UPDATE

Real Estate Trends *in the* Sacramento Region

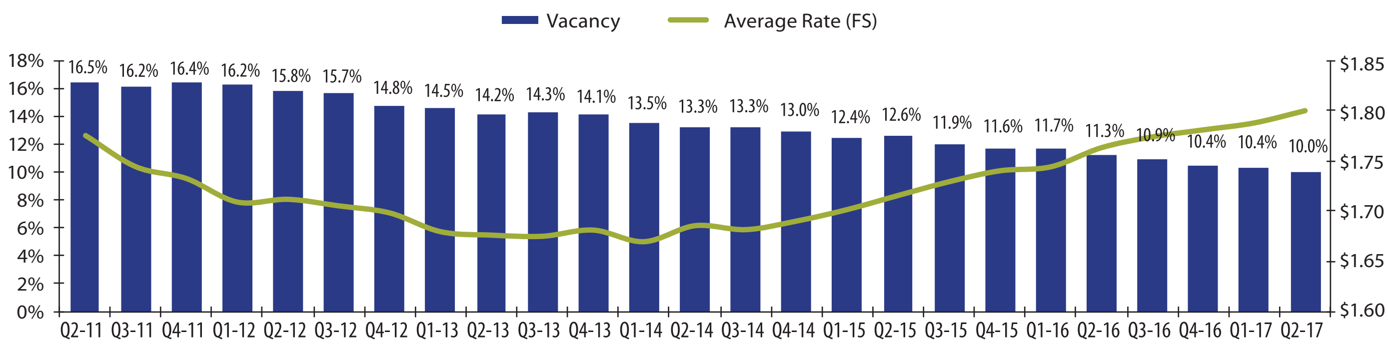
Office

Overall office vacancy in the Sacramento Region decreased by 40 BPS since the previous quarter, and was down by 130 BPS year-over-year (YoY) to 10.0%. Large block space options, particularly in the core Sacramento submarkets, have been growing scarce. With no office projects ready to break ground in the near future, and continuously rising demand, there will be further upward pressure on lease rates. Overall asking rents in the region rose a modest $0.04 PSF since last year to $1.80 per-square-foot-per-month (PSF) on a full service gross (FSG) basis. Central Business District Class A average asking rents remained relatively flat, ending Q2-2017 at $2.86 PSF (FSG). The largest project currently under construction is the build-to-suit (BTS) Adventist Health building located in Roseville, totaling 242k SF and scheduled to deliver in Q3-2018. Second quarter leasing activity was strong, reaching 1.16 MSF and topping that figure from last year by 96k SF. Net absorption was a healthy 290,000 SF for the quarter.

Retail

Although there has been continued pressure from e-commerce, retail is not dead. Grocery, fast casual restaurants, fitness and service oriented sectors have

Figure 1
Office Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

remained the strongest categories in retail, which are predominantly insulated from e-commerce. Demand for Class A retail is strong with vacancy in the 6% range and asking rents in prime submarkets at around $36.00 per square foot per year on a triple-net basis (NNN) and higher for new construction. Overall vacancy has been hovering around 9.4% and is very close to pre-recession levels in 2008 of under 9%. Although leasing activity in the 2nd quarter was slow, this is not an indicator of any lack of demand. There has been a torrential pace of investment activity. Among the numerous retail properties under construction, the most notable in the suburbs is Delta Shores Center (on Beach Lake Rd. at Interstate 5) in the South Sacramento submarket. This new speculative 727,400 SF power center is set to deliver in late 2017, and will add such big box stores as Wal-Mart Super Center and RC Willey Home Furnishings. In Downtown and Midtown, the two key retail projects under construction are Downtown Commons (aka DOCO) and The Ice Blocks. DOCO is situated next door to the Golden 1 Center, and will add 140,000 SF of lifestyle center space, as well as mixed use components like the 20-story Sawyer Hotel, with a delivery date set for the fourth quarter of this year.

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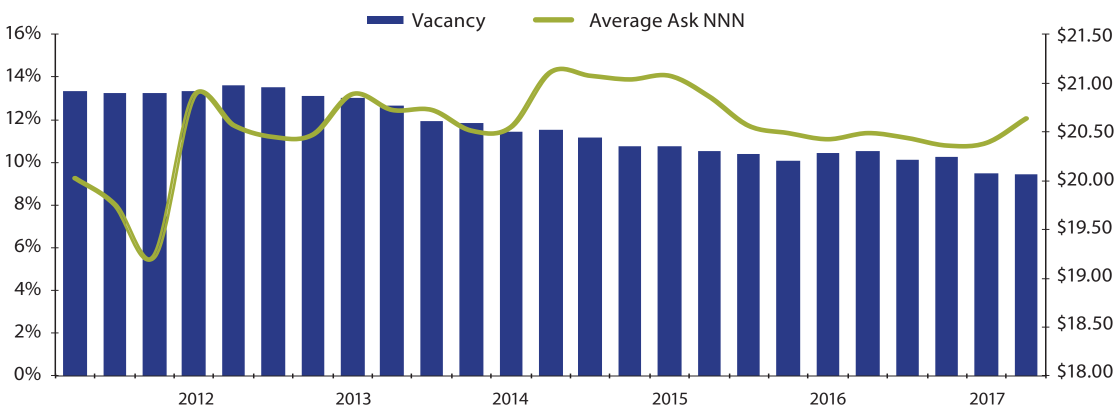
Industrial

Despite the limited amount of available industrial space in Sacramento, the vacancy rate continued to fall in Q2-2017. Compared to only one year ago, the vacancy rate decreased significantly by 200 BPS to 6.2%. Big block spaces (100k SF or larger) in the region grew scarcer during the quarter,

Figure 2
Retail Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

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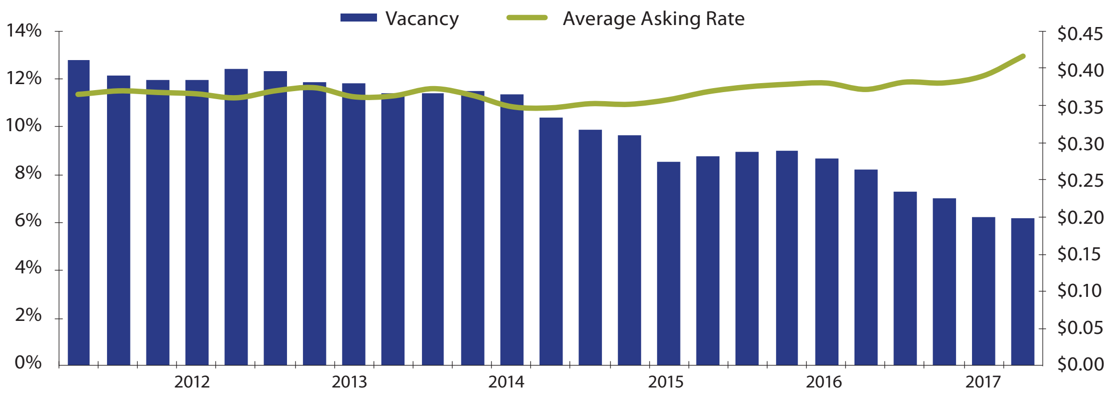
Figure 3
Industrial Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

with only 25 availabilities or half the amount of big block availabilities that were on the market one year ago. The lack of new development in the region is tightening up supply, which will slow the pace of growth if not addressed. Since their lowest point in the last three years (Q2-2015), asking rents have climbed by just $0.07 PSF on a NNN to $0.42 PSF. This can predominantly be attributed to Class A space being leased up at a faster rate leaving more class B space available where rates have not accelerated as fast. There are some buildings that will vacate this year pushing vacancy up, but the current leasing activity should keep the vacancy rate stable or still in decline. With continued demand we anticipate a shift in pricing in response to the shortage of supply and the potential of realizing more speculative development.

Residential

House prices in the Sacramento region continued the recent trend of robust increases during the first half of 2017. The median sale price for all houses in June 2017 was $374,000, which is an approximately 7% increase both from the fourth quarter of 2016 ($350,000) and from June of last year ($349,000). This makes it the 12th consecutive quarter in which prices increased between 6.8% and 9.7% year-over-year, with an 8% average increase in the last three years. Going back a couple more years, house prices in the Sacramento region have almost doubled since the median price bottomed at $179,000 in late 2011. The five consecutive years of significant appreciation have brought the median house price to within 11% of the 2006 peak. In comparison, the Case-Shiller national home price index increased by 5.6% over the past year.

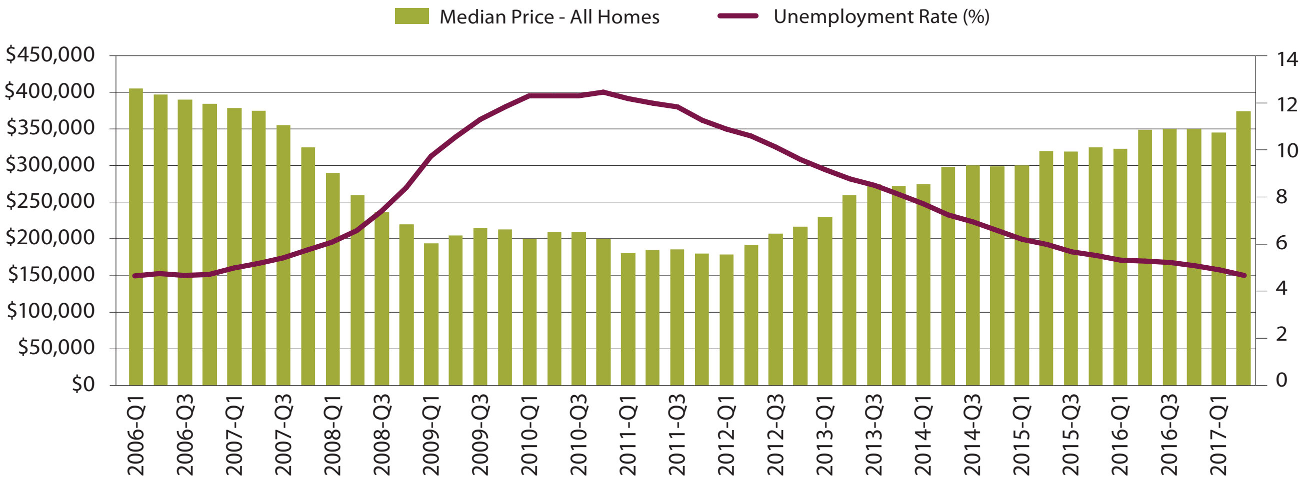
The median price per square foot in the Sacramento MSA for existing single-family residences increased by 9% year-over-year, to $220. Year-over-year changes in price per square foot ranged from 10% in Sacramento County to 5% in Yolo County.

Sales of all homes (condominiums, existing, and new homes) in the Sacramento MSA were essentially the same in the first two quarters of 2017 as in the same period in 2016: slightly under 20,000 units. For perspective, sales increased 14% in 2015 and 6% in 2016. Geographically, Yolo County experienced a 10% increase in sales activity, while El Dorado County saw a 10% decrease.

Just like a year ago, the limited supply of both existing and new housing is the main reason for the robust house price increases. Currently, the average home is on the market for only nine days. The good news is that home construction and sales of new homes continue to trend upward. Sales of new homes increased by 16% year-over-year, from 2,196 in the first half of 2016 to 2,548 in the same period this year. Further, new homes represented 13.9% of all sales in 2017, up from 12.6% in the first two quarters of 2016. However, it is worth noting that both new home inventory and the proportion of new homes in sales both remain far below pre-housing crisis levels. For instance, almost 16,500 new homes were sold in 2005, which represented 28% of all home sales. Other reasons for rising house prices are declining unemployment rates, rising personal incomes, a flood of buyers from the Bay Area, and low mortgage interest rates. In the January issue of SBR, we stated that "significant increases [in mortgage interest rates] may have an impact on the buyers in the entry-level market." This has not materialized, as the average mortgage rate actually declined from 4.2% in January 2017 to 3.9% at the end of June.

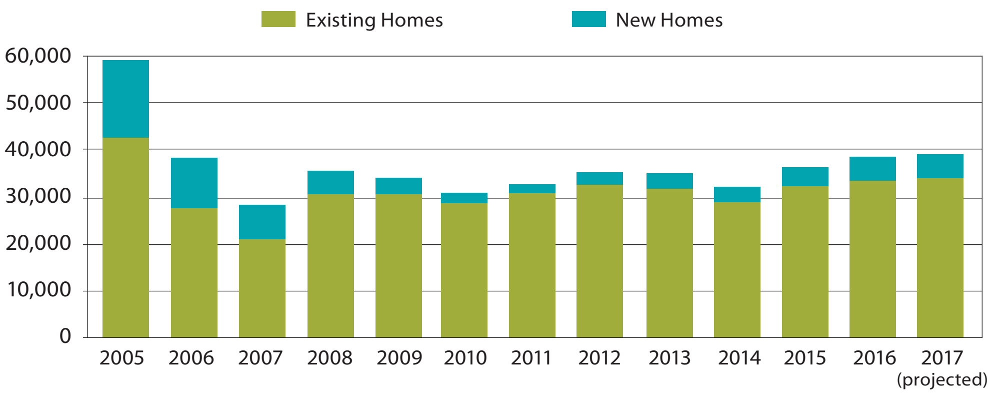
The strength of the housing market is further demonstrated by the continuing decline in distress sales. The real estate owned by banks (REO) represented about 1 out of 40 of all sales in the first two quarters of 2017, while this number was 1 out of 20 even two years ago.

Figure 4
Median Sales Price (All Homes) vs. Unemployment Rate: Sacramento MSA



Data Sources: CoreLogic, Bureau of Labor Statistics

Figure 5
Residential New Home Sales vs. Existing Home Sales: Sacramento MSA



Data Source: CoreLogic