



Medical Office Report

San Diego County

Healthcare Practice Group

Sales ▪ Leases ▪ Renewals ▪ Investments



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JLL Healthcare Practice Group
Healthcare Real Estate Advisory | San Diego

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Market conditions and trends

The San Diego healthcare community as a whole continued to show growth in the first half of the year. Several new medical buildings have been recently completed, are under construction now or are expected to break ground soon – albeit at a pace that is not expected to keep up with demand.

Demand for medical office space is steady, with several submarkets throughout the county seeing new life in terms of leasing and sale activity. Landlords continue to push rents at a moderate pace, a trend that is expected to continue until the market responds in one way or another. Negotiating leases are as challenging as ever at the moment, as tenants point to the impact growing rents have on their businesses while landlords redirect the conversation to market trends and comps. Both parties' positions are justified, and it usually comes down to which party needs the deal more. There are still good opportunities to be found, but the better spaces in well-located buildings are generally not sitting vacant for very long.

The recovery for Class A medical office buildings in particular has been astounding. While the Class B vacancy rate is only half of what it was at its last peak of 15.0 percent in 2009, the Class A vacancy rate is only a fifth of its 2009 peak of 33.3 percent. Additionally, medical office buildings 50,000 square feet or larger are outperforming medical office buildings smaller than 50,000 square feet by greater than one percentage point in vacancy and over two percentage points in overall availability.

Forecast

Seven of the nine submarkets in the county have very healthy vacancy numbers between 5 and 8 percent, and only one of those is over 7 percent. To no one's surprise, this is causing further lift in rental rates. Technically the statistics may not show any growth in average asking rent across the county, but on the front lines rents are no doubt on the rise.

Vacancy



7.2 %

Countywide direct vacancy

Absorption



38,340

YTD net absorption (s.f.)
55,559 s.f. (Q2 2016)

Rents



0%

12-month rent growth
\$2.70 FS Average Asking

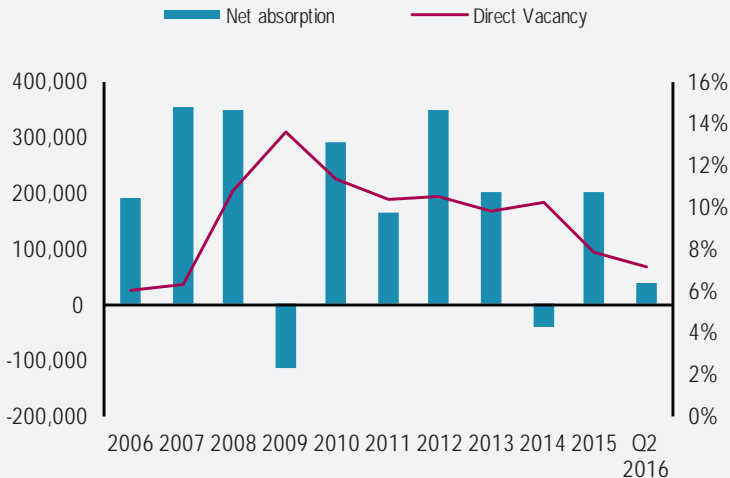
Construction



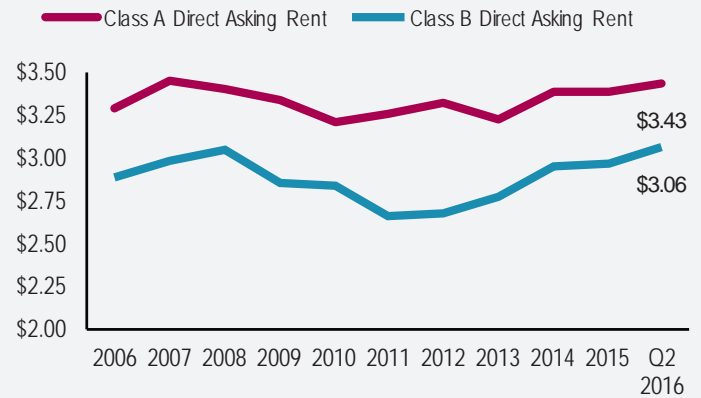
291,680

Total under construction (s.f.)

Net Absorption vs. Direct Vacancy



Class A and B Direct Asking Rents*



* Asking rents weighted by available sf and grossed to FSG

First, landlords are not showing as much room in their asking rents than they were 12-24 months ago (which is not reflected in the published asking rents). Secondly, weighted average asking rent looks only at the vacancy and is more heavily impacted by the buildings housing most of the vacancy, so the lift in rents in the buildings with little to no vacancy is hardly reflected. Finally, the trend over the past several years has been one where doctors are vacating more dated space in B- and C buildings and relocating to A and B+ properties. The result is higher rent space being removed from the market and replaced with lower rent space, keeping a drag on the overall weighted asking rent.

We do expect the rise in rents to slow down, but it will not flatten out anytime soon until more inventory is created in the marketplace. (Investors and developers take note!) It will be interesting to monitor trends in tenant improvement allowances and concessions. At the peak of the last cycle, 10-year leases averaged \$40-50/SF allowances and little to no free rent. Given today's cost of building out or renovating medical office space, we would be surprised if concessions return to such low levels.

S.T.A.T. - Submarkets Tips and Trends

Escondido/San Marcos

The gradual migration of physicians to locales closer to the new Palomar Medical Center campus is finally gaining the momentum we have been expecting since the new hospital opened its doors. It is no small coincidence that this is taking place within a few months of the closure of Palomar's emergency services at its downtown campus, with labor and delivery and NICU services to follow in the near future.

Oceanside / Vista

Tri-City Medical Center and UC San Diego Health have finalized the details of their affiliation and are close to inking UCSD's lease for the entire 3rd floor of Tri-City's new campus MOB, both of which – given some time – will further improve the health of the medical office market in the area. Rents are still low with vacancy still sitting well above the county average, but given the increased activity levels we are seeing in Oceanside and Vista, the future is looking brighter.

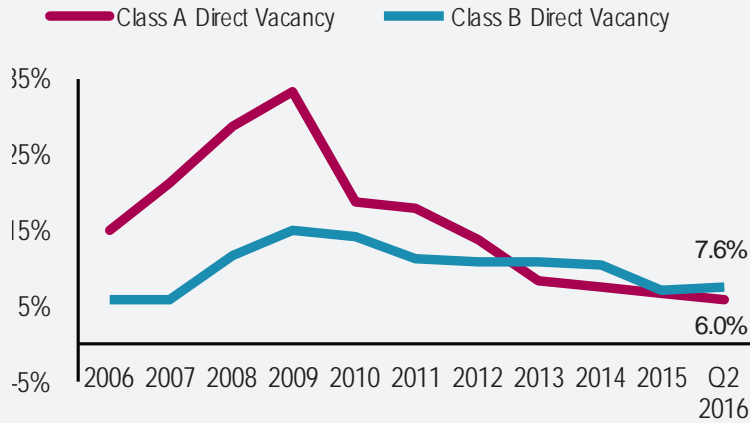
North County Coastal

North County Coastal and UTC/Sorrento continue to battle for bragging rights as the strongest submarket in the county. While NCC's vacancy ticked up slightly and is now higher than that of UTC's, its average asking rent remains higher, and only two of its existing buildings have a total of over 10,000 SF available.

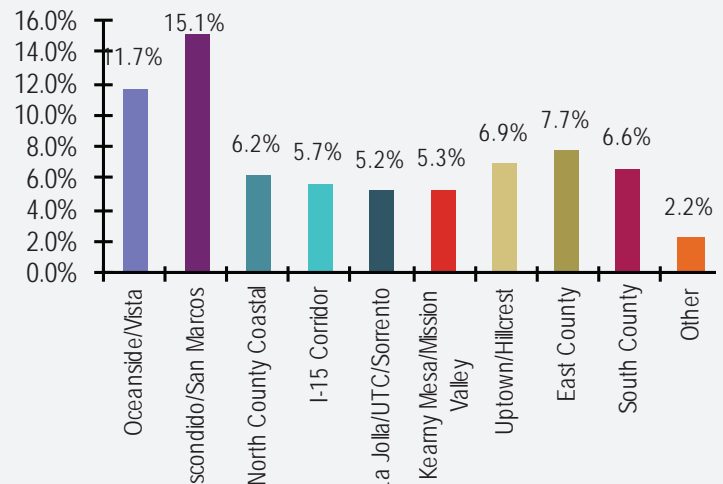
I-15 corridor

It is difficult to talk about the 15 corridor without mentioning Sharp HealthCare. They are making significant progress with their new 100,000-SF MOB above the freeway in Rancho Bernardo, are continuing to expand at Pinnacle Medical Plaza in Scripps Ranch (where they now occupy over 60,000 SF), and most recently they acquired 4.3 acres of land at Del Sur Corporate Center, which is adjacent to the new Target-anchored Del Sur Town Center just west of 4S Ranch. None of this hurts the likelihood of Sharp taking a run at acquiring or affiliating with Pomerado Hospital if the opportunity presents itself.

Class A and B Direct Vacancy Rates



Vacancy Rates - By Submarket



La Jolla / UTC / Sorrento

Scripps has opened its new 175,000-SF Outpatient Pavilion adjacent to the new cardiovascular hospital tower, UCSD has begun construction on its 150,000-SF medical building on campus, and Kilroy Realty will soon be announcing a new proposed 118,000-SF MOB at Mira Mesa Boulevard and Pacific Heights Boulevard. Many wonder how these developments will affect local market conditions; the impact should be minimal. Most of the physicians and services being housed in the aforementioned Scripps and UCSD medical buildings are better suited (if not necessary to be located) on those hospital campuses; and Kilroy's development is about 2.5 years from delivery and is primarily designed for large healthcare providers who would occupy most or all of the building.

Kearny Mesa / Mission Valley

With Kaiser's new hospital set to open in early 2017, it will be interesting to monitor the evolution of not only the area's healthcare and medical office space but the entire eastern Kearny Mesa landscape as a whole. In fact, a brand new, state-of-the-art hospital of a large, growing system will one way or another be part of planning and strategy discussions for many providers throughout the entire county.

East County

After giving back 12,000 SF in 2015 and ending the year at just under 10 percent – with no new leases signed over 3,500 SF in '15 – East County has quietly rebounded with two straight quarters of positive net absorption. Its vacancy now sits at 7.7 percent, and its average asking rent is up nearly 5 percent from a year ago. The uptick in activity is primarily being driven by expansion of existing physician groups.

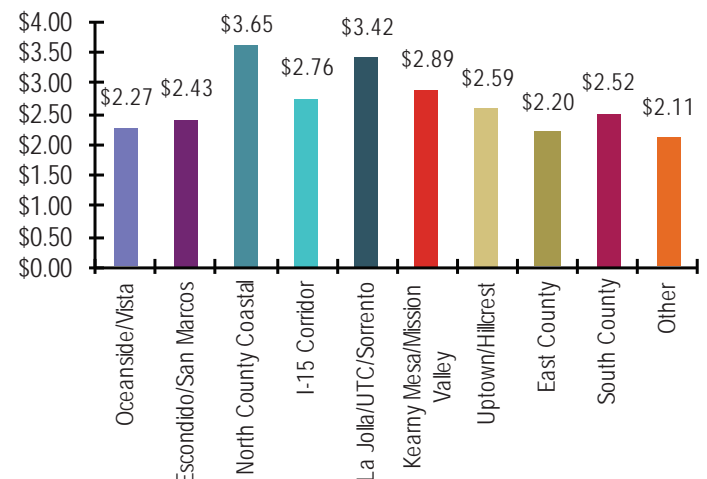
Uptown / Hillcrest

The Hillcrest submarket absorbed 38,000 SF of space last year, dropping vacancy from 12.7 percent to 7.6 percent. This trend is continuing in 2016, with nearly 13,000 SF of positive net absorption year to date. The area's average rental rate has been relatively flat, but most of the buildings near the Scripps and UCSD hospitals are stable and are gradually pushing rents.

South County

Similar to the trends of East County and Hillcrest, South County is another submarket that has shown improvement of late. Over 20,000 SF was absorbed in 2015, resulting in a drop in vacancy from 9.2 percent to 7.7 percent and a rise in asking rents from \$2.35/SF to \$2.47/SF. Another 16,000 SF has been absorbed in the first half of the year, further tightening vacancy to 6.6 percent, and the average asking rent is now at \$2.52/SF. With the population of South County continuing to grow, demand should remain moderately consistent, and local medical office space will slowly continue to be taken off the market.

Direct Asking Rental Rates - By Submarket



754K

current number of Medi-Cal enrollees
(300,000 more than 2013)

2M

increased number of statewide
ER visits by Medi-Cal patients
between 2013-2015
(uninsured visits decreased by 700K)

14.3%

countywide office vacancy
excluding MOB
(7.2% for medical office
and 4.2% for retail)

News and updates

Scripps Health has opened its 175,000-square-foot outpatient clinic next to its cardiovascular hospital tower in La Jolla. The John R. Anderson V Medical Pavilion cost \$130 million and is the first in California to contain cardiac catheterization labs outside of an acute-care hospital. The clinic will house over 50 physicians in 17 different medical specialties, including neurology, endocrinology, gastroenterology, family medicine and imaging.

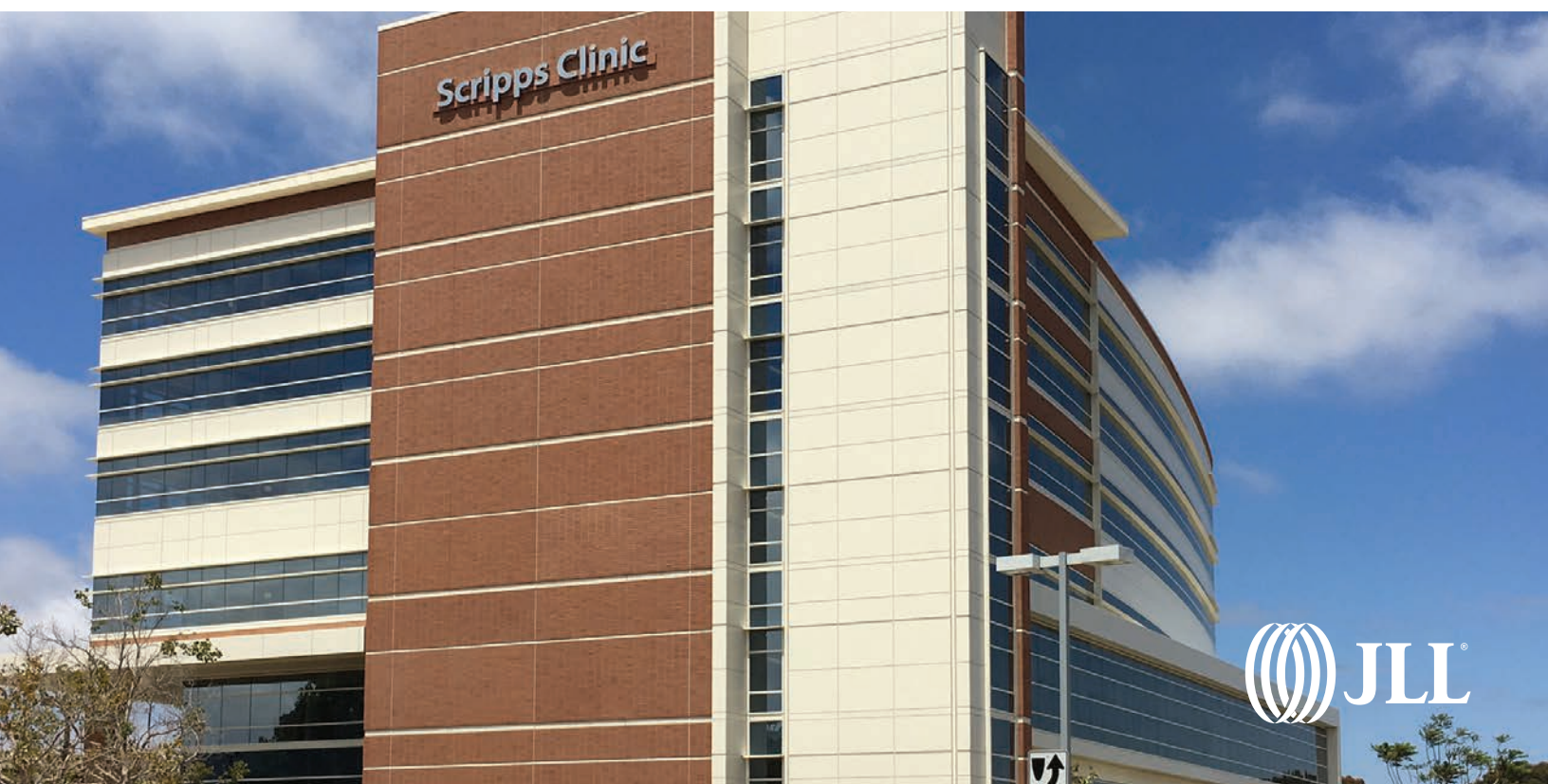
Scripps Health has launched the Scripps Health Network to collaborate with outside free-standing hospitals and physician groups in order to expand its reach without having to purchase those facilities and to create a better continuum of care for its patients. The network is similar to UC San Diego Health's partnerships recently established with hospitals in El Centro, Palm Springs and Oceanside. Additionally, Scripps is working with Sistemas Medicos Nacionales S.A., a health insurance company that serves Californians working across the border in Mexico, who is planning to build a full-service medical center in Tijuana, Mexico.

Palomar Health and Kindred Healthcare have announced their collaboration to build a 58,000-square-foot, 52-bed, acute

rehabilitation facility near Palomar Medical Center. When the new facility opens in 2019, Palomar's existing inpatient rehabilitation program, run by Kindred since 2000, will be moved from the old Palomar Hospital in downtown Escondido.

A jury unanimously decided that Tri-City Medical Center pay \$19.7 million to Medical Acquisition Co. for a 57,000-square-foot medical office building that was built in 2013 and has since remained vacant. The dispute was over the lease entered by Tri-City to lease the building that was built by Medical Acquisition Co. on land owned by the Tri-City Health District. The settlement figure was based upon the jury valuing the building at \$16.8 million and adding \$2.9 million for breach of contract.

San Diego Family Care expanded its Linda Vista Health Care Center to nearly double its size by annexing and converting a neighboring grocery store. The center should accommodate an additional 40,000 patients per year and contains primary care services, dental clinic and a separate space for mental health. It works directly with Sharp Memorial Hospital by receiving direct referrals from the ER for follow up care with patients to be seen within 24-48 hours.



Recently completed lease transactions

Tenant/Use	Cardiology	Confidential	Dentistry	Dentistry
Address	8851 Center Drive La Mesa	865 3rd Avenue Chula Vista	3144 El Camino Real Carlsbad	5525 Cancha De Golf Rancho Santa Fe
Class	B	B	A	A
SF	4,227	9,273	2,102	1,848
Term	84 months	60 months	132 months	126 months
Start Rate	\$1.55 NNN	\$2.85 MG	\$3.12 NNN	\$4.00 FSG
Execution Date	04/18/2016	04/22/2016	06/13/2016	04/11/2016
Increase	3.0%	3.0%	3.0%	3.0%
Free Rent	1 months	3 months	5 months	6 months
TIA/SF	\$19.40	\$15.00	\$20.00	\$60.00
Type	renewal/expansion	renewal	new lease	new lease

Recently completed sale transactions

Project Address	Buyer/Seller	SF	Price/Sale Date	Cap Rate	Leased at TOS	Price per SF
4065 3rd Ave Hillcrest	Family Health Centers of SD Artemisia Property III, LLC	12,050	\$5,969,000 04/14/2016	owner-user	22%	\$495
8933 Activity Rd Mira Mesa	Sharp HealthCare Carson Property Company, LP	36,731	\$9,300,000 06/30/16	owner-user	100%	\$253
3702 Ruffin Rd Kearny Mesa	Gregory Carinci, MD Four D Funding, LLC	4,775	\$1,865,000 12/04//2015	owner-user	100%	\$391
2020 Cassia Rd Carlsbad	Gilbert Lee, MD Amherst Properties, Inc.	6,350	\$4,400,000 03/04/2016	investment	100%	\$693





	Total Inventory (sf)	Q2 Total net absorption (sf)	YTD total net absorption (sf)	YTD net absorption (% of inven- tory)	Direct vacancy (sf)	Direct vacancy (%)	Prior year direct vacancy (%)	Average asking rent (\$ psf)	Prior year avg. asking rent (\$psf)
Oceanside/Vista	972,225	-5,585	-13,511	-1.4%	114,219	11.7%	15.2%	\$2.27	\$2.28
Escondido/San Marcos	929,042	15,949	19,971	2.1%	140,465	15.1%	16.2%	\$2.43	\$2.45
North County Coastal	1,275,126	655	-21,255	-1.7%	79,122	6.2%	6.8%	\$3.65	\$3.61
I-15 Corridor	881,846	1,506	1,501	0.2%	49,905	5.7%	6.1%	\$2.76	\$2.77
La Jolla/UTC/Sorrento	1,804,326	14,324	2,500	0.1%	92,980	5.2%	3.5%	\$3.42	\$3.29
Kearny Mesa/ Mission Valley	1,462,243	-434	-3,155	-0.2%	77,944	5.3%	7.8%	\$2.89	\$2.96
Uptown/Hillcrest	958,378	14,200	12,663	1.3%	66,187	6.9%	7.1%	\$2.59	\$2.78
East County	1,782,824	14,505	18,957	1.1%	136,716	7.7%	8.9%	\$2.20	\$2.11
South County	1,413,762	868	16,112	1.1%	92,999	6.6%	8.3%	\$2.52	\$2.40
Other	525,358	-429	4,557	0.9%	11,525	2.2%	3.7%	\$2.11	\$2.64
Market Totals	12,005,130	55,559	38,340	0.3%	862,062	7.2%	8.2%	\$2.69	\$2.70

Investment sales spotlight

Medical office investment sales activity in 2016 has been very similar to last year. Cap rates remain extremely low but appear to have finally flattened out, and pricing remains at record-breaking numbers. The county saw \$167 million in total sale consideration last year, and it is on pace to reach a similar figure in '16, with \$74.5 million trading in the first half of the year. Interesting to note that none of these sales have been over \$10 million. With several large transactions having just closed or pending in the market as this report is being produced in the 3rd quarter, there is a chance we could see an all-time record sales volume by the time the year closes out. Similar trends are occurring nationally, but the overall sentiment is that many buyers are starting to pull back in hopes of finding better acquisition values in 2017 and beyond. After the sector performed so well during the last recession, it will be interesting to monitor the influx of corporate/traditional office investors into the healthcare market, recognizing that medical office may be more resistant to a dip in the economy than traditional office.

SUBMARKET AND HOSPITAL LOCATIONS



- 1 Scripps Memorial Hospital Encinitas
- 2 Scripps Green Hospital
- 3 Scripps Memorial Hospital La Jolla/Prebys Cardiovascular Institute
- 4 Scripps Mercy Hospital Hillcrest
- 5 Scripps Mercy Hospital Chula Vista



- 6 Sharp Memorial Hospital/Sharp Mercy Birch Hospital
- 7 Sharp Grossmont Hospital
- 8 Sharp Coronado Hospital
- 9 Sharp Chula Vista Medical Center



- 10 UCSD Thornton Hospital/Jacobs Medical Center
- 11 UCSD Medical Center Hillcrest



- 12 Palomar Health Downtown Campus
- 13 Palomar Medical Center
- 14 Pomerado Hospital



- 15 Rady Children's Hospital



- 16 Alvarado Hospital Medical Center
- 17 Paradise Valley Hospital



Tri-City Medical Center

- 18 Tri-City Medical Center



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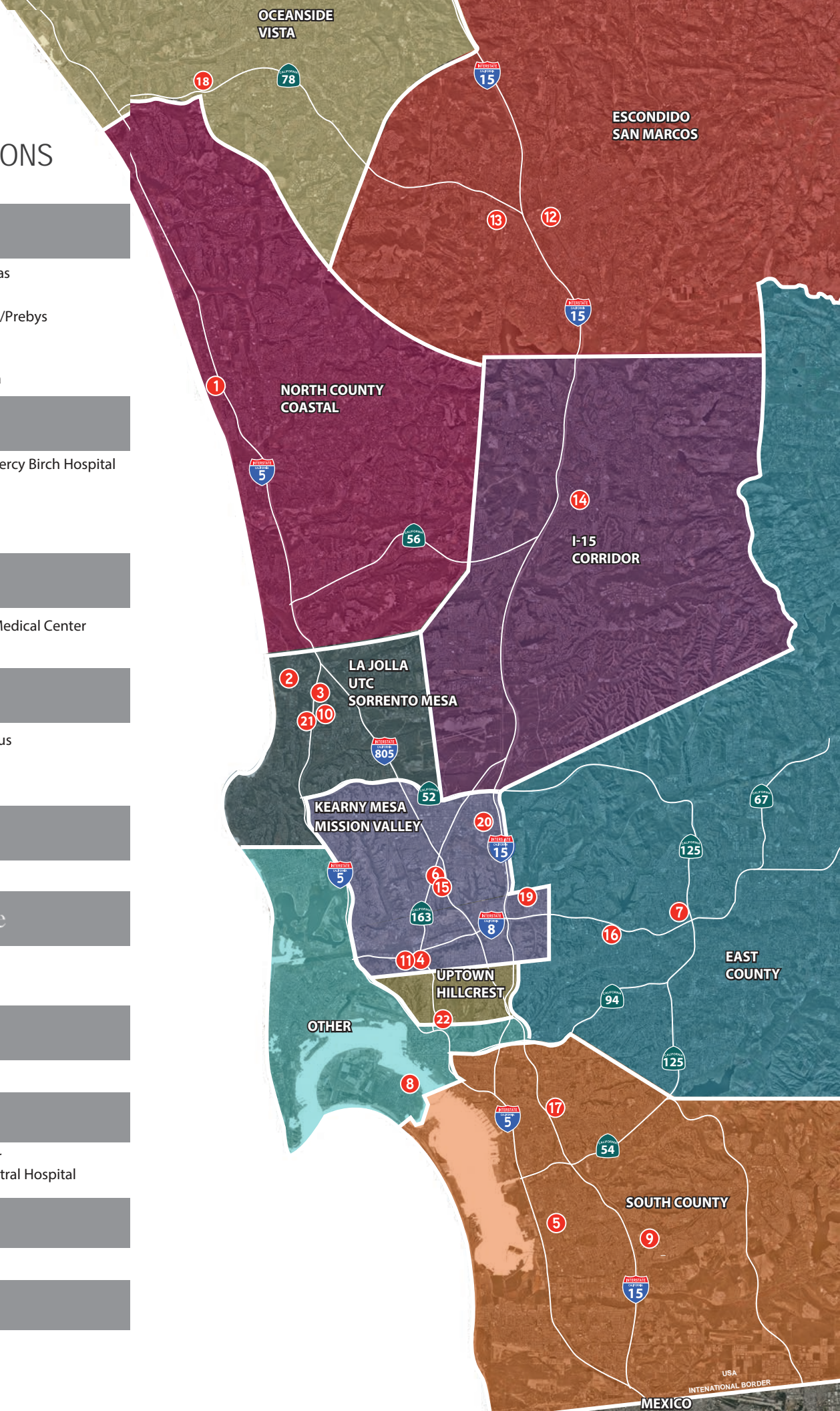
- 19 Kaiser Permanente Medical Center
- 20 Kaiser Permanente San Diego Central Hospital



- 21 VA San Diego Healthcare System



- 22 Naval Medical Center San Diego



JLL Healthcare Practice Group

Healthcare Real Estate Advisory | San Diego

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Hospitals and health systems | Strategic consulting, transactional advisory services, portfolio optimization

Dental practices | Purchases and leases, practice sales, unique opportunities

Developers and investors | Development and asset advisory, leasing, acquisitions and dispositions

JLL Expertise

Hospitals

Health systems

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Medical office buildings

Surgery centers

Large physician practices

Public institutions

Sole Practitioners

Dental Practices



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