Tucson Office, Q3 2017

Tucson office market gains momentum amid healthy demand

Vacancy	Rental Rate	Net Absorption	Under Construction
14.3%	$20.28 Per Sq. Ft.	184,040 Sq. Ft.	87,355 Sq. Ft.

*Trend arrows indicate year-over-year change. Data reflects market totals.

Figure 1: Important Office Indicators

	Tucson Unemployment	*Tucson Employment Growth*	*Finance Employment Growth*	*Business Services Employment Growth*	*BRT CEO Economic Outlook Index*
Q3 2016	5.0%	1.7%	1.2%	2.8%	69.4
Q3 2017	4.5%	0.4%	2.9%	-1.8%	93.3

Source: CBRE Research, Q3 2017. All employment figures reflect the most recent BLS, Economy at a Glance data, August 2017. Business Roundtable, CEO Economic Outlook Survey, Q3 2017.

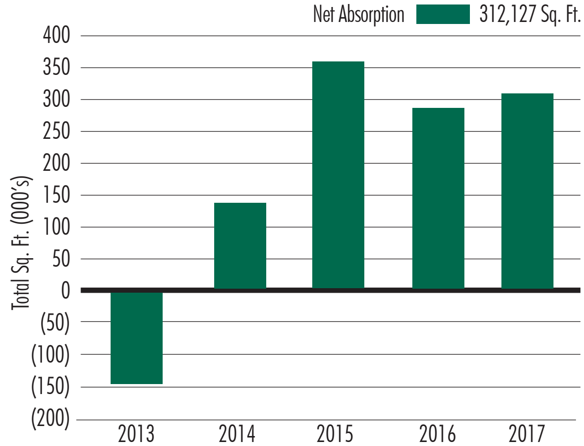
Fundamentals in the Tucson office market improved as healthy demand drove net absorption to 184,040 sq. ft. in the third quarter of 2017, bringing the year-to-date total to 312,127 sq. ft. of net absorption. Marketwide, vacancy fell 190 basis points (bps) from the previous quarter to 14.3%—the lowest rate in nine years. In addition to healthy leasing activity, the vacancy rate was impacted by the removal of two outdated office buildings (totaling 236,133 sq. ft.) from the market's office base. Both buildings, The Westerner and La Placita Village, were in the Downtown submarket and are planned to become residential developments with The Westerner retaining a minor amount of owner/user office space.

In the third quarter, office-users were particularly active in the Downtown and East Central submarkets. Caterpillar absorbed 26,093 sq. ft. of space in the Downtown submarket. This, however, will serve as their temporary facility while they await the completion of their 150,000-sq. ft. headquarters located in the West Central submarket. The Downtown submarket continues to attract new tenants that want to be located near transit-oriented developments and amenities. Meanwhile, medical and professional service users are actively looking in the East Central submarket, where large and quality space is available. As vacancy further contracts in these high-demand submarkets, quality space will become increasingly difficult to find. As this momentum continues, rents are expected to escalate, which should motivate office developers to deliver new product in the near-term.

NET ABSORPTION

In Q3 2017, net absorption totaled 184,040 sq. ft., the highest level of quarterly absorption in two years. The East Central submarket led leasing activity with 85,227 sq. ft. of positive net absorption. In addition to several small leases, Sonora Quest Laboratories took 36,370 sq. ft. of space in the East Central submarket. Demand was also healthy in the Downtown and Northeast submarkets where net absorption totaled 37,267 sq. ft. and 26,383 sq. ft., respectively. The Downtown submarket's positive performance was primarily attributed to expansions by Caterpillar and Sinfonia RX, which absorbed 26,093 sq. ft. and 13,135 sq. ft., respectively. Meanwhile, Dependable Health Solutions absorbed 12,292 sq. ft. in the Northeast submarket

Figure 2: Annual Net Absorption Rate

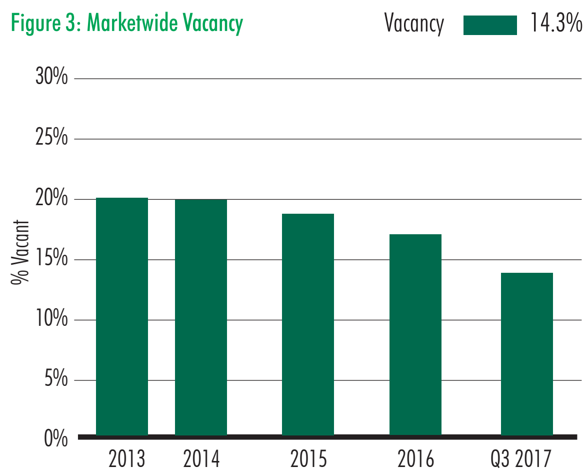


Source: CBRE Research, Q3 2017.

VACANCY

Tucson's vacancy rate tumbled 190 bps quarter-over-quarter to 14.3% during the third quarter of 2017. This is the lowest vacancy rate since Q3 2008. A significant improvement in the Downtown submarket's vacancy rate helped bolster the overall market. Vacancy in the Downtown submarket fell from 19.7% last quarter to 14.8% in the third quarter of 2017. This drop was due to a combination of healthy leasing activity and the removal of nearly 240,000 sq. ft. of functionally obsolete space from the submarket's inventory. Meanwhile, the West Central submarket recorded the most significant annual decrease in vacancy, declining 290 bps to 8.2% this quarter—the lowest vacancy rate in the market. Over the same time span, healthy demand pulled vacancy down 130 bps to 14.4% in the East Central submarket.

Figure 3: Marketwide Vacancy

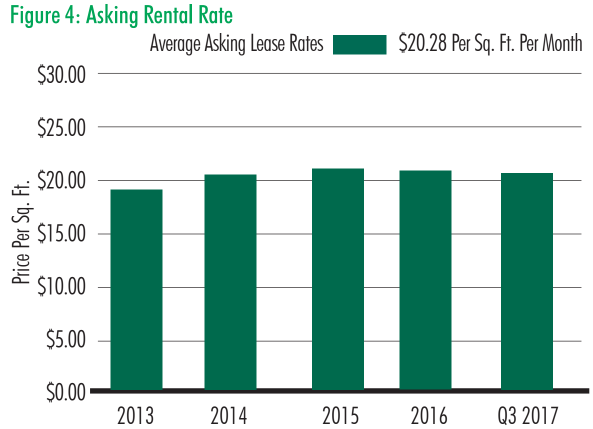


Source: CBRE Research, Q3 2017.

LEASE RATE

The average asking lease rate in the Tucson market increased 2.5% quarter-over-quarter to $20.28 full service gross (FSG) per sq. ft. in the third quarter of 2017. Over the same period, average rent increased in each submarket, excluding the Northwest submarket, where average rent slipped 0.2%. The Downtown submarket recorded the highest quarter-over-quarter increase in the asking lease rate during Q3 2017, rising 9.4% to $22.22 FSG per sq. ft. Additionally, average rent in the North Central and West Central submarkets increased 1.5% and 1.3% to $22.32 per sq. ft. and $18.21 per sq. ft., respectively. Still, average rent marketwide in the third quarter was 1.0% below the rate one year earlier.

Figure 4: Asking Rental Rate



Source: CBRE Research, Q3 2017.

CONSTRUCTION

No new office space came online in the third quarter of 2017 or so far this year. However, three build-to-suit projects totaling 237,355 sq. ft. are currently under construction in the Downtown and West Central submarkets. This includes the 26,000-sq. ft. Hexagon Mining headquarters at City Park in Downtown Tucson, targeted to deliver in the first half of 2018. In the West Central submarket, the Casa de los Niños headquarters (61,355 sq. ft.) remained under construction and is expected to come online in Q4 2017.

Additionally, site work has started on the 150,000-sq. ft. Caterpillar build-to-suit in the West Central submarket and is expected to come online in the first half of 2019. The planning pipeline consists of an additional 430,576 sq. ft. of office space with various delivery dates scheduled through late 2019. Planned projects are concentrated in the North Central and Northwest submarkets.

OUTLOOK

Despite slower than anticipated employment growth in the Tucson market, supply and demand remains balanced, which is supporting office fundamentals. Employment growth modestly increased 0.4% during Q3 2017.[1] By year-end 2017, job growth is expected to rise 0.9%, below last year's gain of 1.3%.[2]

Still, steady demand for space, particularly among medical, professional services and engineering firms continues to support fundamentals. However, the growing gap between tenant demand for large, higher-quality space and the current supply will make it increasingly difficult to find space. New supply is limited as office developers remain cautious and focused on build-to-suit product. As the imbalance grows, developers will become more motivated to repurpose vacant and obsolete office buildings (such as the recently redeveloped La Placita Village and The Westerner) to new mixed-use properties, particularly in the Downtown and East Central submarkets.

Vacancy in the Tucson office market should continue to improve amid limited new supply and steady employment growth. As quality space becomes more limited, rents will escalate.

[1] Bureau of Labor Statistics, August 2017.
[2] University of Arizona, Economic and Business Research Center, 2017.

Figure 5: Office Market Statistics

Submarket	Gross Rentable Area Sq. Ft. (±)	Vacancy Rate %	Availability Rate %	Q3 2017 Net Absorption Sq. Ft. (±)	Under Construction Sq. Ft. (±)	*Average Asking Lease Rate (FSG) $
Downtown	775,166	14.8	16.1	37,267	26,000	22.22
East Central	2,879,559	14.4	14.4	85,227	0	19.04
North Central	2,240,154	8.9	10.8	21,659	0	22.32
Northeast	956,571	30.4	30.5	26,383	0	18.69
Northwest	2,188,065	13.0	13.0	14,075	0	22.15
Southeast	119,157	31.1	31.1	0	0	27.00
Southwest	18,000	38.4	38.4	0	0	25.00
West Central	472,328	8.2	8.1	(571)	61,355	18.21
Totals	**9,649,000**	**14.3**	**17.5**	**184,040**	**87,355**	**20.28**

*Lease rates are quoted as weighted average of all lease types based on asking price per square foot per year.
Source: CBRE Research, Q3 2017.

Figure 6: Key Transactions

Size Sq. Ft. (±)	Tenant	Address
36,370	Sonora Quest Labratories, LLC	630 N Alvernon Way
26,093	Caterpillar Global Mining	1 S Chruch Ave.
14,500	Arizona Minerals Inc.	2210 E Fort Lowell Rd.
13,135	Sinfonia Rx Inc.	100 N Stone Ave.
12,292	Dependable Home Health	1111-1141 N El Dorado Pl.

Source: CBRE Research, Q3 2017.

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