



Office Report

Q2 2016
GALLELLI REAL ESTATE MARKET REPORT

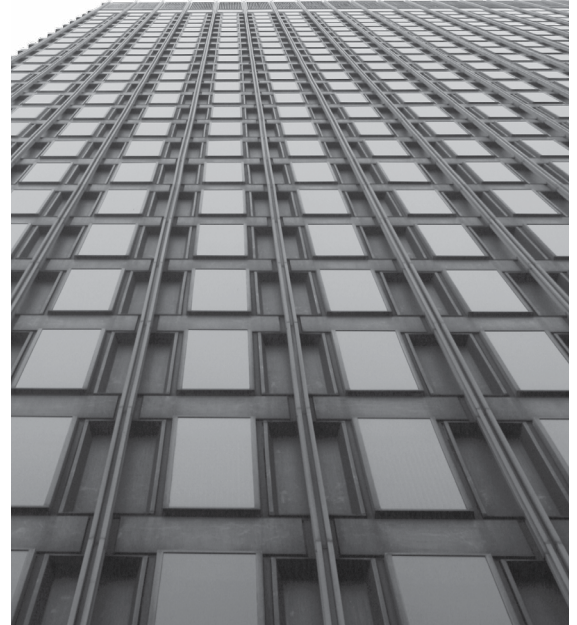
Overview

Despite momentum remaining flat, the Sacramento office market recorded its lowest post-recession vacancy rate during Q2 2016. Sacramento regional office vacancy stood at 15.8% at the end of Q2, reflecting a minimal decline over the 15.9% rate recorded three months prior. The 15.8% rate recorded this quarter is the lowest vacancy rate the Sacramento office market has seen since Q1 2008. Net absorption was positive, recording just over 104,000 square feet of occupancy growth during the quarter. While this number is improved over the negative 268,000 square feet the market lost during Q1, it was not enough to push year-to-date absorption figures out of the red. Year-to-date net absorption currently stands at just under negative 164,000 square feet.

Leasing activity slowed during Q2, with the market seeing nearly 868,000 square feet of deals signed compared to 914,000 square feet in Q1. Though the market saw a few leases signed in excess of 20,000 square feet, the majority of office demand remains focused on smaller spaces from 1,000 to 10,000 square feet.

Market Trends

- Absorption was mostly positive across the local submarkets, with Roseville/Rocklin, Midtown/East Sacramento and Downtown Sacramento all seeing net absorption gains in excess of 30,000 square feet. Negative net absorption was minimal; the



largest occupancy loss was seen in the Highway 50/Rancho Cordova submarket, which recorded 77,000 square feet of negative net absorption.

- Regional year-over-year office vacancy declined to 15.8% during Q2 2016 - one year ago, this metric stood at 17.0%. Quarterly vacancy declined from 15.9% to 15.8% this quarter.
- The current average asking rate for office space remained at \$1.67 per square foot during Q2, which is the highest average asking rate the market has seen since Q1 2011.
- Class A office space is currently asking \$2.04 per square foot; Class B is commanding \$1.67 per square foot; and Class C space is currently asking \$1.44 per square foot, on average.
- Local unemployment saw an uptick during Q2, rising from 4.7% in May to 5.6% in June; however, this uptick is primarily due to the seasonal decline in education jobs when schools are out for summer. Overall, the region added 11,000 jobs between May and June.
- The largest lease of the quarter was signed by the California Office of Statewide Health Planning and Development for 124,341 square feet at 2020 W. El Camino in Natomas.

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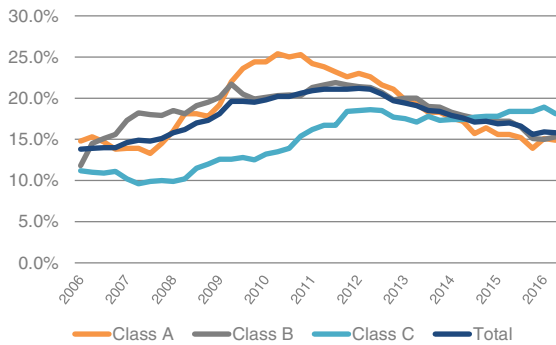
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Office Q22016

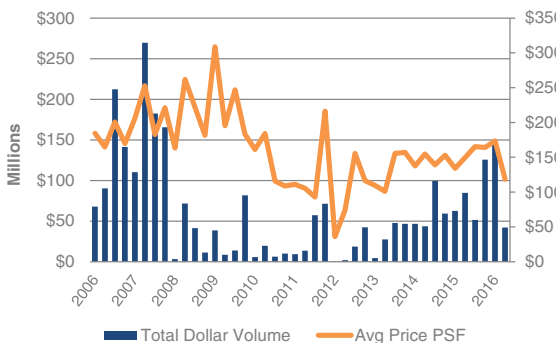
Competition for Downtown office space has steadily increased.

<p>Vacancy</p> <p>15.8%</p> <p>▼</p>	<p>Net Absorption</p> <p>104,222</p> <p>▲</p>	<p>Avg. Asking Rate</p> <p>\$1.67 PSF</p> <p>—</p>
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Historical Office Vacancy by Class

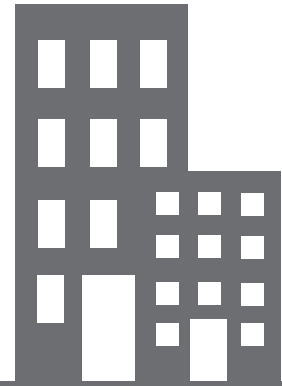


Office Investment Volume



Investment Highlights

- Quarterly transactional volume declined during Q2, with the Sacramento market seeing 25 transactions totaling \$69.3 million in total dollar volume. This is decreased from Q1, which saw 44 transactions totaling \$159.8 million. Year-to-date, the market has recorded \$229.1 million in transactional volume over 69 transactions.
- The average price per square foot fell from \$158 to \$121 during Q2, primarily due to the lack of Class A transactions during the quarter. The majority of sales during Q2 were for older, Class B and C office properties.
- Year-to-date, Class A product has averaged \$184 per square foot; Class B product has averaged \$165 per square foot; and Class C product has averaged \$96 per square foot.
- The largest investment sale of the quarter was the sale of Creekside Oaks office park at 1740 1760 Creekside Oaks Drive in Roseville. This 3-building, Class A office park sold for \$26 million at a 6.5% CAP rate and was 97.0% lease at the time of sale.



Construction
183,859 SF
 ▲

Sacramento Unemployment
5.6%
 ▲

US Unemployment
4.9%
 ▼

Spotlight: Downtown

With construction on Golden 1 Arena nearing completion and the official opening date fast approaching, the Downtown Sacramento office market continues to see more and more activity, both from tenants and investors. Overall office vacancy currently stands at 14.3% and rental rates have been on the rise over the last three years - we are even starting to see a return to pre-recession asking rates, with some of the more prominent, Class A high-rises asking upwards of \$3.00 per square foot. With vacancy continuing to tighten, increasing rents and very little new construction on the horizon, competition for Downtown office space has steadily increased. Larger spaces are getting harder and harder to find - there are currently only nine properties on the market that can accommodate tenants 20,000 square feet or greater. Existing tenants with expiring leases are either looking at renewing at a higher rent or relocating to another submarket entirely.

While these factors may not bode well for tenants vying high-quality Downtown office space, they do bode well for owners and investors. Downtown building owners are starting to test the market by putting their high-profile buildings up for sale. During Q2 alone, three prominent buildings on Capitol Mall went on the market - the Wells Fargo building at 400 Capitol Mall, 520 Capitol Mall and the U.S. Bank Building at 621 Capitol Mall. The

owners of these buildings also benefit from a lack of competition, as there are very few Downtown projects over 50,000 square feet currently on the market. Investors, both local and regional, are also taking advantage of Downtown market conditions. Many of the buildings currently up for sale have high occupancy and high rents, which make them attractive to both institutional and private investors seeking stable, secure and more reasonably priced assets than what is seen in the coastal markets.

Outlook

Though momentum remained sluggish in Q2, the Sacramento office market continues to improve. Vacancy is currently at a post-recession low and we anticipate that the market will continue to see incremental declines in vacancy throughout the rest of the year. Rents are also on the rise, especially for high-quality, Class A product. The decreasing supply of large blocks of Class A office space will continue to put pressure on Class A rents, and tenants may start to turn to Class B product to accommodate larger footprints. Investor interest in the region remains strong, as many private and institutional investors are taking advantage of Sacramento's improving market fundamentals and more affordably priced assets.



Office Q22016

Submarket	Inventory	Direct	Available Space Sublease	Total	Vacancy Q2-16	Net Absorption		Avg. Asking Rate (NNN)
						Q2-16	Q2-15	
Arden/Arcade								
Class A	1,088,930	250,102	3,903	254,005	23.3%	(6,125)	1,973	\$1.91
Class B	3,110,230	652,107	3,492	655,599	21.1%	12,489	(4,700)	\$1.67
Class C	1,772,273	397,176	1,662	398,838	22.5%	10,160	(29,176)	\$1.38
Total	5,971,433	1,299,385	9,057	1,308,442	21.9%	16,524	(31,903)	\$1.65
Auburn/Lincoln								
Class A	-	-	-	-	-	-	-	-
Class B	421,212	53,176	0	53,176	12.6%	13,451	1,863	\$1.31
Class C	528,223	48,643	0	48,643	9.2%	(1,214)	(787)	\$1.10
Total	949,435	101,819	0	101,819	10.7%	12,237	1,076	\$1.21
Downtown Sacramento								
Class A	5,745,114	844,906	10,250	855,156	14.9%	3,306	23,381	\$2.78
Class B	4,650,357	651,803	10,955	662,758	14.3%	6,092	(23,153)	\$2.04
Class C	2,923,426	383,959	0	383,959	13.1%	20,660	2,322	\$1.53
Total	13,318,897	1,880,668	21,205	1,901,873	14.3%	30,058	2,550	\$2.12
El Dorado Hills/Folsom								
Class A	1,217,427	301,405	15,682	317,087	26.0%	7,330	(98,462)	\$1.95
Class B	2,770,901	522,000	12,000	534,000	19.3%	(8,612)	27,148	\$1.64
Class C	753,926	66,922	0	66,922	8.9%	22,657	(4,014)	\$1.40
Total	4,742,254	890,327	27,682	918,009	19.4%	21,375	(75,328)	\$1.66
Highway 50/Rancho Cordova								
Class A	3,907,641	651,715	5,775	657,490	16.8%	(17,414)	37,639	\$1.82
Class B	6,973,682	1,152,427	49,293	1,201,720	17.2%	(75,775)	(16,724)	\$1.53
Class C	2,202,629	539,559	50,000	589,559	26.8%	16,361	(39,715)	\$1.22
Total	13,083,952	2,343,701	105,068	2,448,769	18.7%	(76,828)	(18,800)	\$1.52
Midtown/East Sacramento								
Class A	323,701	0	0	0	0.0%	532	5,149	-
Class B	2,935,644	145,834	0	145,834	5.0%	(6,313)	(10,580)	\$2.12
Class C	1,251,964	222,448	2,120	224,568	17.9%	39,596	(8,731)	\$1.89
Total	4,511,309	368,282	2,120	370,402	8.2%	33,815	(14,162)	\$2.01
Northgate/Natomas								
Class A	3,550,477	540,757	12,920	553,677	15.6%	(6,438)	6,514	\$1.95
Class B	2,057,953	263,843	10,425	274,268	13.3%	2,262	(2,993)	\$1.56
Class C	474,303	140,627	0	140,627	29.6%	29,465	0	\$1.23
Total	6,082,733	945,227	23,345	968,572	15.9%	25,289	3,521	\$1.58
Northeast Sacramento								
Class A	79,163	0	0	0	0.0%	0	0	-
Class B	1,728,351	313,761	0	313,761	18.2%	(6,325)	(40,498)	\$1.35
Class C	2,985,173	582,431	0	582,431	19.5%	13,284	(1,885)	\$1.26
Total	4,792,687	896,192	0	896,192	18.7%	6,959	(42,383)	\$1.31
Roseville/Rocklin								
Class A	3,230,550	306,968	5,455	312,423	9.7%	44,268	11,267	\$1.94
Class B	4,367,712	680,816	0	680,816	15.6%	31,902	11,432	\$1.62
Class C	1,328,772	218,218	0	218,218	16.4%	16,510	(11,835)	\$1.34
Total	8,927,034	1,206,002	5,455	1,211,457	13.6%	92,680	10,864	\$1.63
South Sacramento								
Class A	358,282	10,108	0	10,108	2.8%	(5,804)	0	\$2.14
Class B	2,115,903	302,854	1,182	304,036	14.4%	(15,047)	21,463	\$1.82
Class C	1,306,479	205,266	0	205,266	9.2%	(25,049)	2,445	\$1.37
Total	3,780,664	518,228	1,182	519,410	13.7%	(45,900)	23,908	\$1.78
Yolo County								
Class A	522,792	21,376	11,323	32,699	14.9%	18,366	12,561	\$1.86
Class B	1,633,966	176,594	0	176,594	14.3%	(24,549)	39,286	\$1.69
Class C	358,282	10,108	0	10,108	13.1%	(5,804)	0	\$2.14
Total	2,515,040	208,078	11,323	219,401	8.7%	(11,987)	51,847	\$1.90
Totals								
Class A	68,675,438	10,657,909	206,437	10,864,346	15.8%	104,222	(88,810)	\$1.67
Class B	20,024,077	2,927,337	65,308	2,992,645	14.9%	38,021	22	\$2.04
Class C	32,765,911	4,915,215	87,347	5,002,562	15.3%	(70,425)	2,544	\$1.67
Class C	15,885,450	2,815,357	53,782	2,869,139	18.1%	136,626	(91,376)	\$1.44