

# **2015 Commercial Real Estate**

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## Key Chapter Findings

- Active commercial markets.
- New commercial construction underway.
- Strong interest in mixed use.
- Redevelopment projects starting construction.

## The Residential Market—A Brief Overview

### San Luis Obispo

There continues to be confidence in residential property in San Luis Obispo. Total single family unit sales were up a tick from 259 single family units in 2014 to 283 units in 2015 and the correlating median price moved from \$654,500 to \$667,000. This translates to a 1,704 square foot median home in San Luis Obispo selling for approximately \$391 per square foot. As noted last year San Luis Obispo has passed the 2008 pre-recession high point in both volume and value. The balance of the County is catching up but not with the same velocity.

### North County

In North County 2015 unit sales (1,138 units) are slightly above 2014 (1,032) unit sales. Median prices, however, moved from \$375,000 to \$404,500 and sold in a similar time frame of 35 to 40 days on the market. As a note of comparison, a 1,704 square foot home sells in North County for an average of \$237 per square foot, highlighting the premium in housing prices paid to live in the City of San Luis Obispo.

### Housing Projects in San Luis Obispo

San Luis Obispo, known for slow housing growth, is leading the Central Coast in production and diversity of offerings.

- Sierra Meadows on Prado Road is actively moving through phases of single-family detached homes.
- ROEM Development in conjunction with the Housing Authority is nearing the finishing stage of a housing project on South Street.
- Brownstones on Marsh is now under construction with a price for downtown residential in the \$1,800,000 range.
- The Terraza project at Bridge Street with 18 residential homes and eight live work loft units is under construction.
- The Avivo Townhome project is in full construction and currently is in its second phase.

There are other projects that have been proposed through the years but were mothballed during the economic slow down. These projects have been re-worked and are now in various stages of approval and construction. Some are mixed use redevelopment and some are more typical single-family residential and multi-family projects.

These projects include:

- Pacific Courtyards
- Chinatown—under construction

**Residential Unit Sales, 3rd Quarter Annual Data**

Variable	2008	2009	2010	2011	2012	2013	2014	2015
San Luis Obispo								
# Units Sold	159	163	191	215	273	282	259	283
Median Price (\$)	635,000	569,000	550,000	535,000	535,000	618,500	654,500	667,000
North County								
# Units Sold	638	702	698	892	991	1,045	1,032	1,138
Median Price (\$)	390,000	340,000	296,000	270,000	305,000	355,000	375,500	404,500

Note: Comparative data is for the first three quarters of each year

Source: Central Coast Regional Multiple Listing Service;

Compilation by Stafford McCarty Commercial Real Estate

- Monterey Place
- The reworking of the Dalidio project (now San Luis Ranch) to provide more housing and less commercial space
- Wingate Homes, Righetti Ranch, the Jones Property, and West Creek—all in the Orcutt Area Specific Plan
- Avila Ranch South of the SLO County Airport
- Toscano off of Prado Road

Above is a summary of unit sales from 2008 through 2015 in San Luis Obispo and North County.

The recovery of the housing market is well under way. The new home construction market, which had been noticeably absent, is ramping up on the Central Coast. If this residential growth continues, the spill over effects on demand for home interiors, appliances, furniture, etc., will create increased demand for commercial real estate products.

## Commercial Markets

The commercial markets are active. Land sales for mixed-use redevelopment—primarily residential over retail—in the urban cores has picked up. Ironically, at the peak of the market, this product type was difficult

to finance as it was yet unproven in the Central Coast area. It will be interesting to see how this approach plays out, as not much of this residential over retail has actually been brought to market.

## Commercial Markets in San Luis Obispo

Across all real estate sectors, we are seeing the available inventory shrink to very low levels. There is a vibrancy in San Luis Obispo with restaurants, expanding tech, and real estate and its supporting businesses filling past vacancies.

Several large projects have grabbed recent headlines: The San Luis Ranch Project (formerly the Dalidio Ranch annexation), is still pushing forward and the From Ranch Project on Los Osos Valley Road is now starting the annexation process. Other commercial projects that have been in the planning stages are now under construction. They include Tractor Supply and the University Square make-over, to name a few.

## Redevelopment

Numerous parcels have been purchased in downtown San Luis Obispo and plans are in various stages of approval. PB Group closed on the former Foster's Freeze, Feathers Salon, and a Heritage Oaks Bank Building—as well as two parcels adjacent to Coast National Bank.

**Commercial Vacancy Rates (%), San Luis Obispo City Metropolitan Area, 2014**

Property	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Industrial/Warehouse	6.4	4.0	4.3	2.3	5.4	6.1	9.1	8.7	4.5	1.9	3.1	2.3
Retail Functioning	2.2	1.7	1.8	1.4	3.0	5.6	5.1	3.4	3.7	1.8	2.7	1.3
Office Functioning	5.4	3.2	4.7	3.5	6.1	9.7	12.6	11.6	8.6	6.5	7.5	5.3

Source: Stafford McCarty Commercial Real Estate

Both of these acquisitions provide for redevelopment between Higuera and Marsh Streets. These sales were in the \$100 to \$150 per square foot range and three to four story mixed use and small studio apartments are in the planning stages. The mid 500 Higuera block mobile home park was purchased, the old coaches removed, and plans are moving forward to install new modular houses. The building formerly occupied by CCS, in the 600 block of Higuera Street, continues to be renovated and will eventually house SLO Brew. Progress can be seen on the Chinatown Project with new foundations and steel in the air.

Several downtown improved property and land transactions include:

- 1234 Broad Street (9,000 sq. ft. building shell w/o parking)—\$2,000,000 (\$222 per sq. ft.)
- 1511 Monterey (2,400 sq. ft.)—\$725,000 (\$302 per sq. ft.)
- 590 Marsh Street (13,329 sq. ft. small restaurant improvement to be demolished)—\$2,000,000 (\$159 per sq. ft.)

**New Construction on Raw Land**

Specialty Construction is still doing site work on their approximately 6.16 acre site on Buckley Road for a three building project. The project was originally being built for lease but now the marketing has opened up and these buildings could also be purchased. They also have a ten-acre parcel on the market east of the subject site on Buckley Road.

Small lots, roughly a half-acre in size, have sold for approximately \$18 per square foot on Earthwood Lane.

This is the high watermark on price with other Industrial and CS zoned land at approximately \$10 to \$15 per square foot on offerings and appraisal discussions. Prices can be higher if the parcels have a retail presence or the potential to be rezoned for a more profitable use.

**New Construction—Investment vs. Owner Users**

Over the last few years, the most concentrated new development has been the East Airport lots, located in the County, adjacent to the City of San Luis Obispo. Now with most of the parcels sold, the majority of the sales have gone to owner users and the balance have been built-out by investors with a tenant in tow (government or high tech). Just north, but in the City, there continue to be three large projects approved but waiting for tenants.

**Building in the City of San Luis Obispo vs. the County**

The continuing issue in local development is building fees, which in the City of San Luis Obispo can be \$17 to \$25 per square foot of building area. This, on top of the relatively high cost of the ground, makes many speculative projects non-starters.

The County, on the other hand, can have building fees in the \$8 per square foot range making the economics look affordable. However, building in the County can be resource constrained. Projects can be limited to size and/or the number employees by the availability of water and septic capacity.

## Retail

Retail vacancy has dropped again, now down to 1.33% from an already low percentage of 2.7%, in 2014. This equates to approximately 55,500 square feet vacant in a market with a base inventory of approximately 4,164,000 square feet. A smattering of only 4,817 square feet of new construction was added to the base inventory this past year. Retail, as indexed in our summary table, has been a strong performer over the past year, having the lowest vacancy of any market sector.

## Office

For 2015, the office base inventory is approximately 2,804,000 square feet. Vacancy has turned around, dipping to 5.3%, down slightly from 7.45% last year. Total available office inventory in San Luis Obispo is approximately 148,770 square feet.

There is an interesting shift occurring in the office market. There are many smaller units (1,500 to 2,500 square feet) available, but not much larger office space of 5,000 square feet and up. We see large users looking for office space, but in this market there is no inventory of any significant size, leaving only new construction with corresponding rents for over \$2.00 per square foot NNN.

For the office sector we have seen the following market responses to demand:

**New construction.** Offices and an adjacent parking structure were built for MindBody as a build to suit; there was no existing inventory available in the market to meet their requirements.

**Absorption of older inventory.** The last large □second generation□ space sold was the approximately 19,800 square foot former SESLOC Credit Union building selling to the non-profit Pathpoint for approximately \$3,275,000 or \$164 per square foot.

Finally some speculative office product is being built. There is an approximately 7,300 square foot building that is nearly complete, and foundation work has started on a second building of similar size, at the San Luis Obispo Airport Business Center.

## Industrial

The vacancy rate for industrial product has decreased to 2.27%, down slightly from 3.14% in 2014. Available manufacturing inventory is approximately 86,575 square feet with a total base of industrial inventory at approximately 3,841,000 square feet.

Functional industrial space has all but disappeared. There is currently only one vacant space for lease in the market over 10,000 square feet that is truly warehouse/manufacturing space. Several speculative projects are available for sale, but with the price of new construction and less expensive industrial space in other communities, tenants have been difficult to find.

Quoted industrial rents are approximately \$.90 to \$1.25 per square foot NNN. The following noted sales went quickly into escrow:

- 699 Clarion Court (7,971 sq. ft.)—\$1,795,000 (\$225 per sq. ft.)
- 695 Clarion Court (6,506 sq. ft.)—\$1,250,000 (\$192 per sq. ft.)

A handful of industrial condominiums have sold, selling in the \$120 to \$176 per square foot range for 1,200 to 2,500 square feet. Smaller industrial units are in high demand and are quickly snapped up when they come to market.

The former SLO Motorsports building on South Higuera Street was purchased a couple of years ago for a hotel but the owner decided not to build and it was resold to John Kings operation for \$180 per square foot of building. Speculation is that it will be a new craft beer related enterprise.

## Downtown San Luis Obispo

The younger workforce is eating out and restaurants are reaping the benefits. Bloomberg Business reports that sales at restaurants and bars overtook spending at grocery stores in March 2015 for the first time ever, according to U.S. Commerce Department data. While many lament the loss of mom and pop retailers downtown and their replacement by restaurants, this trend may bode well for the new mix of retail and restaurants in San Luis Obispo.

There continues to be a large spread in rents in downtown SLO. Second and third generation rates are typically \$1.75 to \$2.00 per square foot while remodeled buildings have asking rents between \$2.00 and \$3.50 per square foot. In the core blocks of downtown, rents can be as high as \$4.50 per square foot. As vacancy tightens, lessors are getting higher renewal rents. Higher rents continue to make it difficult for mom and pop retailers to compete for downtown space with larger regional or national retailers.

## Commercial Markets in Paso Robles and North County

Although the market overall has been performing well in 2015, there has been a dearth of new buildings. Within the City of Paso Robles, Firestone Walker Brewery added about 14,000 square feet to its facility. And that was the new, finalized construction in the City. Looking ahead, there have been sales in the industrial parcels north of Golden Hill Road, and a sale on Commerce we would expect building plans to follow.

### Retail

There was a touch more inventory in the Paso Robles retail market in 2015 with approximately 127,726 square feet. With no new inventory added this last

year, the base holds at approximately 4,646,000 square feet. The vacancy rate is 2.75% for 2015, which is, for all purposes, minimal. Recent land sales downtown evince values of \$34 to \$50 per square foot.

### Office

There is confidence in Paso Robles commercial space. In 2015 there is approximately 32,320 vacant square feet of space, down from approximately 61,500 vacant square feet last year. This has cut the vacancy rate almost in half, to 7.48%. No additional inventory was added this last year and the base remains the same at 431,996 square feet.

Sesloc Federal Credit Union sold its downtown prime corner building on a quick sale to Founders Bank. There were multiple offers on the 2,196 square foot free-standing corner building which sold for \$376 per square foot. A well-appointed 2,264 square foot Vine Street Victorian home converted to an office sold for \$405 per square feet. An antidotal note: As one would expect, correlating office rates for well-located spaces have shot up. The former Union Bank space in the heart of downtown is asking \$2.95 per square foot. This high rate is rent territory for this community. We expect more to follow in the key located smaller property offerings. On the flip side, the story for mid-block, non-downtown Spring Street modest offices, are rental rates at about half of these values.

### Manufacturing

The industrial sector added modest inventory of approximately 65,778 square feet in 2015 with a base inventory of approximately 3,353,428 square feet. Most of this inventory was in Templeton on the edge of Paso Robles. There is almost no inventory of industrial space only 37,941 square feet at the time of this reporting in 2015.

### Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2014

Property	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Industrial/Warehouse	10.7	3.5	5.0	2.8	7.5	13.2	8.0	7.7	6.5	5.7	3.6	1.1
Retail Functioning	< 1.0	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5	3.5	4.8	3.3	2.6	2.8
Office Functioning	1.8	1.2	5.2	5.6	7.7	24.1	17.5	18.4	18.3	6.6	14.3	7.5

Source: Stafford McCarty Commercial Real Estate

Industrial vacancy has become even more skinny since last year's 3.62% and now is approximately 1.1%, which is amazingly low.

There have been active industrial parcel sales in the northern industrial area at Golden Hill that demonstrate values of about \$4.00 to \$5.00 per square foot for two to three acres. Asking rates are approximately \$6.00 to 8.00 per square foot for the finished parcels. Smaller industrial condos are selling in the \$100 to \$140 per square foot range depending on interior finish.

Wineries keep driving inventory needs as they fill existing inventory and apply for additional expansion. Bensen Cellars absorbed multiple 10,000 square foot buildings on Limestone in Templeton. San Antonio Winery is under construction on two Wisteria parcels of 85,951 square feet. Speculative buildings are being erected by Cornerstone Development along Ramada Drive, and are leasing before being completed to wine support industries such as Tapp Labels and Scott Labs.

#### Hotels in San Luis Obispo and North County

With both rack rates and occupancy increasing, hoteliers are scrambling to get new product on line. The proposed number of new rooms is staggering.

Hotel projects on the books in San Luis Obispo include:

The historic Motel 6 site on the north end of town, plans for a hotel project behind Pappy McGregor's

restaurant, a hotel at the north end of Calle Joaquin, the San Luis Ranch project which is slated to entitle approximately 200 rooms, the Chinatown and Garden Street downtown projects both have hotels as part of their plans, and the quaint Granada Hotel is looking to expand their number of rooms.

In North County, the behemoth number of hotel rooms proposed has grown even larger. Noting the completed Ayers project of 225 rooms and the La Quinta 37 room expansion project, planning applications have been approved for approximately 600 rooms, with applications submitted for another 124 rooms, and long range proposals for an additional 600 rooms. As an index of how much the area has transformed into a destination, ten to fifteen years ago the business community was trying to figure out how to get people to stay the night in the existing hotels as the overnight stays leaked to the coastal area.

#### A Note on Agricultural Impacts

With all the talk about viticulture and related industries, berries are still a large part of San Luis Obispo County's agricultural picture. Los Primos purchased a 129.4 acre south county strawberry ranch for \$6.25M, or approximately \$49,000 per plantable acre. Ranches in the Santa Maria Valley have been selling in the \$55,000 per acre range.

Demonstrated values for smaller North County cabernet vineyards (extracted values to compensate for other improvements on the property) include: 24.77 acres sold for \$36,612 per acre, a recent sale on San

Marco Road, and an east side sale at \$30,200 per acre for approximately 64 acres.

Many new industrial buildings, which have been added to the inventory in recent years, have been absorbed by wineries or craft beer operations.

Ground water management decisions: The County of San Luis Obispo finally has imposed conservation restrictions mandating conservation off-sets to balance new demand in the Paso Robles and Nipomo basins. The effects and complexities of this decision will come to light over the next years as it is enforced.

### Commercial Investments

The investment market in the Central Coast is active with both on market and off-market sales occurring. We are seeing downward pressure on cap rates as more investors discover the Central Coast and invest here. Properties in good areas continue to sell. Low interest rates are also working to keep cap rates low.

The investment sales selected below demonstrate the range in the present market on the Central Coast:

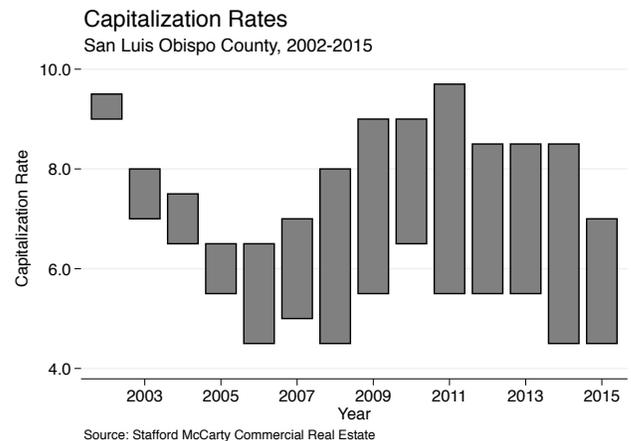
- 560 Higuera (12,017 sq. ft.)—\$2,950,000 (\$245 per sq. ft.; Cap 6.1)
- 102 Cross Street (17,400 sq. ft.)—\$3,225,000 (\$185 per sq. ft.; Cap 6.5)
- 142 Cross Street (12,585 sq. ft.)—\$2,075,000 (\$165 per sq. ft.; Cap 6.75)
- 205 Oak Hill Niblick (12,385 sq. ft.)—\$3,850,000 (\$310 per sq. ft.; Cap 7.4)

There remains a strong market group of buyers seeking multi-family investments, (apartments). These are still in the sub five capitalization rates ranges.

In evaluating a property, appraisers typically apply a 5% vacancy factor to income. We are seeing this va-

cancy factor being pushed down to 3%. This in turn drives the net income calculation for the property higher and provides more value to the property. If lenders and appraisers were forced to pick a single cap rate for our market, we would see them start with a 6.5.

Following are capitalization rate ranges evinced over the last thirteen years for our market area:



To illustrate the capitalization influence on valuation, let us assume a commercial building produces a net income to the investor of \$100,000 per year. The declining market cap rates would correlate to the approximate purchase prices according to the following years:

#### Cap Rates and Implied Value

Year	Cap Rate Range		Implied Asset Value (\$)
	Low	High	
2003	7.0	8.0	1,428,000
2004	6.5	7.5	1,538,000
2005	5.5	6.5	1,818,000
2006	4.5	6.5	2,222,000
2007	5.0	7.0	2,000,000
2008	4.5	8.0	2,000,000
2009	5.5	9.0	1,818,000
2010	6.5	9.0	1,538,000
2011	5.5	9.7	1,818,000
2012	5.5	8.5	1,818,000
2013	5.5	8.5	1,818,000
2014	4.5	8.5	1,818,000
2015	4.5	7.0	1,428,000

Source: Stafford McCarty Commercial Real Estate.

## Conclusions

The post recession economy has finally reached the Central Coast markets. Almost all areas are improving; purchase prices as well as rents are rising. Housing around San Luis Obispo is active and carries an aura of excitement. The planning back-logs remain significant. Mixed use in the downtown cores is trending upward. Paso Robles, once skipped over for overnight stays, has become a destination. There is growing confidence in owning commercial real estate. Long-term money is down right cheap, if you can qualify. Values are near where they were prior to the recession and rents are catching up. With new construction, there are new high water marks being set. And everyone is keeping a watchful eye on interest rates—a potential game changer.