

Commercial Real Estate

by Steve McCarty and Steve Davis

Stafford McCarty Commercial Real Estate

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Key Chapter Findings

- Visible construction throughout the City of San Luis Obispo
- Buyer confidence in commercial real estate
- Sub market trends —banking, hotels, and cannabis

The following is a break out of the local market sectors and regions.

The Residential Market—A Brief Overview

Within the communities of San Luis Obispo County there is an effort to address workforce and affordable housing issues through higher densities in the urbanized areas as well as construction of new single family homes.

San Luis Obispo

The City of San Luis Obispo is recognizing the need to produce more housing and is supporting projects and density increases in the urban core. This has resulted in a wide range of product in both size and purchase price. Presently, the median price for a single family residence is approximately \$700,000 which translates to an average 1,700 sq. ft. home selling for slightly over \$410 per sq. ft.

North County

In the North County the market volume has remained steady over the last several years with approximately 1,000 single family units selling in the same year-over-year period. An average 1,700 sq. ft. home

in the North County would currently sell for approximately \$285 per sq. ft., which is up from 2016's \$250 per sq. ft.

Housing Related Projects in San Luis Obispo

In the City of San Luis Obispo and the immediate surrounding area, an impressive list of projects are in various stages of the planning pipeline.

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 of single family detached homes
- Pacific Courtyards is near construction completion
- Chinatown is partially completed
- Garden Street Terraces is moving toward completion.

Upcoming projects 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
- Wingate Homes, Righetti Ranch, the Jones Property, and West Creek—all located in the Orcutt Area

Specific Plan—are proceeding with construction or planning

- HASLO is under construction on its affordable units on Broad Street

Following is a summary of housing unit sales from 2008 through 2017 in San Luis Obispo and the North County.

Commercial Markets

Buyer confidence in commercial real estate continues and is illustrated in the following sections broken out by regions and market segments.

Commercial Markets in San Luis Obispo

As you drive through San Luis Obispo you see construction throughout the community, including Downtown, Broad and Higuera Streets, and the Airport Area. We are starting to see speculative industrial building but the most noticeable activity is office construction around the airport. The Airport Business Center is constructing another approximately 26,000 sq. ft. of office space after recently completing about 14,000 sq. ft. in two buildings. Ready for final inspection is the approximately 36,000 sq. ft. of office space at 892 Aerovista. These projects have targeted the back logged demand for office space, helping to address the lack of construction during the recession. The East Airport area has seen growth in both office and industrial product.

Retail

Breaking up Forever 21 and Sears

Retail vacancy is extremely small in San Luis Obispo if you exclude the large box footprint of Forever 21. Even with that space included, the vacancy rate is

4.02%, otherwise it is under 2%. With Tractor Supply adding over 19,000 sq. ft. in this last reporting period, the present retail inventory base is approximately 4,118,434 sq. ft. It has just been made public that the existing Sears building will be demolished and three smaller retail buildings will take its place, with two of those spaces being pre-leased. Smaller retail/restaurant buildings are selling for over \$500 per sq. ft.

Office

Office vacancy has ticked up slightly from the 3.82% in 2016 to 5.38% this year. The largest space on the market, 45,350 sq. ft., is the vacancy that was left behind when CalTrans relocated from Atoll Business Center to South Higuera Street. Base inventory is approximately 2,933,380 sq. ft.

The nationally recognized start up, MindBody—as noted in earlier reports—still occupies the largest commercial office space in the market and continues to absorb tech hires. Cal Poly's incubator Hothouse is outgrowing its downtown location of approximately 15,500 sq. ft.

Any new office buildings coming on to the market will be \$2.00+ per sq. ft., NNN.

A few noted sales of other, more typical, office product:

- 2625 Santa Rosa 2643 sq. ft. \$ 1,025,000 \$390 sq. ft.
- 412 Marsh Street 3112 sq. ft. \$ 1,100,000 \$353 sq. ft.

Industrial

The Industrial base of standing inventory is now just under 4,000,000 sq. ft. and has an incredibly low vacancy rate of 1.35%, which is down from the already low 1.6% in 2016. There is approximately 53,626 sq. ft. available on the market in a mixture of sizes. Rents are staying about the same as last year with quoted industrial rents in the \$.90—\$1.25 per sq. ft. NNN range.

Residential Unit Sales, 3rd Quarter Annual Data

Variable	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
San Luis Obispo										
# Units Sold	159	163	191	215	273	282	259	283	337	275
Median Price (\$)	635,000	569,000	550,000	535,000	535,000	618,500	654,500	667,000	661,000	700,000
North County										
# Units Sold	638	702	698	892	991	1,045	1,032	1,138	923	976
Median Price (\$)	390,000	340,000	296,000	270,000	305,000	355,000	375,500	404,500	422,421	483,000

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*

Commercial Vacancy Rates (%), San Luis Obispo City Metropolitan Area, 2017

Property	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
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	2.3	1.6	1.4
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	1.3	5.6	4.0
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	5.3	3.8	5.4

Source: Stafford McCarty Commercial Real Estate

East Airport parcel sales demonstrate increased values. A recent transaction had 2.5 acres selling for \$2,500,000 or approximately \$23 per sq. ft.

The following industrial transactions were on assets targeted for higher and better uses:

- San Luis Obispo Tribune 44,038 sq. ft. \$9,000,000 \$204 sq. ft. 5.37 acres
- 2146 Parker Street 13,227 sq. ft. \$2,600,000 \$197 sq. ft. 1.38 acres

Commercial Markets in Paso Robles and North County

After years of limited sales, all market segments have demonstrated transactions. Properties that have been on the market, some for over 12 months and in and out of escrow, have finally found buyers and closed the transactions. Additionally, investment properties with tenants and sustainable income have moved quickly. On the planning books are mixed use projects, mostly retail below with residential above.

Retail

Retail in Paso Robles has performed very well year-over-year and now again in 2017. It currently has a base of approximately 4,650,000 sq. ft. The vacancy rate was already low (2.1% in 2016) and has dropped to 1.14% in 2017. The approximate 53,000 sq. ft. of vacancy is comprised mostly of small spaces. Little inventory has been added for the last three years.

The Pine Street Promenade project on the former Hayward Lumber site near downtown (approx. 2.4 acres), has been rolled back from approximately 189,000 sq. ft. to 105,195 sq. ft. and will still include a 151 room hotel.

A few noted sales:

- 1315-1317 Park (1,575 sq. ft.)—\$550,000 (\$349/sq. ft.)
- 1436 Spring (3,700 sq. ft.)—\$200,000 (\$ 54/sq. ft.)
- 2111 Golden Hill (4,000 sq. ft.)—\$965,000 (\$241/sq. ft.)
- 1240 Spring Street (7,643 sq. ft.)—\$2,050,000 (\$268/sq. ft.)

Commercial Vacancy Rates (%), Paso Robles Metropolitan Area, 2017

Property	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
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	1.1	9.3	5.8
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	2.8	2.1	1.1
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	7.5	9.2	7.8

Source: Stafford McCarty Commercial Real Estate

- 2727 Buena Vista (19,499 sq. ft.)—\$3,750,000 (\$166/sq. ft.)

Office

Vacancy for the office sector has improved slightly over last year in the North County. Present vacancy is approximately 7.8%, down from 9.2% in 2016. This equates to approximately 34,400 sq. ft. of standing inventory on the market, on a base totaling 440,000 sq. ft. Once again, there has been minimal office inventory added this last year.

Manufacturing

Paso Robles is demonstrating a 5.8% vacancy rate with approximately 201,242 sq. ft. available. Base inventory has grown slightly and is approximately 3,467,000*** sq. ft. for 2017. The new inventory added was split between the "Tin City" submarket in neighboring Templeton and along Hwy 46 in east Paso Robles.

The 220,424 sq. ft. Paris Precision facility, which came on the market at the end of 2016, was purchased and has been repurposed to house multiple tenants. This product—broken up into smaller sections (ranging in size from 11,000 sq. ft. to 47,000 sq. ft.)—holds the bulk of the vacant market inventory. This large facility was purchased for \$15,750,000, approximately \$71 per sq. ft. By comparison, a smaller facility sale was 2921 Union Road, which is approximately 20,000 sq. ft. and sold for \$2,300,000, or \$115 per sq. ft. These sales evince purchase prices under reproduction values.

Multiple small finished parcel land sales in east Paso Robles are demonstrating land values in the \$5.00 to \$10.00/sq. ft. range.

- 3522 Combine St. 17,284 sq.ft. \$185,000 \$10.70 per sq. ft.
- 3523 Combine St. 25,265 sq.ft. \$229,500 \$9.08 per sq. ft.
- Danley Ct. 78,408 sq.ft. \$425,000 \$5.42 per sq. ft.

Commercial Investments

Capitalization rates, or "Cap Rates," have been holding steady but are starting to creep lower. Many investors complain that San Luis Obispo County investment properties are difficult to find given the investment returns they are seeking—forcing them to look out-side the Central Coast market and the state. Yet, there are still enough investors willing to accept lower cap rates and exchange transactions have been an active part of the market.

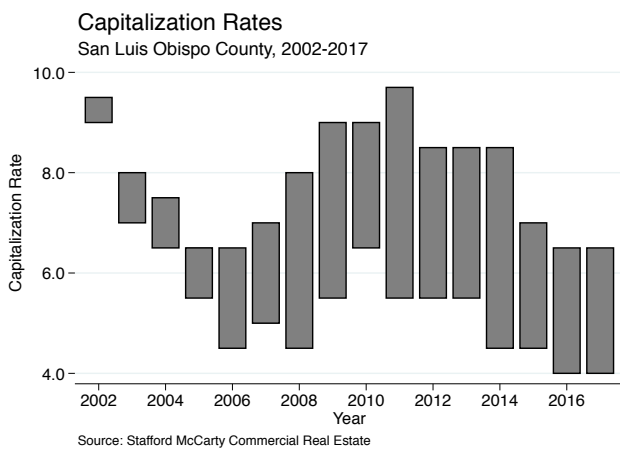
Some examples:

- Marigold Center 217,000 sq. ft. \$43,550,000 \$200 per sq. ft. approx. 6-7 cap
- Fiero Commerce Park 57,878 sq. ft. \$11,250,000 \$194 per sq. ft. approx. 5.9 cap
- 100 Cross Street 40,568 sq. ft. \$13,300,000 \$327 per sq. ft. approx. 6.03 cap
- Grand Ave 6,500 sq. ft. \$1,250,000 \$201 per sq. ft. approx. 4.8 cap
- Farrol Road 16,000 sq. ft. \$1,800,000 \$ 91 per sq. ft. approx. 4.5 cap

Similar to last year, local lenders are seeing imputed capitalization rates in their appraisals in the 5's while other regions in major markets are seeing lower caps, some even in the 3's.

Apartments are a different ball game as they will demonstrate cap rates in the 3's to 4's, and there seem to be more buyers than sellers for this product submarket. Hospitality assets are presently 6 to 9 caps.

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



Data Points in the Region and Data Bumps in the Submarkets

The Doors Close on Community Banks

With the recent sale of Founders Bank, San Luis Obispo County has run out of community banks. The industry prediction of larger banks absorbing smaller ones has finally played out in our community.

Hotels in San Luis Obispo and North County

Hospitality entitlements continue to be processed and will become a significant sector in permit and building activity over the next several years for both urban hotels and those located on the periphery.

There were a number of significant transactions in hospitality sector:

- Springhill Suites, at 130 rooms, sold for \$24,937,000 or \$191,823 per door.
- The Morgan in San Simeon, with 56 rooms, sold for \$8,222,310, or \$146,826 per door
- Azsa Hospitality purchased approximately 4.21 acres of land on 4th Street in Paso Robles for approximately \$22.50 per sq. ft.

There is tremendous hospitality interest in the region, as it has become an increasingly popular tourist destination. The nightly "rack rates" are significantly below rates in neighboring Monterey and Santa Barbara, destinations that partly drive the area's appeal and investor interest for the opportunity to raise rates.

Values in San Luis Obispo County Agriculture Still Hold

Values are still holding in the \$45,000 to \$55,000 per acre range for strawberry and berry ground. North County planted values remain the same as last year: for smaller vineyards (20-80 acres), plantable east side acreage is generally \$18,000 to \$20,000 per acre versus \$35,000 to \$50,000 per acre on the west side. Planted acreage on the east side is \$30,000 to \$35,000 per acre and \$50,000 to \$65,000 per acre on the west side for the smaller vineyards. There were two west side vineyard sales in the mid \$2,000,000 range supporting these planted values this past year.

Trends continue with buildings additions to support viticulture. The past significant growth we have seen in the addition of new wineries (10,000 sq. ft. and larger) has taken a breather, but modest expansion of existing facilities has continued throughout the County. Not enough time has passed to assess how the recent Northern California fires will impact land values in our region. The 100,000 sq. ft. Fetzer winery on 46 acres with some plantings, sold to Sutter Home at the end of last year for \$14,750,000.

The Cannabis Factor in San Luis Obispo County

As of this date, only the City of Grover Beach has elected to allow cannabis activity in their industrial area, including two dispensaries. This has triggered some sales and caused values to skyrocket in the designated areas. Per square foot values for industrial buildings, which may have been around \$100 per sq. ft., have jumped to \$500-\$600 per sq.ft. for smaller buildings.

The County's proposed cannabis regulations are under review and seem to be ever changing, causing great uncertainty for regulators, citizens, and especially those in the cannabis industry seeking to establish locations.

Conclusion

Like last year, 2017 has proved to be a solid year for commercial real estate. Buyer confidence is high, lenders are seeking opportunities to finance, and properties are getting more expensive. Tax deferred exchanges, as anticipated, have been a key part of market vitality. The link between our regional agriculture and tourism is becoming more defined. The nexus at which 'agritourism' and economic development meet is a topic of great interest to the region as well.

* Data from the San Luis Obispo Multiple Listing Service.

** 2017 data variations due to MLS service provider and reporting changes

*** Data correction for 2017.