GALLELLI REAL ESTATE

Q3 OFFICE

market report

2024 | GALLELLI REAL ESTATE

Gallelli Real Estate
3005 Douglas Blvd #200
Roseville, CA 95661
P 916 784 2700
GallelliRE.com

market overview

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

Q3 24

16.8% Direct Vacancy Rate	**(±266,000) SF** Net Absorption	**$2.09** Average Asking Rate (FSG)

±819,000 SF Under Construction	**5.2%** Sacramento Unemployment	**5.3%** California Unemployment	**4.2%** United States Unemployment

**To provide the most accurate snapshot of market conditions, we revise our historical data in cases where new information is uncovered after the fact.*

PUBLIC SECTOR SPACE GIVEBACKS ECLIPSE PRIVATE SECTOR STABILIZATION

At the close of Q3 2024, office vacancy in the Sacramento market stood at 16.8%. This reflects an increase from the 16.4% rate recorded just three months ago with the increase driven primarily by a few key large space givebacks from the region's largest office tenant, the State of California.

The market recorded -266,000 square feet (SF) of negative net absorption in Q3, marking the third consecutive quarter in which occupancy growth has been negative. All told, 694,000 square feet of office space has been returned to market so far this year and continued planned relocations from State of California agencies to their newly completed facilities at the May Lee State Office Complex Downtown will likely result in continued negative net absorption in Q4.

Entering the year, there was hope that 2024 would be see Sacramento's office market finally turning a corner after four consecutive years of declining occupancy trends. The market has recorded positive net absorption in only two of the past 18 quarters going back to Q2 2020, when the impacts of the pandemic and the ensuing trend of remote and hybrid work took off. While the market closed 2020 in modestly positive territory (+85,000 SF of positive net absorption), the years since have been challenging. Nearly 3.2 million square feet (MSF) of space has come back to market since 2021 and that number will likely grow in Q4 with more planned State relocations. But while the numbers may still be in the red, there has been a sizable shift

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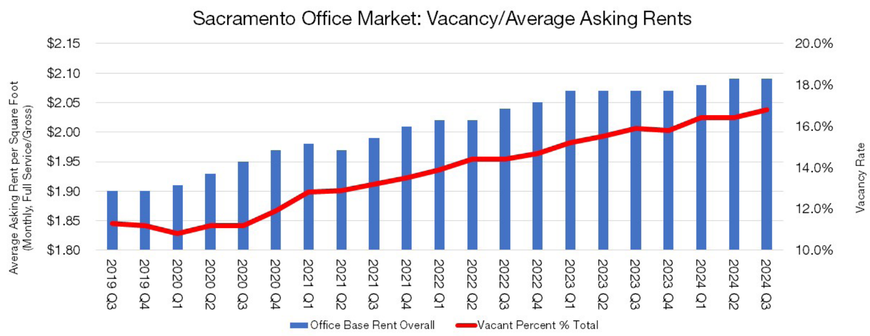
Sacramento Office Market
All Classes of Product
Q3 2024



Source: Gallelli Real Estate; Costar Group

in what is driving occupancy trends this year. Nearly 500,000 SF of the space returned to market so far this year has been from the long-planned (since 2019) State of California relocations from leased real estate to their owned campus. Meanwhile, the trend of private sector users consolidating space to accommodate hybrid, or remote work has slowed considerably. Going on five years out of the pandemic, virtually every tenant that wanted to downsize has already had the opportunity to do so. One telling statistic is that there is roughly 1.0 MSF SF of sublease availability throughout the Sacramento region. From 2021 through 2023, this metric averaged more than 1.5 MSF at any given time. Q3 2024 marks the eighth consecutive quarter in which this bellwether metric for distress has fallen.

Meanwhile, the evidence is growing that corporations are increasingly tiring of the remote work experiment.

Sacramento Office Market Net Absorption Trends	
2014	980,000
2015	1,267,000
2016	865,000
2017	128,000
2018	573,000
2019	1,221,000
2020	85,000
2021	-1,038,000
2022	-791,000
2023	-673,000
2024 YTD	-694,000

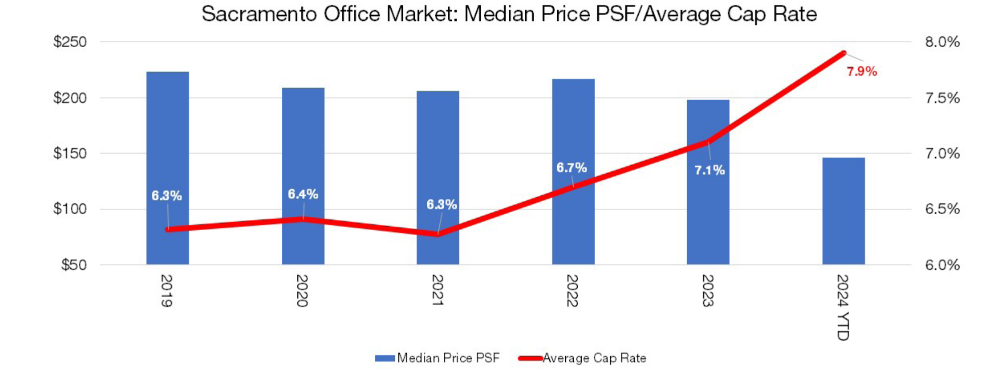
THE RISING BACKLASH AGAINST REMOTE WORK

In June, Dell announced a return-to-office initiative in which employees that wanted to remain remote had to classify themselves as such and that by doing so, they agree they can no longer be promoted or hired into new roles withing the company. In July, Salesforce told its workers to return to the office starting on October 1st. But the biggest news on the return-to-office front was Amazon's September announcement that they would require employees to return to the office five days a week starting in 2025. These moves have prompted some employee backlash—enough so that within a few days Microsoft "reassured" its employees that they had no plans to change their current hybrid work policy. However, Microsoft also advised its workers that the current policy is "not etched in stone," and noted that a lag in productivity could necessitate changes. It remains to be seen if Amazon's announcement will accelerate return-to-office mandates or not, but the evidence is mounting that it likely will.

In September, advisory firm KPMG released the results of a survey of 1,300 chief executives they conducted this past summer. That survey found that 83% of CEOs predicted that companies will shift to a full return of employees to in-office work over the next three years. One year ago, that number stood at 64% or, as KPMG reported, "This year's findings reveal that CEOs are hardening their stance on returning to pre-pandemic ways of working." The survey found that only 4% of U.S. CEOs anticipate a fully remote work culture over the next three years, while 17% expect a continued hybrid approach. Ultimately, while we do not anticipate a full return to 2019 work patterns, our conversations in the market with decision makers align with the findings of the KPMG survey with many corporate leaders increasingly frustrated by the operational challenges that remote or hybrid work present.

Office For Lease
1561 Creekside Drive, Suite 140,
Folsom, CA

Sacramento Office Market
All Product Types
Q3 2024



*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 2024. There have not been enough sale transactions to serve as truly reliable indicators.

Source: Gallelli Real Estate; Costar Group

That said, a May Gallup poll found that only 21% of office employees surveyed prefer exclusively onsite work compared to 53% preferring hybrid and 27% preferring exclusively remote work. These numbers have remained virtually unchanged from past polling from Gallup on the topic going back to 2022. The gap between what employers and employees want is widening. This will remain a challenge for businesses that want a full return-to-office-particularly in a low unemployment environment. But the writing is on the wall, working from home is falling out of favor.

TEPID DEMAND LIKELY TO PICK UP IN 2025

Leasing activity slowed slightly in Q3 2024. We tracked 651,000 SF of total deal activity (gross absorption), making this the slowest quarter for transactions since Q2 2022. Over the previous eight quarters, the region had averaged 860,000 SF per quarter in deal activity.

Seven of Sacramento's 12 office submarkets recorded increased in vacancy and negative net absorption in Q3. The Downtown (-124,000 SF), and Natomas (-115,000) submarkets both saw major blocks of space returned to market by the State of California and led all other trade areas in terms of negative net absorption. The Roseville/Rocklin (-51,000 SF), Arden/Howe/Watt (-31,000) and Elk Grove (-22,000 SF) trade areas experienced modest occupancy declines. Most other submarkets were flat. Highway 50 led all local trade areas in terms of positive net absorption, though occupancy levels here increased by only 33,000 SF.

While the market had seen the return of some larger space users in the first half of 2024, there was little in the way of new deals above 25,000 SF inked in Q3. Small leases still dominate deal activity, with deals of 5,000 SF or less now accounting for roughly a third of all activity.

The recent move by the Federal Reserve to cut interest rates by a half percent obviously has major positive implications for real estate investment, but just as importantly it will likely play a role in fueling office leasing demand as well. The central bank has already signaled it intends to cut rates at least one more time in 2024 and that, so long as inflation numbers continue to come in near their 2.0% target, they will continue their rate cutting campaign deep into 2025. Lower interest rates will spur greater business investment and, for many businesses, will help fuel expansion—including demand for office space.

There is still roughly 1.1 MSF of space that the State of California is likely to vacate as it consolidates to its new campus over the next couple of years. This past quarter's negative net absorption was a result of significant space givebacks and little in the way of new demand to counter the impacts. But heading into 2025, we expect demand from private sector users to return to consistently positive territory. We anticipate this trend to build momentum heading deeper into the year, with the Sacramento market finally returning to a consistent trend of occupancy gains and declining vacancy a full five years after the pandemic.

OFFICE INVESTMENT STALEMATE LIKELY TO BREAK IN 2025

Through the first three quarters of 2024, Costar tracked just 10,045 office transactions nationally, accounting for total sales volume of $24.3 billion. Office investment activity has been hobbled in recent years by challenging underlying fundamentals and high interest rates. By comparison, in 2019 Costar tracked 21,181 transactions accounting for $115.6 billion in total volume.

These same trends have impacted office investment activity locally. Through the first nine months of 2024, 128 deals closed for a combined transactional volume of $358 million. This compares to 283 deals in 2019 and total deal volume exceeding $1.2 billion. Private investors and users (typically in all cash deals) have driven 90% of local activity in the past year while medical office has remained relatively immune from the issues plaguing the rest of the office sector.

Both locally and nationally, deal activity has largely shifted from institutional investors to corporate buyers driven by steep discounts and the chance to buy at a fraction of replacement costs. As mentioned earlier, local distress sales have increasingly picked up in 2024. Two buyers alone (Chavez Management and Ethan Conrad Properties) have accounted for over $88 million across multiple transactions in the past year. This is one trend in which Sacramento is slightly ahead of the national curve. While distress transactions are picking up nationally, price discovery remains tricky due to substantial debt maturities looming ahead, particularly for CMBS-backed loans to which Sacramento has limited exposure.

The Federal Reserve's cutting of interest rates in September (and the high likelihood that further rate cuts are coming in 2025) is easily the most positive development for commercial real estate that has occurred this year. It will, no doubt, begin to bring buyers off the sidelines especially as we get further into the rate cutting cycle. But this does not mean we are at the bottom of the cycle for office pricing.

According to Trepp, there is at least $10 billion in office loans maturing before the end of 2024 and an additional $28 billion coming due in 2025. Delinquency rates, which currently stand at 8.6% are likely to climb above the 10.0% mark by early 2025. Keep in mind that at the peak of the global financial crisis, office delinquency rates set a modern record of 10.5%.

While we have seen a growing trend of lenders granting extensions, additional distress in the market will negatively impact pricing. This is likely to be the case over the next six months even as lower interest rates and slowly improving leasing fundamentals signal that the storm is finally breaking. Unfortunately, these positive developments are not likely to provide relief quickly enough to investors already in distress.

This combination of factors means that we may be in the early stages of one of the most significant real estate distressed investment cycles of the past 40 years. Private equity firms alone have set aside approximately $256 billion in dry powder for North American commercial real estate investment according to investment data tracking firm Preqin. Opportunistic funds have been lining up for over a year now and waiting to pounce, but this vast pool of capital is still on the sidelines. It is no secret that once values sink low enough, there is a vast pool of capital ready to make moves. The question of the last 12-18 months has been when?

It's increasingly looking like that day is coming soon. But we are not quite there yet. We suspect this logjam will break sometime in the first half of 2025 and that when it does, there will be a tsunami of activity and eventually a return to more normalized trends. But in the meantime, expect another quarter or two of sluggish activity with owner and medical office sales dominating locally.

Select Sacramento Region Office Leases Past Six Months (Q2 2024/Q3 2024)				
Address	**Project Name**	**Submarket**	**SF Footage**	**Tenant**
4151 & 4191 E. Commerce Way	4151 & 4191 E. Commerce Way	Natomas	118,934	Alta Regional
10860 Gold Center Drive	White Rock Corporate Campus	Highway 50	67,333	Sacramento County Training & Education Center
2349 Gateway Oaks Drive	Gateway Oaks Corporate Campus	Natomas	30,465	Western Health Advantage
2850 – 2890 Gateway Oaks Drive	Crown Corporate Center	Natomas	30,183	Judicial Council of California
1600 – 1610 R Street	Ice Blocks	Midtown	30,000	Rhombus
11090 White Rock Road	Parmer West	Highway 50	28,090	Prime Therapeutics
4201 – 4207 Town Center Boulevard	Ridge at Town Center West	El Dorado Hills	24,539	Marshall Medical Center
11010 White Rock Road	Parmer West	Highway 50	21,750	GEI Consultants
925 Highland Pointe Drive	Highland Pointe II	Roseville/Rocklin	18,884	Undisclosed
980 9th Street	Park Tower	Downtown	18,507	Deloitte
930 G Street	Law Building	Downtown	16,372	Regus
4110 Truxel Road	Natomas Crossing	Natomas	14,687	United Legal Support Services
3721 Douglas Boulevard	Summit at Douglas Ridge	Roseville/Rocklin	14,000	K. Hovnanian Homes
2839 Gateway Oaks Drive	Gateway Oaks Corporate Campus	Natomas	13,951	First 5 California
11190 Sun Center Drive	Parmer West	Natomas	13,949	ICW Group Insurance Company
2882 Prospect Park Drive	Prospect West Business Park	Highway 50	13,633	Samuel Hail
9323 & 9333 Tech Center Drive	Tech Center 50	Highway 50	13,313	Empyreal Logistics
5140 Robert J. Matthews Parkway	Four Sierra Business Center	El Dorado Hills	11,520	Chelsey Smith Crowns
4950 Hillsdale Circle	El Dorado Hills Business Park	El Dorado Hills	11,380	Able Kids
1478 Stone Point Drive	Stone Point Corporate Center	Roseville/Rocklin	10,592	Sims, Lawrence & Broghammer
3010 Lava Ridge Court	Lava Ridge Business Center	Roseville/Rocklin	10,336	Scansource
2180 Harvard Street	2180 Harvard Street	Arden/Howe/Watt	9,638	Alliant
770 L Street	770 L Street	Downtown	7,276	Wilshire Law
3100 Zinfandel Drive	Capital Center	Highway 50	6,962	IEC Corporation
305 Mace Boulevard	Offices at Mace Ranch	Yolo County	6,671	Symmetry Laser
8950 Cal Center Drive	California Center	Arden/Howe/Watt	6,503	iHealth Lab
500 Capitol Mall	Bank of the West Tower	Downtown	6,392	California CPA Association

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 Last Quarter	Vacancy One Year Ago	Total Quarterly	Total Last Four Quarters			
Arden/Howe Watt											
Class A	-	-	-	-	-	-	-	-	-	-	N/A
Class B	21	431,628	32,485	7.5%	6.4%	4.0%	(4,795)	(15,008)	$1.53	$1.74	(12.1%)
Class C	25	443,062	26,840	6.1%	6.6%	7.8%	2,512	7,901	$1.62	$1.50	8.0%
Total	**46**	**874,690**	**59,325**	**6.8%**	**6.5%**	**6.0%**	**(2,283)**	**(7,107)**	**$1.57**	**$1.57**	**-**
Auburn/Lincoln											
Class A	5	501,038	50,760	10.1%	7.8%	11.6%	(11,861)	7,133	$2.11	$2.21	(4.5%)
Class B	86	4,072,409	844,047	20.7%	19.7%	21.3%	(41,631)	23,942	$1.81	$1.84	(1.6%)
Class C	96	2,731,695	347,030	12.7%	13.5%	14.0%	22,552	36,251	$1.84	$1.78	3.4%
Total	**187**	**7,305,142**	**1,241,837**	**17.0%**	**16.6%**	**16.3%**	**(30,940)**	**67,326**	**$1.83**	**$1.83**	**-**
Downtown Sacramento											
Class A	22	5,244,900	1,137,472	21.7%	19.8%	21.1%	(100,997)	(28,638)	$3.34	$3.36	(0.6%)
Class B	58	3,630,238	598,674	16.5%	15.9%	16.9%	(22,972)	13,281	$2.51	$2.59	(3.1%)
Class C	85	2,490,666	152,122	6.1%	6.1%	8.8%	135	66,798	$2.26	$2.17	4.1%
Total	**165**	**11,365,804**	**1,888,268**	**16.6%**	**15.5%**	**17.1%**	**(123,834)**	**51,441**	**$3.00**	**$3.03**	**(1.0%)**
El Dorado Hills											
Class A	-	-	-	-	-	-	-	-	-	-	N/A
Class B	33	872,196	161,046	18.5%	20.5%	12.2%	17,937	(54,219)	$2.22	$1.99	11.6%
Class C	22	418,922	63,073	15.1%	11.0%	8.5%	(17,108)	(27,282)	$1.44	$1.38	4.3%
Total	**55**	**1,291,118**	**224,119**	**17.4%**	**17.4%**	**11.0%**	**829**	**(81,501)**	**$2.03**	**$1.84**	**10.3%**
Elk Grove/South Sacramento											
Class A	-	-	-	-	-	-	-	-	-	-	N/A
Class B	72	2,280,222	155,613	6.8%	5.8%	5.4%	(22,942)	(32,514)	$2.42	$2.29	5.7%
Class C	45	1,077,168	31,134	2.9%	3.0%	3.5%	696	6,513	$1.75	$1.67	4.8%
Total	**117**	**3,357,390**	**186,747**	**5.6%**	**4.9%**	**4.8%**	**(22,246)**	**(26,001)**	**$2.18**	**$2.05**	**6.3%**
Folsom											
Class A	7	535,365	68,400	12.8%	12.8%	9.1%	-	(19,627)	$2.30	$2.36	(2.5%)
Class B	61	2,306,769	272,050	11.8%	12.8%	13.9%	23,351	48,000	$2.34	$2.33	0.4%
Class C	13	340,186	11,929	3.5%	2.9%	2.2%	(2,008)	(4,587)	$1.91	$1.95	(2.1%)
Total	**81**	**3,182,320**	**352,379**	**11.1%**	**11.7%**	**11.8%**	**21,343**	**23,786**	**$2.32**	**$2.33**	**(0.4%)**
Highway 50/Rancho Cordova											
Class A	22	2,297,639	880,912	38.3%	38.9%	39.1%	12,960	17,248	$2.00	$2.04	(2.0%)
Class B	148	8,145,047	1,968,187	24.2%	24.5%	24.8%	26,968	54,250	$1.66	$1.69	(1.8%)
Class C	71	1,913,710	155,975	8.2%	7.8%	7.6%	(7,022)	(10,245)	$1.28	$1.22	4.9%
Total	**241**	**12,356,396**	**3,005,074**	**24.3%**	**24.6%**	**24.8%**	**32,906**	**61,253**	**$1.72**	**$1.74**	**(1.1%)**
Midtown/East Sacramento											
Class A	3	358,312	-	-	0.5%	1.6%	1,668	5,811	$3.34	$2.75	21.5%
Class B	53	3,127,504	283,669	9.1%	9.0%	5.7%	(2,489)	(104,070)	$2.55	$2.40	6.3%
Class C	38	705,474	148,800	21.1%	20.7%	20.1%	(2,474)	(7,348)	$1.95	$2.06	(5.3%)
Total	**94**	**4,191,290**	**432,469**	**10.3%**	**10.2%**	**7.8%**	**(3,295)**	**(105,607)**	**$2.55**	**$2.32**	**9.9%**
Natomas											
Class A	31	3,265,260	736,748	22.6%	18.5%	16.4%	(133,356)	(200,960)	$2.42	$2.24	8.0%
Class B	53	2,518,865	419,015	16.6%	17.8%	17.8%	28,202	29,560	$1.89	$1.88	0.5%
Class C	18	639,239	120,243	18.8%	17.2%	18.4%	(10,000)	(2,410)	$1.48	$1.48	-
Total	**102**	**6,423,364**	**1,276,006**	**19.9%**	**18.1%**	**17.2%**	**(115,154)**	**(173,810)**	**$2.18**	**$2.01**	**8.5%**
Northeast Sacramento											
Class A	1	90,909	-	-	-	-	-	-	N/A	N/A	0.0%
Class B	40	1,298,860	171,859	13.2%	14.5%	13.5%	16,106	3,454	$1.54	$1.61	(4.3%)
Class C	60	1,429,338	168,440	11.8%	12.1%	11.8%	4,227	519	$1.36	$1.55	(12.3%)
Total	**101**	**2,819,107**	**340,299**	**12.1%**	**12.8%**	**12.2%**	**20,333**	**3,973**	**$1.44**	**$1.57**	**(8.3%)**
Roseville/Rocklin											
Class A	37	3,221,493	851,093	26.4%	25.5%	19.3%	(28,374)	(230,851)	$2.32	$2.35	(1.3%)
Class B	144	4,802,611	656,703	13.7%	13.4%	13.2%	(13,262)	(20,864)	$1.67	$1.69	(1.2%)
Class C	49	1,351,396	159,676	11.8%	11.1%	10.3%	(9,112)	(19,849)	$1.30	$1.31	(0.8%)
Total	**230**	**9,375,500**	**1,667,472**	**17.8%**	**17.2%**	**14.9%**	**(50,748)**	**(271,564)**	**$1.88**	**$1.90**	**(1.1%)**
Yolo County											
Class A	7	746,152	210,846	28.3%	28.3%	11.4%	-	(125,696)	$3.03	$3.24	(6.5%)
Class B	44	2,030,814	174,674	8.6%	8.8%	8.1%	3,781	(9,687)	$2.12	$2.10	1.0%
Class C	37	773,866	67,153	8.7%	9.1%	5.8%	3,217	(22,237)	$2.07	$1.74	19.0%
Total	**88**	**3,550,832**	**452,673**	**12.7%**	**12.9%**	**8.3%**	**6,998**	**(157,620)**	**$2.50**	**$2.59**	**(3.5%)**
Totals	**1,507**	**66,092,953**	**11,126,668**	**16.8%**	**16.4%**	**15.9%**	**(266,091)**	**(615,431)**	**$2.09**	**$2.07**	**1.0%**
Class A	**135**	**16,261,068**	**3,936,231**	**24.2%**	**22.6%**	**20.7%**	**(259,960)**	**(575,580)**	**$2.57**	**$2.61**	**(1.5%)**
Class B	**813**	**35,517,163**	**5,738,022**	**16.2%**	**16.2%**	**16.0%**	**8,254**	**(63,875)**	**$1.89**	**$1.87**	**1.1%**
Class C	**559**	**14,314,722**	**1,452,415**	**10.1%**	**10.0%**	**10.3%**	**(14,385)**	**24,024**	**$1.67**	**$1.66**	**0.6%**

GALLELLI REAL ESTATE

GALLELLI BROKER TEAMS

INVESTMENT


Gary Gallelli
Partner
gary@gallellire.com


Pat Ronan
Vice President
pat@gallellire.com


Aman Bains
Associate Vice President
abains@gallellire.com


Adam Rainey
Associate Vice President
arainey@gallellire.com

RETAIL


Kevin Soares
Executive Vice President | Partner
ksoares@gallellire.com


Bob Berndt
Executive Vice President | Partner
bberndt@gallellire.com


Jeff Hagan
Senior Vice President | Partner
jhagan@gallellire.com


Phillip Kyle
Senior Vice President
pkyle@gallellire.com


Matt Goldstein
Vice President
mgoldstein@gallellire.com


Kurt Conley
Senior Associate
kconley@gallellire.com

OFFICE


Robb Osborne
Executive Vice President
rosborne@gallellire.com


Brandon Sessions
Senior Vice President
bsessions@gallellire.com


Kannon Kuhn
Associate
kkuhn@gallellire.com

CAPITAL MARKETS


Kristopher Krise
Capital Markets Advisor
kkrise@gallellire.com

RESEARCH


Garrick Brown
VP, Real Estate Intelligence & Business Development
gbrown@gallellire.com

JKG GALLELLI REAL ESTATE

Gallelli Real Estate
3005 Douglas Blvd #200
Roseville, CA 95661
P 916 784 2700
GallelliRE.com