UNIVERSITY OF CALIFORNIA SANTA BARBARA
ECONOMIC FORECAST PROJECT

North Santa Barbara County Commercial Real Estate

By Steve McCarty and Steve Davis
Stafford-McCarty Commercial Real Estate

Contents

Key Chapter Findings

- Santa Barbara county is working toward a 'New Normal' in commercial real estate.
- Vacancy rates remain high and continue to inch upward in the Office, Retail and Industrial market segments.
- Downward pressure on commercial real estate values is showing up.
- Minimal commercial transactions in 2009.

Toward the New Normal

As commercial real estate brokers we are continually asked, "Where are we going? Is the recovery happening?" Since we do not have a crystal ball to predict the future, we pose the following question in response: "How do you feel about things now versus where you were last year?" The general outcome of this dialog is that nearly all people decide that consumer confidence is stabilizing and we are now dealing with what will be a 'new normal'. So what will that look like for the north Santa Barbara County commercial markets?[14]

Commercial Financing the Cornerstone

The new normal is being shaped both by lender practices and demand for commercial properties. The nascent level of commercial activity over the previous year is comprised of foreclosure activities, downsizing businesses, a few businesses looking to expand, and some investors taking advantage of the overall declining commercial values. The common thread running through all types of activity is that everyone is looking for a deal.

As commercial lenders work through foreclosures, key issues will be declining rental rates, a smattering of vapid transactions showing no clear direction of valuation, and once lenders have taken the properties back, how to price them.

So where are all the commercial foreclosures?

They just haven't hit the market yet. The emerging lender practice of "Pretend and Extend" became evident last year. Lenders dealt with potentially problematic loans by negotiating work-out deals with borrowers, pushing problems out to the future so that banks did not have to take properties back and could avoid loan losses on their books. But this practice cannot go on indefinitely, as borrowers who held on to their assets last year may have finally hit the wall. There is no wiggle room left.

Part of the new normal is lenders working quietly with select investors to purchase problem loans at discounts. This is in contrast to the more traditional processes of foreclosing and then working with the brokerage community to expose and dispose of the property. This new approach helps keep the banks public profile low in working through troubled assets.

On the demand side of the equation, there is good news for buyers. If they can qualify, loans are at historically low interest rates. Commercial funds are in the low to mid 6% range. Small Business Administration (SBA) loans are active due to their minimum down payment requirements—near 10%. Banks are willing to take the reduced risk given the underwriting criteria. However, the loan process can be challenging. Borrowers are dealing with an appraisal process akin to alchemy. Lenders are favoring income val-

[14] Reported as of the first quarter of 2010.

Single Family Detached Unit Sales

Santa Maria and Orcutt

Category	2006	2007	2008	2009
Single Family Sales in Units	1,335	627	1,242	1309
Single Family Sales OREO in Units	3	116	772	668
Total Sales OREO by Percentage	0.22	18.50	62.16	51
Median Price in Dollars	455,000	395,000	270,000	240,000
Square Foot Cost in Dollars	278	246	179	157

Data Source: Central Coast Regional MLS

Data may vary from last year's reported statistics due to variable change accommodating multi year comparisons and regional reporting.

uation over reproduction methods, and with the lack of transactions, appraisers have had to become more narrative than empirical.

Following is a brief description of the various market segments.

Residential

Santa Maria continues to be the focus for bank owned property in the Central Coast markets. Given that the bulk of new housing was produced in Santa Maria it reasonably follows that the largest foreclosure market is also in Santa Maria. You can buy existing homes cheaper than you can build them. The cost of resale homes declined further this year, more than $20 per sq. ft. from last year. This sets back the start of the new home building market until existing home prices recover to the tipping point, triggering new building. Foreclosed units will need to normalize to pre-2008 numbers before we see a strong new home market emerge.

Retail/Commercial

After years of adding additional inventory, the retail/commercial market ground to a halt this year. Just 4,688 sq.ft. of retail space was added in all of Santa Maria – the size of a retail bank branch or a couple of small restaurants.

Available commercial/retail space within the City of Santa Maria (as of first quarter 2010) is about 521,312 sq. ft., representing approximately +/-12.43% vacancy (total retail inventory base in the City of Santa Maria is approximately 4,189,503 sq. ft.).

Four major retail projects are still on the books for development. Square footages are approximations:

Project	Sq. Ft.
Lakeview Promenade	70,000
The Westgate Marketplace	120,000
Orcutt Plaza	225,000
Orcutt Marketplace	295,000

Together, these total 710,000 sq. ft. or approximately 17% of the existing base.

That said, construction on the Damon Porter complex on North Broadway has started, with approximately 47,633 sq. ft. in two buildings. Vallarta Market will occupy approximately 36,461 sq .ft. market with the balance being constructed as speculative retail. Fresh and Easy is slated for North Broadway on a land lease.

Retail Vacancy Rates by Percentage (%)

City of Santa Maria Metropolitan Area

	2004	2005	2006	2007	2008	2009
	2.3	+/- 1	2.0	2.7	9.8	12.5
Without Gottshalks or Mervyns					5.4	8.2

Source: Stafford-McCarty Commercial Real Estate

A former C-2 zoned United Rentals yard at 2691 Santa Maria Way with an approximately 4,200 sq.ft. building on 1.26 acres, sold for $1,100,000 in September of last year and since has gone back on the market for $1,495,000. It will be telling to see how this works in today's market.

The former 4,160 sq. ft. Bakers Square restaurant at 1841 South Broadway sits on a site that is a little less than an acre and sold to an owner-buyer for $900,000. This translates to approximately $216 per sq. ft.

Previous land price ranges were from $25 to $50 per sq. ft. depending upon size and location of the property. Without any definitive land sales, these ranges still may apply (although, if sales price were calculated on land alone without attributing any value to the functioning building, the well-located Bakers Square sale would come out to $22.38 per sq. ft.)

Office

The office market saw no additions to its base this past reporting period and the market is still very soft. The office vacancy rate, as of this writing, is now at approximately 10.6%, versus 12.4% the year before. After staggering increases, the vacancy has stabilized and even declined a bit. Keep in mind that vacancy in 2008 was 12.4% – almost double what it was in 2007 (6.2%), and triple what it was in 2006 (2.1%).

The office component of this market has a base inventory for 2010 of approximately 1,156,283 sq. ft.

Similar to last year, typical deals are being cut for well located space from $1.15 and up NNN. The typical second generation asking rates are anywhere from $.50 to $1.25/sq. ft./mo./NNN. Newer space has asking rates as high as of $1.85/sq. ft./mo. Modified Gross. Owners are approaching tenants and rewriting leases for less rent to get them to stay.

A prospective bellwether transaction is the expansion of San Luis Obispo-based American Principle Bank into Santa Maria with a 3,500 sq. ft. branch office. This is significant in that banks as an industry are consolidating. And the rent was approx $1.79 per sq. ft with minimal concessions, which was favorable for the ownership given the state of the market.

Some medical spaces have been on the market for over a year. The 220 South Palisades property of 3,213 sq. ft has gone into escrow. With just a few properties selling each year, comparable sales for medical units over the last several years demonstrate values of approximately $300 per sq. ft.

Office Vacancy Rates by Percentage (%)

City of Santa Maria Metropolitan Area

2004	2005	2006	2007	2008	2009
2.7	2.5	2.1	6.2	12.4	12.2

Source: Stafford-McCarty Commercial Real Estate

The price of land zoned for construction of office space is similar to land prices in the retail segment, as Santa Maria's C-2 zoning allows office uses as well as retail uses. Land price asking rates have dropped—some larger parcels are at $10.00 per square foot and there are still no takers. Hard-to-find smaller parcels, which typically command a higher price, have come down in asking rates as well.

Industrial

Industrial vacancy again increased from 8.8% in 2008 to 9.57% as of this writing. There is approximately 741,744 sq. ft. of industrial space available for lease (the industrial base is approximately 7,672,586 sq. ft.).

It was a slow year with a notable lack of transactions. A 12,000 sq. ft. concrete tilt up facility on A Street sold for under $100 per sq. ft. after long exposure on the market – this is a number to watch. This square foot price has fallen close to $50 per square foot from past neighboring sales.

McCoy Land 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.

Industrial Vacancy Rates by Percentage (%)
City of Santa Maria Metropolitan Area

2004	2005	2006	2007	2008	2009
7.5	5.6	3.6	5.7	8.8	9.6

Source: Stafford-McCarty Commercial Real Estate

There are several noted industrial lease transactions on Industrial Parkway:

- 10,000 sq. ft. – warehouse requirement leased to SAC at $0.50/sq. ft/mo. gross
- 9,800. sq. ft. – plus yard space leased to Berrypack for $0.50/sq. ft /mo. Modified Gross plus yard rent
- 14,950 sq. ft. – a 3 year lease renewal at lower rates to PODS for $0.55 Modified Gross

Sublease availability is increasing in the market and will most likely drive rents downward as sub-lessors will want to stop the bleeding of paying for under utilized space, taking a small loss in rent versus no income on the excess space. Rents and deals are offered below current market rates.

Asking rental rates have shifted downward by moving more toward gross rent from triple net rent. Rents for smaller industrial spaces were approximately $0.75 to $0.85 per sq. ft. NNN. Demand has tapered off and is demonstrated by vacancy increases in the "bread and butter" user segment of the Santa Maria market place. These are typical multi-tenant industrial units, in the range of 1,000 to 4,000 sq. ft. where actual rents have decreased to make them effectively gross leases.

Industrial Land

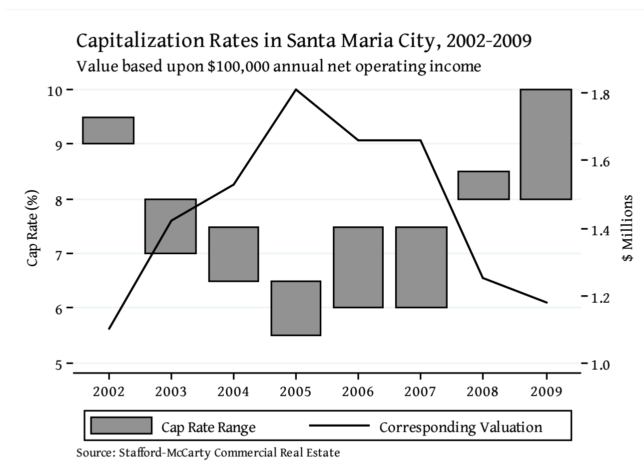
Land sales hibernated this last year. Asking price reductions from appraised values at $11.00 per square foot for finished industrial parcels three years ago are now on the market for $9.50 asking values.

Finished or near finished lot product is minimal. Valuations between the M1, CM, and M2 zones are becoming more singular. Acre sale prices can range from $7 to $8 per square foot. Comparable sales are now eighteen month plus in age. Oddly enough, these sales are still being used for comparable data in appraisal refinance and re-evaluations by lenders.

Agricultural

This market segment has had several noteworthy transactions.

The following sale runs counter to the market of downward valuations: Approximately 110 acres of Santa Maria's best row crop land sold and raised the watermark to approximately $58.5k per acre, topping a neighboring ranch, which previously set the high watermark at approximately $56,000 per acre. As always, quality parcels rarely become openly available on the market. These values are approaching values in the iconic Salinas Valley.



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It has been rumored that Fosters has the White Hills vineyard south of Orcutt Hill along Highway 1 in escrow in excess of $25,000,000. This was primarily valued at $10,000 per planted acre. In comparison, vineyards can cost up to $30,000 per acre to establish.

Commercial Investment

The 5,450 sq. ft. Carrrow's Restaurant at 1635 S. Broadway on approximately 34,258 sq. ft. was recently sold for $1,580,000 and was valued at a 9.7 capitalization rate.

Although there are very few sales, the following are key for different reasons. One of the highest priced properties to sell in 2009 was the resale of the Hollywood Video at 1846 N. Broadway selling for $1,888,544. It sold for $2,350,000 approx a year before.

The estimated cap rate range is the low nine's and indicates both a downward valuation and demand for higher caps. Again with limited transactions, sellers are concerned about "leaving money on the table" and are pricing their asset offerings at 8.0 to 9.5 caps; yet no takers.

CalPortland is offering a sale-leaseback of their 27 plus acre site and operation on Donovan Road for an 8 cap on a long term lease.

The table above shows the capitalization rate ranges evinced over the last eight years. To illustrate the capitalization influence on valuation, assume a commercial building produces a net annual income to the investor of $100,000. 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

The new normal is seeking stability. It will be that platform from which we will work in the coming years. The market segments of commercial real estate in Santa Maria are experiencing increased vacancy rates—some at all time highs. Lenders taking property back in 2009, flat out, just did not happen. It is anticipated that this year deals will begin to emerge to bring investors back into the market, as well as user-buyers. As those deals materialize we will see the new normal stabilize.

Note: For the purpose of this report, databank numbers include functional, non-competitive inventory (older buildings and warehouses) and exclude 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).