2014 Commercial Real Estate

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Key Chapter Findings

- Transitioning from a period of inventory surplus to scarcity.
- New commercial construction underway.
- Strong interest in hospitality.
- Larger projects coming back on line.

A Brief Note on Residential Market—How Deep is the Market?

San Luis Obispo

The housing market in San Luis Obispo has seen paced growth this past year. Total single family unit sales were slightly less than in 2013, but the median price, which topped $375 per square foot, increased over the previous year and has exceeded the pre-recession 2008 high water mark. Other areas of the Central Coast have yet to experience the same percentage increase in price per square foot. Mixed use projects (residential over commercial spaces) are getting a lot of attention in the downtown core.

North County

The North County shows increasing price trends, but is not on the same trajectory as San Luis Obispo. Unit sale volume is down slightly from 2013 but median prices have increased. In the North County, the median price per square foot is $233, compared to San Luis Obispo's $375 median price (noted above).

Housing Related Projects

Growth in the new construction housing market is continuing to gain momentum.

- Sierra Meadows on Prado Road is actively selling single-family detached homes.
- The first downtown mixed use project at the corner of Marsh and Nipomo has sold all of its residential (and commercial) units.
- ROEM Development, out of San Jose, has closed on the McCarthy Steel property on South Street for a housing project in conjunction with the Housing Authority.

Many other projects are once again working their way through the planning/entitlement pipeline. Projects with housing components that have been on hold for some time are now being actively processed, including:

- Pacific Courtyards
- Chinatown
- Bridge Street
- Monterey Place
- The reworking of the Dalidio project to provide more housing and less commercial space

Other new projects include:

- Wingate Homes, Righetti Ranch, the Jones Property, and West Creek—all in the Orcutt Area Specific Plan
- Avila Ranch South of the SLO County Airport
- Brownstones on Marsh

Residential Unit Sales, 3rd Quarter Annual Data

Variable	2008	2009	2010	2011	2012	2013	2014
San Luis Obispo							
# Units Sold	159	163	191	215	273	282	259
Median Price ($)	635,000	569,000	550,000	535,000	535,000	618,500	654,500
North County							
# Units Sold	638	702	698	892	991	1,045	1,032
Median Price ($)	390,000	340,000	296,000	270,000	305,000	355,000	375,500

Note: Comparative data is for the first three quarters of each year
Source: Central Coast Regional Multiple Listing Service;
Compilation by Stafford McCarty Commercial Real Estate

Following is a summary of unit sales from 2008 through 2014 in San Luis Obispo and North County.

Clearly the market is supporting new construction and inviting builders to return. The remaining question is how much new housing, and at what price, will the market absorb in the post recovery.

Commercial Markets

Overall there is new vitality and a sense of excitement in Central Coast commercial real estate. The market is finally showing sales activity across all sectors, including medical, retail, office, R and D, industrial, and land.

Both the industrial and office categories are seeing new construction completed, adding to the existing inventory. We have also seen a slight rise in the vacancy rates in these categories. As companies such as Rosetta and Family Care Networks have moved into their new facilities, the vacancies left behind have not been completely backfilled as of this writing.

Commercial land has even "flipped"—bought for one price and resold at a higher price —in a relatively short time. An example is 791 Orcutt Road, an entitled multifamily project of approximately 80 units, which sold in 2012 for approximately $2,300,000 and resold 2 years later for $3,600,000.

Regarding rent recovery, the market is just starting to revive after the 25% to 30% rental rate decrease that occurred during the economic downturn. New construction, or first generation space, have higher rents that are more closely tied to the costs of construction.

Lenders have been the focus of conversation, but now OREO's (bank owned properties) have virtually been cleared up and lenders are targeting new loans. Equity requirements for conventional loans are still problematic for many borrowers. Small Business Administration (SBA) loans and owner financing are the most common commercial loan vehicles.

Commercial Markets in San Luis Obispo

The market is continuing to grow in confidence with commercial sales returning after years of scant activity. Big projects are back as well. One of the most noted has been the San Luis Ranch Project (formerly the "Dalido Ranch" annexation), which has occupied more newspaper space over the years than any other development we can remember. Coastal Community

Commercial Vacancy Rates (%), San Luis Obispo City Metropolitan Area, 2014

Property	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Industrial/Warehouse	2.8	3.8	6.4	4.0	4.3	2.3	5.4	6.1	9.1	8.7	4.5	1.9	3.1
Retail Functioning	1.9	2.4	2.2	1.7	1.8	1.4	3.0	5.6	5.1	3.4	3.7	1.8	2.7
Office Functioning	9.9	8.4	5.4	3.2	4.7	3.5	6.1	9.7	12.6	11.6	8.6	6.5	7.5

Source: Stafford McCarty Commercial Real Estate

Builders is making progress on reworking the 131-acre 101 freeway frontage entitlements. The project is dependent upon the current draft Land Use Circulation Element (LUCE) being approved, but the LUCE is in conflict with current airport safety zones. The coordination of these agencies is critical to the growth of San Luis Obispo and the outcome is yet to be determined.

The downtown core of San Luis Obispo continues to be active with low vacancy and infill projects in various stages of planning and completion. Restaurants are predominating the downtown experience and as suspected not all of them are making a go of it. However, the ones that do not endure are soon replaced and vacancy remains tight. The former Daylight Gardens location has been reworked into a project called Heritage Plaza and has signed leases for most of the renovated space.

Tech sector expansion continues to be robust, with many "home-grown" companies sustaining growth. The Hothouse partnership between Cal Poly, the City, and local businesses is fostering new company formation and a cross pollination of ideas. Mind Body continues its staggering growth and has plans to occupy 180,000 square feet (Mind Body is an anomaly for our market with most companies being significantly smaller).

Manufacturing is seeing growth in our area as well. Cloud completed 26,000 square feet of construction, SRAM is in the process of completing its 20,000 square foot new location, and AccuAir continues its growth and need for square footage. Other smaller manufacturers are moving up and into larger facilities as well.

Aside from downtown, the other area seeing a lot of activity is on South Broad Street. In addition to the new construction across from the airport, SESLOC is settling into their new 40,000 square foot headquarters and Mind Body (noted above) is deep into the construction of their new corporate headquarters (both are within the City limits).

In other parts of town, owner and users projects are still moving forward including: Digital West, McCarthy Steel, Tractor Supply, and University Square, to name a few.

Retail

Retail vacancy stands higher than last year at 2.7%, with approximately 112,505 square feet vacant in a market with a base inventory of 4,163,270 square feet. Only 3,987 square feet of new construction was added to the retail sector base inventory this past year. Retail has the lowest vacancy of any market sector and has been a strong performer in the post recession years.

Confidence from investors is noted here as well. At 1119 Chorro Street, 3,500 square feet sold for $1,500,000, ($429 per square foot) vacant, and listed at 5 cap on proforma rents (capitalization rates discussed in later section).

Kreuzberg Cafe at 685 Higuera (5,500 square feet) sold for $2,215,000, or $386 per square foot, to a quasi related owner/user demonstrating substantial value as an improved property sale downtown.

Office

The office inventory base is approximately 2,842,000 square feet. Vacancy is up slightly to 7.45% from 6.47% last year. Total available office inventory in San Luis Obispo is approximately 212,000 square feet. New or "newer" space has been able to command the upper rental range of approximately $2.00 NNN per square foot.

The office market is growing as seen by the initiation of some speculative building projects. San Luis Obispo Airport Business Park is about ready to break ground on building 7,300 square feet of office/retail space. This is a significant turning point with the return of spec product.

Within the office market, the submarket of medical offices has seen robust sales and leasing activity. Pacific Eye has leased approximately 9,000 square feet at the new SESLOC Campus, and groundbreaking has commenced on the new medical education center at the French Hospital Campus for approximately 18,000 square feet.

Several medical office sales demonstrate the range of sale prices per square foot:

- 1531 Higuera Street (6,000 sq. ft.)—Newer Product—$900,000 ($435 per sq. ft.)
- 1304 Ella Street #A (3,072 sq. ft.)—$875,000 ($285 per sq. ft.)
- 1250 Peach #A (2,760 sq. ft.)—$712,500 ($258 per sq. ft.)

Industrial

Although the vacancy rate for industrial product has increased up to 3.14% (1.9% in 2013), functional industrial space has all but disappeared. Available manufacturing inventory is approximately 121,200 square feet with a total base of industrial inventory at approximately 3,854,600 square feet.

There is still unmet demand across the board for industrial spaces of up to 25,000 square feet and larger. No significant buildings have been added to the manufacturing inventory. Approximately 49,000 square feet has been added in the last four years and 40,000 square feet of that was in 2013. This segment of the market is seeing rental rates start to climb with the dearth of inventory. Quoted industrial rents have risen from $0.65 to $0.85 per square foot NNN.

The following noted sales show a range of pricing for industrial type product:

- 785 Buckley Road (10,000 sq. ft. with surplus land)—$2,800,000 ($280 per sq. ft.)
- 805 Aerovista #104 (9,593 sq. ft.)—$1,600,000 ($167 per sq. ft.)
- 4120 Horizon (8,600 sq. ft.)—$825,000 ($99 per sq. ft.)

In other industrial activity, Specialty Construction has started moving earth on their approximately 6.16 acre site on Buckley Road for a multi building project.

Industrial and CS zoned land is approximately $10 to $15 per square foot on offerings, and appraisal discussions and can be higher if the parcels have a retail presence.

Downtown San Luis Obispo

Scaffolding and blocked sidewalks are recent signs of construction starts and building renovations which have come to life again.

Developers are looking for projects in the downtown area as the City is supporting residential in that area. Mixed use (typically retail or office below and residential above) has drawn attention. PB Group has the Foster's Freeze corner under contract and has closed escrow on adjoining properties for development. The remodeling is underway at 650 Higuera (formerly Central Coast Surfboards) for the new home of SLO Brew.

Following are recent land sales on the edges of the downtown core:

- 7,841 square feet of downtown property was purchased on the corner of Marsh and Broad for approximately $800,000, or $102 per square foot.
- 581 Higuera: the 26,000 square foot lot was purchased for $1,555,000 (former Heritage Oaks Bank Branch), or $73 per square foot of land area.

Commercial Markets in Paso Robles and North County

Issues surrounding water rights and control of the over-drafted basin have escalated to new levels and will be key to future development and the expansion of the viticulture industries.

Excluding the office market sector, Paso Robles vacancies have decreased again over the previous year.

The Firestone Walker Brewery, and noted 805 brand, has absorbed the vacant industrial parcels at Vendels Circle and continues its expansion and popularity at the southern gateway to the City.

A prominent property of approximately 2.5 acres, entitled for mixed used at 4th and Spring Streets, has changed hands. This highly visible gateway property sold for approximately $18.65 per square foot.

Retail

All in all, retail in Paso Robles has done very well in the post recession. The retail base inventory for the market remains at approximately 4,646,000 square feet. Retail vacancies have again decreased slightly from 3.3% last year to 2.61% this year. There is approximately 121,000 square feet of retail space on the market at this time.

Spaces have been slow to fill with some well located properties still having vacancy in spite of tight inventory. Real estate can be quirky this way sometimes.

Office

Office remains a weak spot in the Paso Robles market. After year-over-year improvement for the last several years, vacancy has nearly doubled, climbing from 6.58% in 2013 to 14.25% in 2014. The sizes vary from small units up to the largest vacancy of approximately 10,000 square feet. There is approximately 61,500 square feet vacant at this time.

Rent recovery for second generation office will be on hold in this market sector until absorption improves. Targeted asking rents are centered around $1.50 per square foot gross for better finished units. Older units will compete for rents at lower levels.

Technical companies such as IQMS, Santa Cruz Biotech, Applied Technologies, and Silicone Fabricators are settling into their recently added expansions. North County is steadily growing its tech base.

Manufacturing

The manufacturing sector has performed well and inventory has become increasingly snug. Overall absorption has been lackluster but the owner/user expansion has continued with companies noted above. The industrial sector added approximately 119,000 square feet,with vacancy now standing at a modest 3.62%. Paso Robles' industrial base is presently approximately 3,287,650 square feet.

Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2014

Property	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Industrial/Warehouse	9.4	10.7	3.5	5.0	2.8	7.5	13.2	8.0	7.7	6.5	5.7	3.6
Retail Functioning	1.9	< 1.0	< 1.0	< 1.0	< 1.0	2.2	4.1	4.5	3.5	4.8	3.3	2.6
Office Functioning	1.2	1.8	1.2	5.2	5.6	7.7	24.1	17.5	18.4	18.3	6.6	14.3

Source: Stafford McCarty Commercial Real Estate

Please note our comments in the Agricultural section as the viticulture industry has filled many manufacturing vacancies in the City as well as the surrounding county areas.

Recent industrial parcel sales indicate values at about $3.00 per square foot for two to three acres.

Hotels in North County

Hospitality interest in the Paso Robles area is extremely high. Aside from the Ayers project of 225 rooms and the La Qunita 37 room expansion now under construction, there are an additional 535 rooms by multiple hospitality operators approved by the City. Neighboring Atascadero has a Marriott project being completed. There are even more hospitality projects in planning stages. Given the size of the market, rack rate, and occupancy, there is tremendous confidence in the market. Whether or not they will be built immediately is yet to be seen.

Agricultural Impact: Wine Industry Facilities Continue to Expand.

Our viticulture industry is pushing roots further into the economic base. Buildings and facility additions specific to the industry continue in a significant way. After adding approximately 122,000 square feet last year and 150,000 square feet the year prior, the Paso Robles and San Luis Obispo areas combined added an additional 92,000 square feet this year. Again, most of this inventory is in North County outside of city limits.

Notable vineyard transactions include Global Ag Properties' purchase of the Sunbelt Vineyard for $15.25M or $45K/planted acre. Estrella River Vineyard sold for $14.6M or about $55K/planted acre, and the price was $18Kk/acre for the open ground by Sunshine Agriculture. These have set the bar higher for valuations of larger plantings.

A lender driven sale of the winery and the hospitality/tasting room (approximately 13,000 square feet and 7,900 square feet, respectively) on 25 (11 planted) acres at Anderson/46 West sold for $4,800,000. Another smaller winery (5,000 cases) on 20 acres with about 9 acres of planting sold for $2,279,000. All are signs of active markets.

Commercial Investments

The investment market sector has been elusive in regards to establishing/determining a capitalization rate (cap rate). The most notable change is that the delta between higher and lower cap rates has become wider. Arriving at a generic capitalization rate has become more of an art than a science.

As we anticipated, with interest rates remaining low, there were increased sales transactions in 2014. Entry-level investors have decided to come off the side lines, moving from purchasing residential units as investments into the commercial arena. Product under one million dollars is difficult to find.

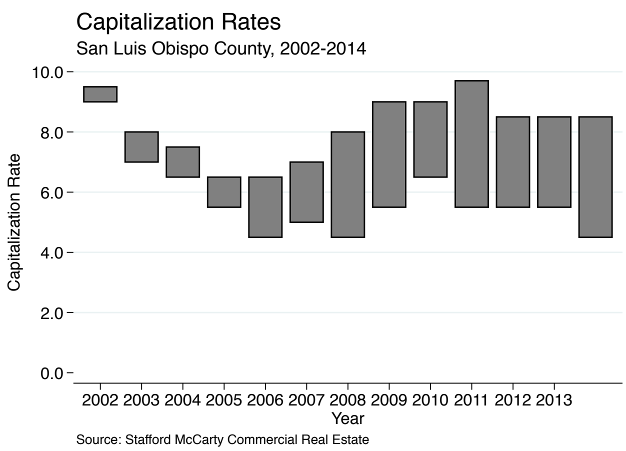
Multi-family investments, (apartments) have been active and producing capitalization rates mostly in the sub five cap rate range.

The investment sales selected below demonstrate the range in the present market on the Central Coast:

- 110 Mary Ave. (37,939 sq. ft.)—$12,000,000 ($280 per sq. ft.; Cap 7.7)
- 3701 S. Higuera (18,620 sq. ft.)—$4,150,000 ($223 per sq. ft.; Cap 8.4)
- 1255 Grand Ave. (4,017 sq. ft.)—$1,060,000 ($263 per sq. ft.; Cap 5.55)

Investment sales with credit tenants are offered in the mid 5's. The higher cap rates in the examples above indicate investments with more associated risk, lease terms which were short, or impending lender issues. If lenders and appraisers were forced to pick a rate we would see them start with a 7.

Following are capitalization rate ranges evinced over the last eleven years for our market area:



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:

Cap Rates and Implied Value

Year	Cap Rate Range Low	Cap Rate Range High	Implied Asset Value ($)
2002	9	9.5	1,100,000
2003	7	8	1,428,000
2004	6.5	7.5	1,538,000
2005	5.5	6.5	1,818,000
2006	4.5	6.5	2,222,000
2007	5	7	2,000,000
2008	4.5	8	2,000,000
2009	5.5	9	1,818,000
2010	6.5	9	1,538,000
2011	5.5	9.7	1,818,000
2012	5.5	8.5	1,818,000
2013	5.5	8.5	1,818,000
2014	4.5	8.5	1,818,000

Source: Stafford McCarty Commercial Real Estate. Note: Value based upon $100,000 in annual net income

Conclusions

Given the dour nature of commercial real estate in recent years there is a frisson of excitement at this time. The question is how long will it last and will the general business owner benefit, as opposed to the well-heeled plucking of the best deals. Commercial properties are selling faster and there is interest in new development. Overall, there is strong market activity and pent up demand. How the current and planned projects develop will shape the Central Coast for the foreseeable future.