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Santa Maria Real Estate Market – Where We Have Been and What's to Come?

(Reported as of the First Quarter 2009)

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Highlights

- **Call it what you like, "Credit Crunch" or "Financial Meltdown" financing is everything to the new commercial markets.**
- **Vacancy rates have increased appreciably in the Office, Retail and Industrial market segments.**
- **Market influences are putting downward pressure on commercial real estate values.**
- **A Dearth of Data: the pending "domino effect" on commercial valuations.**

Ubiquitous real estate signs, limited commercial financing and a disparity in the perceived value of commercial real estate (depending on whether you are a buyer or a seller) has set-up a pending domino effect leading to declining real estate values. Aside from the present lack of demand in the commercial markets the structural component of commercial financing has moved from a predictable practice to a precarious art form.

In the past, the two major parties in a transaction were the buyer and the seller. Appraisers, financial institutions, title companies, etc. effected the transaction, but functioned in a behind the scenes role. Now those involved in financing have become gate-keepers to buyers and sellers and control key elements of the commercial real estate puzzle.

Commercial Financing

Although there are many factors affecting commercial financing, presently they can be grouped into two main components: regulatory factors and the consequences of perceived weakening values. Following is a brief overview of some of the current issues.

Regulatory Factors

Federal regulations---the increasing restrictions on the total amount of commercial lending, as a percentage of a bank's value. The regulator's goal is to reduce individual bank's exposure to the softening commercial market. The

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residual effect is that a lender, given the size of their present portfolios, may not be allowed to make new or even renew existing loans.

Weight on Income Valuation--Commercial properties are analyzed on essentially thee elements, 1) what it costs to construct or reconstruct the asset (reproduction), 2) what similar properties are selling for (comparable sales) and 3) what the asset is worth as an investment to the general market determined by the net income it can produce (income valuation). The income valuation is presently the most conservative method resulting in lower asset valuations.

*"Burn-downs"--*When calculating net operating income (NOI), banks estimate the rent that a property can generate from tenants. "Burning-down" the rents is the practice of adjusting downward the value of the market rents a building is either projected to or actually collecting. This analysis is based on the premise that market rents have gotten too high and if a tenant or owner were to leave, the vacant space would be reoccupied at a much lower rate than the present. Conversations with local lenders indicate burn-down adjustments can be a 30% decrease in monthly income. Lower rental rates pull down the valuation of a commercial asset when capitalized, which in turn reduces the loan amount the bank will lend, especially when the weight of the appraisal is focused on the income valuations as noted above. Ultimately a borrower is required to have more cash in the transaction—always a challenging factor.

Increased Debt Coverage Ratios (DCRs)—this component of loan analysis says that the payment to the lender has to exceed the actual or anticipated rent collected by a factor of say 10 to 25% (1.1 to 1.25--some lenders are pushing this ratio even higher). In more conservative times, such as the present, the DCRs are at the higher range with the final results similar to burning down the rents: the lender will lend less on the building and the borrower is required to come up with more cash.

The Perception of Weakening Valuation.

Perception of Price--With such great declines in values affecting the residential market, commercial buyers are looking for the same type of downward adjustment in value for commercial properties.

Increased Vacancy—basic lack of demand has lenders worried that if they foreclose on a building it will take a longer period than "normal" to find a tenant or buyer. The result-- lower the amount loaned to decrease risk to the lender.

Falling rents—owners are fearful of tenants leaving and are proactively lowering rents to keep tenants. With the increased vacancy as noted above, tenants are finding opportunities to move at better values.

> Dearth of Commercial Data— last year there were few transactions to document the actual declination of commercial property. Commercial appraisers are having trouble documenting transactions to satisfy lenders' concern for valuation. If you are a seller it is hard to "prove" the buildings or assets are worth less. Yet the market is offering commercial assets with more favorable terms and values than previous years and no buyers are stepping forward. Example: local capitalization rates have been 6-7% (6-7 caps). Presently offered is an 8.5 cap property with a 2 year rental guarantee—still on the market. Given present market jitters, lenders are seeking to lend less on any given asset. Once we start to see lower values documented we will see prices adjust downward.

The above factors (and this is only a partial list) have created a challenging environment in which to write and renew commercial loans. This is why we predict more "For Sale" properties on the market this year—owners may need to sell if they cannot get acceptable financing. The bright spot is that interest rates are relatively low—approximately 6.5% for conventional loans. If you can qualify given the above issues, this is perceived as "good money".

On the seller side of the equation if lenders are financing less and buyers are limited by the cash they can place into the transaction, sellers may have to take less than they want or move into the area of "creative financing" as coined in previous economic downturns. Creative financing is when sellers look to financing vehicles other than traditional lender sources, and may typically include seller carry backs and third party loans.

The resulting "Domino Effect": this evolution in financing is presently the most dynamic aspect of the commercial real estate market. Once a number of transactions are completed with what will surely be lower values, the dominos will begin to fall...

The following is a brief description of the various market segments.

Residential

The sub-prime fallout is old news but its effects are lingering and tangible. Santa Maria is the epicenter for bank owned property in the Central Coast markets. As the bulk of new housing was produced in Santa Maria it stands to reason that the bulk of foreclosure inventory resides here as well. New unit production is essentially at a halt as existing units on the market are cheaper than the cost of new units. New home sales over the entire Central Coast may be 1 to 2 units a month per project. This trend is likely to continue until the foreclosed units are absorbed or the inventory is rolled back to previously low numbers.

Single Family Detached Unit Sales Santa Maria and Orcutt	**2006**	**2007**	**2008**
Number of Single Family Sales	1,335	627	1,242
Number of Single Family Sales OREO	3	116	772
Percentage of Total Sales OREO	0.22%	18.50%	62.16%
Median Price	$455,000	$395,000	$270,000
Cost Per Square Foot	$278	$246	$179

Data Source: Central Coast Regional MLS
Data Table and Compilation: Stafford-McCarty Commercial Real Estate
*Data may vary from last year's reported statistics due to data variable change accommodating multi year comparisons and regional area reporting.
Source: Stafford-McCarty Commercial Real Estate

Good news - residential sales velocity: more homes have sold this year than last and the monthly number of single family units is picking up. The not so good news is that the sales are approximately 62% foreclosures. Values have not yet stabilized and more foreclosures are projected to keep the pipeline full. The median price has dropped from $455,000 to $270,000 within the last three years.

The Santa Maria market sold 1,335 units in 2006, 627 units in 2007 and 1,242 units in 2008. 49% of homes sold moved within 30 days at 99.5% of the listing price. Bank owned foreclosures are selling at over the listing price with multiple offers. These may be signs of a turning point, but the volume of future foreclosure inventory is still an unknown quantity.

Retail/Commercial

The smatterings of past retail vacancies has become unabashed. Retail vacancies for businesses associated with new home construction were the early victims. Now it has run the gamut across almost all retail sectors.

Available commercial/retail space within the City of Santa Maria (as of first quarter 2009) is about 379,000 square feet for a vacancy rate of 9.8%. Total retail inventory base in the City of Santa Maria is approximately 4,143,000 square feet. Not much new inventory has been added and four major retail projects are on hold.

Lakeview Promenade – 70,000 square feet
The Westgate Marketplace +/-120,000 square feet
Orcutt Plaza - approximately 225,000 square feet
Orcutt Marketplace - approximately 295,000 square feet
Total – 710,000 square feet (approximately 17% of the existing base)

Approximately 41,864 square feet of retail space has been added since the last reporting period.

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Retail Vacancy Rates City of Santa Maria Metropolitan Area					
	2004	**2005**	**2006**	**2007**	**2008**
Retail	2.3%	+/- 1%	2.0%	2.7%	9.8%
Vacancy not including Gottshalks or Mervyns					5.4%

Source: Stafford-McCarty Commercial Real Estate

From a larger perspective, pressure to build shopping centers is off, especially in less then first tier markets such as Santa Maria. As there have been almost no land transactions, values have not demonstrated a fall. Previous prices ranges were from $25 to $50 per square foot depending upon size and location of the property. There is anticipated downward pressure on prices and yet again no shared data to support this.

Office

The office market is showing stress signs – i.e. skyrocketing vacancy for this market component. The office vacancy rate, as of this article, had doubled over last year and is now at approximately 12.4% versus 6.2% from the year before. Keep in mind that 2007's vacancy rate was almost three times that of 2006. There was approximately 17,444 square feet of new office space added to the base inventory in 2008 with a total approximate base of 1,156,000 square feet

Typical deals are being cut for well located space from $0.50 to $1.25 NNN. Asking rates have declined 20 to 30%. The typical 2nd generation asking rates are anywhere from $.50 to $1.25/square foot/month/NNN. Newer space has asking rates as high as $1.85/square foot/month/modified gross. Owners are approaching tenants and rewriting leases for less rent to get them to stay.

As noted above, there has been very little sales activity.

Two local doctors purchased approximately 3,800 square feet in the South Stratford stand- alone medical office building adjacent to the hospital for $925,000 or approximately $250 per square foot. The building had been on the market for over a year and needed remodeling.

Cannon Associates leased approximately 6,000 square feet at close to $0.50 per square foot/NNN on a three year lease in an office building in a manufacturing zoned area.

Office Vacancy Rates City of Santa Maria Metropolitan Area					
	2004	**2005**	**2006**	**2007**	**2008**
Office	2.7%	2.5%	2.1%	6.2%	12.4%

Source: Stafford-McCarty Commercial Real Estate

The price of appropriately zoned land allowing construction of office is similar to the discussion of land prices in the Retail segment, as Santa Maria's C-2 zoning allows office uses as well as retail uses. Land price asking rates have dropped—some parcels are at $10.00 per square foot and still no takers. Hard-to-find smaller parcels have come down in asking rates as well.

Industrial

Industrial vacancy increased in 2008 from 5.7% to 8.8% as of the date of this article. There is approximately 670,000 square feet of industrial space available for lease. The industrial base is approximately 7,595,000 square feet.

It was a relatively slow year with some notable transactions but not necessarily market comparable sales. The City of Santa Maria purchased a portion, approximately 68,237 square feet of the former 124,532 square foot Santa Barbara Research property for its Police Department. The sale was approximately $13,750,000. Cal State Auto Parts purchased a 14,200 square foot build-to-suit at approximately $180 per square foot.

More typical to the market: A Street Business Center sold four smaller building ranging in size from 3,300 to 6,000 square feet for approximately $150 to $160 per square foot and several leases of units of similar sizes for approximately $0.80 to 0.85 NNN, depending upon owner build out.

Industrial Vacancy Rates
City of Santa Maria Metropolitan Area

	2004	**2005**	**2006**	**2007**	**2008**
R and D / Industrial / Warehouse	7.5%	5.6%	3.6%	5.7%	8.8%

Source: Stafford-McCarty Commercial Real Estate

Noted Industrial lease transactions on Industrial Parkway:

33,000 square feet leased to Seaside Packaging at $0.55 NNN
16,000 square feet leased to Fess Parker for $0.49 Modified Gross
25,000 square feet leased to The Army for $0.55 NNN

Asking rental rates are holding steady. Rents for 1,000 to 4,000 square foot spaces are approximately $0.75 to $0.85 per sq. ft. NNN. Demand has tapered off and vacancy increases in the "bread and butter" user segment of the Santa Maria market place--typical multi-tenant industrial units in the range of 1,000 to 4,000 square feet have increased. Not only has demand fallen, but more inventory in this product type was added last year with the A Street Business Center project.

The seven-building, 139,000+/- square foot FairSky Project originally targeted for larger office and R & D users has been, to a large extent, halved into smaller units of

approximately 10,000 square feet. Users vary widely. Approximately 13% of the complex, or 18,658 square feet, has remained vacant for over a year.

Industrial Land

Finished or near finished lot product is minimal. Valuations between the M1, CM and M2 zones are becoming more singular. Acre sale prices can range from $7 to $8 per square foot. Some noteworthy land transactions:

--La Brea (M2 zoned land), seven (7) acres sold to Old Dominion Trucking for approximately $7.50 per square foot.
--Tama Lane (M1 zoned land) sold to an investor for approximately $7.50 per square foot. The size of the parcel was approximately 1.37 acres.
--A sale of 225 acres occurred in December of last year within the recent 932 acre industrial annexation known as Area 9. Greka Energy sold the land for approximately $23,000 an acre.

Agricultural

The demand to own strawberry and vegetable ground is still active. As always, quality parcels rarely become openly available on the market. The high water mark sale is approximately 110 acres for about $56,000 an acre.

This brings the Santa Maria Valley close to other key regions: Oxnard land valuations are in the low to mid $70,000 per acre range, Salinas Valley valuations are in the mid to high $50,000 per acre range.

Commercial Investment

Commercial investment sales were almost non-existent as with 1031 exchanges which were active several years ago. One of the highest priced properties to sell in 2007 was the Hollywood Video at 1846 N. Broadway selling for $2,350,000. It sold as trade property in a larger exchange at the back end of December 2008 for approximately $2,450,000. To generate cash it is offered for sale again at an asking price of $2,254,000 for a 7.75% cap rate.

A Regency shopping center ground lease sold for an approximately $10.7 million. The cap rate was 5.2%. This was seen as a "last hurrah" and appraisers are noting it as an anomaly. Cap rates are coming up. As noted earlier there are offerings at 8.5 caps and no takers.

Following are capitalization rate ranges evinced over the last seven years:

Capitalization Rates **City of Santa Maria Metropolitan Area**							
(Value based upon $100,000 annual net operating income)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Cap Rate Ranges	9.0 to 9.5	7.0 to 8	6.5 to 7.5	5.5 to 6.5	6.0 to 7.5	6.0 to 7.5	8 to 8.5
Corresponding Valuations	$1.10M	$1.42M	$1.53M	$1.81M	$1.66M	$1.66M	$1.25M

Source: Stafford-McCarty Commercial Real Estate

Summary

The overall economic picture of the Santa Maria real estate market has changed dramatically from a year ago. All segments of the commercial real estate market are experiencing increased vacancy rates—some all time highs. The next twelve months will be seen as a transition period for the commercial markets. Lower values will be driven in large part by regulatory demands on lending practices and working through absorption of the increased inventory. For those who have cash and lender relationships, there will be some very good values available across all commercial segments in the Santa Maria and Central Coast areas.

Note: For the purpose of this report, databank numbers include functional, non-competitive inventory (older buildings and warehouses) and excludes non-market square footage such as mini-storage, airport hangers, etc.

A Cap Rate (Capitalization Rate) is calculated by dividing the annual net operating income (NOI—which does not include debt service) by the purchase price, e.g.. $100,000 NOI/ $1,500,000 purchase price equals .0667 or a 6.67 cap rate.