2013 Commercial Real Estate

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Contents

Key Chapter Findings

- Vacancy is dropping, but there has not been a significant increase in rents.
- New commercial construction is starting.
- Land for residential development has been an active part of the market.
- Commercial investment data is scant for 2013.

A Brief Note on Residential Market—Here We Go Again?

San Luis Obispo

In the current economic recovery, housing foreclosure and short sale inventory has all but disappeared, and the lower end residential market has bolted from the starting blocks. Prices have more than stabilized in San Luis Obispo; they are approaching the median value of 2008. The volume of transactions is up as well. With square foot prices at approximately $361, approved housing tracts are actively being purchased and concomitant new housing is on its way. Properties under $600,000 are selling within weeks.

North County

North County is also experiencing upward movement in both pricing and velocity. Square foot prices are approximately $208, bringing builders back into the market. The entry level market is selling quickly.

Housing Related Projects

- ROEM Development is working on another housing project at South Street in conjunction with the Housing Authority.
- An approved project for 16 residential units was purchased on Bridge Street in San Luis Obispo.
- With a new developer in place, building is continuing at Sierra Meadows and sales are active.
- 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 Foreclosure Activity

Residential foreclosure activity has moved from headline news to the back burner as the housing market has gained momentum.

Commercial Markets

As detailed below, vacancy has fallen for each market sector, some to historic, or near historic lows. However, even with the general indicators pointing to a recovering market and more vigorous transactions, the real story is that rents have been slow to recover—and are still 25% to 30% off from previous highs. So even as available space is growing very tight, these low rental rates make properties more difficult to finance.

The Changed Lender's Environment

As with the residential markets, commercial OREO (bank owned properties) portfolios have thinned and only a few work-out deals remain. Now the focus is on loan production.

Residential Unit Sales, 3rd Quarter Annual Data

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

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

With banks shoring up equity ratios, lenders are now competing more aggressively for loans. However, qualifying for commercial loans is still problematic for many borrowers as the cash requirements remain the same. SBA (Small Business Administration) loans are still the favored vehicle given the lower amount of cash required versus conventional loans: 10% to 20% down for SBA loans versus 30% to 40% down for commercial loans. Owner financing is also a sought out vehicle for acquiring property.

Leasing Activity

Growth in the tech sector has been strong in the San Luis Obispo market. With a couple of key companies making commitments to stay in the area, tech businesses continue to flourish. One aspect of tech sector growth has been the requirement for larger spaces—20,000 to 30,000 sq. ft. or more, versus the 5,000 to 10,000 sq. ft. that used to be required. Mind Body has broken ground on its expansion wanting to grow to 1,000 employees and needing to build its own parking structure. Ifixit has purchased the old Cole Motors building on Monterey and is renovating it for its new corporate headquarters. Rosetta has recently completed a 46,000 sq. ft. facility across from the airport on Broad Street. Cloud is moving from an 8,000 sq. ft. leased space to an expanded facility they are constructing across the street from Rosetta's new home. There are signs of new construction mostly along the Broad Street corridor.

Commercial Markets in San Luis Obispo

This past year has seen the return of new construction to our market. Rosetta , Cloud (noted above), Family Care Network, PG&E, Ewing, and Arsenal Rentals all have built, or are in the process of constructing, new buildings in the County across from the San Luis Obispo Airport. SESLOC and MindBody have started construction on their new corporate headquarters within the city limits. The former Daylight Gardens location is getting reworked into a new project called Heritage Plaza.

Additional projects are beginning to queue up and are waiting for the right tenants to begin construction. There are five projects along Broad Street south of Tank Farms for over 200,000 sq. ft. in various stages of entitlements. San Luis Obispo Airport Business Center is planning to speculatively build 8,000 of the 47,000 sq. ft. project. Downtown also has multiple projects waiting for the right tenant mix to begin construction.

- Chinatown - The approved project includes commercial retail.

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

Property	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Industrial/Warehouse	2.8	3.8	6.4	4.0	4.3	2.3	5.4	6.1	9.1	8.7	4.5	1.9
Retail Functioning	1.9	2.4	2.2	1.7	1.8	1.4	3.0	5.6	5.1	3.4	3.7	1.8
Office Functioning	9.9	8.4	5.4	3.2	4.7	3.5	6.1	9.7	12.6	11.6	8.6	6.5

Source: Stafford McCarty Commercial Real Estate

- (46,000 sq. ft.), 32 residential condominium units, and a 78-room hotel
- Garden Street Terraces - The revised project includes 48 hotel rooms; 8 residential units; and 25,000 sq. ft. of retail, including a market.
- Monterey Place –The project includes 23 residential units, 24,000 sq. ft. of commercial uses, and a 12-room hotel (bed & breakfast).

Other owners and users in the process of getting approvals include Digital West, McCarthy Steel, Tractor Supply, and University Square.

Retail

Given the implosion from the financial market collapse of the Great Recession, it is astonishing how stable the retail market has been. With only a few new retail spaces added as part of a mixed-use project, there have been no real inventory additions for 2013. Retail vacancy stands at a low of 1.87% with approximately 78,000 sq. ft. vacant in a market with a base of 4,156,000 sq. ft.. Retail has the lowest vacancy of any market sector.

If you were to cruise the shopping centers, the most noticeable vacancy is in the Marigold Center, with a 9% vacancy factor. These offerings are smaller shop spaces.

Office

Office has continued to be the weakest segment of the market statistically and sports the greatest number of individual offerings—meaning increased choices for tenants, but continued low rents for landlords.

While the new construction by the San Luis Obispo Airport and new corporate headquarters being built are positive signs of economic growth, what remains to be seen is how fast the larger office spaces made available by this new building flurry will take to back fill.

The office inventory base is approximately 2,758,000 sq. ft. for the market with Rosetta being the only significant addition. Vacancy is 6.47%. Available office inventory in San Luis Obispo is approximately 178,000 sq. ft. at present.

As with last year, depending on location and landlord tenant improvement contributions, second generation downtown office rents have continued to be $0.20 to $0.40 per sq. ft. off of their average before the recession. We see this situation changing if vacancy tightens and landlords have the opportunity to renew at higher rates. New or newer space has been able to command the upper rental range of approximately $2.00 per sq. ft..

The question, as noted above, is how long will it take to backfill the larger spaces left behind.

Since reporting from one year ago, there are a few sales to note, as there have not been many for 2013:

- 1039 Murray–approximately 8400 sq. ft. of professional office across from Sierra Vista Hospital, an off-the-market transaction selling to a user-buyer for approximately $350 per sq. ft..

- Ifixit purchased the former Cole Motors on Monterey. It is being remodeled. Adjacent land was purchased for parking at approximately $50 per sq. ft..

Industrial

The vacancy rates for industrial product has dropped to 1.9% (4.5% in 2012) with San Luis Obispo's available manufacturing inventory standing at approximately 73,412 sq. ft.. The total base of industrial inventory is approximately 3,814,000 sq. ft..

Industrial users are finding it difficult to locate suitable property. There is unmet demand across the board for industrial spaces of up to 25,000 (plus) sq. ft.. This is the third year in a row that no significant buildings have been added to the manufacturing inventory. This segment of the market is seeing rental rates start to climb with the dearth of inventory. The current market lock-up is due to the fact that the rents required to make new construction economically feasible for an owner/investor are still significantly higher than the rents being collected for existing space. As that gap starts to narrow, we should see new industrial construction begin again and rents start to rise in the meantime.

Industrial sales have fallen off as there is little inventory. A few reported parcels are in escrow on Tank Farm, Broad Street. and Prado Roads Other than that there is not much to report. Building fees within the City are still an issue. The lack of available industrial inventory is driving prices back towards $10 to $12 per sq. ft. on offerings and appraisal discussions.

Vacant building values are still registering under reproduction costs, but we will see this change as functional inventory comes to the market.

Downtown San Luis Obispo

There is confidence in well-located downtown parcels. Union Bank had multiple offers in excess of $6 million for its surplus branch, which reportedly sold for $6.4 million, putting the residual ground value at over $200 per sq. ft..

The Shell gas station on Santa Rosa between Higuera and Monterey Streets is reportedly in escrow for well over $100 per sq. ft. in land value.

Available downtown inventory has nearly vanished, however there continues to be quick turnover of tenants. If there is space, it is not vacant for long.

Key projects that are still moving forward include:

- Garden Terraces is proposing 35,000 sq. ft. of commercial space.
- The Chinatown Project with 50,000 sq. ft..
- Marsh Street Commons has broken ground on 8,500 sq. ft. of commercial space; 4 lofts and 8 single family homes have been completed and sold.

These are all in the downtown core and have multiple stories with retail on the ground floor and residences on the upper floors. Garden Terraces and the Chinatown Project both include hotels as well.

As reported previously, 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 of between $2.00 and $3.50 per sq. ft.. The core block units of downtown, have achieved high watermark rents as high as $4.50 per sq. ft..

Commercial Markets in Paso Robles and North County

The adage attributed to Mark Twain, "Whisky's for drinkin' and water's for fightin'" has come home to roost in North County. Water overdraft issues have property owners and citizens piqued regarding new developments and agricultural demands on the basin. The County's cessation intervention has placed red flags on key proposed developments such as the Gateway project (which is at the north corner of Highway 46 west and US 101 and is proposing multiple hotels, a conference center, and housing) and on continued planting and development of the viticulture industry.

Compared to San Luis Obispo, vacancy rates in Paso Robles and the North County are higher across all market segments but have made substantial improvements. The wine industry and associated spinoffs have added prestige and prominence to the area. Treks to the newly completed Vina Robles Amphitheater to see named artists are common for San Luis Obispo County residents. A few properties which have been on the on the market for a long time are finally selling. Entitled housing tracks are also selling.

Retail

Paso Robles added a scant approximately 12,000 sq. ft. of retail from three different entities. The retail base inventory for the market currently stands at approximately 4,646,000 sq. ft. (similar in size to San Luis Obispo). Retail vacancies decreased slightly from 4.7% to 3.3% last year and have been fluctuating in this range for several years. There is approximately 154,000 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 activities:

- Partial occupancy of the former 66,000 sq. ft. Kmart by Tractor Supply; the balance of the building is still available.
- American Tire Store completed its construction in the Lowe's Center along Highway 46.
- The former A&R Furniture in downtown Paso Robles was remodeled into smaller retail spaces, all of which have been leased.

Surprisingly, well located properties are still on the market after a year of exposure.

Office

As the story goes for office product across the Central Coast region, office vacancy in the North County is still the weak spot. But it has improved dramatically and vacancy presently stands at 6.58%, down from 18.27%. Office vacancy is scattered and is predominately in smaller unit sizes (under 2,500 sq. ft.). There is approximately 28,500 sq. ft. currently vacant.

A few larger users, such as Community Health Centers, have absorbed significant vacancy and can skew the data as the office component of the market is small. The changes can appear exaggerated by the absorption or decrease of 15,000 sq. ft.. The office market is still in recovery from the financial market fall out at the beginning of the recession. However, all in all, it has improved.

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. We project rent recovery as the market tightens.

Technical companies such as IQMS and Santa Cruz Biotech have added inventory. This is also good news for the North County as the related jobs are coined as 'head of household', which is a desired demographic for economic growth.

Manufacturing

Overall absorption has been lackluster but the owner-user expansion has continued with the companies noted above. The industrial sector added approximately 131,000 sq. ft., and vacancy now stands at a modestly improved 5.69%, down slightly from 6.47% last year. Paso Robles has an industrial base of approximately 3,229,000 sq. ft..

Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2013

Property	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Industrial/Warehouse	9.4	10.7	3.5	5.0	2.8	7.5	13.2	8.0	7.7	6.5	5.7
Retail Functioning	1.9	< 1.0	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5	3.5	4.8	3.3
Office Functioning	1.2	1.8	1.2	5.2	5.6	7.7	24.1	17.5	18.4	18.3	6.6

Source: Stafford McCarty Commercial Real Estate

Sale prices vary widely for industrial finished parcels. Comparable sales can range from $1.50 per sq. ft. to $6.00 per sq. ft.. North of Highway 46, lenders sold foreclosed finished parcels at the lower end of comparables.

Agricultural Impact: Wine Industry Facilities Continue to Expand.

Buildings and facility additions specific to the viticulture industry are continuing to be added. Combined, the Paso Robles and San Luis Obispo areas added over 122,000 sq. ft.. Please note that this falls on the heels of the previous year's 150,000 sq. ft.. Most of this inventory is in North County outside of the city limits.

Institutional private trusts are purchasing thousands of acres in North County, reportedly paying approximately $40,000 to $45,000 per acre for established vineyards, and approximately $15,000 per acre for plantable ground.

This all points to further maturation of the county's recognition within the viticulture industry. The overdrafting issues and resolution are critical to this industry sector.

Commercial Investments

Investment sales across the Central Coast have been scattered and there is no clear pattern. Many investors have placed their monies in residential housing, as most of the entry level inventory has been this buyer type. Mutifamily (apartments) comparable cap rates are more focused.

Apartments have had the most activity of any single type (office, industrial, retail) and demonstrating capitalization rates from 4.1 to 5.7.

Some notable sales include:

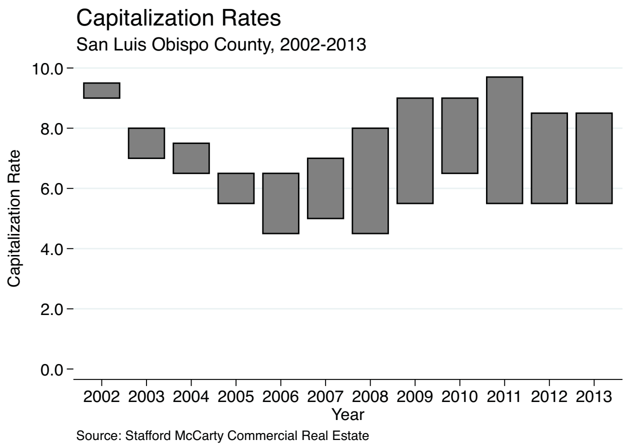
- 805 Boysen, San Luis Obispo, June 2013, $5,850,000, Cap 5.3.
- 310-330 Kentucky San Luis Obispo, June 2013, $1,975,000, Cap 5.0.

But excluding residential multifamily sales, the market is void of generally useable comparable sales for 2013. This is causing appraisers great frustration. Cap rates often are being imputed from user-buyer sales, or 2012 data is being relied upon, or even out-of-the-area transactions are being used.

Well anchored centers are listed at below 6 caps. Smaller product with greater risk is at a higher cap range. Generally, leased investment properties are listed in the 6 cap range to sell around the 7s. Lenders appear to be comfortable with a 7 cap rate number, however, each transaction is being evaluated on a case-by-case basis.

We anticipate more sales and investment in 2014 even with the uncertainty of rising interest rates.

Following are capitalization rate ranges evinced over the last eleven 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 Low	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	5.5	8.5	1,818,000
2013	5.5	8.5	1,818,000

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

Final Words: Waiting to Pick Up Momentum

Knowing that our region tends to lag Northern and Southern California markets, we see activity coming our way and initial signs of expansion. Increased demand for properties has caused inventory to shrink, but rents have not yet begun to rise significantly. Buyers are still having difficulty qualifying for loans due to equity requirements, but are actively seeking property to buy. As more transactions occur and values start to rise, the financing issues should ease. We should see the momentum build within the markets next year.