2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

Commercial Real Estate

by Steve McCarty and Steve Davis, McCarty Davis Commercial Real Estate

Key Issues:

Confidence in Commercial Real Estate

Increased Construction Costs

Rising Interest Rates, Recession Worries?

The Residential Market - A Brief Overview

As housing costs continue to rise, housing affordability has become one of the major issues facing San Luis Obispo County. As you can imagine, there are many opinions on how to address the problem and those discussions often come with associated and heated politics. A number of differences between the City of San Luis Obispo and North County markets are discussed below.

San Luis Obispo

The average price for a home in the City of San Luis Obispo is approximately $450 per square foot. This is an increase from $410 last year. In addition, the homes that have been selling are larger—now averaging over two thousand square feet. Construction time for a new single family residence has pushed out from 6 to 9 months. All in all, this translates to approximately $937,000 for the average (median $800,500) new home is San Luis Obispo. There were approximately 258 units sold through the third quarter of 2018. Needless to say, not everyone can afford these prices and many residents commute from more affordable areas such as Santa Maria, South San Luis Obispo County, and North County.

North County

In the North County the residential market sales volume has decreased to 916 single family units from 978 units last year. Average prices have increased from $534,500 to $575,000 ($521,250 median price) for a 1,900 sq. ft. house—approximately $302 per sq. ft. In short, compared to last year, in the North County, as in San Luis Obispo, home sales are more expensive, larger, and the overall number of sales has decreased slightly.

Housing Related Projects in the City of San Luis Obispo

There is noticeable construction within the City of San Luis Obispo and in immediate surrounding areas.

Noted projects at or near completion include:

- The Avivo Townhome project is in its final phase west of Sacramento Street.
- Sierra Meadows and Toscano, off Prado Road, are actively moving through their phases for single-family detached homes.
- Wingate Homes, Righetti Ranch, the Jones Property, and West Creek – all located in the Orcutt Area Specific Plan – are proceeding through construction.
- Chinatown is partially completed.

- Garden Street Terraces are moving toward completion.
- 22 Chorro Street, with 27 residential units and approximately 2,000 sq. ft. of commercial space, is under construction.
- The Yard, 43 residential units throughout 8 new buildings on the former Waste Management site, is under construction.

Upcoming projects still include:

- Avila Ranch, on Buckley south of the County Airport, has been approved for 720 units.
- San Luis Ranch, the former Dalidio project, has been approved for 580 homes plus hotel and commercial space.
- The Junction, 69 residential units and approximately 3,000 sq. ft. of commercial space on Santa Barbara Street by Miners is on the books.
- Numerous other projects are also working their way through the planning and design pipeline.

Housing unit sales from 2008 through 2018 in San Luis Obispo and North County are illustrated in the summary table below.

RESIDENTIAL UNIT SALES DATA

Source: MLS Data; Compiled by McCarty Davis Commercial Real Estate

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

Commercial Markets

Key activities and trends in San Luis Obispo County's commercial real estate are outlined in the following sections and broken out by regions and individual market segments.

City of San Luis Obispo

Office

Office vacancy has inched slightly downward from 5.4% in 2017 to 4.2% this year. Base inventory is approximately 2,969,200 sq. ft. Approximately 35,900 sq.ft. of inventory was added this last year. Leasing activity has been vibrant. Office space, which has been the slowest market segment to absorb, has been filling up.

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

The reduction in vacancy has reduced the number of office space options for tenants. Second generation spaces are leasing at lower rates than new construction. However, spaces over 5,000 sq. ft. are difficult to find and tenants have been turning to new construction to meet their needs.

The Broad Street corridor from Tank Farm Road to the East Airport area has been the focus of new commercial activity with a mix of user types. Harris' new legal offices have just been added at a prominent Broad Street location. Meathead Movers are moving their offices to a new building across from the airport.

At 892 Aerovista, approximately 36,000 sq. ft of office space has just been completed and fully occupied, filled mainly by medical and financial tenants. The Airport Business Center has been absorbing to the point where its ownership has triggered construction of the next phase of development. New market base rents for these assets are approximately $2.25 per sq. ft NNN (with some dollars being given for Tenant Improvements). Given land costs, fees, and increasing construction costs, any new office buildings coming on to the market will be $2.00+ per sq. ft., NNN. In addition to the cost of shell construction, TI costs for office build-outs have moved up to the $100+/sq. ft range.

Medical users have been a big part of the new absorption and activity. Two large medical users account for over 60% of the occupancy at 892 Aerovista. Most recently, the older 30,500 sq. ft. medical campus on California Boulevard sold for $5,683,750 ($186.35 per sq. ft.) and will be given new life through updating. Additional square footage will be built there as well. Larger medical providers are continuing with strategic additions and consolidations with their various clinics.

Generally, office sale prices in the San Luis Obispo area in the $300 - $400+ /sq. ft. range. A nicely finished, first floor suite (1,379 sq. ft.) at 805 Aerovista sold this spring for $515,000, or $373/sq. ft. On the larger side (18,447 sq. ft.), 3701 South Higuera St. sold for $5,600,000, which translates to $304 per sq. ft.

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

COMMERCIAL VACANCY RATES
San Luis Obispo City Metropolitan Area
Source: McCarty Davis Commercial Real Estate

Upated 3rd Qtr 2018	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%

Retail

Retail vacancy in the City of San Luis Obispo remains relatively low (5.0%), and has increased a percentage point over last year. Hardly any new stock has been added and the present retail inventory base is approximately 4,189,400 sq. ft.

When the retail vacancy data is parsed, it is interesting to note that the larger vacant spaces, formerly housing the likes of Gotthshalks's and Staples, have created the bulk of the vacancy, while smaller square footages, 5,000 sq. ft. and under, have, for the most part, been faring well. There is turnover in these spaces, but new tenants generally follow within a reasonable time frame.

The larger brick and mortar vacancy issues with national and regional tenants are the fall-out of changing consumer trends and continued growth in online retail sales. The former Sears and Forever 21 have been broken up and are currently being renovated into a greater number of new users with smaller footprints.

Downtown SLO

Downtown San Luis Obispo is an iconic location for both tourists and locals. The demand for ownership of downtown assets remains robust and larger properties, when they become available, create strong interest. This last year the Naman properties went on the market and there were immediately multiple buyers. The mid-downtown, multi-building asset of approximately 19,300 sq. ft., reportedly sold for $13,125,000 or approximately $680 per sq. ft. of usable area. By way of comparison, a 12,930 sq. ft. building in the same block, 736 Higuera, sold for $5,199,600, or approximately $402 per sq. ft.

There remains a vitality to downtown San Luis Obispo as other community's downtowns have experienced increasing vacancies and diminution of their former cache.

Industrial

It is difficult for users to find industrial space in San Luis Obispo. The vacancy has declined slightly from an already previous low of 1.4%, and for 2018, stands at 1.28%.

Very little inventory has been added to the market, approximately 70,700 sq. ft., and there is not much in the pipeline so we anticipate another year of low vacancy. Lockheed has informed their landlord that they will be vacating the 80,000 sq.ft. they currently occupy and demand for the space has been strong.

The standing inventory of industrial space has just tipped over the 4,000,000 sq. ft. mark. Space availability over 15,000 sq. ft. is virtually absent from the market. Rents are about the same as last year with quoted industrial rents in the $.80 – $1.25 per sq. ft. NNN range depending on the size of the space.

The East Airport area of San Luis Obispo has seen the strongest concentration of industrial growth in the past few years. Parcel sales in that area have demonstrated values over $20 per sq. ft.

Paso Robles and North County

COMMERCIAL VACANCY RATES
Paso Robles Metropolitan Area
Source: McCarty Davis Commercial Real Estate

Updated 3rd Qtr 2018	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%

Retail

Given the smaller population base of Paso Robles, as compared to South County, retail has been a strong suit over the years. It currently has a base of approximately 4,650,000 sq. ft. Not much retail inventory has been added since last year, similar to prior years.

The retail vacancy rate was very low in 2017 (1.1%) and has ticked up to 2.63% in 2018. The approximate 122,092 sq. ft. of vacancy is comprised mostly of small spaces. As noted in the San Luis Obispo segment, retail is continuing to evolve and bigger units are trending to go dark. The 47,000 sq. ft. Orchard Supply Hardware on Theater Drive has posted closing signs.

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

Office

This segment of the market has had the largest vacancy swings over the last 10 years and has been the weakest segment for the region. Office vacancy, just short of doubling, has moved upward from 7.8% to 13.5% in 2018. There is now approximately 59,528 sq. ft. of standing inventory on the market; this is on a base of approximately 442,000 sq. ft. and again, minimal office inventory has been added. Small office buildings are selling for between $200 and $300 per sq. ft.

Community Health Centers is constructing new medical offices in Templeton of approximately 26,000 sq. ft. As they occupy the new facility they will transition from their current offices, vacating medical space that will need to be filled. Given current conversations, there appear to be a number of medical groups interested in occupying the space.

Industrial

Paso Robles' industrial space, although close to holding constant, is showing slight improvement with a 5.1% vacancy rate for 2018, down from 5.8% in 2017. There is approximately 180,200 sq. ft. of space currently available. Base inventory has grown slightly to approximately 3,530,000 sq. ft. for 2018.

An interesting aspect of the market is that available space has been absorbed quickly. The former Paris Precision building of approximately 200,000 sq. ft. went vacant, was purchased, broken down into multiple sections, and mostly leased out within the year. The majority of the new inventory-added vacancies that have been absorbed have been related to viticulture as wineries and support industries continue to expand.

Land values for small, finished parcels in east Paso Robles are still in the $5.00 to $10.00/sq. ft. range.

The City of Paso Robles sold two parcels comprising 1.4 acres, both positioned for redevelopment/better futures. One on Riverside Drive (acre +), and a small ancillary parcel near downtown, sold for $1,525,000 to a local businessman/investor. At just land values alone, this works out to approximately $25 per sq. ft.

Commercial Investments

Already low capitalization rates, commonly called "Caps" or "Cap Rates", have been similar to last year. Historically, higher valuations have been centered around San Luis Obispo with values softening as they radiate outward, like concentric circles. Now, with the difficulty of finding investment properties, the cap rates have become similar over geographic areas. Determining a cap rate has become more of an art than science.

Exchange monies have led to further exchanges. Transactions have occurred across the board: apartments, self-storage, office, retail, hotels, mobile home parks, viticulture—and each with their own metrics for valuation. With greater variability by product type, it is becoming more difficult to assign a cap rate predominately by location.

Examples of commercial buildings:

1704 Spring St.	4,800 sq. ft. $1,050,000	approximate 5.3 cap
4120 Horizon	8,600 sq. ft. $1,650,000	approximate 6.1 cap
445 Higuera St.	7,000 sq. ft. $2,200,000	approximate 6.5 cap
7 Archer St.	8,304 sq.ft $3,085,000	approximate 5.8 cap (imputed)
2238 Broad St.	9,938 sq. ft $3,500,000	approximate 4.8 cap
3195 McMillian	14,152 sq. ft. $2,900,000	approximate 6 cap
3701 S Higuera	18,447 sq. ft $5,600,000	approximate 6.9 cap
1135 Santa Rosa	11,780 sq. ft $7,350,000	approximate 4.2 cap

Appraisers have been wrestling with a larger variance in cap rates as investors seek out specific investments in smaller areas. This deemphasizes the investment location somewhat and puts more emphasis on the type of investment or franchisee, giving cap rates a wider range.

Hotels in San Luis Obispo and North County

The many hospitality projects that were entitled are now moving through the building phase and signs of their construction are apparent.

A number of hospitality properties have sold this last year. Among the most notable are:

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

San Simeon Quality Inn - San Simeon	$5,000,000
Paso Robles Courtyard Marriott	$15,000,000
456 Embarcadero - Morro Bay	$10,000,000

These assets were selling between 7 and 8 caps. Hospitality cap rates are typically higher than non operational assets where there is no associated business or operational component.

Row Crops

This past year approximately 230 acres of row crops sold in South County for $6,500,000. In the break-out of farmable and non-farmable ground, farmable ground was valued at approximately $51,500 per acre.

Vineyard Sales

North County had a number of key vineyard sales this last year:

3330 Pleasant Road	$8,500,000	149 ac
Four Palms Vineyards	$16,838,500	98.2 ac
Shandon Valley Vineyards	$20,656,000	204 ac
Shell Creek Road	$36,700,000	68 ac

In breaking down sales, the general guidelines are as follows:

East Side Paso Robles runs in the low $40,000s to $50,000/ac. A recent outlier in Shandon reported $74,000/ac. West Side sales have been at $50,000/ac and up. There was recently a West Side sale at $100,000/ac for a small vineyard.

Break-outs for actual farmable ground can be very complex as there is often a residential component included as part of the vineyard asset.

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

Cannabis Activity

Cannabis activity on the Central Coast continues to be an interesting market segment to follow. Last year saw a bit of the “Wild West” syndrome play out as Grover Beach moved to license both dispensaries and other cannabis related activities. Property values in the industrial area rose from roughly $150/sq. ft. to over $500/sq. ft. for buildings. Prices have now fallen back into a range of about $300/sq. ft. Lease rates for cannabis related businesses are in the $2.00 - $3.00/sq. ft. range. This has caused the migration of many businesses that had occupied the Grover Beach industrial area to other locations.

The City of Grover Beach approved four dispensary operators and it appears that only two of those operators/locations will actually operate. This is not uncommon in the industry as this product has attracted a wide range of people with various backgrounds and financial and business capabilities.

The City of San Luis Obispo has been patient in forming their cannabis ordinances and appears to be the only City in the County that will allow a retail, non-medical dispensary to operate (they have discussed allowing two such dispensaries).

The County has approved their Land Use Designations which has forced many existing operations to cease as they are no longer are allowed to cultivate at their current locations.

There has recently been a surge in demand for smaller non-cultivation related (manufacturing, testing, distribution, etc.) activities in the County.

Apartment Notes

In 2018, there were five sales between $1,200,000 and $4,000,000 and numerous sales below the $1,000,000 threshold. In their analysis these cap rates are typically between 3 and 4s.

Following are demonstrated capitalization rate ranges over the last fifteen years for the Central Coast market area:

2002	9.0 to 9.5
2003	7.0 to 8.0
2004	6.5 to 7.5
2005	5.5 to 6.5
2006	4.5 to 6.5
2007	5 to 7
2008	4.5 to 8
2009	5.5 to 9
2010	6.5 to 9
2011	5.5 to 9.7
2012	5.5 to 8.5
2013	5.5 to 8.5
2014	4.5 to 8.5
2015	4.5 to 7.0
2016	4.0 to 6.5
2017	4.0 to 6.5
2018	4.0 to 6.5

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:

2002	$1,053,000
2003	$1,250,000
2004	$1,333,333
2005	$1,538,000
2006	$1,538,000
2007	$1,428,000
2008	$1,250,000
2009	$1,111,111
2010	$1,111,111
2011	$1,031,000
2012	$1,818,000
2013	$1,818,000
2014	$1,818,000
2015	$1,428,000
2016	$1,538,000
2017	$1,538,000
2018	$1,538,000

A major community issue is the upcoming closing of the PG&E nuclear power plant, Diablo Canyon. The closing will affect jobs and trickle-down income for many parts of the community. From a commercial real estate perspective, there is both a large office building (one of, if not the, biggest in the County) and a large warehouse at the plant that will likely become available for lease. When these buildings are available, they will, in one fell swoop, add 3 to 4 years of commercial absorption into the market. However, although breathtaking and sitting on the coast, the location is not central and uses within the Coastal Zone may be problematic.

2018 CCEF FORECAST - COMMERCIAL REAL ESTATE

Conclusion

Continuing confidence in commercial real estate over the last five years is a precursor to, “when will this change” conversations. There are various changes occurring that could affect commercial real estate over the coming year. Interest rates are rising although it is not clear how significant of an impact that will have on continued growth. But the higher rates for loans will affect cash flows and affordability. Mixed-use projects are becoming more common in both proposed plans as well as in terms of interest from buyers.

There is strong interest from developers for housing projects as well. We are, however, seeing some developers putting entitled projects up for sale, causing one to wonder how long they see strong growth in jobs and incomes continuing. Increased housing costs are a key factor in determining where people live and work. High housing costs are causing problems for employers and affecting their ability to attract key employees. Given the large volume of transactions this past year, it appears that people could be repositioning themselves for the next cycle of the economy.

Despite the few warning signs flickering in the distance, the Central Coast remains a desirable place to locate your business, operate, and to invest.