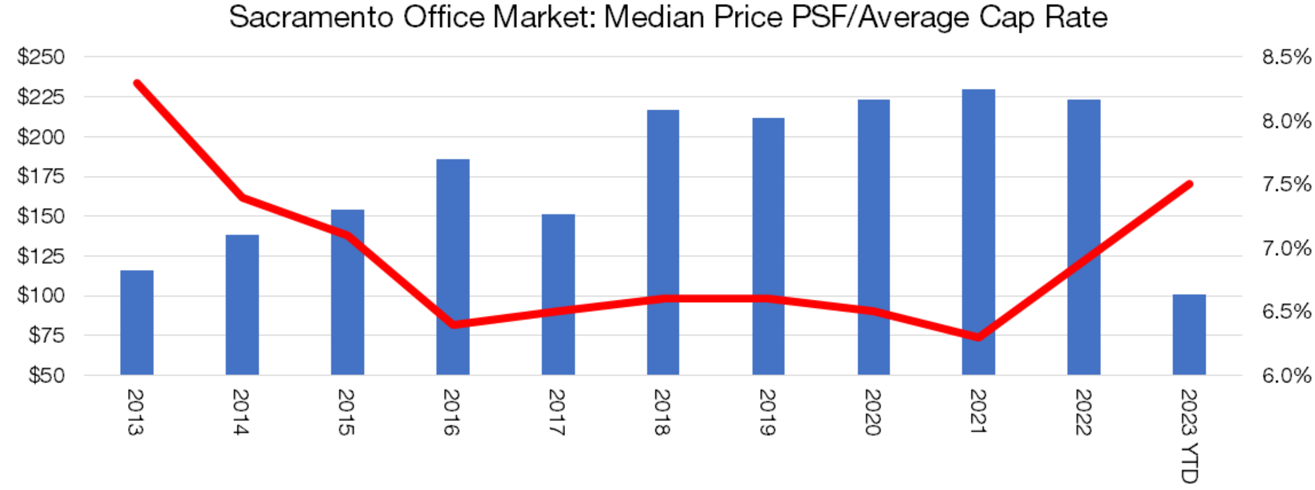
Meanwhile, the Arden/Howe/Watt submarket recorded its second consecutive quarter of gains with 67,000 SF of positive net absorption as vacancy here fell from 19.2% to 18.3%. The Roseville/Rocklin trade area, which has been—by far—the strongest of the region's submarkets over the past three years, posted 62,000 SF of positive net absorption as its vacancy rate dipped from 15.8% to 15.1.%. Among the other submarkets to post modest occupancy gains and declining vacancy levels were Folsom (+16,000 SF), Midtown (+9,000 SF), Northeast Sacramento (+5,000 SF) and Yolo County (+5,000 SF).

The most notable performance in Q3 likely came from a market that posted near-flat growth; Downtown, which recorded just under 1,000 SF of positive net absorption. Normally, flat growth is not a story, but here is why this is significant. The Sacramento two submarkets that have experienced the greatest levels of disruption since 2020 have been Downtown and the Highway 50 corridor. This is partially because both markets tend to be dominated by larger footprint users and this is where most of the office rightsizing trend has been focused. Downtown alone has accounted for 29.0% of the space that has been returned to the market since the pandemic. Yet, vacancy held steady at 16.7% in Q3, reflecting only the second time in the past 12 quarters where this metric did not climb.

Breaking out performance by Class, we also see some potential early signs of stabilization. Class A office recorded -210,000 SF of negative net absorption in Q3 as vacancy for upper echelon office product in the region climbed from 19.2% to 20.3%. At the other end of the spectrum, Class C office added another -82,000 SF of space givebacks as its vacancy levels inched up from 9.5% to 10.1%. But Class B office product posted gains for a second consecutive quarter—to the tune of 74,000 SF. Class B vacancy fell slightly from 16.2% to 16.0%.

One other potentially positive sign for landlords is that sublease availability, which stood at 755,000 SF three months ago, fell in Q3 to 656,000 SF in Q3. Though this was largely because space that had been available as a sublease opportunity reverted to direct availability, it is notable because no large new blocks of sublease space were brought to market. Sublease availability is now at its lowest point in the past 12 months. 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.

Sacramento Office Market
All Product Types
Q3 2023



*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

Office For Lease
917 7th St, Sacramento, CA

However, it is increasingly looking like the trend of sublease availability due to remote/hybrid downsizing has peaked.

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 in the final quarter of 2023 are those that initially inked deals late in 2018. Those who signed five-year deals in 2019 will be coming up for renewal next year. So long as economic conditions do not deteriorate and add another round of office consolidation into the mix, the pipeline of pandemic-related rightsizing is emptying.

CLOUDY ECONOMICS REMAIN

Further complicating the forecasting picture is the state of the overall economy. Since April of last year, economists have been debating whether the Federal Reserve (Fed) 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 within the next six months. That pessimism has since reversed itself. In their recently conducted August 2023 survey, 69% of NABE economists said they see a “soft landing” on the horizon. So far, the economy has proven to be far more resilient than analyst expectations with both consumer spending and the labor markets defying forecasts and outperforming.

This has certainly remained the case for the labor market; September's job report reflected job creation of a whopping 336,000 new positions. However, the biggest drivers of growth were leisure and hospitality (+96,000), government (+73,000), and healthcare (+41,000). Employment growth for the categories that drive office employment were substantially below those levels with professional and business services (+21,000), financial services (+3,000), and information (-5,000) job growth reflecting an entirely different picture.

Meanwhile, consumer spending has been coming back to earth. The most recent retail sales report from the Census Bureau reflected 2.5% annual growth in August. Despite the elevated inflationary pressures that have been in play since late 2021, this metric has remained positive since the early days of the pandemic (May 2020). This metric has measured outsized gains in 2021 (averaging 19.0% y-o-y for each month) and 2022 (averaging 9.8% annual growth). But since March 2023 retail sales have fallen below the 5.0% growth rate.

Meanwhile, much of the excess savings that consumer built up during the pandemic (roughly $2.1 trillion according to Bureau of Economic Analysis) has dissipated—falling by $1.6 trillion through May 2023. Meanwhile, household credit card debt has also climbed. According to the Federal Reserve, Americans owed $4.2 trillion in non-housing debt at the end of 2020. By midyear 2023, this number had climbed to $4.7 trillion. Meanwhile, most of the programs that the government put in place to shore up the economy and consumer finances in the pandemic are gone. The pause in student loan repayments ends in October, meaning that a large swath of Gen Z and younger Millennial consumers are about to take a considerable financial hit. It is unclear if this will finally derail the growth trend in consumer spending that has been in place since late 2020, but retail spending is facing significant headwinds heading into the final months of 2023 with holiday spending expected to be muted.

As of Fall 2023, with economic indicators remaining mixed, the US economy is in what could be best described as a "hold your breath moment," where it will become apparent if the Fed has successfully engineered a "soft landing," versus a bumpy one, or a crash landing. Economic readings regarding job creation, retail sales and inflation will have outsized importance over the next few months as the longer-term impacts of the Fed's rate hike campaign increasingly become clear. However, most economic forecasters that see a recession as likely in the next six months believe it likely to be short and shallow.

What is likely to be more challenging for the commercial real estate market is the continued possibility of future Fed rate hikes. August's inflation report (the most recent data as this report went to press) reflected an uptick in from 3.4% to 3.5% annually. That number was thanks to elevated energy prices that were in place before

the October Hamas attacks on Israel, which have initially resulted in additional upward pressure on oil. Meanwhile, September's incredibly robust jobs report is another factor that makes it more likely the Fed will raise interest rates yet again.

While the good news for Sacramento-region landlords is that the structural issues impacting space demand from hybrid work have been mitigated by the area's strong tenant presence from government and smaller, professional services firms (neither of have returned the levels of office space as large-block, corporate users), the market still has at least another five quarters in which we anticipate space givebacks related to rightsizing to continue. We believe that we are past the worst of that trend, however, an economic downturn—even if brief and shallow—would mean the high likelihood of cyclically-driven reductions in demand on top of structural issues that have been driving declining occupancy trends since 2020.

Looking forward, assuming a "safe landing," the market has already passed its pandemic peak of rightsizing, but the trend will not be over until at least 2025. Assuming the U.S. economy can navigate the next six months without a greater economic downturn, we anticipate a lessening of the negative occupancy trends ahead. Though net absorption is not likely to turn positive, the trend of rising vacancy will continue to slow.

However, in the event of a recession, the office market will have an additional set of occupancy headwinds to challenge it. If such a downturn is short and shallow as most economists believe it will be, the Sacramento office market is still looking likely to 2025 as the year that occupancy growth finally returns. Either way, the growing mantra we are hearing from both landlords and the brokerage community is, "Survive until 2025."

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 Q3				
Address	**Project Name**	**Submarket**	**SF Footage**	**Tenant**
3707 Kings Way	3707 Kings Way	Arden/Howe/Watt	57,368	County of Sacramento
3721 Douglas Boulevard	Summit at Douglas Ridge	Roseville/Rocklin	11,958	TRC Trading Company
1401 El Camino Avenue	El Camino Tower	Arden/Howe/Watt	14,679	Agency on Aging
9310 Tech Center Drive	9300- 9310 Tech Center Drive	Highway 50	9,272	County of Sacramento
915 Highland Pointe Drive	Highland Pointe Business Park	Roseville/Rocklin	7,214	Regus
1111 Howe Avenue	1111 Howe Avenue	Arden/Howe/Watt	4,472	Opening Doors
1750 Howe Avenue	The Landmark	Arden/Howe/Watt	4,233	State of California
3301-3307 Broadway	3301-3307 Broadway	Elk Grove/South Sacramento	3,483	City Year
920 Reserve Drive	Vintage Oaks Office Park	Roseville/Rocklin	3,368	California Recovery Center
1111 Howe Avenue	1111 Howe Avenue	Arden/Howe/Watt	3,063	New Dreams Beauty Studio
3301-3307 Broadway	3301-3307 Broadway	Elk Grove/South Sacramento	2,904	City Year
3800 Watt Avenue	Watt Executive Plaza	Arden/Howe/Watt	2,431	North Metro Church
2440 Gold River Road	Gold River Business Park	Highway 50	2,242	McKenzie Real Holdings
1624 Santa Clara Drive	Center Park East	Roseville/Rocklin	2,104	THC Inc.
100 Iron Point Circle	Broadstone Business Center	Folsom	2,019	One Point Human Capital Management
4600 47th Avenue	4600 47th Avenue	Elk Grove/South Sacramento	1,878	RC Tax Services
2233 Watt Avenue	2233 Watt Avenue	Arden/Howe/Watt	1,679	JRPCC Adult Day Programs
7248 S. Land Park Drive	South Land Park Office Center	Elk Grove/South Sacramento	1,649	Dr. Wu & Dr. Pan
1851 Heritage Lane	1851 Heritage Lane	Arden/Howe/Watt	1,586	Steve & Mai Lee
7777 Greenback Lane	Suncreek Corporate Center	Northeast	1,515	High Tech Lending

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	875,003	123,000	14.1%	21.1%	63,854	61,875	$2.09	$2.14	(2.3%)
Class B	88	3,879,766	878,390	22.6%	23.0%	28,708	12,091	$1.80	$1.83	(1.6%)
Class C	95	2,629,669	349,994	13.3%	12.5%	(25,579)	(22,272)	$1.83	$1.81	1.1%
Total	**191**	**7,384,438**	**1,351,384**	**18.3%**	**16.8%**	**66,983**	**51,694**	**$1.84**	**$1.86**	**(1.1%)**
Auburn/Lincoln										
Class A	-	-	-	-	-	-	-	$0.00	-	-
Class B	22	444,938	17,477	3.9%	7.1%	(600)	14,106	$1.74	$1.68	3.6%
Class C	25	443,062	34,741	7.8%	8.2%	(1,800)	1,528	$1.50	$1.48	1.4%
Total	**47**	**888,000**	**52,218**	**5.9%**	**7.6%**	**(2,400)**	**15,634**	**$1.57**	**$1.59**	**(1.3%)**
Downtown Sacramento										
Class A	21	5,655,488	1,084,033	19.2%	15.8%	(27,025)	(191,031)	$3.40	$3.40	-
Class B	63	3,958,024	760,960	19.2%	18.4%	23,039	(34,094)	$2.76	$2.78	(0.7%)
Class C	85	2,541,480	180,306	7.1%	6.5%	4,759	(14,245)	$2.20	$2.16	1.9%
Total	**169**	**12,154,992**	**2,025,299**	**16.7%**	**14.7%**	**773**	**(239,370)**	**$3.04**	**$2.96**	**2.7%**
El Dorado Hills										
Class A	1	67,300	31,822	47.3%	18.6%	(12,073)	(19,329)	$2.00	$1.88	6.4%
Class B	33	834,562	84,232	10.1%	7.3%	(13,051)	(23,628)	$2.03	$1.80	12.8%
Class C	25	454,106	40,327	8.9%	6.0%	(8,906)	(13,225)	$1.40	$1.36	2.9%
Total	**59**	**1,355,968**	**156,381**	**11.5%**	**7.4%**	**(34,030)**	**(56,182)**	**$1.88**	**$1.78**	**5.6%**
Elk Grove/South Sacramento										
Class A	6	481,431	200	-	0.2%	-	928	$2.78	$2.55	9.0%
Class B	69	2,056,608	124,220	6.0%	7.6%	(319)	31,869	$2.27	$2.28	(0.4%)
Class C	46	1,080,986	39,921	3.7%	4.2%	(3,044)	5,057	$1.36	$1.38	(1.4%)
Total	**121**	**3,619,025**	**164,341**	**4.5%**	**5.6%**	**(3,363)**	**37,854**	**$2.01**	**$2.04**	**(1.5%)**
Folsom										
Class A	10	843,584	88,134	10.4%	12.9%	9,168	20,982	$2.40	$2.46	(2.4%)
Class B	61	2,138,775	331,787	15.5%	13.7%	5,107	(21,057)	$2.35	$2.24	4.9%
Class C	12	321,671	7,342	2.3%	3.0%	1,464	2,173	$1.95	$1.87	4.3%
Total	**83**	**3,304,030**	**427,263**	**12.9%**	**12.5%**	**15,739**	**2,098**	**$2.36**	**$2.29**	**3.1%**
Highway 50/Rancho Cordova										
Class A	31	2,985,410	1,199,329	40.2%	19.3%	(230,809)	(624,170)	$1.93	$1.87	3.2%
Class B	141	7,671,706	1,757,366	22.9%	19.1%	(102,536)	(294,800)	$1.71	$1.75	(2.3%)
Class C	69	1,862,186	148,554	8.0%	10.9%	15,387	54,623	$1.22	$1.30	(6.2%)
Total	**241**	**12,519,302**	**3,105,249**	**24.8%**	**17.9%**	**(317,958)**	**(864,347)**	**$1.74**	**$1.72**	**1.2%**
Midtown/East Sacramento										
Class A	4	465,701	8,802	1.9%	1.7%	(2,991)	(872)	$2.83	$2.93	(3.4%)
Class B	55	3,280,126	176,608	5.4%	10.6%	34,475	169,587	$2.36	$2.34	0.9%
Class C	39	759,684	150,502	19.8%	10.8%	(22,665)	(68,241)	$2.14	$1.90	12.6%
Total	**98**	**4,505,511**	**335,912**	**7.5%**	**9.7%**	**8,819**	**100,474**	**$2.35**	**$2.31**	**1.7%**
Natomas										
Class A	38	3,946,491	683,297	17.3%	15.7%	(36,527)	(62,011)	$2.23	$2.23	-
Class B	51	2,003,446	398,127	19.9%	14.2%	16,800	(95,784)	$1.81	$1.82	(0.5%)
Class C	17	586,039	82,776	14.1%	8.2%	(4,999)	(34,538)	$1.45	$1.15	26.1%
Total	**106**	**6,535,976**	**1,164,200**	**17.8%**	**14.6%**	**(24,726)**	**(192,333)**	**$2.00**	**$2.00**	**0.0%**
Northeast Sacramento										
Class A	1	90,909	0	0.0%	0.0%	-	-	-	-	-
Class B	41	1,299,470	196,087	15.1%	18.1%	16,465	39,181	$1.61	$1.66	(3.0%)
Class C	65	1,523,774	175,349	11.5%	15.4%	(11,295)	59,084	$1.55	$1.41	9.9%
Total	**107**	**2,914,153**	**371,436**	**12.7%**	**16.1%**	**5,170**	**98,265**	**$1.57**	**$1.51**	**4.0%**
Roseville/Rocklin										
Class A	39	3,492,299	670,908	19.2%	15.4%	25,648	(133,293)	$2.32	$2.30	0.9%
Class B	146	5,089,661	623,500	12.3%	12.7%	59,577	25,260	$1.66	$1.72	(3.5%)
Class C	50	1,066,814	165,327	15.5%	16.4%	**(23,191)**	9,729	$1.44	$1.44	-
Total	**235**	**9,648,774**	**1,459,735**	**15.1%**	**14.1%**	**62,034**	**(98,304)**	**$1.89**	**$1.87**	**1.1%**
Yolo County										
Class A	7	706,467	85,150	12.1%	12.5%	1,050	2,915	$2.25	$2.30	(2.2%)
Class B	45	1,681,626	155,708	9.3%	10.7%	6,517	23,827	$2.09	$2.08	0.5%
Class C	36	754,947	39,904	5.3%	3.3%	(2,114)	(14,876)	$1.69	$1.80	(6.1%)
Total	**88**	**3,143,040**	**280,762**	**8.9%**	**9.3%**	**5,453**	**11,866**	**$2.01**	**$2.05**	**(2.0%)**
Totals	**1,545**	**67,973,209**	**10,894,180**	**16.0%**	**14.3%**	**(217,506)**	**(1,132,651)**	**$2.05**	**$2.01**	**2.0%**
Class A	**166**	**19,610,083**	**3,974,675**	**20.3%**	**15.5%**	**(209,705)**	**(944,006)**	**$2.48**	**$2.47**	**0.4%**
Class B	**815**	**34,338,708**	**5,504,462**	**16.0%**	**15.5%**	**74,182**	**(153,442)**	**$1.89**	**$1.90**	**(0.5%)**
Class C	**564**	**14,024,418**	**1,415,043**	**10.1%**	**9.8%**	**(81,983)**	**(35,203)**	**$1.68**	**$1.63**	**3.1%**

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