Commercial Real Estate

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Key Issues:

The H's: Hotels and Housing are Active Markets

Continued Increased Construction Costs

Cannabis Conundrum

The R Word: Market Looking for Recession Indicators

The Housing Market - Overview

Needless to say, housing is a hot topic with cities across the region trying to meet state requirements for increased units. The "how" is a big part of the question and centers on discussions of "up or out" meaning should densities be increased in the urban core, or should more land be annexed on the city fringes to meet the need. Following is a summary of how the County's current housing markets are faring.

San Luis Obispo

Residential construction is very visible in all shape and sizes in San Luis Obispo. Tiny homes, downtown “brownstones”, mixed-use residences, and traditional single-family homes are all present.

The residential market is relatively flat compared to a year ago. There have been slightly more sales to date in 2019, the time on the market for existing homes to sell is about the same, and square foot prices are up a touch for San Luis Obispo.

In 2019, homes in the City of San Luis Obispo are approximately $477 per square foot. This is a slight increase over $450 per square foot in 2018. The median price dropped slightly, but the price per square foot increased since the average square footage dropped a bit. The median home in San Luis Obispo is approximately 1,805 square feet and sells for $790,000. All in all, the volume of the market held steady with about 40 more units selling in 2019 than 2018. Costs for residential housing in San Luis Obispo remains high and inward and exiting commutes to and from the City are still heavy.

North County

For North County, there is a similar story: a modest increase in unit sales and a flat median price ($291 per square foot). The median home in North County is approximately $1,800 square feet and sells for $507,375.

Housing Related Projects in the City of San Luis Obispo

There is noticeable construction occurring within the City of San Luis Obispo and immediate surrounding area.

There are two area specific plans that are moving forward with construction:

- The Orcutt Area Specific plan has multiple projects with multiple phases in full gear. Wingate Homes, Righetti Ranch, the Jones Property, and West Creek – all located in the Orcutt Area Specific Plan and all proceeding with construction.
- San Luis Ranch, the former Dalidio project, has been approved for 580 homes plus hotel and commercial space. The project has seen lots of grading in preparation for future construction.

Avila Ranch is a third specific plan that is approved and will begin construction soon, including 720 residential units and 20,000 sq. ft. of commercial space.

Other projects with significant unit counts that have broken ground include:

- The Junction – 69 residential units and approximately 3,000 sq. ft. of commercial space on Santa Barbara Street by Miners (under construction)
- The Connect – 78 residential units and 6,800 sq. ft. of commercial space on Orcutt and Duncan Lane
- Twin Creeks – 94 residential units on Orcutt close to Broad

There are many more projects moving through the planning stages, with a significant amount in or close to the downtown core. Recently completed downtown projects range from the 30 new manufactured units at Downtown Terrace on Higuera Street to the four high-end units at the Moderns on Marsh Street.

Projects on the books for downtown include:

- Marsh and Carmel Mixed Use – 8 residential units plus 1,100 sq. ft. of commercial space (under construction)
- Monterey Place - 29 residential units plus 12,255 sq. ft. of commercial space (under construction)
- 545 Higuera St – 64 residential units plus 4,649 sq. ft. of commercial space
- South Town 36 – 36 residential units plus 500 sq. ft. of commercial space
- San Luis Square – three buildings consisting of 63 residential units, 36 hotel rooms, and 19,792 sq. ft. of commercial space
- Marsh and Chorro Mixed Use – 55 residential units plus 30,000 sq. ft. of commercial space

Apartments are a big part of the housing equation as well. Vacancies are approximately 3% currently. Values remain strong and the cap rates for sales are still centering around 4s and an active market.

RESIDENT UNIT SALES DATA

3rd Quarter 2019 Annual Data	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
San Luis Obispo									**	**	**	**
# Units Sold	159	163	191	215	273	282	259	283	337	275	258	296
Median Price	$635,000	$569,000	$550,000	$535,000	$535,000	$618,500	$654,500	$667,000	$661,000	$700,000	$800,500	$790,000
North County												
# Units Sold	638	702	698	892	991	1045	1032	1138	923	976	919	928
Median Price	$390,000	$340,000	$296,000	$270,000	$305,000	$355,000	$375,500	$404,500	$422,421	$483,000	$521,250	$507,375

Source: MLS data complliled by McCarty Davis Commercial Real Estate

Hotels in San Luis Obispo and North County – The other H and the Increasing Influence of Tourism

Hotels in both San Luis Obispo and Paso Robles are increasing their capacity and room counts. Occupancy and room rates are both up in the County. Hotels are capitalizing on the closely linked hotel stays associated with increased air traffic at San Luis Obispo County Regional Airport. Recently added routes include Dallas, Las Vegas, and Seattle – and routes are soon to be added to San Diego and Portland.

San Luis Obispo has seen the recent opening of:

- The La Quinta on upper Monterey with 102 hotel rooms
- The Hotel SLO just opened with 78 hotel rooms
- Hotel Cerro is set to open anytime with 64 hotel rooms

On the books in downtown San Luis Obispo are:

- Hotel at the Creamery with 47 hotel rooms
- Granada Hotel Expansion with 22 hotel rooms
- San Luis Square with 36 hotel rooms

In Paso Robles, new hotels are highly visible along the 101 and Highway 46 East Corridor. Given all the new units recently completed, there are reported to be another 1500 rooms on the books in the County. This coincides with continued agri-tourism growth, particularly in the wine industry: North County now has 11 sub-AVAs and 150 plus tasting rooms.

At different price points and stay experiences, the branded hotel Oxford Suites Paso Robles (101 rooms), as well as the Martin Resorts boutique 23-luxury suite Piccolo Inn, are now open for business.

Below, a few noted transactions at hospitality properties reflect the wide difference in cost per room, although the cap rates are somewhat similar (see Commercial Investments below for a further explanation of "cap rates").

Inn at the Cove	$17,400,000	6.9 cap	52 rooms	$334,615/rm
Holiday Inn Pismo/Grover	$11,000,000	5 cap	78 rooms	$141,025/rm
Ascot Inn at the Rock	$6,200,000	6.5 cap	32 rooms	$193,750/rm

Hotels have gained in value over last year as the cap rates for hotels has dropped slightly over last year. As a note, cap rates are slightly higher than non-operational assets where there is not business or operational component associated.

Cannabis and Hemp – An Evolving Part of the Local Economy

The Cannabis market has moved from wild frenzy to more measured growth. Demand continues to be strong for cannabis related industrial facilities. We are seeing smaller users want space for manufacturing and distribution. Some operations want to remain small and independent while others seek locations in the County as it serves as a well-placed node in their statewide supply chain.

Between the County's ordinances and the rise of Hemp production for CBD, demand for cannabis growing ground has slowed as it is challenging for growers to be economically viable. The County placed a moratorium on new hemp production in June, so growers are again waiting to see what the County will allow them to produce. Large greenhouse facilities that were initially home to cannabis production as the new regulations were being adopted are now trying to become reclassified as nurseries to take advantage of the large square footage they have available.

Dispensaries have or will soon open in a number of cities. A retail operation in Grover Beach handed the City a check for $500,000 which represented approximately $10,000,000 in reported sales revenues. San Luis Obispo has approved three dispensary operators and they are currently in the process of their regulatory review.

Commercial Markets

Key activities and trends in commercial real estate are outlined in the following sections broken out by region and individual market segments.

Commercial Markets in the City of San Luis Obispo

Overall, the commercial markets continue to look solid with Buyers and Tenants demonstrating strong confidence.

We are seeing costs for Tenant Improvements (known as TIs) climb and climb. This is due to both the cost of supplies (in part driven by steel and other tariffs) and labor. Tenants are complaining that it can take a month to get a bid from a contractor. Higher construction rates and TI costs drive rents up and will eventually put a damper on growth as concomitant rents could become prohibitive. Land costs and fees remain at high water marks and office improvements over a shell have moved up to the $100+/sq. ft. range.

Office

Office vacancy grew somewhat this past year, increasing from 4.2% for 2018 to 5.4% for 2019. Base office inventory is now approximately 2,975,288 sq. ft with just 6,000 sq.ft. of inventory being issued final permits this last year.

The approximate 200,000 square foot Laurel Creek/Atoll Business Center was taken off the market as the large property was being considered for residential redevelopment. However, the owners have decided to lease the building and build a smaller number of residential units on the perimeter of the 17 acre parcel.

The East Airport corridor continues to establish itself as a strong business hub with new buildings being completed and more being planned. New market base rents for these assets are approximately $2.25 per sq. ft NNN (with some dollars being given for Tenant Improvements).

Leasing activity continues to be solid with a reasonable amount of businesses upsizing and downsizing to meet changing needs. The most active user bases presently are medical users transitioning into newer spaces as well as expanding “start ups” within the tech sector. These user groups have been a challenge to place as parking requirements for these tenants are high—5 spaces for every 1,000 sq. ft as compared to the more common office parking requirements of 3.5 to 4 spaces per 1,000 sq. ft. Many existing buildings with vacancies cannot necessarily accommodate these users.

Here are some representative sales for office buildings in San Luis Obispo:

3592 Broad St. #100	689 sq. ft.	$370,000	$537 per sq. ft.
1177 Palm Street	1,375 sq. ft.	$825,000	$600 per sq. ft.
184 Casa Street	2,350 sq. ft.	$940,000	$400 per sq. ft.
444 Higuera #100	2,024 sq. ft.	$985,000	$486 per sq. ft.

COMMERCIAL VACANCY RATES

San Luis Obispo City Metropolitan Area

3rd Quarter 2019	Industrial / Warehouse	Retail Functioning	Office Functioning
2002	2.8%	1.9%	9.9%
2003	3.8%	2.4%	8.4%
2004	6.4%	2.2%	5.4%
2005	4.0%	1.7%	3.2%
2006	4.3%	1.8%	4.7%
2007	2.3%	1.4%	3.5%
2008	5.4%	3.0%	6.1%
2009	6.1%	5.6%	9.7%
2010	9.1%	5.1%	12.6%
2011	8.7%	3.4%	11.6%
2012	4.5%	3.7%	8.6%
2013	1.9%	1.8%	6.5%
2014	3.1%	2.7%	7.5%
2015	2.3%	1.3%	5.3%
2016	1.6%	5.6%	3.8%
2017	1.4%	4.0%	5.4%
2018	1.3%	5.0%	4.2%
2019	1.9%	6.8%	5.4%

Source: McCarty Davis Commercial Real Estate

Retail

Given the breaking up of larger retail spaces and the visibility of shuttered storefronts, it may not be a surprise that retail market vacancy has grown in 2019 to 6.8%. Last year it was 5%, and in 2017 was 4%. Little retail inventory has been added. Base inventory is now $4,200,260 per sq. ft.

Some of the larger spaces have been, or are now being, reworked to accommodate the changing face of local retail. Some examples include breaking up the former Forever 21 into Sprouts and the soon to be opened REI, and demolishing the former Sears store and replacing it with Michaels and Ross, which will leave holes in market.

Vacancy has increased somewhat downtown. Rising lease rates are making it challenging for small companies to generate enough sales to cover rent. Restaurants are continuing to come and go and many of those that seem to be successful have alcohol as part of their menu offering.

An interesting observation in San Luis Obispo is that stores on both ends of the price spectrum seem to do well. Value driven retailers like Target and Ross are finding success and higher end stores like Sprouts and Williams-Sonoma continue to pull in a strong customer base.

Banks have seen a resurgence of activity after a number of quiet years.

- Bank of America moved across the street to a new branch building, (leaving a vacant building in its wake)
- American Riviera Bank renovated a former restaurant space into a downtown branch
- First Capital Bank has signed a lease at the corner of Higuera Street and Nipomo
- Murphy's Bank moved into a new office space on Aerovista

Sample office sales:

1127 Broad Street	3,795 sq. ft.	$1,850,000	$487 per sq. ft
1146 Farmhouse	18,700 sq. ft.	$6,500,000	$348 per sq. ft (excess land)

Industrial

We noted last year that is was difficult for users to find industrial space in San Luis Obispo—and things have not changed much in 2019. Vacancy grew slightly to a rate of 1.92%, which is up from 1.28%, but still extremely low.

Approximately 35,826 sq. ft. of industrial space has been added to the inventory this last year. Base inventory is now at 4,071,301 sq. ft.

The East Airport area of San Luis Obispo has seen the strongest concentration of growth in the past few years. Parcel sales in that area have demonstrated values over $20 per sq. ft. 4750 Allene Way (.97 Acres) sold for $875,000 or $20.70 per sq. ft.

Given land prices and the cost of construction, very little pure industrial property is being constructed in San Luis Obispo. This is in spite of the fact that lease rates are at least $.30 per sq. ft. higher in San Luis Obispo than in other areas of the County or Santa Maria. Given the vacancy rate, there is clearly demand, but builders are looking to achieve the higher office rental rates of over $2.00 per sq. ft. if possible.

The largest industrial projects we see are two new, large self-storage facilities under construction as well as the expansion of ACI Jet facilities at the San Luis Obispo Airport.
A middle of market transaction for size and price: 958 S Higuera, 9,000 sq. ft. for $1,850,000/$205 per sq. ft. on a $1.25 NNN per sq. ft.

Commercial Markets in Paso Robles and North County

The Paso Robles market continues to show strength and mature into its revitalized persona as a foodie and agri-tourism destination. Across all market segments, the area has seen shrinking vacancy. There continues to be solid expansion of commercial activity in the non-incorporated area as wineries improve and expand their facilities.

COMMERCIAL VACANCY RATES
Paso Robles Metropolitan Area

3rd Quarter 2019	Industrial / Warehouse	Retail Functioning	Office Functioning
2003	9.4%	1.9%	1.2%
2004	10.7%	< 1%	1.8%
2005	3.5%	< 1%	1.2%
2006	5.0%	< 1%	5.2%
2007	2.8%	< 1%	5.6%
2008	7.5%	2.2%	7.7%
2009	8.6%	2.7%	13.9%
2009	13.2%	4.1%	24.1%
2010	8.0%	4.5%	17.5%
2011	7.7%	3.5%	18.4%
2012	6.5%	4.8%	18.3%
2013	5.7%	3.3%	6.6%
2014	3.6%	2.6%	14.3%
2015	1.1%	2.8%	7.5%
2016	9.3%	2.1%	9.2%
2017	5.8%	1.1%	7.8%
2018	5.1%	2.6%	13.5%
2019	2.7%	2.2%	4.2%

Source: McCarty Davis Commercial Real Estate

Office

This market segment has demonstrated the greatest vacancy improvement. Office vacancy has dropped from 13.4% to 4.42% in 2019. The base has grown slightly to 443,338 sq. ft. after adding approximately 26,200 sq. ft of new medical office for CHC in Templeton.

Demand for medical space continues to be strong in the area even with CHC's expansion. The ever-evolving absorbtion of individual providers into employees of larger health care organizations and the entry of new regional players in the market is maintaining a strong demand for medical space.

Small office buildings are still selling between $200 to $300 per sq. ft.
355 Posada Ln., at 3,799 sq. ft., sold for $1,070,00, translating to $281 per sq. ft.

Retail

Retail also continues to be a strong market sector with the vacancy rate improving a bit in the Paso Robles market to 2.2% in 2019 compared to 2.63% in 2018. There is approximately 102,400 sq. ft. on the market out of a base of 4,4652,400 sq. ft.

Similar to San Luis Obispo, there is a trend of larger spaces being divided into smaller spaces, whether it is a portion of boxstores (Kohls) looking to sublease, or smaller private holdings, such as a larger physical therapy space on Park Street. There is an ebb and flow occurring in these spaces. However, there are still small amounts of inline space at larger retail centers that remain vacant year over year.

End caps and pad buildings trade at good rates: 2341 Theatre Drive, at 6,575 sq. ft., sold for $1,475,000 or $224 per sq. ft.

Industrial

Industrial space in North County, has also demonstrated improvement with a reduced vacancy of 2.71%, down from, 5.1% vacancy in 2018. There is approximately 102,000 sq. ft. available on a 2019 base inventory of approximately 3,765,100 sq. ft. New inventory of just under 300,000 sq. ft. has been added, specifically user driven as opposed to buildings built for speculative purposes.

The Ramada Drive area of Paso Robles has seen a large expansion of the Firestone Walker facilities. In addition, the large 200,000 sq. ft. facility at 1650 Ramada Drive has been filled, predominately with wine related tenants. Wine and beverage permits accounted for the bulk of added industrial inventory in the region.

There continues to be steady demand for smaller industrial product. This can be seen by the continued build-out along Combine Street off of 46 and Golden Hill Road as well as demand for acquisition. 2140 Tractor, at 20,000 sq. ft., sold for $3,100,00 or $155 per sq. ft.

There is still a significant amount of large industrial land parcel inventory available in the Wisteria Road area north of 46. These larger parcels are on the market in the $7.00 to $9.00 per sq. ft. range.

Agriculture

Prices for production ground for row crops and berries are holding steady and can be as high as $65,000 per acre. Availability is rare especially for production of crops that can be certified as organics.

North County vineyards continue to change hands, a few noted sales:

Armor Ridge Vineyard	$2,690,000	130 ac. 98 planted
Clautiere Winery	$1,380,000	25 ac./with winery improvements
37500 Foothill Road	$31,250,000	+/-450 ac. (Monterey County)

Winery and wine related building permits have been issued for over 130,000 sq. ft within North County alone and outside of the urban boundaries.

Determining actual farmable acres can be very complex as there is often a residential and production component as part of the transactions.

Commercial Investments

Capitalization rates, one of the key metrics used to determine the values of commercial real estate, known as "Caps" or "Cap Rates," have been very similar for the last three years. This has also been consistent across the investment product types of office, retail, industrial apartments, etc.

Investment properties remain difficult to find. Potential sellers are reluctant to sell properties even though they can currently obtain "top dollar" prices. Often a potential seller will respond to a good offer with, "but what can I buy as an exchange?" as they do not want to pay the capital gains taxes associated with the sale. Many potential transactions never leave the gate as owners decide to hold steady with their current investments.

Examples of commercial building sales:

350 Posada	19,400 sq. ft.	$7,500,000	6 cap (approximate)
625 Spring Street	8,500 sq. ft.	$2,300,000	5.2 cap
2140 Tractor St.	20,000 sq. ft	$3,100,000	4.7 cap
668 Marsh St.	7,000 sq. ft	$2,100,000	4.7 cap (approximate)
3566 S Higuera	31,304 sq. ft	$5,600,000	6.8 cap (proforma)
3536 S Higuera	25,454 sq. ft	$5,725,000	5.4 cap (Nov 2018 sale)

Following are demonstrated capitalization rate ranges over the last eighteen years for our market area:

To illustrate the capitalization influence on valuation, 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:

2002	9.0 to 9.5	2002	$1,053,000
2003	7.0 to 8.0	2003	$1,250,000
2004	6.5 to 7.5	2004	$1,333,333
2005	5.5 to 6.5	2005	$1,538,000
2006	4.5 to 6.5	2006	$1,538,000
2007	5 to 7	2007	$1,428,000
2008	4.5 to 8	2008	$1,250,000
2009	6.5 to 9	2009	$1,111,111
2010	5.5 to 9	2010	$1,111,111
2011	6.5 to 9	2011	$1,031,000
2012	5.5 to 9.7	2012	$1,818,000
2013	5.5 to 8.5	2013	$1,818,000
2014	5.5 to 8.5	2014	$1,818,000
2015	4.5 to 8.5	2015	$ 1,428,000
2016	4.5 to 7.0	2016	$1,538,000
2017	4.0 to 6.5	2017	$1,538,000
2018	4.0 to 6.5	2018	$1,538,000
2019	4.0 to 6.5	2019	$1,538,000

Conclusion

The commercial markets in both Paso Robles and San Luis Obispo remain strong. Office growth in San Luis Obispo continues to be fueled by innovation from Cal Poly and tech companies that have small (and some big) footprints in the area. Medical office space is a high dollar investment and the absorption of private medical practices by larger health groups, as well as new groups making investments in the local market, continue to drive office conversions.

The shortage of housing is driving investment into both single-family and multifamily projects. San Luis Obispo is in the middle of unprecedented housing growth. Although potentially affordable for those moving in from the coastal urban centers of the state, many housing options still remain out of reach for County residents, resulting in a significant number of people commuting into San Luis Obispo for work each day.

Continued efforts by local business groups such as the Economic Vitality Corporation (EVC) and the new Hourglass Project highlight how regional, big picture, economic shepherding can make the County economy more resilient to both the closing of Diablo Canyon and the eventual economic slowdown that will arrive as markets cycle through ups and downs.

Although many are looking over their shoulder as the longest economic expansion in U.S history continues, confidence in the commercial markets remains strong and we are seeing a continuance of economic growth. The R for recession word, seems to be a subject for economists to debate.