

# Commercial Real Estate

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## Key Chapter Findings

- Active commercial markets.
- San Luis Obispo is under construction.
- Strong interest in mixed use.

San Luis Obispo County is seeing confidence in commercial real estate and residential development. The following is a break out of the County's market sectors and regions.

## The Residential Market—A Brief

### Overview

#### San Luis Obispo

San Luis Obispo is producing a wide range of housing products from small, subsidized housing to downtown brownstones selling for over \$2,000,000. Total single family unit sales were virtually the same in 2015 (283 single family units) and 2016 (286 units in 2016), and the correlating median price went from \$667,000 to \$705,000. This translates to a 1,772 sq. ft. median priced home in San Luis Obispo selling for just under \$400 per sq. ft. The surrounding market areas, from Santa Maria in the south to Paso Robles in the north, have not shared in the same economic recovery as San Luis Obispo, but are starting to gain momentum.

#### North County

In the North County the market volume was slightly lower this year than last (1,137 units sold in 2015 compared to 1,088 units in 2016), but values have risen. The median price has grown to \$250 per sq. ft. for a 1687 sq. ft. home. The median price increased from \$404,500 in 2015 to \$422,421 in 2016 and homes sold

in a similar amount of time, averaging 35 to 40 days on the market in both years. Although the price per sq. ft. in Paso Robles is less than in San Luis Obispo, the prices in Paso Robles are rising at a faster rate. As an additional note of comparison, the median home price in Santa Maria is just over \$200 per sq. ft. This is evinced by the jammed north and south traffic corridors into job rich San Luis Obispo during the mornings and evenings—workers will commute to purchase a home they can afford.

#### Housing Related Projects in San Luis Obispo

San Luis Obispo, long known for its slow growth approach, is now seeing many residential projects coming on the market, with more breaking ground and more still making their way through planning.

Projects at, or near completion:

- The Avivo Town Home project has completed its building east of Sacramento Street and is in full construction of its final phase west of Sacramento Street.
- HASLO is completing construction of its affordable housing units on Humbert and Victoria.
- Sierra Meadows on Prado Road is actively moving through phases of single-family detached homes.
- The Terraza project at Bridge Street, with 18 residential homes and eight live/work loft units, is under construction.

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

Variable	2009	2010	2011	2012	2013	2014	2015	2016
San Luis Obispo								
# Units Sold	163	191	215	273	282	259	283	286
Median Price (\$)	569,000	550,000	535,000	535,000	618,500	654,500	667,000	705,000
North County								
# Units Sold	702	698	892	991	1,045	1,032	1,138	1,088
Median Price (\$)	340,000	296,000	270,000	305,000	355,000	375,500	404,500	422,421

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

- Coastal Community Builders has completed their SLO Terrace construction and sold 12 of their 17 units.

On-going projects include:

- Pacific Courtyards is currently under construction.
- Chinatown is currently under construction.
- The Dalidio project, now known as San Luis Ranch, is continuing to rework its entitlements for more housing and less retail.
- Wingate Homes, Righetti Ranch, the Jones Property, and West Creek □ all located in the Orcutt Area Specific Plan □ are proceeding.
- Avila Ranch, south of the SLO County Airport, is continuing through planning.
- Toscano, off of Prado Road, is under construction.

Above is a summary of housing unit sales from 2008 through 2016 in San Luis Obispo and North County.

## Commercial Markets

There is strong confidence in real estate as outlined in the following sections broken out by regions and market segments.

### Commercial Markets in San Luis Obispo

There is a vibrancy about San Luis Obispo with new construction and revitalization projects occurring throughout the City. Over the past few years, much of the new commercial construction in town has been completed in the East Airport area, currently part of the County with its lower fee structure. As confidence in the economy has increased, we have seen buildings constructed for owners/users themselves and/or build to suits for particular tenants. More recently we are starting to see speculative building to meet the backlog of demand. Wineries, craft beer, new retail downtown, mixed use—it is all happening simultaneously.

### Retail

Retail vacancy increased this last year due to a few large spaces that came on the market—former Forever 21 and Staples—otherwise it remains very strong. Present vacancy stands at 5.62%, up from the previously low percentage of 1.33%, in 2015. This equates to approximately 234,250 sq. ft. (about half of that is the former Forever 21) vacant in a market with a base inventory of approximately 4,169,000 sq. ft. Retail square footage added virtually nothing to the in-

**Commercial Vacancy Rates (%), San Luis Obispo City Metropolitan Area, 2016**

Property	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Industrial/Warehouse	4.0	4.3	2.3	5.4	6.1	9.1	8.7	4.5	1.9	3.1	2.3	1.6
Retail Functioning	1.7	1.8	1.4	3.0	5.6	5.1	3.4	3.7	1.8	2.7	1.3	5.6
Office Functioning	3.2	4.7	3.5	6.1	9.7	12.6	11.6	8.6	6.5	7.5	5.3	3.8

Source: Stafford McCarty Commercial Real Estate

ventory this last year, however there was a lot of re-purposing of existing buildings.

A telling land comparable, 245 Higuera, a lower Higuera midblock location with an older metal building, was razed and sold for the purposes of its land, which calculated to approximately \$96 per sq. ft.

### Revitalization of Retail Centers

San Luis Obispo currently has a number of retail areas that are being rebuilt, revitalized, with some things yet to come.

University Square on Foothill and Santa Rosa has upgraded many of its buildings and created a vibrant tenant mix with new a new grocery, restaurant, pharmacy, and numerous new retail businesses.

Foothill Plaza is in the midst of a makeover with its first phase near completion and its second phase set to start in December. California Fresh Market is scheduled to open soon, providing a full service grocery store on that side of San Luis Obispo.

Chinatown has seen the opening of H&M, Williams Sonoma, Lululemon, and others as part of the first phase of downtown retail development. This project has a larger percentage of national tenants compared to the other revitalized centers.

Tractor Supply on Tank Farm, close to Higuera, has completed construction of its new building and is open for business.

The 95,000 sq. ft. Forever 21 space at Madonna sold at the beginning of the year for \$13,650,000, or approximately \$144 per sq. ft. This product is presently vacant and its repositioning is still unclear.

### Office

The office market segment is exciting and seeing new product. Vacancy has dropped to an historic low of 3.82% for 2016. This is down from 5.3% in 2015. The base inventory is approximately 2,906,000 sq. ft. Presently it is difficult to find any large square footage (greater than 10,000 sq. ft. for our market area), but this will soon change as there are current projects under construction to address the inventory shortage:

The newest inventory on the market is the French Hospital Medical Center, 17,742 sq. ft. adjacent to French Hospital. This, like any new inventory added to the market, will command rents in the \$2.00 NNN range. Existing inventory is receiving the benefits from this new benchmark.

The office market is also seeing speculative development, which is addressing the backlog of demand. On Broad Street, two roughly 8,000 sq. ft. buildings have been constructed, with a third 42,000 sq. ft. building also recently breaking ground. Rents for this new office space range from just under \$2.00/sq. ft. to up to \$2.50/sq. ft., depending on the level of TI allowance. Community West Bank has placed their sign on the San Luis Obispo Airport Business Park location for approximately 5,055 sq. ft., with the balance of the new building taken by The Barre Method. Leases are being

negotiated for the second building. And a third building of approx. 21,000 sq. ft. is ready to start when Letters of Interest concretize.

Caltrans is set to occupy the retrofitted van and storage building on South Higuera and relocate from the Atoll Business Park.

A number of older homes, with zoning that allows commercial occupancy, or "bungalows" already converted to office use, are still in demand and are selling for \$250 to \$550 per sq. ft. These are typically in the 1,200 sq. ft. to 1,800 sq. ft. size range.

A few noted sales of other more typical offices:

- 225 Prado Road #D (2,257 sq. ft.)—\$452,500 (\$232 sq. ft.)
- 2420 Broad Street (2,643 sq. ft.)—\$910,000 (\$344 sq. ft.)
- 1010 Peach Street (8,755 sq. ft.)—\$3,800,000 (\$434 sq. ft.)
- 711 Tank Farm (24,012 sq. ft.)—\$8,350,000 (\$348 sq. ft.)

## Industrial

The vacancy rate for industrial product has decreased to 1.6%, down from 2.3% in 2015. Scant available manufacturing inventory is approximately 40,500 sq. ft. with the total base of industrial inventory at approximately 3,870,000 sq. ft.

Finding industrial space is difficult as available inventory has all but disappeared. Quoted industrial rents, if you can find spaces, are approximately \$.90 to \$1.25 per sq. ft. NNN.

In addition, there has been some speculative industrial building on Buckley Road. Two of three proposed buildings have been built and both have been sold in the \$200 per sq. ft. range. New construction costs for

industrial trigger rents to be over a \$1.00 per sq. ft. NNN.

A key 19.6 acre land sale, which can accommodate both industrial and office product on Tank Farm Road, sold for \$6.4 million—approximately \$7.50 per sq. ft. for the undeveloped land. The new owners are finalizing the tract map for multiple parcels and planning to develop the infrastructure.

## Downtown San Luis Obispo

Major projects that have long been in planning are coming to life. The first phase of the Chinatown project is complete and stores are now opening for business. Garden Street Terraces is also under construction.

In addition to the retail space at Chinatown, 36 business minded students associated with Cal Poly's Hot-house are living in loft spaces that the University has leased from the Copeland family asset group. The mixed use Pacific Courtyards is under construction. Other mixed use projects at the western end of the City are in the final stages of planning and will soon begin construction.

The City is working on a long-term conceptual plan that will envision how the downtown core, with Mission Plaza as a central element, can become more vibrant and appealing to both residents and tourists alike. The Downtown Association has embarked on an effort to engage both business owners and residents in discussions on key issues such as downtown vitality, parking, downtown residences, and of course—funding.

## Commercial Markets in Paso Robles and North County

After years of limited sales, all market segments have demonstrated transactions. Properties that have been on the market, some for over 12 months and in and

**Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2016**

Property	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Industrial/Warehouse	3.5	5.0	2.8	7.5	13.2	8.0	7.7	6.5	5.7	3.6	1.1	9.3
Retail Functioning	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5	3.5	4.8	3.3	2.6	2.8	2.1
Office Functioning	1.2	5.2	5.6	7.7	24.1	17.5	18.4	18.3	6.6	14.3	7.5	9.2

Source: Stafford McCarty Commercial Real Estate

out of escrow, have finally found buyers and closed the transactions. Additionally, investment properties with tenants and sustainable income have moved quickly. On the planning books are mixed use projects, mostly retail below with residential above.

**Retail**

The retail market segment has performed very well year over year. It currently has a base of 4,646,000 sq. ft., and the vacancy rate, an already low 2.75% in 2015, dropped further, to approximately 2.1% in 2016. There is a wide variety of space available, adding up to approximately 97,300 sq. ft. No inventory of any significance was added over the last two years.

A few noted sales:

- 1315-1317 Park (1,575 sq. ft.)—\$550,000 (\$349/sq. ft.)
- 1436 Spring (3,700 sq. ft.)—\$200,000 (\$ 54/sq. ft.)
- 2111 Golden Hill (4,000 sq. ft.)—\$965,000 (\$241/sq. ft.)
- 1240 Spring Street (7,643 sq. ft.)—\$2,050,000 (\$268/sq. ft.)
- 2727 Buena Vista (19,499 sq. ft.)—\$3,750,000 (\$166/sq. ft.)

**Office**

Vacancy in the office sector continues to ebb and flow. For 2016, the vacancy rate increased to 9.2%, up from 7.5% in 2015. Currently, there is approximately 40,200

vacant sq. ft. Minimal office inventory was added this year, creating a base of approximately 438,000 sq. ft.

An interesting comparison is the tale of two cities, San Luis Obispo and Paso Robles:

Retail inventory in Paso Robles only slightly exceeds the square footage in San Luis Obispo (4.6M sq. ft. to 4M sq. ft.), yet office space in San Luis Obispo exceeds that of Paso Robles (2.9M sq. ft. to 438K sq. ft.) by a factor of 6.7 to 1. A cursory explanation: As noted above, San Luis Obispo is the base for many jobs in office spaces, but many workers live outside the City and tend to shop near their residences.

A few noted sales:

- 935 W Riverside #14 (854 sq. ft.)—\$160,000 (\$187/sq. ft.)
- 1924 Spring Street (1,850 sf. ft.)—\$484,500 (\$261/sq. ft.)
- 614 13th Street (3,633 sq. ft.)—\$850,000 (\$234/sq. ft.)

**Manufacturing**

The industrial sector added modest inventory of approximately 73,500 sq. ft. in 2016, which is slightly more growth than in 2015. This sector now has a base inventory of approximately 3,869,600 sq. ft. And like last year, most of the inventory was added in the "Tin City" submarket in neighboring Templeton.

There is very little space available in this market segment with one exception. Near the end of the report-

ing period, the Paris Precision building came on the market adding 220,424 sq. ft. and essentially tripling the vacant space in the market. Thus, the vacancy rate for 2016 jumped from 1.1% to 9.3%.

Other than this large asset being on the market, smaller industrial condos have sold, depending on the interior finish, in the \$100 to \$140 per sq. ft range.

Finished industrial parcels have been selling for around \$5.00 per sq. ft. and unfinished zoned land for under \$2.00 per sq. ft. Market asking rates are still approximately \$6.00 to \$8.00 per sq. ft. for the finished parcels. San Antonio's 85,951 sq. ft. winery is nearly complete. Expansion continues in the now firmly established viticulture industry in the region.

### Commercial Investments

San Luis Obispo and North County are benefitting from an overall confidence in real estate. Capitalization rates have dropped further and realize the concomitant rise in prices. Listed income properties are going into escrow quickly. We identify two main reasons for this: 1) there is inherent value in existing product, given the high cost of reproduction, and 2) real estate is currently offering diversity and higher returns than the present capital markets.

Noted sales clustering in the 6 cap range.

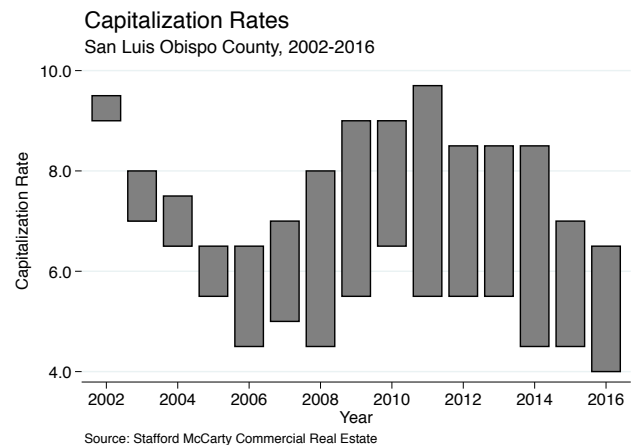
- 862 Meinecke #200 (2,545 sq. ft.)—\$1,200,000 (\$451 per sq. ft., an approx. 6.2 cap)
- 615 Clarion Court (14,000 sq. ft.)—\$3,050,000 (\$217 per sq. ft., an approx. 6.5 cap)
- 3510 Broad Street (18,758 sq. ft.)—\$4,075,000 (\$201 per sq. ft., an approx. 6 cap)
- 2915-2921 Union Rd (68,945 sq. ft.)—\$6,250,000 (\$91 per sq. ft., an approx. 6.5 cap)

Smaller buildings/investments, under 2,000 sq. ft. being sold on caps, are in the 4 to 5's. The above noted,

lenders are seeing appraisers impute capitalization rates in the 5's to compensate for rent and debt coverage ratios. Across all other regions in major markets, lenders are even seeing 3's.

A brief note regarding the apartment market: The caps are in the 3 to 4's, demonstrating demand for the submarket type.

Following are capitalization rate ranges evinced over the last fifteen 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	
2002	9.0	9.5	1,100,000
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
2016	4.0	6.5	1,538,000

Source: Stafford McCarty Commercial Real Estate.

**Further Notes****Hotels in San Luis Obispo County and North County**

This region is preparing to meet growing tourism needs and last year we noted an unprecedented number of new hotel rooms on the books. There has been no backing away from these projects as they move through planning.

**Investments in San Luis Obispo County Agriculture**

Agriculture is a stable investment attraction. Berry ranches in the County are holding values in the \$45,000 to \$55,000 per acre range. When talking about vineyard values in North County, it is always an east side/west side conversation. For smaller vineyards (20-80 acres), east side plantable is generally \$18,000-\$20,000/acre versus west side plantable, which is \$35,000-\$50,000/acre. Planted east side acres range from \$30,000 to \$35,000/acre and planted west side acres range from \$50,000-\$60,000/acre.

After discussion last year regarding ground water management, there are no new plantings on the east side. This action potentially brings monopolistic value effects to the existing vineyard as it basically bars any new competition.

Growth continues in the industry and in its supporting infrastructure. New buildings outside city sphere areas of San Luis Obispo and Paso Robles again have added over 100,000 sq. ft. of wine serving facilities.

**Conclusion**

It has been a good year as it relates to commercial real estate in San Luis Obispo and North County. Construction is booming and there is confidence in the economy based on the building and expansion in which businesses are willing to invest. Speculative building has started to return to the market place and land that has languished on the market for years is finding new owners.

In addition, this year has quietly seen many more investment transactions than in recent years. This increase in activity has put downward pressure on cap rates and has created broader geographic ranges in which buyers will venture seeking returns. Vacancy rates continue to be low even with new construction taking place. The few sectors with higher vacancy rates in 2016 are typically due to one or two large vacancies influencing the statistics.

2017 should continue to be a solid year for commercial real estate in San Luis Obispo and North County.