CBRE **MARKETVIEW**

Tucson Office, Q4 2017

Strong demand bolsters market fundamentals, vacancy falls sharply

Vacancy	Rental Rate	Q4 Net Absorption	Under Construction
12.6%	$19.60 Per Sq. Ft.	167,413 Sq. Ft.	61,355 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*
Q4 2016	4.4%	2.3%	1.2%	-0.5%	74.2
Q4 2017	4.0%	-0.7%	-0.5%	-2.7%	96.8

Source: CBRE Research, Q4 2017. All employment figures reflect the most recent BLS data, November 2017. Business Roundtable, CEO Economic Outlook Survey, Q4 2017.

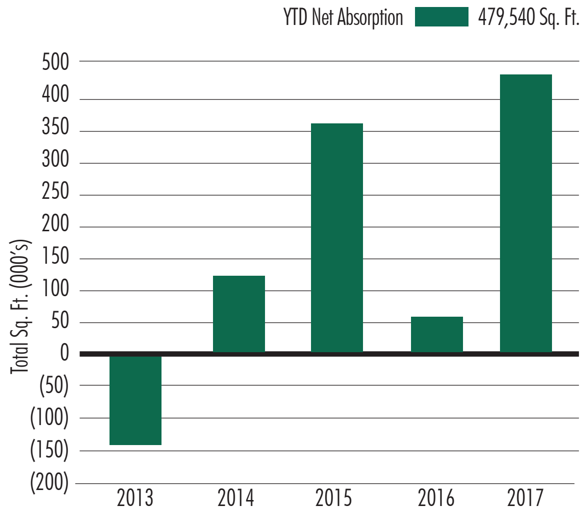
Tucson's office market continued to gain momentum during the fourth quarter of 2017, closing the quarter with 167,413 sq. ft. of net absorption. Year-to-date, Tucson recorded a total of 479,540 sq. ft. of net absorption, marking the highest level of net absorption in a decade. Marketwide, vacancy tumbled 170 basis points (bps) from the previous quarter to 12.6%. In addition to strong demand, several build-to-suit (BTS) projects broke ground or inched closer to completion in Q4 2017. Most notably, the Caterpillar Surface Mining & Technology Division BTS in the West Central submarket broke ground this quarter after extensive site preparation. Upon completion, the project will add 150,000 sq. ft. of office space adjacent to Downtown Tucson.

Marketwide, professional services and engineering industry users remained particularly active during the fourth quarter. These users absorbed large amounts of space in the East Central and Northwest submarkets. SimpleView Inc., a destination marketing provider, purchased 41,134 sq. ft. of office space in Oro Valley, which helped drive vacancy down 250 bps in the Northwest submarket to 10.4%. Tightening vacancy amid healthy demand for quality and large office spaces has increased the need for speculative product. Without speculative construction on the horizon, office users will continue to seek out build-to-suit opportunities to satisfy their space and quality requirements.

NET ABSORPTION

Healthy tenant activity continued in Q4 2017 as the market recorded 167,413 sq. ft. of net absorption. This was a notable improvement from the same time last year, when absorption totaled 62,147 sq. ft. Net absorption was bolstered by the East Central and Northwest submarkets which accounted for 87,882 sq. ft. and 55,188 sq. ft., respectively. Demand for Class A office space was notable in the East Central submarket, which accounted for 75,006 sq. ft. of the submarket's net absorption. In the Northwest submarket, absorption was driven by Simpleview Inc. after purchasing the former Pulte Building (41,134 sq. ft.). Additionally, the Department of Veteran Affairs leased 11,200 sq. ft. of space in the Northwest submarket. The North Central submarket recorded the only negative net absorption at 7,259 sq. ft.

Figure 2: Annual Net Absorption Rate

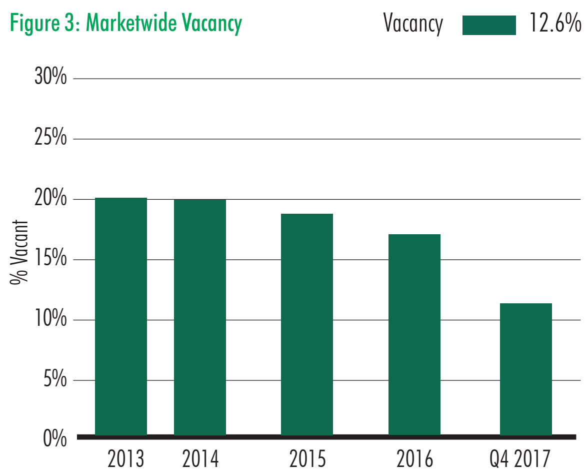


Source: CBRE Research, Q4 2017.

VACANCY

Strong demand pushed vacancy down 170 bps quarter-over-quarter to 12.6% in the fourth quarter of 2017. On a year-over-year basis, vacancy tumbled 300 bps marketwide. Suburban Tucson posted the most significant improvement in vacancy, decreasing 190 bps quarter-over-quarter. The greatest decline in vacancy was recorded in the East Central and Northwest submarkets, which dropped 310 bps and 250 bps, respectively. Over the same period, the vacancy change in the Downtown Tucson submarket was minimal. However, over the past 12 months, the Downtown submarket posted the strongest improvement in vacancy as the rate fell from 21.8% to 14.4%. This change was largely due to healthy tenant demand in addition to the demolition of outdated office space.

Figure 3: Marketwide Vacancy

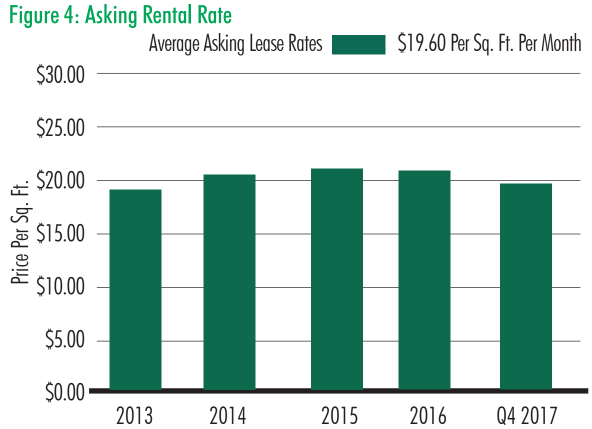


Source: CBRE Research, Q4 2017.

LEASE RATE

Tucson's average asking lease rate declined slightly in Q4 2017 by 3.4% to $19.60 per sq. ft. full service gross (FSG). This is largely attributed to aggressive price reductions by owners of older office product, which is a significant portion of Tucson's office inventory. The Northwest and East Central submarkets recorded the most significant decreases in asking rents by 9.3% and 5.3%, respectively. Demand for quality Class A and Class B space remains healthy, consistent with what the Tucson market has seen over that past several years. As desirable, high-quality space becomes more limited, rents are expected to rise, while downward pressure will continue to be placed on lease desirable, outdated product.

Figure 4: Asking Rental Rate



Source: CBRE Research, Q4 2017.

CONSTRUCTION

New office delivery remained muted during Q4 2017, with no new office product delivered. Meanwhile, construction started on the Caterpillar Surface Mining & Technology Headquarters BTS in the West Central submarket. The 150,000-sq.-ft.-facility is slated for completion in the first half of 2019 and will house approximately 600 workers. Another project in the West Central submarket—the 61,355-sq.-ft. BTS for the Casa de los Niños—is nearing completion.

Minimal new construction is placing pressure on landlords to become increasingly creative in repurposing obsolete space to meet tenant preferences. This includes the Mister Car Wash office conversion project in the Downtown submarket. Upon completion, the project will feature nearly 21,000 sq. ft. of converted office space in a former flex showroom.

OUTLOOK

Despite lackluster employment growth, Tucson's office fundamentals improved throughout 2017 due to a healthy balance of tenant demand and limited new supply. Tucson's employment growth was slower than expected, declining 0.7% over the past 12 months in the fourth quarter of 2017.[1] However, the employment outlook is projected to tick up to 1.2% in 2018, with the financial services sector significantly contributing to this growth.[2]

The outlook remains mixed as asking lease rates remain flat and vacancy edges near Tucson's last cyclical low of 10.2% in 2006. The first half of 2018 will remain active as users continue to lease out remaining quality space. Healthy demand in addition to expected employment growth will support market fundamentals throughout the next term. Business, financial and medical users continue to drive demand in the market and desirable space will become increasingly more limited. In 2017, vacancy fell to its lowest rate since 2009 and high demand for limited amounts of large blocks of space will result in more build-to-suit projects. This dynamic should also motivate developers in 2018 to strongly consider new speculative development. However, as supply remains limited to build-to-suit projects, asking lease rates will remain competitive as landlords try to fill vacancies.

[1]Bureau of Labor Statistics, November 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 %	Q4 2017 Net Absorption Sq. Ft. (±)	Under Construction Sq. Ft. (±)	*Average Asking Lease Rate (FSG) $
Downtown	776,166	14.4	14.4	3,417	0	21.30
East Central	2,879,559	11.3	11.4	87,882	0	18.97
North Central	2,240,154	9.2	10.8	(7,259)	0	22.41
Northeast	956,571	27.6	27.7	26,518	0	18.72
Northwest	2,188,065	10.4	10.4	55,188	0	21.11
Southeast	119,157	16.7	16.7	17,102	0	27.00
Southwest	18,000	38.4	38.4	0	0	25.00
West Central	472,328	11.5	11.5	(15,435)	61,355	18.46
Totals	**9,649,000**	**12.6**	**13.1**	**167,413**	**61,355**	**19.60**

*Lease rates are quoted as weighted average of all lease types based on asking price per square foot per year.
Source: CBRE Research, Q4 2017.

Figure 6: Key Transactions

Size Sq. Ft. (±)	Tenant	Address
41,134	Simpleview Inc.	8950 N Oracle
25,271	US Oncology	2625 N Craycroft
20,000	Mural Consulting Corporation*	1455 W River Rd.
14,985	Community Partners	44 E Broadway Blvd.
14,500	Arizona Mining	2210 E Fort Lowell Rd.

renewal*
Source: CBRE Research, Q4 2017.

CONTACTS

Robert Baker
Researcher
CBRE | Southwest Region
3719 N. Campbell Avenue
Tucson, Arizona 85719
+1 520 323 5103
+1 520 323 5156
robert.baker2@cbre.com

Jessica Glick
Senior Research Analyst
CBRE | Southwest Region
2415 E. Camelback Road
Phoenix, Arizona 85016
+1 602 735 5554
+1 602 735 5532
jessica.glick@cbre.com

Jeff Cooledge
Research Manager
CBRE | Southwest Region
2415 E. Camelback Road
Phoenix, Arizona 85016
+1 602 735 5586
+1 602 735 5655
jeff.cooledge@cbre.com

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