Q3 2018
Quarterly Report

SOUTH COAST COMMERCIAL REAL ESTATE

COMMERCIAL SALES

	YTD 2018	vs 2017*	vs 5-yr Avg
Sales Transactions	55	- 18%	- 17%
Volume (excl. hotels)	$168 M	- 33%	- 26%

* Annualized

The South Coast sales market has recovered much of its momentum since the natural disasters of last December and January. Transactions during the past two quarters are trending only 10% below the prior 5-year average. However, the current inventory of 74 properties for sale is the largest in recent memory and represents an 80% expansion since the beginning of the year. With demand from investors still recovering, there do not appear to be sufficient buyers to address current supply.

To date, Santa Barbara has produced 44 sales valued at $209 million. In the South Coast's largest sale to date, the 200-key Hyatt Centric hotel at 1111 E Cabrillo Blvd sold for $87.5 million in Q3. Otherwise, sales in Santa Barbara have been relatively quiet since Q1 when the Saks building at 1001 State St sold for $18.5 million and the Macy's building at 701 State St sold for approximately $12 million. The third quarter brought one of the few Santa Barbara office sales as an owner-user purchased the 9,673 SF office/R&D building at 819 Reddick St for $3.5 million. Land deals have been unusually prodigious in Santa Barbara, and five of the nine land sales to date were in the "Lagoon District"/ Eastside neighborhood, which is currently a hot spot for transactions.

Goleta has been relatively quiet with just six transactions to date. The most notable sale was the Q3 purchase of three industrial buildings totaling 124,754 SF at 839-879 Ward Dr for $16.5 million by Majestic Asset Management. The ownership of Patterson Plus Self Storage bought 4.18 acres along the train track at 10-20 S Kellogg Ave for $6.775 million with entitlements to build self-storage. There are a few high-value properties in escrow as of this writing, which could boost Goleta's dollar volume in the next quarter or two. In addition, well-funded investors have new offerings to consider as the 106,309 SF office/ R&D building at 6300 Hollister Ave came to market for $37 million, and 50 & 70 Castilian Dr – office buildings leased by AppFolio – were listed for a combined $39.8 million.

There have been just five sales to date in Carpinteria and Summerland. The most notable Q3 transaction was the Sly's restaurant building at 686 Linden Ave in Carpinteria, purchased by an owner-user for $2.09 million.

Heading into the final months of 2018, South Coast inventory is the largest it has been in at least a dozen years. Office and retail property transactions to date are both trending about 40% below the prior 5-year average. It's not clear yet whether investor demand will recover to the levels seen in recent years, or if the market is entering a new phase of deceleration. We can say with confidence that interest rate increases will place downward pressure on prices, as investors will require a higher return to cover their financing. On the bright side, there has been a surge of owner-user buyers to date, which suggests the local business community is rebounding well, even if investors are being cautious.

OFFICE LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	6.0%	8.6%	3.8%	7.0%
Available Space	+ 3%	- 2%	- 38%	- 2%
Transactions	- 12%	+ 44%	+ 52%	+ 4%
Achieved Rents	+ 5%	+ 3%	- 13%	- 5%
Gross Absorption	- 25%	+ 97%	+ 122%	+ 36%

Change percentages are compared to 2017, annualized where appropriate.

In the aggregate, South Coast office leasing has been robust in 2018, but activity has not been evenly distributed across the South Coast. Goleta has produced unprecedented transaction volume while Santa Barbara and Carpinteria have been sluggish.

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GOLETA

- Deal volume is heavy in Goleta with 38 transactions to date, the highest Q3 count in at least 10 years. Gross absorption is similarly at a level unmatched in recent history and 70% above the prior 5-year average.

- More new leases are being signed, as opposed to renewals. Only 18% of the lease transactions have been renewals, less than half the percentage from 2017.

- The underlying trend in Goleta is toward contraction of available space. Vacant space decreased for the second straight quarter in Q3 to 8.6%. Setting aside the 112,480 SF space at 71 S Los Carneros Rd – which will be occupied by Apeel Sciences until 2020 – available office space has decreased 30% so far in 2018.

- A significant factor in the contraction of available space is the resurgence of larger leases. There have been 13 leases larger than 10,000 SF to date, the highest Q3 count on record.

- AppFolio consolidated a three-building, 165,462 SF campus in Q3 by leasing the 86,246 SF former FLIR building at 70 Castilian Dr. The software/SaaS company already occupies the two adjacent buildings at 50 and 90 Castilian Dr.

SANTA BARBARA

- Santa Barbara's office vacancy rate of 6.0% is the highest since 2012 and represents a 13% expansion in available space over the past 12 months.

- Gross absorption in Santa Barbara through Q3 is tracking 25% below the prior 5-year average, partly due to fewer transactions and partly due to smaller space sizes. The average office lease size to date in 2018 is the smallest since 2007.

- 40% of the square footage leased this year has been renewals, including most recently Mission Wealth's extension on 7,449 SF at 1111 Chapala St.

- The Saks building at 1001 State St has been leased by a Fortune 100 company that will reportedly convert at least 40,000 SF of the building to creative office space. If so, it will likely be the largest non-government office space in downtown Santa Barbara.

CARPINTERIA

- Available space has decreased by 56% over the past 12 months.

- Synectic Systems leased 8,896 SF in the former Lynda.com building at 6398 Cindy Ln. The balance of the building – 10,167 SF – is in negotiations and expected to lease in October.

- Printing equipment manufacturer ZBE Inc renewed 13,800 SF at 1033 Cindy Ln.

RETAIL LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	3.4%	2.0%	7.9%	3.2%
Available Space	- 10%	- 7%	+ 6%	- 8%
Transactions	- 8%	+ 33%	- 11%	- 1%
Achieved Rents	+ 0%	- 11%	- 17%	- 7%
Gross Absorption	+ 20%	+224%	- 25%	+ 54%

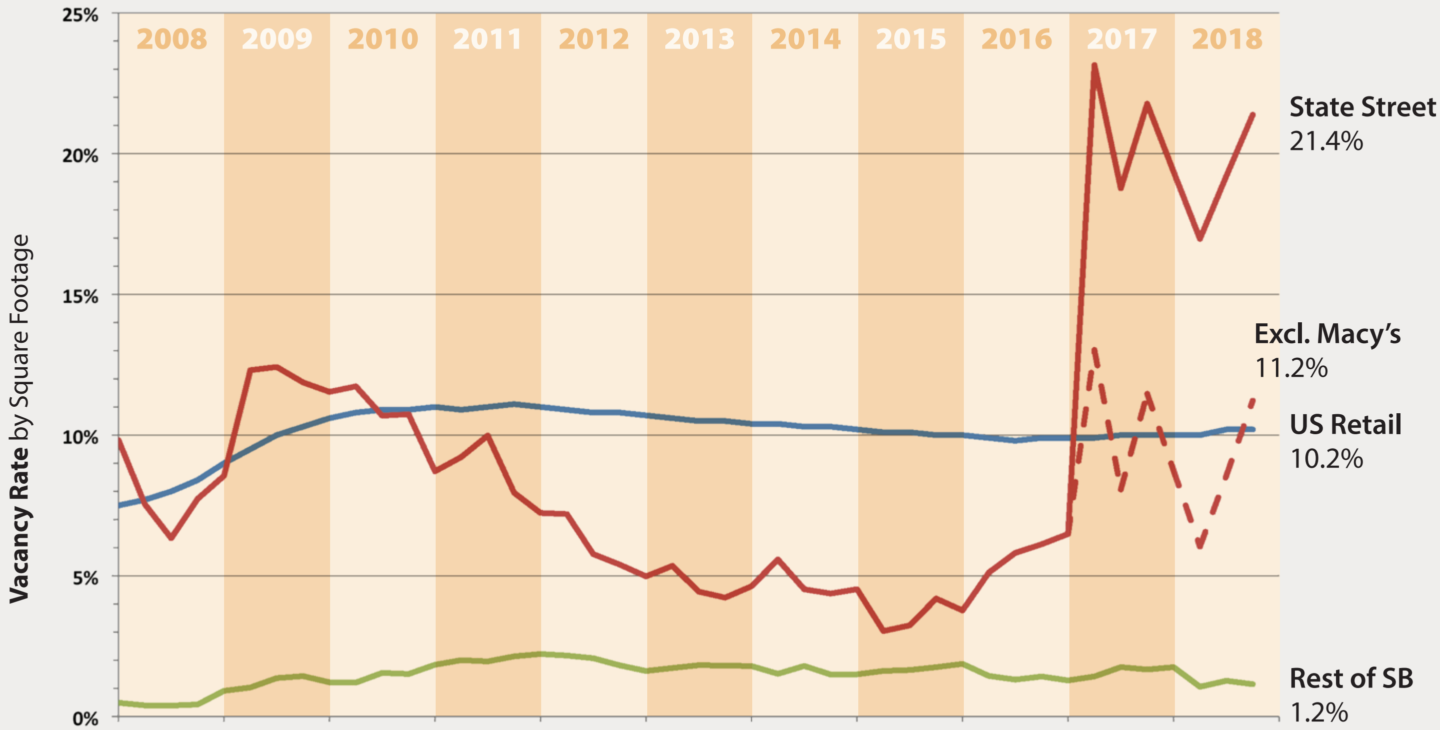
Change percentages are compared to 2017, annualized where appropriate.

In many ways, the plight of retail on State Street in downtown Santa Barbara has gotten bleaker. In the past six months, 17 storefronts have been affected by tenant departures, including Aaron Bros, Chipotle, Lole, Peet's Coffee, Staples, and Tonic. There are 37 vacancies along the main retail corridor of State Street from Gutierrez to Sola Streets (400 to 1300 blocks), which represents a 14.9% storefront vacancy rate. This is higher vacancy than at any point during or in the wake of the Great Recession. It's worth noting, however, that several spaces on the market are currently occupied by short-term "pop-up" stores. When pop-ups and other storefronts that still have an operating tenant are subtracted the "perceived" storefront vacancy rate drops to 11.6%.

On the bright side, as noted in the office summary, the Saks building at 1001 State St has been leased and is expected to be occupied by the new tenant late next year. This is good news for State Street, since the specter of another

STATE STREET RETAIL

Cabrillo to Sola (00 to 1300 blocks)



Vacant space along the State Street corridor jumped during the recession and followed a trend of recovery through Q1 of 2015, when it bottomed at 3.0%. Since then vacancy has expanded while the rest of Santa Barbara and US retail have remained stable. Both the Macy's and Saks buildings came on the market in early 2017, causing the dramatic spike.

prominent vacant building will be avoided. The rumor that the tenant is Amazon provides an interesting twist, as the internet commerce behemoth blamed for contributing to State Street's vacancy blight could also become part of the solution.

As for the Macy's building at 701 State St, according to reporting by the Independent there are lease negotiations in progress, perhaps involving an IMAX theater. Holiday pop-ups are in place as a good temporary use for the 146,000 SF building, but a longer-term solution would go a long way to help get State Street back on track.

We continue to observe that although vacancy is alarmingly high on State Street, the retail core is not stagnant. There have been 23 retail transactions along the downtown State Street corridor in the past 12 months. Among the notable Q3 signings, the national cosmetics retailer Bluemercury leased the 1,667 SF former Pinkberry space at 742 State St, and Turn Key Wine Brands leased 1,000 SF next to Finney's at 35 State St.

Goleta has a slim vacancy rate of 2.0%, and 90% of the available square footage is in the eastern half of the city, east of the airport. Following the opening of HomeGoods, Camino Real Marketplace is fully leased for the first time in several years. The adjacent University Plaza at 7127 Hollister Ave is not faring as well – its second-largest tenant, Pacific Sales, will be vacating its 20,000± SF space. Meanwhile at Fairview Center, with Orchard Supply Hardware now closed there are reportedly tenants interested in the building. With several years remaining on OSH's lease, it is unclear yet whether a lease termination or a sublease will ensue to get a new tenant in place.

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INDUSTRIAL LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	**1.1%**	**4.7%**	**3.8%**	**2.9%**
Available Space	**+279%**	**+ 43%**	**+150%**	**+ 74%**
Transactions	**+ 26%**	**- 33%**	**+ 19%**	**- 2%**
Achieved Rents	**+ 27%**	**+ 5%**	**+ 23%**	**+ 13%**
Gross Absorption	**- 46%**	**- 20%**	**+ 37%**	**- 20%**

Change percentages are compared to 2017, annualized where appropriate.

South Coast industrial inventory is the largest it has been since 2012 and has expanded 74% since the beginning of 2018. That said, the combined vacancy rate is still modest at 2.9%. After a quiet first quarter, lease transaction volume recovered in Q2 and Q3 to a level approaching the prior five-year average.

In Goleta, an increasing share of the available inventory in the near future will be either remodeled or new space. As noted in the sales summary, the 124,754 SF Channel Technologies property at 839-879 Ward Dr was purchased in Q3 by Majestic Asset Management with plans to remodel and lease approximately 66,000 SF of vacant space. Other freshly renovated properties either on the market or coming soon are 759 Ward Dr (8,145 SF) and 601 Pine Ave (12,600 SF). In addition, new construction is underway on City of Santa Barbara land at 6100 Hollister Ave, which will add 18,400 SF of industrial product to the Goleta market. Also in the likely pipeline, a developer is in escrow to purchase the remaining developable land in Cabrillo Business Park with entitlements to build more than 100,000 SF of high-quality industrial/R&D/flex space.

Santa Barbara currently offers a lean supply of eight available industrial spaces, amounting to a 1.1% vacancy rate. The largest availability is 25,570 SF for sublease at 30 S Calle Cesar Chavez, marketed as office/R&D/flex space. Gross absorption to date is proceeding 17% below to the prior 5-year average. Achieved rents are on the rise as the year-to-date average is 27% higher than 2017. Some of the smaller spaces – especially those with an office component – are achieving rents comparable to what tenants are paying for pure office space.

In Carpinteria, 95% of the square footage leased to date has been renewals, including two 20,000+ SF extensions by Reality Church and TE Connectivity. At the same time, the vacancy rate has more than doubled since the beginning of the year, reaching 3.8%, a rate not seen since 2012. Most of the availability is in two large spaces: the 24,030 SF building at 6384 Via Real vacated by Astro Aerospace (Northrop Grumman), and 20,000 SF at 550 Linden Ave.

Notable Q3 leases: Deployable Space Systems leased 22,001 SF at 153 Castilian Dr in Goleta; Reality Church renewed 20,632 SF at 5251 6th St in Carpinteria; TE Connectivity renewed 20,504 SF at 550 Linden Ave; Tileco renewed 8,621 SF at 7 N Nopal St in Santa Barbara.

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