Commercial Real Estate

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Key Chapter Findings

- Residential Market stabilizes in sales volume, yet values continue to decline.
- Regulator curve balls make it tough on commercial lenders and borrowers.
- Commercial markets are seeing some leasing activity, but rents are declining and sales are limited.
- San Luis Obispo vacancy rates are creeping upwards while vacancy in most Paso Robles commercial segments are declining.

A Note on Residential Market--Buyers, But at What Price?

The free-fall fears of the residential market have subsided. However, at the same time, the current state of the residential market does not inspire confidence. The San Luis Obispo (SLO) market is faring better than the northern part of SLO County in regards to increased velocity of sales volume, but both markets continue to experience a decline in median values as the data table below evinces.

Residential Unit Sales

Location	2008	2009	2010
San Luis Obispo			
Units Sold (#)	159	163	191
Median Price ($)	635,000	569,000	550,000
North County			
Units Sold (#)	638	702	698
Median Price ($)	390,000	340,000	296,000

Source: Stafford-McCarty Commercial Real Estate

Foreclosures and subsequent dispositions, and the recent cloud regarding foreclosure procedures, are adding uncertainty to a market segment that is trying to regain its footing. It appears the market has seen the low point for volume and is still favorable if you are a buyer. There also appears to be a significant backlog of troubled residential assets. This will keep housing values down until they clear the marketplace and consequently these continued foreclosures will suppress new housing starts.

Commercial Markets

This past year has seen an increase in lease transactions, but these are typically tenants who are shopping to reduce their lease expenses□many tenants have cut deals with their landlords and have stayed in place. Most of the leasing activity has been under 5,000 sq. ft. The past few months has seen an increase in inquiries from out of the area companies looking to expand into the central coast market.

Not enough deals have concluded to reset the dials on sale valuations. The financial community is in turmoil as regulators push banks to allocate more funds to their reserves and lenders are continually reappraising their portfolios. Given the scarcity of market transactions, the data is not sufficient to definitively support lower values, although market perception clearly expects value diminution. The only telling index is lower rents, listings with lower values than recent appraisals, and still a lack of renters and buyers. Following the residential market as a guide, we expected to see a blend of regular sales and foreclosure sales this past year. Instead we have seen a small number of lease transactions and very few sale transactions (although this activity is greater than last year).

Where are the Deals and Where are the Commercial Foreclosures?

There has been a lot of media commentary about impending commercial foreclosures, but why have we not seen these foreclosures occurring in our market place in any great numbers? Given our conversations, it appears that all roads lead, at some point, to bank regulators, although depending on whom you talk to, the emphasis is inconsistent.

On one side, the street news is that due to a “molasses like” process of clearing the back log of residential foreclosures, the FDIC does not want lenders to dump the lagging commercial market problems into the economy for fear of creating a “double-dip” recession. With a down market, those who can afford to hold on to their property are choosing to do so and waiting for better returns when the market picks up again. Those who are unable to meet their loan obligations are seemingly the beneficiaries of a quiet “extend and pretend” policy that is reinforced by Federal regulators. Consequently, properties that would normally come to market are not being put up for sale, resulting in a smaller inventory of for sale properties. That is in sharp contrast to the number of listings that are available for lease.

On the other side of the commercial lending conversation is the dialog with local commercial lenders. The common pang is about how much pressure the FDIC is putting on them to write down loans, even performing ones. Writing down loans in turn affects bank ratios monitored by the Feds. As bank ratios start to get out of line, banks try to limit their commercial loan exposure and the bar for obtaining conventional commercial financing is raised higher and higher. Small Business Administration (SBA) loans, where the government shares the risk and the banks have less exposure, have a predictable process for funding and are occurring in the market.

Via regulators, lenders are maintaining the emphasis on economic valuation—what a property may be worth to an investor—which in the present market is lower than the reproduction costs. Given the types of commercial inventory (investment, owner/user, and land), properties that are faring well have income associated with it, as opposed to raw land (which has no income vehicle to offset debt service).

At the local level there has been a smattering of foreclosed commercial loans. Compared to the residential world, commercial lenders individually have relatively few bank owned properties. It is not as if you could grab a shopping cart, waltz down the aisle and pick and choose among various foreclosed commercial properties.

Capitalization Rates: What is A Reasonable Rate?

It is very difficult to get a good grasp on a consistent range for local cap rates. Those investors/buyers who have cash are looking for double digit returns that they see in other markets around the country. On the other hand, with money markets returning 0.5% - 1.5%, and stock markets volatile (investor are still waiting to get their money back), owners and lenders feel a 6% -7% return in real estate is a relatively good return. The problem is getting buyers and sellers to agree. If you believe investors/buyers are voting with their wallets, they are voting to wait, contributing to the dearth of transactions.

Commercial Markets in San Luis Obispo

Similar to last year there is little commercial bank inventory of commercial property.

The number of property showings and increased interest in commercial properties (always a good sign) is up. While last year was a "hunker down and watch" mode, this year, expansion and relocation discussions are a daily event.

Given the "where are the deals" environment there is no evidence for valuation tarnish: downtown properties are still approximately $300 to $600/sq. ft. However, there are sellers with big expectations and few buyers. Note on the market: we are seeing listing prices for small standalone downtown properties in the $300 per sq. ft. range and still no takers. This is a key sign of things to come.

Retail

The retail sector demonstrated slight improvement with vacancies declining from 5.64% a year ago to 5.06% this year. There is approximately 200,000 sq. ft. of retail space available within the San Luis Obispo market, which has a base retail inventory of approximately 3,959,000 sq. ft. Although these approximately 5% vacancy numbers are within normal market parameters, they are higher than what this community has experienced in better times.

Annexations and big projects: the Dalidio property along the freeway is back on the planning books again after yet another judicial ruling. The property across from the Home Depot and Costco along Los Osos Valley Road, known as "the Gap Property" is under construction. Target carved out and purchased their ten-acre site from the Madonna family who is developing the Gap Property.

Office

The office segment has also added inventory in the past twelve months, almost all of it medical.

Office vacancy, again, has crept upward to 12.56% from 9.73% one year ago. Inventory is presently approximately 339,000 sq. ft. Free rent and larger owner contributions to tenant improvements are part of current deal making. Depending on location and landlord tenant improvement contributions, downtown offices have leased for $1.00 per sq ft. per month gross. Second generation unit rents have dropped $0.20 to $0.40 per sq. ft.

Companies have moved out of downtown to achieve lower rents. Etna Interactive moved from downtown Marsh Street and leased 10,000 sq. ft. north of the airport on Fiero Lane at $0.90 sq. ft. gross rent.

Manufacturing

This market segment although stabilized has been lack luster.

A lender owned property at 825 Capitolio resold for $605,000, or approximately $97.00 per sq. ft. of building.

Multiple buildings have been on the market for over two years:

- Poly Performance just leased 25,000 sq. ft. at 870 Industrial for $0.30 sq. ft. NNN on a 5-year contract (a sublease for 10,000 sq. ft. is available).
- New West Communications, approximately 25,000 sq. ft. on Sacramento.
- 21 Zaca Lane with approximately 21,800 sq. ft.
- Farm House, approximately 20,000 sq. ft. of newly constructed office/manufacturing product on five acres, (a deal is presently pending).

The vacancy rates for manufacturing product has risen to 9.1% (6.1% in 2009) with San Luis Obispo's available manufacturing inventory standing at approximately 346,000 sq. ft. Contributing to the upward tick in the vacancy increase is Foster Grant moving their 80,000 sq. ft. distribution/manufacturing component out of the area.

Commercial Vacancy Rates, City of San Luis Obispo

Property Type	2002	2003	2004	2005	2006	2007	2008	2009	2010
Industrial/Warehouse (%)	2.8	3.8	6.4	4.0	4.3	2.3	5.4	6.1	9.1
Retail Functioning (%)	1.9	2.4	2.2	1.7	1.8	1.4	3.0	5.6	5.1
Office Functioning (%)	9.9	8.4	5.4	3.2	4.7	3.5	6.1	9.7	12.6

Source: Stafford-McCarty Commercial Real Estate

The East Airport Development has numerous finished lots suitable for constructing larger warehouse and office buildings, but there are few takers. This property is now in litigation between lender and borrowers. To date only one of the twenty-plus lots have been built on and several others are reported to be in escrow. Land comparables for the finished lots have gone from a previous sale in the Development over two years ago at approx. $17 per sq. ft. to current listing prices in the $8.50 range.

All this said, there are several large players, looking at 50,000 sq. ft. or greater, who will hopefully land next year.

San Luis Obispo Downtown

As discussed last year, two tier rents are emerging. At the upper end are newly retrofitted buildings at market-high rents to the cover costs of retrofitting. On the other end is existing inventory in which longer term owners can cut deals to acquire tenants at better rents (rents that are little changed over the last fifteen years). These are typically under $1.50 per sq. ft. while retrofitted buildings are asking rents between $2.00 and $3.00 per sq. ft. Well located spaces have achieved high watermark rents exceeding $4.00 per sq. ft.

Many key properties retrofitted for seismic compliance are now reoccupied, in leasing status, or near completion.

Owners with vacant downtown land, or land with a □tear-down□ building, are experiencing a wake up call trying to establish what will be the new land value and challenging the approximately $250 per sq. ft. former level.

An index of mixed signals for smaller buildings: a modest corner location building at 1264 Monterey Street, 2,364 sq. ft., sold for $610,000 or $258 per sq. ft. This is a key sale to watch □ to gauge its influence on resetting registers for downtown values. At the same time, a bank owned property at 745 Higuera St, 1540 sq. ft., was sold by a lender for $770,000, which works out to be $500/sq. ft.

As with last year, no larger projects are currently in the building phase. But projects that were on the books are optimistically still on the books. These include:

- Vaquero 32,000 sq. ft.
- Garden Terraces proposing 35,000 sq. ft. of commercial space
- Chinatown Project with 50,000 sq. ft. of commercial space

All are in the downtown core and have multiple stories; retail on the ground floor and residences on the upper floors. Projects are waiting for more certain times.

Commercial Investments

The dearth of investment transactions continues to make it difficult to set cap rates.

Two noted downtown sales:

560 Higuera Street, 12,242 sq. ft. with Rob Rossi selling in January of this year for $2,500,000orapproximately$207 per sq. ft.

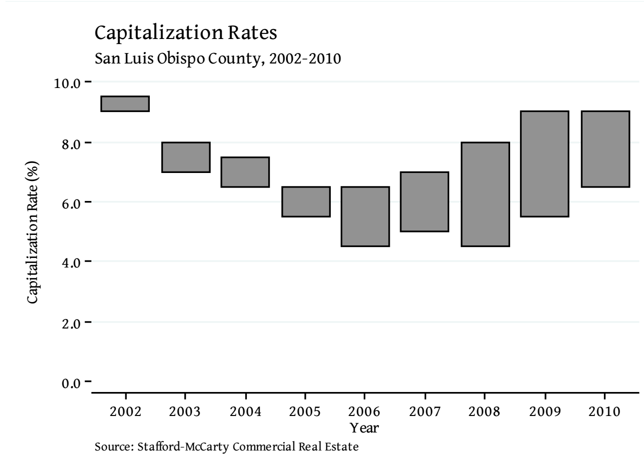
733 Marsh Street, approximately 20,055 of gross building sq. ft., Fiber Coast LLC selling to NKT Commercial on the last day of 2009 for $3,375,000orapproximately$168 per sq.ft.

Both of these properties were occupied by multiple tenants. Low capitalization rates could be imputed, however it is more likely the properties were purchased at a price point verifying inherent value.

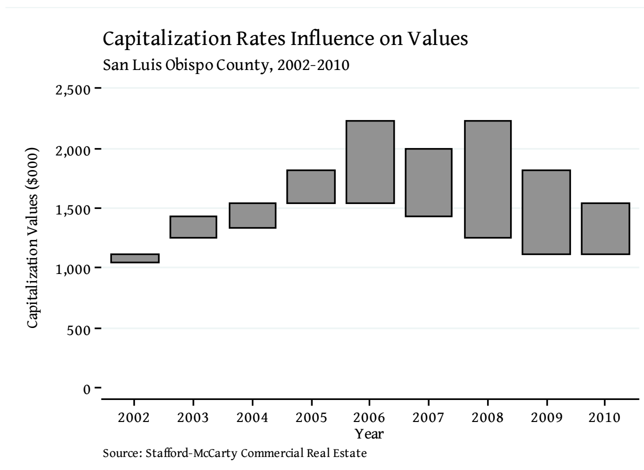
So what are current cap rates? Appraisers are sifting data only to conclude there is no evidence to demonstrate lower cap rates. One appraiser adds 50 basis points to reflect an overall soft market and to concur with lender concerns that the market is stressed. Where are the values to the buyers? Local market perception: rising interest rates, a flood of inventory, and better deals □ they have just not emerged. Tax deferred driven transactions, once an active part of the market, are on hiatus. Each transaction is a case-by-case basis, with buyers having their own basis for determining value.

Following are capitalization rate ranges evinced over the last nine years for our 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........... 5.0 to 7.0
2008........... 4.5 to 8.0
2009........... 5.5 to 9.0
2010........... 6.5 to 9.0



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........... $1,100,000
2003........... $1,428,000
2004........... $1,538,000
2005........... $1,818,000
2006........... $2,222,000
2007........... $2,000,000
2008........... $2,000,000
2009........... $1,818,000
2010........... $1,538,000

Commercial Markets in Paso Robles

Given the dour face on commercial real estate, Paso Robles, with a functioning population base of approximately 30,000, appears to be on fire, adding approximately 218,100 sq. ft. of retail in the Regency Center along east Highway 46 at Golden Hill. This has been anchored by Lowes, with junior anchor Bed Bath and Beyond. This project, planned prior to the recession, emerged as an anomaly to the market in terms of its timing. Inked deals with major players, notably Circuit City, have fallen apart and predictably, almost all of the speculated space and pads stand vacant. However, aside from retail, the Paso Robles market has made, statistically, significant improvement over last year in regards to vacancy.

Retail

The Retail base inventory for the market currently stands at approximately 4,608,000 sq. ft. which is presently larger than San Luis Obispo. Retail vacancies have increased slightly to 4.5% from 4.1% one year ago. There is approximately 207,000 sq. ft. of retail space on the market at this time.

Office

About two years ago it was difficult to find office inventory or sale of almost any size. The office base inventory for the market, which does not include the medical base surrounding Twin Cities Hospital in neighboring Templeton, is approximately 344,000 sq. ft. Office vacancy currently stands at approximately 17.52%; this has decreased from approximately 24% one year ago. This is still a distance from market norms of approximately 5% in 2005. There is approximately 67,130 sq. ft. available in the market.

New shell medical buildings have supported values of approximately $250 per sq. ft. A mid-year closing was Pacific Eye□s 3,500 sq. ft. acquisition of a free-standing new building off Niblick Road. Older and smaller medical condos are on the market for various prices, some for approximately $140 per sq. ft.

Leasehold transactions are slowly back filling vacancies, which have been on the market for over a year. California Department of Corrections and Rehabilitation leased 8,259 sq. ft. at 1344 Oak Street. Rents are dropping and more product has become available for sale. The vacancy is still in recovery from the fall of the financial markets.

Manufacturing

Industrial vacancy has improved over the last year as well. Vacancy now stands at 7.98%, which is down from 13.2% last year. For the most part, the bulk of vacant space is in newly constructed buildings and has contributed to oversupply. The wine and supporting industries are common signage for new occupants.

Noteworthy sales:

- 500 Line Road, 48,300 sq. ft., $27.50 per sq. ft.
- 3450 Riverside, 10,336 sq. ft., 141 per sq. ft., meat processing facility

Land is, and will be, difficult to valuate. Lender owned industrial subdivisions that were on the market for approximately $9.00 per sq. ft. dropped to $4.50 per sq. ft. for finished small parcels before they were withdrawn□waiting for sunnier days.

Agriculture Investments are Significant and Noteworthy

Back to basics: a large transaction, and seldom occurring in the market, was 190.5 acres of heartland vegetable ground selling in southern San Luis Obispo County to an established Santa Maria grower at a per acre price of approximately $53,800 per gross farming acre. Similar sales in recent years for smaller acreage

Commercial Vacancy Rates, City of Paso Robles

Property Type	2003	2004	2005	2006	2007	2008	2009	2010
Industrial/Warehouse (%)	9.4	10.7	3.5	5.0	2.8	7.5	13.2	8.0
Retail Functioning (%)	1.9	< 1.0	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5
Office Functioning (%)	1.2	1.8	1.2	5.2	5.6	7.7	24.1	17.5

Source: Stafford-McCarty Commercial Real Estate

have been in this same range, demonstrating confidence for this product type.

The large insurance lender, Aegon, has taken back Villa Toscana, part of the David Weyrich assets, and it is on the market for $9,900,000. Aegon has resold the well-appointed and well-located tasting room along Highway 46 East this year to San Antonio, price officially undisclosed.

J. Lohr leased 46,000 sq. ft of the former Templeton Wine Services facility for approximately $0.54 per sq. ft. for barrel storage on a sublease from Treasury Wine Estates.

The bucolic Niner Winery completed it tasting and hospitality center adding an additional 15,900 sq. sq. ft. to its present state-of-the-art facility at Heart Hill on Highway 46. Justin Winery completed its 30,700 sq. ft. winery in Paso Robles as well. As indicated last year, significant investment into the wine industry continues to add to the prestige of the community.

Final Words

Unfortunately, the residential world is facing larger backlogs and workouts than anticipated, which indirectly compounds problems in the commercial sector. Foreclosures and their mechanics will be a significant part of this market sector.

For commercial properties, we are seeing the beginnings of what will be the "new market." As buyers and sellers are coming together, the critical component, financing, is plagued by continued uncertainty of the commercial lending industry, still heavily pressured by regulators. Successful closings with SBA loans have been evident. We look forward to similar clear paths with conventional loans building upon this initial momentum.

Cash is still sitting on the sidelines waiting to play. We anticipate seeing more sales as owners and lenders work to dispositions of debt leveraged properties. There is a general "feeling" that the deals will be out there.