UNIVERSITY OF CALIFORNIA SANTA BARBARA
ECONOMIC FORECAST PROJECT

SAN LUIS OBISPO COUNTY ECONOMIC OUTLOOK 2010

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ECONOMIC FORECAST PROJECT

Commercial Real Estate

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Stafford-McCarty Commercial Real Estate

Contents

Key Chapter Findings

- Banks are making an earnest attempt to work through residential inventory.
- Commercial Markets are a dichotomy of expectations.
- The regulatory crunch on lenders continues to make deals difficult.
- The San Luis Obispo market is showing signs of stabilization.
- Vacancy rates have increased in all market segments.

The Residential Market

Problems Being Worked Through

Because public and media perceptions are rooted in the residential market, it is important to include a brief note about that market as it relates to the commercial sector.

There has been a quiet stabilization in the residential market. Last year the number of sales through the third quarter was 159 single-family units within the City of San Luis Obispo. This year the number of units sold through the third quarter is 163; a modest 2.5% increase in sales. However the median price one year ago was $635,000 and dropped this year to $569,000, about 10.4%.

The story for the North County area is similar in that sales for the first three quarters are up, but values have fallen. In 2009, 702 single-family units sold during the first three quarters compared to 638 units in 2008. This represents an approximate 10% increase in sales unit volume and a 12.8% decrease in median value ($390,000 for 2008 compared to $340,000 for the first 3 quarters of 2009).

Anecdotally, judging by the quantity of junk email and direct mail, residential lenders are coming back into the market. Refinancing has picked up at the title companies and, most telling, is the dawn of few new construction starts—an entry-level buyer market.

The point, as it relates to commercial markets, is that problems in the residential sector are being worked through in earnest and very visible ways. This should not be an indication of what is happening in commercial markets.

Commercial Markets

A Dichotomy of Expectations

There is always an inherent difference between what a seller thinks their property is worth and what a buyer is willing to pay. In today's commercial market, sellers continue to expect the pre-recession prices that were driving the market. Buyers, looking at the decrease in values in the residential market, expect to find similar deals in the commercial sector. Presently, sellers are not needing to sell, or have been holding off outside pressures to do so.

This past year has seen some lease transactions, but those are typically tenants who are shopping to decrease their lease expenses—many tenants have cut deals with their landlords and have stayed in place. Most of the leasing activity has been under 5,000 sq. ft. The past few months has seen an increase in inquiries from out-of-area companies looking to expand into the Central Coast market.

There have not been enough deals to reset the dials on sale valuations. The financial community is in turmoil as regulators push banks to allocate more funds to their reserves and lenders are asking for reappraisals to minimize this impact. Given the lack of market transactions, the data is not there to support lower values, although market perception clearly expects value diminution. The only telling index is lower rents and listings with lower values than appraisals, and no buyers to date. Following the residential market as a guide, we expected to see a blend of regular sales and foreclosure sales this past year. Instead, we have seen a small number of lease transactions and very few sales transactions.

Banks have been slow to foreclose on properties in the commercial sector as compared to the certainty they have demonstrated in the residential market. We expect this to change in the next 18 months.

Although interest rates continue to be in an attractive range, obtaining funds has become more difficult. Via regulators, lenders have shifted their emphasis from reproduction to economic valuation, meaning that the value of the asset is based not on what it costs to produce it but what it may be worth to an investor—which in the present market is lower than the reproduction costs. Thus, more cash is needed in the deal from borrowers. However, given the current economic climate most businesses are not in a position to provide "extra" cash to make deals work.

Commercial Markets in San Luis Obispo

Presently there is little commercial bank inventory As noted in the chart below these market transactions indicate stable values. Appraisals have assigned capitalization rates as these were not investment sales; cap rates for the transactions were imputed in the mid 5%. This leads to the question: Where are the desperate deals and fire sale pricing?

Given the "where are the transactions and REOs" environment, there is no evidence for valuation tarnish:

San Luis Obispo Commercial Building Sales, 2009

Address	Sq. Ft.	Sales Price ($)	Close Date	$/Sq. Ft.	Retrofit Req'd
715 Tank Farm	8,892	2,400,000	Jul-09	269	No
1114 Marsh St	5,032	2,275,000	May-09	452	No
1308 Broad St	3,623	1,100,000	Aug-09	304	No
119 Chorro	3,500	1,075,000	Mar-09	307	Completed
1060 Palm St	2,450	1,319,242	Feb-09	538	No

Source: Stafford-McCarty Commercial Real Estate

downtown properties still are approximately $300 to $600/sq. ft., however, there are few buyers.

San Luis Obispo Vacancy Rates, 2005 to 2009 (%)

Type of Property	2005	2006	2007	Q1-08	Q3-08	Q1-09	Q3-09
Industrial	4.0	4.3	2.3	4.7	5.4	6.9	6.1
Retail	1.7	1.8	1.4	2.4	3.0	7.7	5.6
Office	3.2	4.7	3.5	2.8	6.1	9.8	9.7

Source: Stafford-McCarty Commercial Real Estate

Retail

San Luis Obispo is proving resilient in this market segment and, for all intents and purposes, has "dodged the bullet." Box stores, which have gone vacant, have been quickly backfilled. For example: Forever 21 replaced approximately 100,000 sq. ft. of Gottschalks, New Frontiers is soon to be moving into Circuit City's 30,300 sq. ft., Kohl's is backfilling Mervyn's at the Madonna Plaza, and TJ Maxx is replacing the 28,400 sq. ft. Linen and Things. For this market these are big spaced being refilled.

Contrary to the general feeling and media coverage regarding weak retail markets, the retail sector reduced vacancy from six months ago. Vacancy actually declined from 7.7% six months ago to 5.6% today, but still remains higher than last year for the overall market. Although the data is optimistic it does not necessarily reflect attitudes of merchants coping with lackluster sales. There are roughly 192,600 sq. ft. of retail space available within the San Luis Obispo market.

There are annexations and big projects in the works: the Dalidio property along the freeway is back on the planning books after yet another judicial ruling; and the property across from the Home Depot and Costco along Los Osos Valley Road, known as "the gap property," is in annexation with Target being identified as the major tenant.

Office

Presently, office vacancy has crept up to 9.7% from 6.1% one year ago, but has held steady and slightly declined from six months ago. Inventory is presently at approximately 258,000 sq. ft. Free rent and larger owner-tenant improvement contributions are part of current deal making. Second-generation unit rents have dropped $0.20 to $0.40 per sq. ft.

The approximate 17,000 sq. ft. Hamilton Coating office/warehouse facility was absorbed by Live Eyeware on Broad Street. WestPac Development has completed construction on their offices medical/office project on Aerovista, and is also under construction on the first phase of their 22,000 sq. ft. Railroad Square project.

Industrial

This market segment although stabilized has been lackluster. Multiple buildings have been on the market for over a year: Industrial Parkway has approximately 36,000 sq. ft., New West Communications has approximately 25,000 sq. ft. on Sacramento, 21 Zaca Lane has approximately 21,800 sq. ft., and on Farm House there are approximately 20,000 sq. ft. of newly constructed office/manufacturing product on five acres. It has not been quite a year, but the approximately 150,000 sq. ft facility on Buckley is still for sale although occupied. The vacancy rates for manufacturing product have risen to 6.1% (5.4% in 2008) but still remains relatively stable and, in fact, has improved over the last six months. San Luis Obispo's manufacturing inventory stands at approximately 233,000 sq. ft.

The East Airport development has numerous finished lots suitable for construction of larger warehouse and office buildings, but few takers. To date, only one of the twenty-plus lots have started construction and one property is in escrow (to have closed by the date of this publication).

Downtown San Luis Obispo

Key renovations have continued to take place in downtown San Luis Obispo. These include properties known as the Wiemann Hotel, Warden Building, Davidson's Furniture, Leon's Bookstore, and the former Johnson's Children's Store. While it has been costly to the ownerships, once reopened, the buildings have added increased pride of ownership and curb appeal to an already quaint downtown.

As discussed last year, a new rental paradigm is continuing to emerge. Newly retrofitted buildings are achieving market-high rents, evincing the large spread between existing rents which have been little changed over the last fifteen years and are typically under $2.00 per sq. ft., and retrofitted buildings which are asking rents between $2.00 and $3.00 per sq. ft. Well located spaces have achieved high watermark rents exceeding $4.00 per sq. ft. Vacant downtown land or land with a "tear-down" building is still approximately $2.50 per sq. ft.

This translates into higher rents, and results in attracting more national and regional tenants as opposed to local tenants. Chipotle is going in downtown with advertised rents in the $4.00 sq. ft. range. This is a good indicator for downtown, but there is not a backlog of high rent payers waiting for space.

Although no larger projects are currently in the building phase, projects which were on the books are still on the books: Vaquero with 32,000 sq. ft., Garden Terraces proposing 35,000 sq. ft. of commercial space, and the Chinatown Project with 50,000 sq. ft. of commercial component in the downtown core—retail on the ground floor and residences on the upper floors.

Commercial Investments

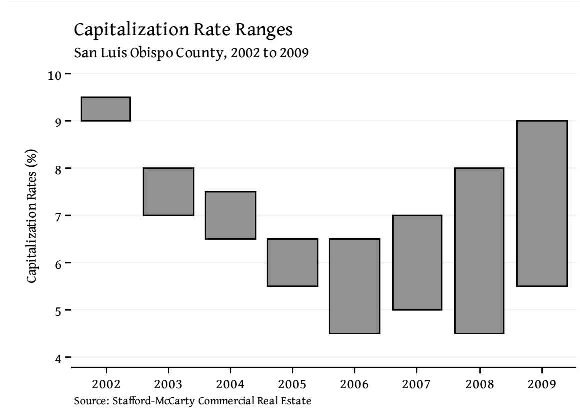
Where are the values for buyers? The local market perception is that interest rates will rise and there will be a flood of inventory and better deals than what they have seen—this has not happened to date.

Local investors have been waiting for rising cap rates, which have surfaced in other California markets—although there has not been supporting transaction evidence to quantify this. Tax deferred driven transactions have virtually dried up as have market rate purchases.

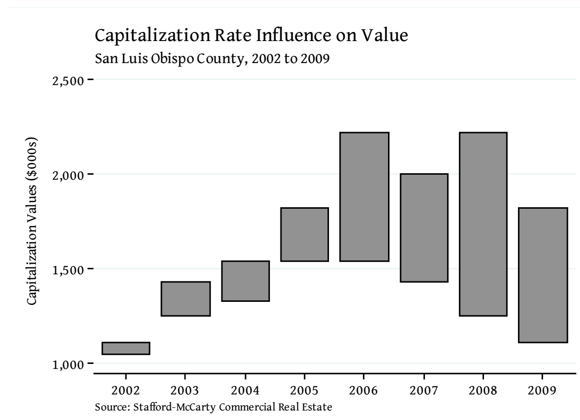
Properties that have typically "not been for sale" have come on the market—but no deals yet. Additionally, there is not a market-wide cap rate. Appraisers are actively calling commercial brokers to field any additional data and noting that they are having a hard time justifying value declination which is, as mentioned above, the market and current investor perception.

In San Luis Obispo, appraisers have been using imputed cap rates in the mid 5s and 6s. Although investment transactions are noticeably absent, there have been several sales in the Santa Maria area demonstrating 9 caps under $2 million in asset values. A shopping center in Arroyo Grande, with underperforming rents, sold for an operational cap rate of 7.7. Each transaction is a case-by-case basis, with the buyer having their own basis for determining value.

Following are capitalization rate ranges evinced over the last eight 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:



Commercial Markets in Paso Robles

This smaller community on the Central Coast has been bursting with commercial activity the last several years. Paso Robles has added significant amounts of square footage for a community with a functioning population base of approximately 30,000. Correspondingly and predictably, this year's vacancy has increased over all market segments.

At this time last year it was difficult to find office inventory for sale of almost any size. Starting around mid-year a steady stream of small product has hit the offerings—from private ownership to bank owned. Vacancy now stands at approximately 24.1%—an increase of approximately 13.9% from six months ago. Most of the vacancy has been attributed to both increased supply and lack of demand from users in the financial markets. Rents are dropping and more product has become available for sale, but again, there are no definite sale trends to establish reliable market data.

The present retail inventory base is approximately 4,374,000 sq. ft., which is slightly larger than the retail base in San Luis Obispo. A major current project is the soon-to-open Regency project on 46 and Golden Hill Road, which is just completing construction. Announced tenants are a 139,300 sq. ft. Lowe's and a 27,000 sq. ft. prospective Bed Bath & Beyond. Retail vacancies have increased from 2.2% one year ago to 4.1% today. There are approximately 17,400 sq. ft. of retail space on the market at this time. All in all this is modest vacancy, but it is still on the rise.

Industrial vacancy has jumped upward. Vacancy now stands at 13.2% up from 7.5% last year. For the most part, the bulk of vacant space is in newly constructed buildings; this is mostly seen as an oversupply issue. Generally, occupancy in established industrial areas remains stable. Lender owned industrial subdivisions have shown up and are on the market at approximately $9.00 per sq. ft. for finished small parcels.

Paso Robles Vacancy Rates, 2005 to 2009 (%)

Type of Property	2005	2006	2007	2008	Q1-09	Q3-09
Industrial	3.5	5.0	2.8	7.5	8.6	13.2
Retail	< 1	< 1	< 1	2.2	2.7	4.1
Office	1.2	5.2	5.6	7.7	13.9	24.1

Source: Stafford-McCarty Commercial Real Estate

An Untold Story of North County and the Wine Industry

Within the last year and a half there have been approximately 126,000 sq. ft. of buildings and improvements that are specifically winery related. These numbers incorporate tasting rooms, additional storage, and facilities located outside of the urban boundaries.

This is significant as it points to the established underpinnings of an ever-maturing industry. This data is staggering in that this mostly single purpose square footage is approximately 70% of the new Paso Robles market inventory and functions, in a sense, "off the beaten path."

Moreover, it also points to a cultural shift and its concomitant links to agri-tourism and a perceived gentrified new customer base. Will there be a fall out among wineries given the economic downturn? Some wineries are presently for sale; this story will need to play out.

Final Words

The residential world has put its work-out systems in place and is sifting its way through problem properties. The commercial markets have yet to produce such an oiled machine.

In San Luis Obispo, vacancy is stabilizing, however, debt laden properties continue to be cash drains for ownerships. We anticipate more sale transactions this next year as leveraged property owners will need to dispose of non-performing assets.

Pressure from regulators is making it tough on banks. High equity requirements make it extremely difficult for borrowers to qualify—refinancing falls into this category as well. Yet, problems in our local markets pale to other regions in the state—we simply do not have the quantity of inventory. "Cash is king" is the mantra for investors seeking deals, and visa versa. This next year may be the one for deals.