2012 Commercial Real Estate

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Stafford McCarty Commercial Real Estate

Contents

Key Chapter Findings

- The market is moving in a positive direction, although at a slow pace.
- Interest rates continue to remain near record lows, but qualifying remains an issue.
- The volume of on market and off market commercial transactions is increasing.

A Brief Note on Residential Market—Over-Coming Inertia

San Luis Obispo

Prices have stabilized in San Luis Obispo; homes are selling faster than in the prior year and the volume of transactions has increased. Agent interviews point to shrinking inventory and faster transactions. Volume is up and agents are reporting a lack of lower end inventory—homes priced under $400,000. Properties in this lower price range are receiving multiple offers. Even with the median price staying flat at $535,000 for this last year, the lack of lower end inventory is creating economic opportunity to build and the market is seeing the start of new construction. Median values in San Luis Obispo remain approximately $100,000 less than they were in 2008 and houses are selling at approximately $305 per square foot.

North County

The North County home market is also seeing an increase in the volume of sales and a decrease in average time on the market. Contrasted to San Luis Obispo, there has been upward movement in median valuation in the North County. Median values in North County have risen $35,000 over 2011 numbers and houses are selling for approximately $180 per square foot.

Also in North County, sales volume is up and agents there are reporting a lack of lower end inventory–under $300,000. With the lower price in North County, buyers are taking advantage of buying property for less than the price of production. However, the lower median price does not provide the economic confidence to build new tract housing product at this time.

In both market areas there is movement in multi-family land development and renewed interest in identifying projects.

Housing Related Projects

- ROEM Development completed its tax credit project at the Village at Broad.
- The balance of the housing component at the Village at Broad is under construction for studio product.
- The Housing Authority has nearly completed the first phase of work on their low income project at the old railroad "Y" site off of Broad Street.
- A land sale at Orcutt and Broad Street, approved for approximately 80 entitled units, sold for $28,750 per unit.
- Prado Road was previously purchased and construction has commenced on the residential portion of the project.
- The Marsh Street Commons, a 32,000 sq. ft. mixed use project on the corner of Marsh and Nipomo, is under construction with presales occurring.

Residential Unit Sales, 3rd Quarter Annual Data

Variable	2008	2009	2010	2011	2012
San Luis Obispo					
# Units Sold	159	163	191	215	273
Median Price ($)	635,000	569,000	550,000	535,000	535,000
North County					
# Units Sold	638	702	698	892	991
Median Price ($)	390,000	340,000	296,000	270,000	305,000

Source: San Luis Obispo Multiple Listing Service;
Compilation by Stafford McCarty Commercial Real Estate
Note: Comparative data is for the first three quarters of each year

Residential Foreclosure Activity

The number of reported defaults is less than in previous years. However, this can be misleading as short sales are making up a larger part of the market transactions. All in all, most feel the worst is behind us.

Commercial Markets

Lending

Evidence of new commercial loans is emerging as lenders are placing their signs on construction sites. Loans are being refinanced and there seems to be a relaxing exhale as compared to the tightness of the market in previous years.

The lender pipeline of commercial product coming on the market is thinning. Lenders appear to have increased their willingness to deal with borrowers, extending credit and working out short sales on troubled commercial assets, which decreases the number of properties going to foreclosure.

Leasing Activity

Leasing activity is being driven by two factors. First are companies that have made it through the downturn, have resized, and are matching their leasehold space to their new requirements. Second are companies moving into the market and companies that are expanding (particularly in the tech and medical sectors). A few examples: American Tires is opening new locations in San Luis Obispo and Paso Robles. Tek Tegrity, Rosetta and Mind Body are expanding operations. Franchises such as Plutos, Rocket Fizz, Mr. Pickles, etc. are all moving into the San Luis Obispo trade area.

Buyer Sources of Capital

User buyers are turning to banks mostly for Small Business Administration (SBA) loans in which cash for down payments can be minimized. Investors are coming in with cash, taking advantage of opportunities, repositioning assets, and meeting tenant need within the market. The exchange market is reemerging and brokers are seeing exchange monies seeking replacement properties.

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

Property	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Industrial/Warehouse	2.8	3.8	6.4	4.0	4.3	2.3	5.4	6.1	9.1	8.7	4.5
Retail Functioning	1.9	2.4	2.2	1.7	1.8	1.4	3.0	5.6	5.1	3.4	3.7
Office Functioning	9.9	8.4	5.4	3.2	4.7	3.5	6.1	9.7	12.6	11.6	8.6

Source: Stafford McCarty Commercial Real Estate

Commercial Markets in San Luis Obispo

Retail

The retail market segment was the only segment adding inventory last year (approximately 51,000 sq. ft.) and now stands with a base retail inventory of 4,156,000 sq. ft.. Despite the recovering economy, the retail segment remains flat with just a slight increase in vacancy: up to 3.7% compared to 3.4% from last year. There is approximately 154,000 sq. ft. on the market.

These retail additions were primarily at the Target Center on Los Osos Valley Road which is now home to Olive Garden and Dick's Sporting Goods. Additionally, Fresh and Easy opened its 9,000 sq. ft. operation on Broad Street at the beginning of the year.

There has been a shuffling of grocery store inventory. A group of Scolari's Markets closed its doors and was purchased by NKT Commercial in markets from Santa Barbara to Paso Robles. Locations will be backfilled by such tenants as Albertsons, Smart and Final, and Fresh Market. NKT recently has taken over University Square in San Luis Obispo, an approximately 89,000 sq. ft. former food/pharmacy center undergoing a makeover.

Office

Given the lingering effects of the economic downturn, there have been no new office additions to the market this year. The office inventory base is approximately 2,700,000 sq. ft.

Throughout the Central Coast, the office sector remains the market segment with the largest vacancy, although office vacancy dropped, 25% compared to last year, to 8.6%. There is an interesting disparity in the San Luis Obispo market where the available office inventory is not matching user needs. The user requirements are currently for larger office product, 20,000 sq. ft. to 60,000 sq. ft (some even larger). The existing vacant inventory is undersized, averaging 2,500 sq. ft. As a result, there are a number of users waiting to have build-to-suits completed, and there are other projects currently in the negotiation stage.

At present, available office inventory in San Luis Obispo is approximately 234,000 sq. ft. Depending on location and landlord tenant improvement contributions, downtown offices have leased for as little as $1.00 per sq ft. per month gross. Second generation unit rents continue to be $0.20 to $0.40 per sq. ft. off of their pre-recession average. Free rent and larger owner contributions to tenant improvements are part of lease negotiations.

Buildings with character, especially former residences converted to offices, continue to be desirable. A few sales noted:

- 1305 Marsh Street: 2,564 sq.ft. Approximately $279 square feet
- 1118 Palm Street: 2,144 sq.ft. Approximately $210 square feet

SESLOC Federal Credit Union had approximately 9.5 acres of land it owned for sale but has subsequently withdrawn it from the market electing to build a new

35,000 sq. ft. headquarters, plus a 5,000 sq. ft. retail branch. The project is presently in planning.

Manufacturing

The vacancy rates for manufacturing product has dropped to 4.5% (8.7% in 2011) with San Luis Obispo's available manufacturing inventory standing at approximately 171,000 sq. ft. The total base of industrial inventory is approximately 3,804,000 sq. ft.

Similar to the office market, user demand for manufacturing product is there, but users are having difficulty finding suitable property. Demand is, across the board, for small manufacturing spaces up to warehouse spaces of 15,000 (plus) sq. ft. This is the second year in a row that no new buildings have been added to the manufacturing inventory.

Sales

Industrial land sales have been brisk in an area known as East Airport. However, there is a key backstory. These finished lots sat on the market for several years, tied up in litigation. The parcels, located in the County of San Luis Obispo adjacent to the City, have a competitive advantage with lower impact fees. By way of example, the fees for a 50,000 sq, ft. building in the County could be as much as $750,000 less than in the City. Like water seeking low spaces, emerging activity and new construction are happening on these parcels. Last year, a local buyer purchased 10 lots from the lender and this year purchased the balance for under $5.00 per sq. ft. Some of these lots were subsequently re-traded. This, coupled with tenant demand for large buildings (noted earlier), has led to new construction. New construction rents are approximately $2.00 per sq. ft., triple net (NNN).

The comparable sales have established a new market value ($6 to $8 per sq. ft), and other parcels, from two acres to ten acres, which have subsequently sold, are aligning themselves with these East Airport parcel transaction valuations, adjusting downward to offset for impact fees, level of lot finish, and available services. A ten acre parcel with similar zoning sold for $1.71 per sq. ft., as it had none of the off site improvements, no services installed, and was tagged with impact fees of approximately $17 per sq. ft.

Along with this, existing buildings for sale have been absorbed, and as noted above, larger product is not available. In the first two sales noted below, the buildings had been on the market for over three years.

- 21 Zaca Lane with approximately 21,800 sq. ft. at 980,000 or $87 per sq. ft.
- Farm House, approximately 20,000 sq. ft. of shell construction, $2,700,000, sold to a high end manufacturer/retailer - office/manufacturing product on five acres at approximately $135 per sq. ft.
- 4500 Santa Fe, approximately 21,000 sq. ft of metal industrial buildings with excess land; the asset was purchased by San Luis Garbage for $3,700,000 or approximately $173 per sq. ft.

Underscoring these sales is the fact that assets are continuing to sell for less than current reproduction values. This is soon to change as the inventory disappears.

As noted in previous years' reporting, the East Airport Development has numerous finished lots suitable for constructing larger warehouse and office buildings. To date only one of the twenty-plus lots has seen completed construction and the price paid for the land was approximately $17 per square foot. This year ten parcels of acre-plus lots have sold from just under $5 per square foot to $6 per square foot.

Downtown San Luis Obispo: A Changing Face—Restaurants

With modest exceptions, available downtown inventory has all but disappeared with only a few lingering vacancies on the fringe. The changing face of downtown noted in previous articles has taken place—soft goods retailers are being replaced by restaurants.

Key projects are moving forward:

- Garden Terraces is proposing 35,000 sq. ft. of commercial space.
- Chinatown Project with 50,000 sq. ft. of commercial space has broken ground on the Palm Street side of the project.
- Marsh Street Commons has broken ground on 8,500 sq. ft. of commercial space, 4 lofts and 8 single-family homes.

These are in the downtown core and have multiple stories; retail on the ground floor, residences on the upper floors. Additionally, Garden Terraces and the Chinatown Project both include hotels.

Rents downtown can vary widely. Second and third generation rates are typically under $1.75 to $2.00 per sq. ft. while retrofitted buildings have asking rents between $2.00 and $3.50 per sq. ft. The units in the core blocks of downtown, have achieved high watermark rents as high as $4.50 per sq. ft.

Commercial Markets in Paso Robles and North County

Vacancy rates in Paso Robles and the North County are higher than in San Luis Obispo across all market segments. Compared to previous years, there appears to be more product available for purchase, as opposed to being available just for lease. A few properties which have been on the on the market for a long time are finally selling. Valuation patterns follow a familiar story where sale prices are below reproduction costs. However, even with all of these factors, the influx of new businesses and the expansion of existing businesses are providing a sense of vitality to the area.

Retail

Modest inventory has been added to the retail market—most noticeable is the 25,000 sq. ft. building for TJ Maxx in the Regency anchored center along Highway 46. The Retail base inventory for the market currently stands at approximately 4,634,000 sq. ft. (similar to San Luis Obispo) Retail vacancies have increased slightly from 3.5% last year to 4.75% this year. A significant amount of that vacancy is in the Scolaris building (+/- 40,000 sq. ft.) and former Powerhouse buildings (+/- 60,000 sq. ft.). There is approximately 220,000 sq. ft. of retail space on the market at this time and, like last year, smaller, speculative spaces have been slow to absorb. A few noted sales:

- Downtown, 12th and Pine, A & R Furniture and adjacent buildings, 27,853 sq. ft. sold for approximately $3,400,000 or $122 per sq. ft.
- 205 Oak Hill, $3,317,500, 12,384 sq ft., approximately $267 per sq. ft.

A flurry of smaller buildings, 1,000 to 3,000 sq. ft., have sold throughout the market at varying price points from approximately $100 to $295 per sq. ft.

Office

Office product in the North County is still the weak spot and absorption has only marginally decreased from 18.41% in 2011 to 18.27%. Office vacancy is scattered and is predominately in smaller unit sizes—under 2,500 sq. ft. There is approximately 71,000 sq. ft. vacant.

As noted in previous years, this market is still in recovery from the financial market fall out that occurred at the beginning of the recession. Asking rents have shifted to gross versus NNN rents and are still in the middle range for the overall Central Coast market at approximately $1.50 per sq. ft for quality office space.

Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2012

Property	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Industrial/Warehouse	9.4	10.7	3.5	5.0	2.8	7.5	13.2	8.0	7.7	6.5
Retail Functioning	1.9	< 1.0	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5	3.5	4.8
Office Functioning	1.2	1.8	1.2	5.2	5.6	7.7	24.1	17.5	18.4	18.3

Source: Stafford McCarty Commercial Real Estate

We project more sales next year as there is available inventory on the market for purchase. Rents are still down which in turn keeps a lid on upward values for buildings.

Notably, this last year there was a LEED office building short sale at 2727 Buena Vista Dr, 19,499 sq. ft., $2,800,000 or approximately $144 per sq. ft.

Manufacturing

Overall absorption has been lackluster but the owner/user expansion has been active. A few include Silicone Fabricators, Santa Cruz Biotech, and a number of wineries. The industrial sector added approximately 170,000 sq. ft., with vacancy now standing at 6.47%, (down slightly from 7.73% last year). Paso Robles has an industrial base of approximately 3,100,000 sq. ft. A 5,000 sq. ft. building at 2754 Concrete Ct., sold at $110 per sq. ft. Otherwise, there have been sales in the market of smaller units in the similar price point range.

North of Highway 46, lenders have taken back finished industrial parcels and placed them on the market. Finished parcels vary widely in price and can range from $1.50 per sq. ft. to $6.00 per sq. ft.

Agricultural Impact: The Wine Industry and Commercial Inventory

This industry sector continues to broaden its base as it matures in the market. Buildings supporting viticulture are continuing to be built. This last year over 150,000 sq. ft of facilities have been issued final permits in the County. Over an 11-year period, this growth of additional winery related inventory in the County translates to approximately 50% of the entire Paso Robles industrial base.

The region is attracting greater attention as major corporations establish themselves and continue expanding and having existing operations change hands. Weyrich's vacant Villa Toscana sold, as did the former Arceiro/EOS approximately 112,000 sq. ft production facility (both to off shore money). Most noticeable is the sale of the 300,000 sq. ft. (plus) San Miguel custom crush operation, to Gallo, another major player expanding their roots in the County.

Commercial Investments

Investment sales are continuing throughout the Central Coast. Some are true investment sales, having a stabilized tenant base and easily calculated cap rates. Other investment sales are buildings which can be repositioned by filling vacancies or changing tenants and have an anticipated cap rate. These investments are selling for below reproduction costs and are being turned around in a short time with higher rents, The trend has been more on the latter investment sale type. Discussions with lenders and appraisers indicate cap rates at this point to be in the mid 7s.

Investors are expecting well-anchored centers to be priced below 6 caps. Locally, buyers are still looking for 8 caps, but these are rare to find.

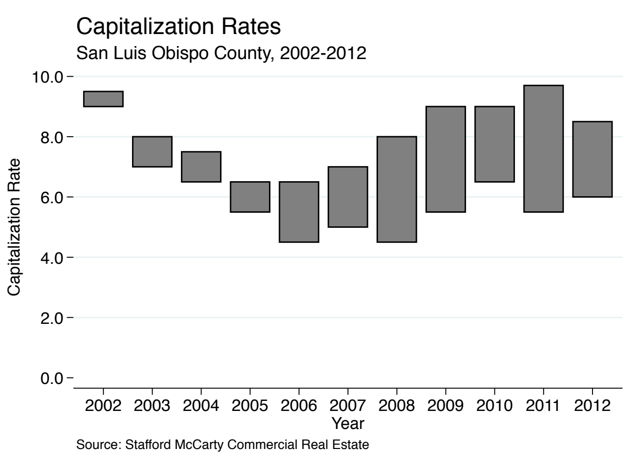
Local capitalization rates are firming up and the examples are noted to evince:

- 205 Oak Hill in Paso Robles (mentioned above), 7.3 cap on existing rents, 12,384 sq ft., $3,317,500, approximately $267 per sq. ft (with 30% vacancy).
- 105 South Main Street, Templeton, $2,483,750, 13,144 sq. ft., approximately $190 per sq. ft., 6.7 cap.
- 1327 Archer Street in San Luis Obispo, $1,800,000, 8,076 sq. ft., approximately $223 per sq. ft., 6.7 cap.
- 1001 Marsh Street, San Luis Obispo, $2,300,000, 5,126 sq.ft., approximately $450 per sq. ft, 5.9 cap.

Lenders are looking to loan on "bankable deals"–meaning transactions involving cash flow and good credit. Available financing for institutional investments can be at sub 5% interest rates while conventional financing is sub at 7%.

As noted earlier, tax deferred exchanges, once an active part of the market, have begun to surface again. But each transaction appears to be occurring on a case-by-case basis, with buyers having their own basis for determining value.

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

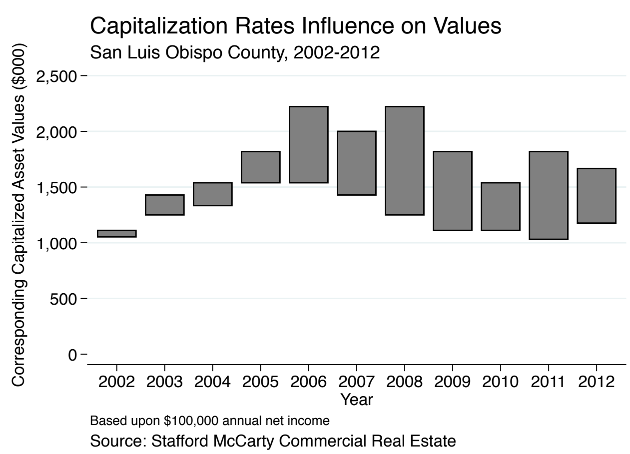


Cap Rates and Implied Value

Year	Cap Rate Range Low	Cap Rate Range High	Implied Asset Value ($)
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	6.0	8.5	1,176,471

Source: Stafford McCarty Commercial Real Estate
Note: Value based upon $100,000 in annual net income

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:



Final Words—Turning a Corner

In summation, the signs of recovery are reaching our area and the commercial real estate market is improving, although slowly. The data from our region demonstrates that properties are starting to sell but are still below reproduction values, and nowhere close to previous high water marks. Data from other parts of the state, the San Francisco Bay Area, and the coastal side of Southern California, indicate a market recovering more quickly. Historically the Central Coast region has lagged them.

There is demand for new construction in certain markets and sectors, but rents for these newly constructed properties are higher than rents for existing buildings, as rents are down in today's market. The exchange market is bringing out buyers for commercial properties. Banks are cautiously lending, but those buyers with cash are still able to command the best deals in the market. All in all there is reason for optimism.