

# North County Commercial Real Estate

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## **Key Points:**

- **Agricultural and medical market sectors are staying strong despite a weak economy**
- **Vacancy rates remain high with small reductions in the Retail and Industrial market segments, while Office vacancy increases**
- **Commercial transactions are starting to occur, downward pressure on commercial real estate values can be seen in the recent sales prices**

## **Commercial Financing is the Lynchpin to Completing Transactions**

Commercial financing, or the lack thereof, is still an impediment to commercial real estate transactions coming to fruition. Some local banks are simply out of the market at this time and will not, or cannot (by determination of the regulators), lend on commercial property.

More often, the case is that borrowers are having difficulty qualifying for loans as the equity requirements have become burdensome—in some cases upwards of 50% down for conventional transactions.

On the other hand, Small Business Administration (SBA) financing, with its 10% down program for owners which occupy the majority of the building, has been well received for those owner/users looking to purchase a commercial asset. But for investor financing and new construction, the pool of lenders is shrinking. Profitable and growing businesses with good cash flow have been told by some banks that they (the bank) will not finance new construction for expansion. Other financial institutions are reluctant to commit to multiple loans to a single client.

Commercial money is still available at a relatively low—6%-8% —interest rate depending on the credit of the asset and borrower's ability to pay debt service. Given the tremendous uncertainty on what a property is worth in today's market with limited buyers, appraisal valuations have become touchstone events. With land values dropping and the cost of new construction above prices of existing inventory, land has become the biggest risk.

There is still private money sitting on the sidelines looking for deals. One problem that has arisen is that the smaller investor has lots of company looking for deals resulting in cap rates remaining lower than many people have projected; too many dollars chasing too few deals. Commercial inventory is still a step or two away from coming to market in more significant numbers in the regional market. Until that occurs and assuming interest rates remain about the

same, cap rates will continue to be lower in our area than in major markets or blighted area discussed in the news.

With the economy bumping along, more distressed properties are starting to surface as owners can no longer hang on to their properties. As the properties are about to be foreclosed upon, it is not uncommon for the debtor to file bankruptcy, delaying the asset from coming to market.

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

## **Residential**

In the Central Coast, Santa Maria remains the focal point for bank owned residential assets. Numbers point to a change of tide regarding median price as it has ticked upwards slightly for the 2010 market. These numbers fall on the back of two important data points: total unit sales have fallen from 2009 by approximately 25% and that the combined REO and short sale market has decreased by approximately 28% from 2009 as a percentage of total sales. Bank owned properties on the market are selling in approximately 30 days for higher than asking prices. The bottom of the market is selling. It is still unclear the amount of remaining foreclosure, short sale and workouts yet to make it to the market.

In regards for forecasting new construction, one key measuring point will be price per square foot. Presently it is still less expensive to buy the median priced home in Santa Maria than it is to build one. One builder noted, "You would have to pay me to take the land." The Santa Maria housing market will continue to work through the debt burdened assets. Developers report that financing for new residential construction is non-existent.

## **Retail/Commercial**

Available commercial/retail space decreased slightly from last year within the City of Santa Maria (as of first quarter 2010) with about 451,000 sq. ft. vacant. This represents approximately 10.62% vacancy (total retail inventory base in the City of Santa Maria is approximately 4,242,000 sq.

ft.). All in all, the range of vacancy for the last three years is about three times higher than previous periods.

There has been new development at both ends of the market area. Approximately, 50,000 sq. ft. was added to the official roster of retail within the City's boundaries. This was primarily the 36,461 sq. ft. Vallarta Market at the northern end of the market.

At the southwestern end of the market area is the Will family's 110,000 sq. ft. project in Old Orcutt (technically the County of Santa Barbara). From a subjective viewpoint the center has captured an "Old Orcutt" essence with new product. 40,000 sq. ft. has been developed in the first phase. Achieved rents are approximately \$1.75 per sq. ft. net according to the ownership. Only 5,000 sq. ft. remains available in the speculative development's first phase.

Four major retail projects are still on the books for development:

Lakeview Promenade – approximately 70,000

The Westgate Marketplace – approximately 120,000 sq. ft.

Orcutt Plaza – approximately 225,000 sq. ft.

Orcutt Marketplace – approximately 295,000 sq. ft.

Total – 710,000 sq. ft. (approximately 17% of the existing base)

However, faded leasing signs and project extensions are more telling of the projects' impending status.

Rental negotiations to keep tenants in place are the norm. A local regional operator indicated that of the fourteen locations they lease from a variety of landlords, all of them had had at least a 20% reduction in rents to maintain their occupancy.

Previous retail land transaction ranges were from \$20 to \$50 per sq. ft. depending upon size and location of the property. Without any recent definitive land sales for several years, these ranges still may apply for appraisal purposes but asking prices are softening.

## Office

The office market saw little additions to its base this past reporting period and is still the weakest market segment. The office vacancy rate, as of this article, is now at approximately 16.7% versus 12.2% from the year before. The major increase is primarily due to the closing of CafeFX, adding approximately 37,500 s.f. of office/R and D product back into the vacant office inventory. Excluding that large market addition, the market vacancy has remained approximately the same. The office component of this market has a base inventory for 2010 at approximately 1,183,000 sq. ft. with just under 200,000 sq. ft. vacant (19,633 sq. ft.). Again, there are minimal sales to report this year.

Similar to last year, typical deals are being cut for well located space at \$1.15 and up NNN. The typical 2nd generation asking rates are anywhere from \$.50 to \$1.25/sq. ft./mo./NNN. Newer space has asking rates as high as \$1.85/sq. ft. Modified Gross. Owners are approaching tenants and rewriting leases with rent reductions to get them to stay. The market is moving to quote Gross rates as opposed to NNN.

Marion Medical Center's new addition of approximately 216,000 sq. ft. is in the very visible process of being constructed. Marion has also expanded operations to absorb some vacancy at a nearby former Saturn dealership.

Medical spaces are the most positive portion of the office segment. Medical spaces that have been on the market for over a year are finally selling. 220 South Palisades, a medical condo of 3,213 sq. sold for approximately \$307 per sq. ft. Also there is new Medical construction: the recent completion of Dr. Babu's approximately 16,550 sq. ft. Kidney Disease Center on McCoy Lane and Depot.

Asking rates for land suitable to build office product have dropped—some larger parcels are at \$10.00 per square foot and still no takers. Hard-to-find smaller parcels which typically command higher prices, have come down in asking rates as well. More specifically, CPO zoned land has fallen from its high water mark of \$20 to \$25 per square foot three and four years ago to speculative deal making in the \$12 to \$17 per square foot for semi improved product.

## Industrial

As to be expected given the weakened market, very little inventory has been added (approximately 11,800 sq. ft.) to the industrial base which now stands at 7,685,000 sq. ft. Over the last three years, industrial vacancy has not shifted dramatically. Industrial vacancy decreased slightly from 9.6% in 2009 to 9.08% as of the date of this article.

Improved industrial assets are declining in value. Quality industrial buildings are offered below reproduction costs and have been on the market for 12 to 24 months. McCoy Lane has two side by side offerings from the same owner with listing prices which have just dropped to \$98 per sq. ft. for each of two approximately 21,000 sq. ft. buildings. Rumored deals in the making at \$75 per sq. ft.

This year saw the closing of SAC, a motorcycle/ATV distributor that a few years ago occupied 50,000 sq. ft., CafeFX which at one time was bursting the seams of 37,500 sq. ft of office/R and D and the exiting of Cresco Restaurant Supply of approximately 40,000 sq. ft.

On the expansion side of the market, Pacific Petroleum purchased 1530 East Betteravia, with 24,000 sq. ft. of buildings (former cooler and crate shed) on 7.4 acres for

\$3,550,000. This “old Santa Maria” – oil field support-industry is seeing renewed activity as well as employment growth. North American Fire Hose purchased approximately 40,000 sq. ft. (the former Pacific Beverage facility) on Carlotti Drive for \$2,200,000 or about \$55 per square foot.

One of the largest industrial transactions and construction projects in Santa Maria is the Windset Farms operations. Under construction is approximately 165,000 sq. ft. of operations/warehouse and 2.8 million sq. ft of green house on Black Road.

Several noted Industrial lease transactions occurred on Industrial Parkway providing an index of how competitive some landlords are willing to be with lease rates:

9,800 sq. ft of warehouse plus yard area at \$0.24/ sq. ft. mo. Modified Gross to Sambrailo packaging for a second carton yard with in the market and

9,800. sq. ft. of warehouse plus yard space to Direct TV for \$0.29/sq. ft /mo. Modified Gross base rent plus yard.

Asking rental rates have shifted downward by moving more towards gross rent from triple net rent. Hardy Enterprise Center has leased the balance of their approximately 25,000 square multi-tenant project, comprised of twenty two 1,100 sq. ft. units in the \$0.50 to \$0 .60 s. ft. gross range and plans on adding a deli in several of the units to service the surrounding business community.

### **Industrial Land**

Land sales have been in hibernation the past couple of years: hopeful awakening; the Chumash Tribe purchased four acres at approximately \$5.00 per square foot to establish a new comparable sales figure. Previous comparable sales were twenty four months plus in age. Asking prices are being reset downward, but not yet reflecting the new \$5.00 per sq. ft. value. Recent appraisals for smaller parcels are still registering higher values per square foot.

Finished or near finished lot product is still minimal. Price differentials between M1, CM and M2 zoned land are negligible; location is more of a determining factor influencing the interest and price of land. This is significant as the City of Santa Maria is in the process of making ready extensive industrial land inventory within Area 9 of the city planning areas. EIRs are being prepared to deal with infrastructure and traffic mitigations. Typical deliverable parcels in 1 to 5 acres sizes may still be years away.

### **Agricultural**

2010 was another solid year for agricultural values. A large asset sale of consisting of 190 acres of prime row crop ground sold on the west side for \$53,500 per acre to a Betteravia

Farms ownership mix. Following months thereafter was a sale of the Tognazzini property of approximately 230 acres of quality west side ground near Guadalupe, netting out at approximately \$49,000 per acre. It is rare that two large closely held assets have come on the market much less have both sold. Right at year end, a 78 acre parcel sold at \$60,000 an acre with some underlying factors supporting the higher range value. These are on the tail of a transaction reported last year of approximately 110 acres at approximately \$56,000 per acre. These values are approaching pinnacle Salinas Valley bread basket numbers. And there are still buyers looking for this product type.

### **Commercial Investment**

Market expectations of upwardly moving capitalization rates have just not materialized on a consistent basis in our market. Market uncertainty and mixed signals are the norm. There are some rumored transactions at cap rates of high nines and low tens in the making—more in line with market expectations. Then we see a documented closing of an age-restricted residential income project selling for \$11.5m in a limited market, Vandenberg Village, at approximately a 7 cap. This was a bank owned asset from the failed Los Padres Bank portfolio having surplus land; if there were ever elements in a property offering throwing up red flags for valuation concerns, this would be it, yet a sizable transaction closed with limited time on the market.

As noted above the “too many dollars chasing too few deals” is applying to investments as well. Given the lack of sales and data, appraisers are needing to impute cap rates in their valuations. Paraphrasing a conversation a local MAI appraiser: “If its good (the asset) then it’s a 7 if its not, it’s a 9.5”.

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 market cap rates would correlate to the approximate purchase prices for the same piece of property and income according to the following years as noted in the table.

### **Summary**

We are continuing to discover what a “new normal” is for our market area and consequently there is still a disparity in market indicators. Discounting larger properties which overly influence vacancy numbers, the Santa Maria market vacancy rates have only improved slightly compared to 2009. There is increased interest from prospective tenants and buyers signaling a strengthening of demand; however that demand is at lower price points than previous years and buyers and sellers are still struggling to find the nexus where they can strike a deal.

We are seeing more distressed product come to the market, but not in the numbers expected. Banks and other lenders are using a wide variety of solutions to dispose of properties, and the bankruptcy filings have slowed the foreclosure process down as borrowers scramble to recover as much of their investment as they can. With the prices of existing buildings being significantly below reproduction costs, non agricultural land continues to be a product type with weak demand, unless the buyer can get it for a perceived steal.

Financing continues to hamper those parties wanting to enter into commercial purchases let alone trying to complete a transaction. More typically, SBA loans or owner financing continue to be the methods through which purchases are getting financed. As borrowing gets easier coupled with increased consumer confidence, we should see a corresponding increase in real estate activity.

Notes:

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.

NNN: A triple net lease.

<b>Single Family Detached Unit Sales</b> Santa Maria and Orcutt	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Number of Single Family Sales	1,335	627	1,242	1309	993
Number of Single Family Sales OREO	3	116	772	668	364
Percentage of Total Sales OREO	0.22%	18.50%	62.16%	51.03%	36.66%
Median Price	\$455,000	\$395,000	\$270,000	\$240,000	\$247,000
Median Cost Per Square Foot	\$278	\$246	\$179	\$157	\$154

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 to accommodate multi year comparisons and regional area reporting.

<b>Capitalization Rates</b>									
<b>City of Santa Maria Metropolitan Area</b>									
(Value based upon \$100,00 annual net operating income)	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Cap Rate Ranges	9.0 to 9.5	7.0 to 8.0	6.5 to 7.5	5.5 to 6.5	6.0 to 7.5	6.0 to 7.5	8.0 to 8.5	8.0 to 10.0	7.0 to 9.5
Corresponding Valuations	\$1.10M	\$1.42M	\$1.53M	\$1.81M	\$1.66M	\$1.66M	\$1.25M	\$1.25M	\$1.42M

Source: Stafford-McCarty Commercial Real Estate

<b>Office Vacancy Rates</b>								
<b>City of Santa Maria Metropolitan Area</b>								
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	
Office	2.70%	2.50%	2.10%	6.20%	12.40%	12.20%	16.70%	

Source: Stafford-McCarty Commercial Real Estate

<b>Industrial Vacancy Rates</b>							
<b>City of Santa Maria Metropolitan Area</b>							
R and D / Industrial / Warehouse	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
	7.50%	5.60%	3.60%	5.70%	8.80%	9.60%	9.08%

Source: Stafford-McCarty Commercial Real Estate