

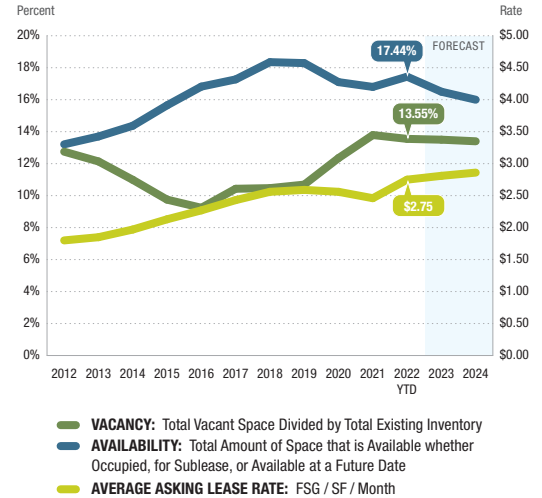
OVERVIEW. The Orange County office market continued to hold its own under difficult economic circumstances in Q2. Vacancy moved up again after posting a moderate decline in Q1. Average asking lease rates held steady while both gross and net absorption levels improved. The office market is still feeling the effects of COVID-19 even though lockdowns are in the rearview mirror. The pandemic has fundamentally changed the way office users do business and decision makers continue to wrestle with how to move forward in terms of hybrid and work-from-home scenarios, and how they will change the size and configuration of office suites in the future. Even today, with the worst of the health crisis behind us, fewer than half of office workers are back at their desks on a regular basis. As we reported last quarter, high-rise and mid-rise buildings are facing the biggest challenge because of employee density and dependence on elevators for access to individual spaces. So, uncertainty over how to proceed in terms of space utilization continues to slow the decision-making process, and that is most certainly impacting market metrics across the board. Thankfully, construction activity is light and is expected to remain so going forward.

VACANCY & AVAILABILITY. The overall rate in Q2 moved back up after a significant decline in the first period. Vacancy stood at 13.55% at the end of Q2, up 31 basis points after Q1's 52-basis-point drop. However, the current vacancy rate is 21 basis points lower than it was in Q2 of 2021, which does indicate that the market is recovering slowly from the worst effects of the pandemic. Class A buildings are still carrying the bulk of the vacancy, due to their bigger price tag, higher employee density, and need for elevator access.

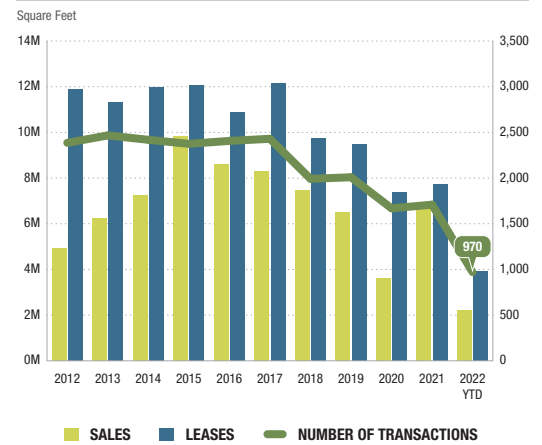
LEASE RATES. The average asking lease rate for all office space countywide was unchanged in Q2 at \$2.75. Class A space in the Airport Area is still the most expensive, up slightly again in Q2 to \$3.21, followed closely by South County at \$2.94. Class B asking rents are highest in South County at \$2.81, down 2 cents, and lowest in North County at \$2.33, unchanged during the period. On a year-over-year basis, the overall average asking rate is unchanged for the second consecutive period, further evidence that the market has stabilized. However, landlords tend to hold the line on asking rates and become more flexible when negotiating for free rent, parking and tenant improvements. So, the effective rate of each transaction offers a more accurate reflection of true market conditions.

TRANSACTION ACTIVITY. Lease and sale activity by square footage fell to 2.6 MSF in Q2 from 3.5 MSF in Q1, and the number of sale and lease transactions decreased to 463 in Q2 from 507. Countywide, 450 lease transactions and 13 sales were made in the current period. Most of the transactions are in the lower size ranges, as larger tenants who tend to sign longer-term leases are still unsure about their needs for space and remain on the sidelines. Those who are still considering a switch to hybrid work environments over the long term may be able to reduce their need for space, which could impact absorption and transaction activity going forward.

VACANCY, AVAILABILITY & AVERAGE ASKING LEASE RATES



TRANSACTION VOLUME & NUMBER OF TRANSACTIONS



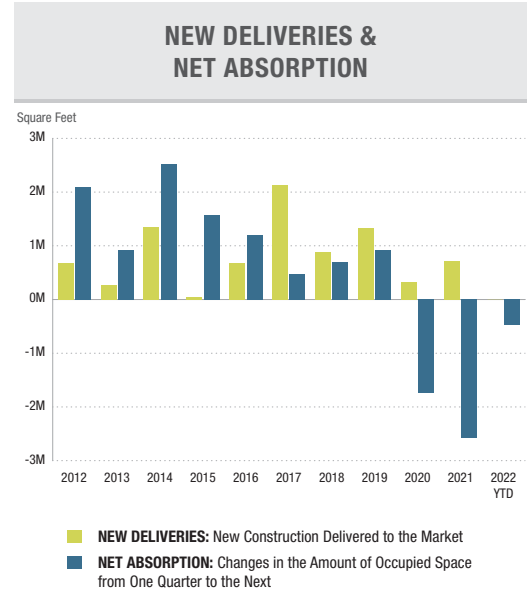
Market Statistics

	Change Over Last Quarter	2Q 2022	1Q 2022	2Q 2021	% Change Over Last Year
Vacancy Rate	▲ UP	13.55%	13.24%	13.76%	(1.52%)
Availability Rate	▲ UP	17.44%	16.80%	18.35%	(4.99%)
Average Asking Lease Rate	▬ FLAT	\$2.75	\$2.75	\$2.74	0.36%
Sale & Lease Transactions	▼ DOWN	2,614,010	3,504,071	3,116,776	(16.13%)
Gross Absorption	▲ UP	3,537,622	1,837,972	1,206,229	193.28%
Net Absorption	▼ NEGATIVE	(198,002)	(278,859)	(512,502)	N/A

ABSORPTION. Net absorption was still negative in Q2, as expected, but the net loss in occupied space fell to 198,002 SF during the period from negative 278,859 SF in Q1. That represents a significant improvement on a year-over-year basis when negative net absorption was over 512,000 SF. Year to date, negative net absorption is almost 476,861 SF, but the numbers are moving in the right direction, albeit slower than the county’s office landlords would like. Until more business owners make decisions on whether or not to move to hybrid workplaces, net absorption will remain sluggish.

CONSTRUCTION. As we have been reporting, construction activity remains thin, a welcome situation for the owners of existing office buildings. The construction queue is still confined to the same three projects: The Press in Costa Mesa along with Spectrum Terrace and Innovation Office Park in Irvine Spectrum. Those projects add up to just over 993,161 SF. Another 986,408 is in the planning stages, all of which is confined to the cities of Irvine and Laguna Hills.

EMPLOYMENT. The unemployment rate in Orange County was 2.4 % in May 2022, down from a revised 2.7% in April 2022, and below the year-ago estimate of 6.2%. Between May 2021 and May 2022, total nonfarm employment increased by 76,100 jobs, or 4.8%.



Forecast

The unexpected success of the forced work-from-home environment has thrown the office market into a time of uncertainty, which has slowed decision making enough to keep many requirements, large and small, on the sidelines. That has presented a major challenge to building owners who are doing everything possible to encourage their tenants to get their employees back to the office. So far, those efforts have fallen short as fewer than half of all employees are back in the office on a regular basis. We expect this uncertainty to continue into next year, which will keep lease rates near current levels and net absorption near zero.

The new wild card in terms of the overall economy is the rise of inflation to levels not seen in over 40 years. That prompted the Fed to bump its benchmark rate twice during the period to approximately 1.75%. The Fed’s actions have sharply increased the cost of capital, specifically mortgage interest rates for office properties. The SBA 504 mortgage has gone from 3.21% to 5.19% since the beginning of the year. Cap rate decompression becomes a very real possibility in the coming quarters, as leverage buyers refuse to pay for a mortgage with an interest rate higher than their cap rate.

Significant Transactions

Sales						
Property Address	City	Class	Square Feet	Total Price	Buyer	Seller
15771 Red Hill Ave.	Tustin	B	103,281	\$46,000,000	Rexford Industrial	GVI (SW) Red Hill Owner LLC
1801 W. Romneya Dr.	Anaheim	B	87,854	\$17,900,000	2751 Chapman LLC	KPM
3111 N. Tustin Ave.	Orange	B	65,460	\$15,101,000	Lutheran High School Association of OC	Angelo, Gordon & Co
9800 Muirlands Blvd.	Irvine Spectrum	B	56,773	\$18,000,000	Oceans Church	Chapman University
23101 Lake Center Dr.	Lake Forest	A	51,136	\$11,500,000	Gulton Court LP	Angelo, Gordon & Co
Leases						
Property Address	Submarket	Class	Square Feet	Transaction Date	Tenant	Owner
535 Anton Blvd.	Costa Mesa	A	50,261	May-2022	Siemens	McCarthy Cook & Co.
611 Anton Blvd. – Renewal	Costa Mesa	A	35,699	May-2022	Comerica Bank	The Irvine Company
27442 Portola Pkwy.	Foothill Ranch	A	27,191	May-2022	US Real Estate Services	Barings
2010 Main St. – Renewal	Irvine	A	25,544	Jun-2022	AmWINS Group Inc.	Emmes Realty Services LLC
2020 Main St. – Renewal	Irvine	A	22,539	May-2022	New York Life	PGM Real Estate



Four-Day Work Week Anyone?

by **Stefan Rogers, MRICS**

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2022 has presented encouraging signs of a recovery in demand for office space, as we unravel from COVID-19 and negotiate the power struggle between employers and employees over hybrid work policies and the long-term demand for office space. There's no clear sign of a resolution, and there likely never will be unless we can compromise on a new general standard for hybrid work.

Add to this a generous dose of economic uncertainty, and corporate decision makers quickly find themselves in a holding pattern, pending future outcomes. This sounds like a recession in the making to me. We're pretty much talking ourselves into one—some are actually hoping for a “reset.” And the Fed is now facing the reality that it may not be able to rein in inflation without creating some significant economic downsides such as stagflation.

That said, the office sector is arguably already in a recession of its own. The metrics say vacancy has somewhat stabilized. However, as leases signed “pre-COVID” are expiring, the possibility of more short-term lease renewals underpins the risk of further vacancy and downward pressure on rents, particularly in less desirable office buildings. The outlook is consequently still cloudy for most office building owners, with many OC landlords openly admitting to trying to make every deal they possibly can. All these talking points are usually reflective of a tenant's market, but where are the tenants?

Something has to give, and it's going to take something impactful enough to equalize the power balance between employers and employees. A recession accompanied by high unemployment may well achieve this, as employees' job security diminishes, and they're forced into self-preservation mode. In this scenario, many will be forced to stand up and be counted, or risk falling into the category of the forgotten, surplus worker, and risk getting downsized. Thus, the office market evolution would continue, and as the power balance stabilizes and the dust settles, the chance of a standard compromise on hybrid work policies could increase.

A four-day work week could be a pretty good compromise. It's a bold, progressive solution, but we do need a solution. We have the technology to succeed with this scenario, and multiple international studies into four-day work weeks have demonstrated higher productivity across the board. Who doesn't enjoy a long weekend anyway?

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This survey consists of properties representing both single tenant and multi-tenant buildings. The lease rates are based on a full-service gross basis. The information contained in this report is gathered from sources that are deemed reliable, but no guarantees are made as to its accuracy. This information is for Voit Real Estate Services' use only and cannot legally be reproduced without prior written consent from the management of Voit Real Estate Services.

Product Type

CLASS A: Most prestigious buildings competing for premier office users with rents above average for the area. Buildings have high-quality standard finishes, state-of-the-art systems, exceptional accessibility and a definite market presence.

CLASS B: Buildings competing for a wide range of users with rents in the average range for the area. Building finishes are fair to good for the area, and systems are adequate. However, Class B buildings cannot compete with Class A buildings of the same price.

CLASS C: Buildings competing for tenants requiring functional space at rents below the area average.

Submarkets

AIRPORT AREA

Costa Mesa, Irvine, Newport Beach

CENTRAL COUNTY

Anaheim, Orange, Santa Ana, Tustin

NORTH COUNTY

Anaheim Hills, Brea, Buena Park, Fullerton, La Habra, La Palma, Placentia, Yorba Linda

SOUTH COUNTY

Aliso Viejo, Dana Point, Foothill Ranch, Irvine Spectrum, Laguna Beach, Laguna Hills, Laguna Niguel, Lake Forest, Mission Viejo, Rancho Santa Margarita, San Clemente, San Juan Capistrano

WEST COUNTY

Cypress, Fountain Valley, Garden Grove, Huntington Beach, Los Alamitos, Seal Beach, Stanton, Westminster