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2021 Q4 Market Report

South Coast Commercial Real Estate

A RECORD YEAR FOR SALES, A RECOVERY YEAR FOR LEASING

With momentum building each quarter, 2021 proved a banner year for commercial sales, posting record transactions and dollar value. Whereas the unexpected surge of sales volume in 2020 came mostly from well-funded investors, in 2021 sales proceeded at all price levels from all kinds of buyers. In the leasing market, all indicators show growth from the slowdown in 2020, but activity has nonetheless been affected by the ups and downs of the pandemic, and the recovery phase is still in progress.

Here are some summary highlights:

- Q4 was the highest-volume sales quarter on record, capping an unprecedented year of 117 commercial sales and allaying any doubt the market had recovered from the pandemic recession.
- Leasing volume, on the other hand, has not recovered to pre-COVID levels. Lease consideration in 2021 was 26% below the pre-pandemic 5-year average.
- On the other hand, rents rebounded fully after dipping in 2020. Lease rates grew 10% year-over-year in 2021 and were 5% above the pre-pandemic average.
- Santa Barbara's office and retail leasing markets continue to have record-high vacancy rates, while all other sub-markets on the South Coast are at or below pre-pandemic supply.
- However, commercial sales volume in Santa Barbara was tremendous, far exceeding any prior year on record.

COMMERCIAL SALES

In our Q3 report we concluded that South Coast commercial sales had fully recovered from the pandemic recession, and Q4 activity put an exclamation point on that assessment with $283 million in non-hotel sales, the highest quarterly volume on record. Strong demand converged from both investors and owner-users, and at every price level. The prospect of rising interest rates may have added extra motivation to buyers. The year closed with 117 sales valued at $770 million ($524 million excluding hotels), all record-high totals.

Looking at the activity by city, Santa Barbara was the primary locus of the surge in deal flow. Its 89 transactions and $340 million in non-hotel volume were 53% and 78% above the 5-year averages, whereas activity in Goleta and Carpinteria generally matched recent historical trends. Transactions were also heavily skewed toward the latter half of the year, which yielded twice as many deals as the first half. In fact, dollar volume in the latter half of 2021 surpassed every full-year total on record except 2019.

Two Santa Barbara hotels were acquired by billionaires in recent months. In Q4, Diane Hendricks purchased the

The Hotel Santa Barbara was purchased in November by Diane Hendricks for $41.9 million.

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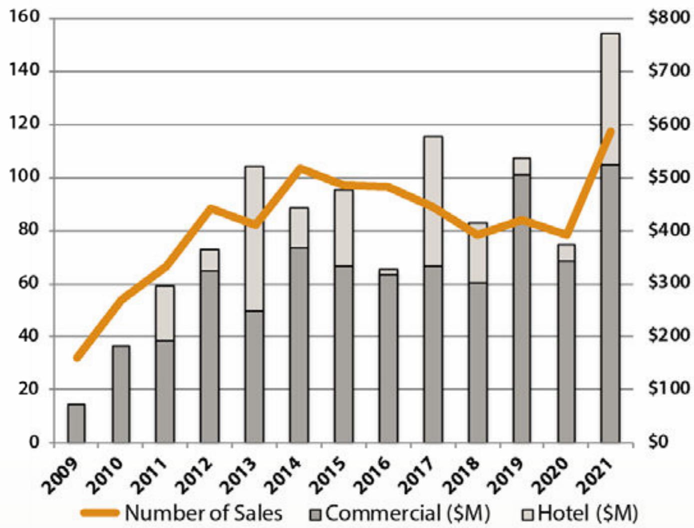
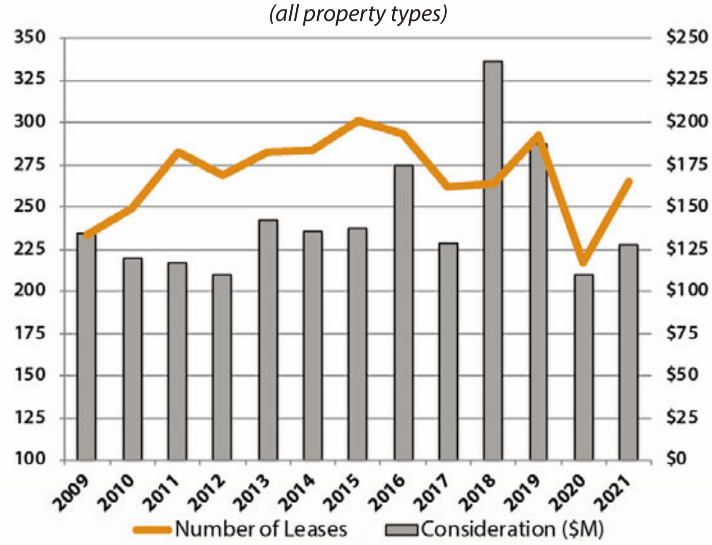
South Coast Sales



South Coast Leases

(all property types)



75-room Hotel Santa Barbara at 533 State St for $41.9 million, following Bill Foley's purchase of the Hotel Californian for $130 million in Q3. Completing a State Street hotel trifecta, the Hotel Indigo on the 100 block also sold in Q4 for $18.7 million. If you were considering scooping up a hotel at a bargain price while the hospitality industry is in recovery mode, these three hotels all traded for more than $1,000 per sf, not exactly "COVID-discount" pricing.

On the retail front, a local development team purchased most of La Cumbre Plaza—including the Macy's anchor building and surrounding parking areas—for $63 million.

The Santa Barbara Public Market and the adjacent building at 28 W Victoria St were purchased for over $10 million.

A month earlier, the Nordstrom building in Paseo Nuevo was purchased for $13 million by an investor. Both buyers will reportedly be pivoting the properties away from retail as the primary use, which echoes a pattern emerging in cities across the country. The La Cumbre Plaza buyers are planning a large residential redevelopment, while sources say the Nordstrom building will mainly be converted to office space. There were five retail property sales on State Street in downtown Santa Barbara, and four more within a block of State. One notable example is the Public Market at 38 W Victoria St, which was purchased by the local Winn-Twining family partnership, with Travis Twining looking to build on Marge Cafarelli's creation. When combined with the prominent hotel sales, this group of buyers represent new ownership blood willing to have a stake in downtown, despite the challenges facing that commercial zone.

Industrial property traded in record quantities of 26 sales valued at $74 million. In Q4, 1150 Mark Ave in Carpinteria was purchased for $6.3 million by Avantor/NuSil for its own use. For the year, 20 of the 26 industrial sales were owner-user buyers, including the Santa Barbara County Foodbank which bought a 78,000 sf facility at 80-82 Coromar Dr in Goleta, as well as a number of wealthy individuals who purchased small industrial properties in Santa Barbara for personal use (i.e. man-caves). Across all commercial property types, 47% of transactions were owner-user buyers, which is on par with the recent historical average. While owner-users made nearly half of the transactions, those sales only represented 16% of the total dollar volume.

Office property sales did not repeat the remarkable volume seen in 2020, and the $154 million transacted in 2021 was 11% below the prior 5-year average. In Q4, Apeel's 105,000 sf building at 71 S Los Carneros Rd in Goleta was purchased by an investor, which is the fourth time the property has sold in the past 20 years. It's a flex building rather than pure office, but it still fetched $344 per sf on the strength of the tenant. In downtown Santa Barbara, two large office buildings recently changed hands: the 14,000 sf building at 21 E Victoria St—leased to Green Hills Software—sold for $10.3 million, while the 19,600 sf building at 111 E Victoria St was purchased by an investor, with UCLA Health lined up to lease the entire building. Office investments traded at an average cap rate of about 5.5%, which is consistent with pricing prior to the pandemic.

A record 49 off-market sales were recorded in 2021, which reflects high-demand conditions. At the same time, the number of on-market sales also established a new high mark of 68 transactions, most of which closed in Q3 & Q4. Consequently, inventory for sale decreased 27% from midyear and ended 2021 at its lowest level in three years.

Turning ahead to 2022, there is evident and persistent baseline demand for commercial property from both owner-users and investors. The two factors with the greatest potential to limit deal flow in the coming year are lack of supply and rising interest rates. The pandemic could also hinder sales momentum if a super-variant emerges, but at this point the pandemic is not expected to be a major factor.

Concerning supply, the fourth quarter flurry of sales depleted inventory, leaving only 60 properties on the market, which may constrict deal flow somewhat in coming quarters. However, the last time inventory was this low was year-end 2018, and 2019 proved the be a record year for sales volume. In other words, the

Home to Apeel Sciences since 2017, the 105,000 sf flex building at 71 S Los Carneros Rd sold for $36.2 million.

number of properties being marketed for sale is an imperfect indicator of the number owners willing to sell. Nevertheless, given the sheer number of sales (both on- and off-market) in recent months, it may take a quarter or two for the supply of willing sellers to recover.

On the question of interest rate increases, the impact on demand will depend on how much the Fed raises rates to address inflation, and predictions as to the timing and size of increases vary substantially. Demand appears strong enough to endure incremental changes, whereas the "sticker shock" of larger rate hikes would likely sideline a segment of buyers. In any case, the prospect of rising rates may motivate buyers to compress their timelines in order to secure financing and complete their purchases while rates are still low.

OFFICE LEASING

South Coast office leasing has not shown convincing signs of recovery since the pandemic slowdown in 2020. The gross consideration of $68 million in 2021 was 26% below the prior 5-year average and only modestly higher than 2020. On the bright side, transactions increased 28% from 2020, and average achieved rent increased 4.5%. During the pandemic, demand has favored the higher quality, "class A" office space, while less improved space has been harder to lease. Landlords of vacant class B or C space face a tough decision whether to spend money on improvements or lower the asking rent.

Ontraport leased 23,760 sf at 2030 Alameda Padre Serra, thereby bringing all their employees under one roof at Riviera Business Park.

As the pandemic wanes, and the risk to most employees and their families decreases, it will be interesting to see what "new normal" emerges for office use. During 2021, most offices we encountered were not as densely occupied as before the pandemic, and many—particularly in the tech sector—were practically empty. Looking at the local data, during the pandemic there has been no significant change in the average size of office space leased or in the number of renewals. Anecdotally, there have been a lot of tenants signing renewals without changing their footprint, and yet there are also a significant number of tenants moving to smaller spaces, so the jury is still out on this question.

Santa Barbara

Santa Barbara's office leasing volume was close to pre-pandemic levels, posting 106 transactions totaling 343,000 sf. Six of the eight largest transactions by square footage were renewals. With many employees still working remotely due to the pandemic, most large tenants facing an end of term are opting to renew—sometimes while giving up or subleasing some of their space—rather than moving to a new property. Most recently, Well Health renewed 14,476 sf at 1025 Chapala St, and HUB International Insurance renewed 14,158 sf at 40 E Alamar Ave, both in December. Aside from renewals, there were plenty of small leases and very few large ones, as has been the case during the pandemic. This is partly due to tenants "right-sizing" to smaller spaces combined with a shortage of larger tenants looking for space in Santa Barbara. The year's most sizeable new signing came in Q4 as Ontraport secured 23,760 sf at 2030 Alameda Padre Serra. They had occupied suites in the complex for many years, spread across several buildings, and this move allowed them to consolidate all of their employees in one building. In another Q4 deal of note, Fluidstance leased 13,667 sf of creative office at 402 E Gutierrez St, the former RightScale building.

Santa Barbara's vacancy rate continues to flirt with double digits, ending the year at 9.6%, which represents a slight contraction from 10.8% at midyear, the highest vacancy rate on record. Inventory is showing some stagnation, as about half of the spaces for lease have been available for more than a year. Based on recent deals and current requirements we can anticipate decent demand for smaller spaces in the near future, especially as the Omicron variant recedes. Demand for large spaces is harder to foresee. The vacant upper two floors of the Ortega Building at Paseo Nuevo have attracted interest, but no leases have materialized yet. As previously mentioned, the new owner of the Nordstrom building at Paseo Nuevo is expected to market the majority of the building to large office tenants. When this happens, the vacancy rate could easily approach 12%, with a surplus of space in the 20,000-plus sf range and scarce demand from large office tenants to meet the supply. Setting aside these offerings at Paseo Nuevo, there is still 85% more space available in Santa Barbara than there was five years ago.

Microsoft renewed 7,035 sf at 5383 Hollister Ave, but there were only nine renewals in Goleta during 2021.

Majestic Asset Management completed 44,000 sf of leasing at 110-150 Castilian Dr, which it acquired in April 2021.

Goleta

Leasing velocity was limited in Goleta's office market during 2021, with gross absorption 5% lower than 2020 and 40% below the prior 5-year average. However, the tepid volume did not cause an expansion in available space. The vacancy rate was below 6% for the entirety of 2021 and finished the year at a record low of 5.2%. Achieved lease rates increased 7.5% compared to 2020, and have achieved nominal growth of 33% over the past 10 years. Taken together, the indicators reflect a market that is stable but in low gear.

There were only five transactions totaling 21,000 sf in Q4, including a renewal by Microsoft on 7,035 sf at 5383 Hollister Ave. Majestic Asset Management was Goleta's busiest landlord in 2021, signing 13 leases that comprised 65% of the total square footage leased. These included the year's two largest leases, signed by L3 Technologies and Asylum Research at 7414 & 7416 Hollister Ave, which are 40,400 sf and 38,400 sf buildings purchased by Majestic in 2020. Majestic also purchased the three-building campus at 110-150 Castilian Dr in April 2021, and has since signed deals there totaling 44,000 sf with CACI, AppFolio, Scalable Commerce, Serimmune, Mechanics Bank, and Odulair.

There are eight spaces available larger than 10,000 sf, five of which have been on the market for more than a year. The two largest spaces are 38,000 sf at 326 Bollay Dr vacated by Inogen and 31,500 sf at 6310 Hollister Ave vacated by Asylum Research. Finding tenants for the larger vacancies continues to be challenging, though demand for smaller space remains relatively stable.

Carpinteria

Carpinteria's vacancy rate contracted significantly from a relatively high 7.4% at the beginning of the year to 3.5% at year-end. Leasing momentum petered out in Q4, but there were 10 leases for the year, which is on par with the pre-pandemic average. However most of the leases were for smaller spaces and all but two had terms of 36 months or less. As a result, gross consideration was very modest at $1.2 million, second only to 2020 as the lowest annual total on record. Five spaces have come to market in the past few months, including two suites totaling 7,615 sf at 1145 Eugenia Place, in addition to 3,370 sf at the former Big Yellow House (108 Pierpont Ave) in Summerland, which is back on the market after a three-month pause.

RETAIL LEASING

In many ways it was a year of economic recovery for the local retail sector. Taxable retail sales on the South Coast rebounded to 2019 levels, according to midyear reporting by California Economic Forecast, while hospitality indicators show a huge rebound in tourism. At the same time, 2021 proved to be another challenging year for many South Coast restaurants and retailers, with coronavirus surges undercutting shopping and dining traffic at local businesses. "The Restaurant Guy" on santabarbara.com reports that 2021 brought the fewest new restaurant openings in a year (30) since he began tracking 15 years ago, but also—surprisingly—the fewest closings (26). By his count there are 32 food and beverage locations already projected to open in 2022. That level of investment reflects an expectation that this year will bring strong consumer spending at restaurants, and presumably, brick-and-mortar retail and entertainment as well.

While preparing this report, news broke that the 142,000 sf former Sears building at 3845 State St has been leased on a 10-year term by a local retail tenant and will reportedly become a mix of furniture and general consignment, antiques, and maybe more. Coming on the heels the purchase of most of La Cumbre Plaza by a developer, the

The former Sears building at La Cumbre Plaza will was leased by a local retailer.

speculation that the Sears property might be redeveloped as residential has been supplanted by a scenario where a large residential development replaces the north side of the mall, while the south end where Sears was remains retail for the time being. In any case, this lease brings the Santa Barbara vacancy rate back down to a more typical level, around 3.3%.

In addition to the big news at La Cumbre Plaza, 2021 produced nine retail leases on upper State totaling 18,000 sf. For instance, a local restaurateur leased the former Dunkin Donuts at 3771 State to try a taco concept. And Cottage Clinics leased 2,500 sf in the Marc complex at 3885 State for a walk-in clinic. Not including space in La Cumbre Plaza, there are six spaces totaling 14,400 sf available in the upper State neighborhood.

Turning to downtown, it was a very slow leasing year for the State Street corridor, with only eight leases signed, the lowest tally in at least 10 years. The most notable deals were on the 700 block, where a local team signed a long-term lease at 700 State to become Augie's Tequila, and the national apparel company Athleta leased the former Miniso storefront at 733 State. Nearby, after Starbucks departed 800 State, landlord Michael Sheldon took matters into his own hands and will open Belching Dragon Tavern in the space shortly. The lone Q4 lease was 1309 State, signed by Maune Contemporary Gallery, which is already open for business. Despite the low leasing volume, the storefront vacancy rate has decreased from a peak of 18.0% during the depths of the pandemic to 14.3% at year-end.

State Street has officially hit the grim milestone of five consecutive years of storefront vacancy over 10%. By comparison, the 2008 recession triggered less than two years of double-digit vacancy during 2009-2010. The root causes of the current blight—including online commerce and shifts in consumer behavior, the rise of the Funk Zone, homelessness, and the pandemic—have been discussed at length. A decade ago, the recession caused several tenants to leave, and many tenants that replaced them were lower-price point chains, such as Marshall's, H&M, and the 99 Cent Store. In the current high-vacancy cycle, and especially during the pandemic, there appear to be more local entrepreneurs trying concepts on State Street, which is encouraging and has the potential to help the district evolve and attract locals again. The makeshift promenade lined with parklets, combined with a critical mass of homegrown restaurant and retail businesses, are promising ingredients to help bring about a revitalization of State Street. Other components will be needed, along with effective leadership to guide the process, and soon, but there is evident courage and creativity happening on the business side that should be welcomed and supported.

In Goleta, 20 transactions totaling 76,385 sf were proof of one of the most active leasing years the city has seen. Planet Fitness leased the 21,372 sf anchor space


Maune Contemporary Art leased the ground floor of 1309 State St. The upper level has been converted to a residence.

Planet Fitness is scheduled to open in March after leasing the former Pacific Sales space at The Plaza center in Goleta.

in the Albertsons center at 7127 Hollister Ave. If you are having déjà vu, Planet Fitness leased the same space in 2020 but never moved in and ultimately terminated that lease. This time it appears they will actually open for business in March. In another Q4 deal, Goodland BBQ leased the 2,655 sf building at 5725 Hollister Ave in Old Town. Vacancy decreased to 1.9%, the lowest rate since 2015. Aside from Magnolia Center, which still has about 18,000 sf available, the rest of Goleta's centers are not contending with significant vacancies.

INDUSTRIAL LEASING

Goleta's industrial market established new highs for gross absorption (260,000 sf) and consideration ($18.8 million) in 2021, including nine leases larger than 10,000 sf. Four transactions totaling 47,000 sf at 30 S La Patera Ln, including a renewal by Microdyn and new leases by OSI Hardware, Lemonkind, and Jordano's, were all signed in Q4. There is 19,500 sf still available there of the 102,000 sf made available after Skate One departed. Another notable Q4 deal was Sonatech's renewal of 40,000 sf at 879 Ward Dr. The year's largest transaction was 47,000 sf at 7418 Hollister Ave, signed by Deployable Space Systems. Two sizeable spaces were brought to market in Q4: 26,875 sf at 26 Castilian Dr and 23,150 sf at 147-149 Castilian Dr. Even with these new additions to inventory, available space contracted 51% year-over-year, and the year-end vacancy rate of 2.8% is the lowest since 2016.

In addition to seeing heavy sales activity, Santa Barbara's industrial leasing market was relatively active in 2021 as well. The gross absorption of 88,000 sf was the highest total in four years, and contributed to a 57% year-over-year contraction of available space. Just a handful of spaces are available, the largest being 15,674 sf at 4183 State St. There were only three leases in Q4, including 8,617 sf at 4179 State St leased by Kopu Water Company and 4,000 sf at 614 Santa Barbara St leased by the Varela Company. With an industrial vacancy rate of 0.6%, Santa Barbara is back in its familiar state of undersupply. However, lease rates have remained stable, and the 2021 average gross rate was $1.81 per sf.

Carpinteria's contraction to sub-2% industrial vacancy at midyear proved short-lived. There were a handful of leases in the early months of the year, including the 19,400 sf lease at 1015 Cindy Ln by Dakar. The remaining transactions of size were renewals, including ZBE, Inc's renewal of 18,700 sf at 1035 Cindy Ln in Q3. Vacancy grew as two substantial offerings emerged late in the year: Procore brought the 24,030 sf building at 6384 Via Real to market for sublease, and 14,500 sf was listed for direct lease at 1025 Cindy Ln, which had been occupied by an event rentals business. All told, the year-end vacancy rate was 3.7%, which is lower than 2020, but still relatively high compared to the historical trend.

Four Q4 leases absorbed 47,000 sf of the former Powell/Skate One space at 30 S La Patera Ln in Goleta.

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LEASING MARKET DATA

Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE								
Santa Barbara	**9.39%**	+12%	**106**	+31%	**343,180**	+13%	**$2.99**	+3%
Goleta	**5.23%**	-20%	**31**	+0%	**257,562**	-5%	**$2.10**	+8%
Carpinteria	**7.45%**	-53%	**10**	+233%	**30,460**	+301%	**$1.84**	-4%
RETAIL								
Santa Barbara	**4.80%**	+26%	**47**	+27%	**93,717**	-8%	**$3.78**	+19%
Goleta	**1.92%**	-24%	**20**	+150%	**76,385**	+51%	**$3.00**	+37%
Carpinteria	**6.65%**	+1%	**2**	-33%	**3,041**	-91%	**$2.14**	-13%
INDUSTRIAL								
Santa Barbara	**0.65%**	-57%	**17**	-11%	**88,754**	+35%	**$1.81**	-14%
Goleta	**2.84%**	-51%	**25**	-17%	**260,013**	+22%	**$1.64**	+5%
Carpinteria	**5.31%**	-31%	**7**	+40%	**78,749**	+188%	**$1.17**	-1%

Change percentages are compared to 2020 values.