Disruption Spreads Across San Diego's Office Landscape
Sublet Space Reaches Highest Level on Record

By Joshua Ohl

San Diego's office market continues to face obstacles. Although CoStar research will continue to collect lease deals for the third quarter, new leasing volume largely matched the prior quarter and is still down almost 20% compared to the pre-pandemic period.

Both the average new lease size and number of new engagements were roughly 15% and 20%, respectively, below the typical quarterly level between 2015 and 2019.

The lease signed by the San Diego Association of Governments during the third quarter highlights the trend of not only a flight to quality but of tenants rightsizing their footprints. The government agency leased nearly 90,000 square feet at Holland Partner Group's West development in Downtown. That deal shaves roughly 25% from its current location at the 1980s vintage Wells Fargo Plaza there. While the effective rate for the new lease is higher, its monthly gross rent will be lower.

The amount of available office space has eclipsed 20 million square feet this year, and the level has increased for five straight quarters to an all-time high.

The rise can be attributed to a 20-year high of available space in the pipeline, most of which is Downtown. Those projects will begin delivering by the end of this year and are likely to push the local vacancy rate to an all-time high in the process.

Local market participants have noted that the vacancy rate is likely much higher than the headline rate of 11.1% following the third quarter. Some estimates have placed it above 20%, considering the amount of space that is being unused.

That has coincided with a drop in demand. Net absorption, which is the change in square feet occupied, has been negative for the past five quarters. That has matched the streak from the beginning of the pandemic and is otherwise the longest period of declining demand this century.

San Diego's four- and five-star buildings have seen negative absorption in four of the past five quarters, with the third quarter momentarily disrupting the downward spiral.

Conversely, the newest buildings in the region built since 2015 continue to glean demand from firms. Net absorption has been positive for four straight quarters. Those buildings have seen the vacancy rate fall year over year, while the highest-rated properties have seen the rate rise by more than 150 basis points.

Yet, the newest buildings have not been able to sidestep a rise in sublet space, either. Nearly 10% of the newest inventory has been placed on the sublet market, and the amount of overall sublet space peaked at the end of the third quarter above 3.1 million square feet. It was the first time that the total level has exceeded 3 million square feet, and the amount has increased for eight straight quarters.

With an estimated 55% of office leases signed prior to 2020 yet to expire, there is an expectation here that fewer firms will renew their current footprint and instead seek out smaller accommodations, particularly the largest occupiers.