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2022**Q2** Market Report

South Coast Commercial Real Estate

HIGHLIGHTS

- Record year-to-date sales volume continued the trend from late 2021, led by a pronounced return of investors.
- The heavy sales activity spanned all property types (except commercial land) and locations throughout the South Coast.
- Leasing activity, in general, was on par with recent historical averages, though gross absorption varied considerably by location and property type.
- Office leasing to date was much more active in Santa Barbara than in the neighboring cities; however, Santa Barbara office remains in oversupply.
- Three large tech firms now offering creative office spaces for sublease are likely a bellwether for future increase of office vacancy.

COMMERCIAL SALES – Boom Times

South Coast sales volume at midyear was tremendous: 69 commercial transactions and $386 million in value (excluding hotels). These are by far the highest midyear totals we have witnessed, as transactions and dollar volume increased 99% and 182% compared to prior 5-year averages. Aside from land sales, which have been limited to date, the surge in sales volume was distributed across all property types and in all locations. Combined with record volume during the second half of last year, the activity through midyear of 2022 completes a red-hot 12 months of sales that is unlikely to be surpassed for a very long time.

The biggest transaction year-to-date was the sale of the 29-acre hilltop office/R&D campus on Innovation Place above Summerland which has been owned and occupied by QAD for decades. The property was purchased by UC Investments (University of California's investment division) for $104 million. It is the highest sale price on record for a South Coast commercial (non-hotel) property.

As we observed in our last report, both investor and owner-user purchases have been on the rise, but investor activity has grown at a higher rate. Investor sales dropped into cyclical lull back in 2018, which lasted through the first year of the coronavirus pandemic until mid-2021. Since then, a rapid rebound produced 83 investor sales, the most we have seen in any 12-month period. The causes of the shift in investor demand are complex, but clearly the economic fog and stock market volatility of the past two years has elevated the relative appeal of commercial real estate with a stable return. At the same time, investors looking for "value-add" projects have found more sellers willing to part with underperforming properties in a time of economic uncertainty.

During Q2, investors purchased two high-value properties with a blend of retail and office space. One was

UC Investments purchased 100-101 Innovation Pl, perched between Summerland and Montecito. The buildings total 123,000 SF.

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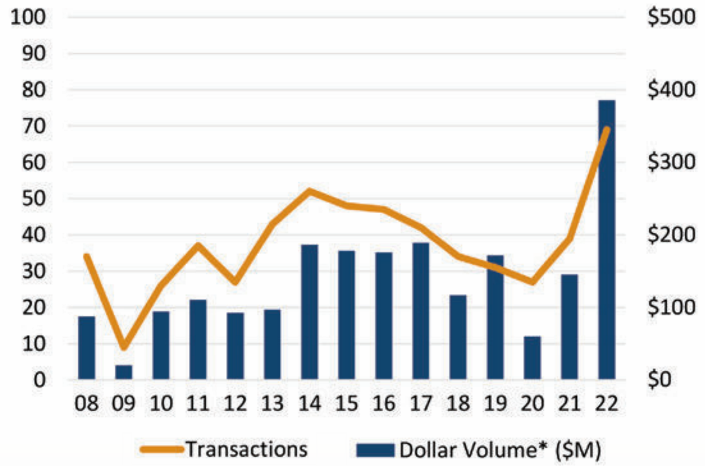
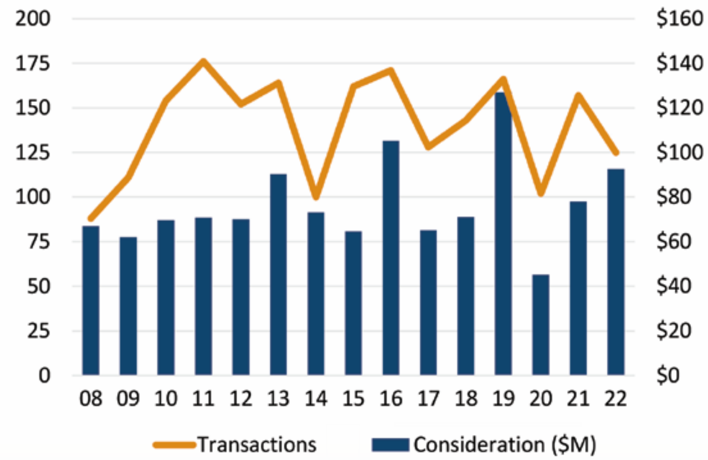
South Coast SALES at Midyear
(all property types)



*Excluding hotel property

South Coast LEASES at Midyear
(all property types)



the unique "Las Aves" property at 1801 E Cabrillo Blvd, purchased off-market for $19.2 million. The other, 1221 Coast Village Rd & 1224 Coast Village Circle in Montecito, was purchased for $17.2 million. Investors also acquired two substantial Goleta office buildings, starting with 6500 Hollister Ave, a 74,000 SF building purchased off-market for $21 million. Next came the sale of 50 Castilian Dr for $13.9 million, one of three buildings leased by AppFolio for its Goleta headquarters. The remaining two buildings at the AppFolio campus—70 and 90 Castilian Dr—are also for sale.

Hospitality property sales volume over the past 12 months totals $350 million on 13 transactions, quite a boost compared to the prior 5-year averages of $86 million and 3 sales annually. In Q2, the Waterman Hotel at 12 E Montecito St sold for $14.6 million, or $472,500 per room. This sale, following the sales of the Hotel Californian and Hotel Indigo last year, has brought extensive turnover to lower State Street's hospitality corridor, and at prices suggesting the new owners' optimism for tourism in the Funk Zone & waterfront area. After obtaining entitlements for a boutique hotel at the entrance to Paseo Nuevo, the ownership of 801 State St has decided to sell rather than proceed with the redevelopment and are offering the property for $6.8 million. G6 Hospitality is liquidating batches of the 1,400 motel properties it controls nation-wide, which resulted in three sales of Motel 6 properties on the South Coast in Q2: 443 Corona Del Mar Dr in Santa Barbara, and 5550 Carpinteria Ave and 4200 Via Real in Carpinteria.

Retail property sales have also shown a great upswing in momentum with 20 sales at midyear, a 144% increase over the prior 5-year average. In Q2, the Paxti's Pizza building at 515 State St was purchased by an investor for $4.9 million, which was above the asking price. Two retail buildings also changed hands on the 1000 block of State Street in Q2: the existing Turkish Coffee tenant purchased 1019 State as an owner-user, and an investor purchased the vacant restaurant building at 1027 State. In another example of downtown retail space being repurposed for office, 127 W Canon Perdido St (previously occupied by a dry cleaner and a gym) was purchased by 19six Architects for its own use.

There were eight industrial transactions in Q2, including the 12,700 SF building at 201 W Montecito St (aka the Hangar), purchased by RAF Pacifica for $8.9 million, and the 39,125 SF building at 6382 Rose Ln in Carpinteria, purchased by an investor for $8 million. Inventory remains slim with only four properties available, three of which came to market in Q2, the most recent being the 41-unit self-storage property at 2165 Ortega Hill Rd in Summerland listed for $3.8 million.

Commercial land was the only property type to show a lull, with just three transactions to date, all completed in

Q1. Most notable of these was 5.7 acres at 7780 Hollister Ave in Goleta purchased by Goleta Self Storage LLC for $5.0 million.

Will the boom continue? Q2 surpassed all expectations for sales activity, and historically ranks second only to Q4 of 2021 for sheer volume in a single quarter. Looking ahead, evidence of strong demand from buyers persists. This could easily change if the economy appears headed for a prolonged recession, or the Fed continues to make frequent, large interest rate hikes to curtail inflation, either of which could make buyers more cautious or impede their path to financing. On the other side, there is also ample supply of sellers. One indication of this was the surprising recovery of inventory during Q2. There were 23 on-market sales during Q2, a lot for our market, and yet during the quarter the number of properties for sale grew by 37%. In other words, a lot of property has been coming to market. On top of that, 17 off-market sales closed in Q2, demonstrating an additional cohort of owners willing to sell. Given relatively high levels of both supply and demand, strong sales activity could easily proceed through the balance of the year, and if the seasonal pattern of recent years holds, Q4 could bring another crescendo of transactions.

OFFICE LEASING

The Future of the (Creative) Office

The rise in remote work triggered by the pandemic is having an increasing impact on South Coast office leasing. A significant proportion of South Coast office is "creative" space leased by tech and bioscience tenants, whose employees tend to be younger and comfortable working almost anywhere they can open a laptop. Since the pandemic began, these companies have found a lot of their employees prefer primarily working remotely, regardless of health considerations, and the preference is not temporary. If remote work becomes a durable norm in tech culture, it will obviously have major implications for the use and occupancy of office space in our market.

Our impression is that most tech offices on the South Coast continue to have a small fraction of employees working in them, compared to before the pandemic. The offices of LinkedIn, Amazon, Yardi, Sonos, and Honey are reported to be far below capacity. Three tech companies have taken steps this year to reduce facilities expenses as they incorporate remote work into their operations: AppFolio, Procore, and Invoca have offered 132,000 SF combined for sublease. As companies downsize, the space they retain is increasingly configured for meetings and in-person collaboration, rather than clusters of workstations and private offices.

Bartlett, Pringle & Wolf signed a renewal at 1123 Chapala St in Santa Barbara, securing 15,503 SF for 10 years.

It seems inevitable this trend and its effects will outlive the pandemic and continue to ripple increased vacancy through our market. However, it's too soon to predict the permanent demise of tech office space. There could be a reversal down the road, driven by various potential economic or cultural factors. For example, when unemployment increases tech employees may have less leverage to decide where they work. Also, this shift is not uniform across all tech tenants, and companies such as LogicMonitor and ShipHawk have signed lease renewals this year. In addition, the South Coast's 150-plus businesses with government contracts are more likely to expect employees to work onsite due to security requirements. Lastly, remote work is not as prevalent across other industries beyond tech. While there have been some requirements lately from traditional office tenants looking to downsize, in our experience, most professional services tenants—including legal, finance, engineering, and real estate—are essentially back in their offices.

Santa Barbara

A year ago, Santa Barbara's office inventory reached a historical peak of 10.8% vacancy and 104 spaces on the market. During the past 12 months, available space has contracted by 11% and the number of available spaces has decreased 25%, which are welcome signs toward stabilizing supply. On the other hand, the current vacancy rate of 9.6% is extremely high for Santa Barbara, and does not include up to 150,000 SF of conceptual office space in the former Nordstrom building, which is currently being marketed quietly for occupancy in a few years. Meanwhile, the Ortega Building (formerly Macy's) has not yet attracted office tenants for its planned office conversion. Furthermore, Invoca is offering for sublease the entire 27,700 SF building at 419 State St. So, while the recent activity and net absorption of space is encouraging, Santa Barbara is still in a period of oversupply, especially in regard to larger spaces.

On the bright side, leasing activity in Santa Barbara was robust in Q2. The majority of larger signings were renewals, resulting in a modest net absorption of vacancy. Bartlett, Pringle & Wolf renewed 15,500 SF at 1123 Chapala St for 10 years, and Hawk Applications (ShipHawk) signed a renewal/expansion totaling 12,320 SF at 925 De La Vina St. Aside from renewals, the largest lease was American Riviera Bank's 9,990 SF lease at 3780 State St, to provide more space for administrative offices. Achieved rents have stepped up a notch to date this year, averaging $3.20 gross per SF, a 7% increase compared to 2021.

Goleta

Office leasing activity in Goleta was light in Q1 and even lighter in Q2. Gross absorption at midyear was less than 70,000 SF, the lowest 6-month total in at least 10 years. In Q2, Jordano's leased 9,736 SF at 5425 Hollister Ave, and SoftAcuity subleased 5,745 SF at 5540 Ekwill St. Despite sparse leasing, the midyear vacancy rate of 5.2% remained near the historical low end. However, in early Q3 AppFolio offered two buildings for long-term sublease, adding 79,600 SF of availability to the market, and Goleta vacancy is almost certain to drift upward in the near term.

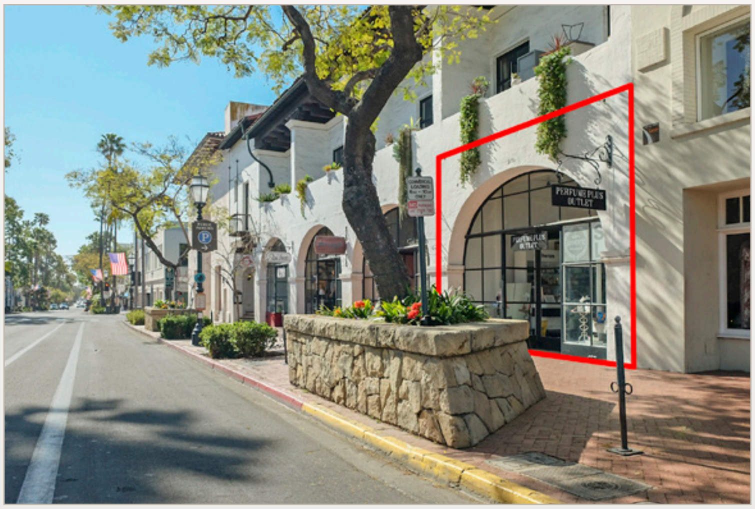
Carpinteria

Five spaces totaling 42,000 SF of available space have come to market during the past two quarters, helping push the vacancy rate from 3.5% at the beginning of the year to 9.7%. (Swings of this magnitude are fairly common in Carpinteria, given it's the smallest submarket on the South Coast.) This rate does not include 82,750 SF now being marketed at 6380 Via Real, which will be new construction by RAF Pacifica for delivery at the end of 2024. There has only been one lease to date: Lionel University signed 3,467 SF at 1013 Mark Ave in Q2. Tenant requirements in Carpinteria continue to be limited, and vacancy is likely to remain relatively high in the near future.

RETAIL LEASING

South Coast retail vacancy exceeded 4% throughout 2021, a record-high level. As of midyear, the vacancy rate had contracted to 3.4%, which is still relatively high but marks a return to the pre-pandemic level. La Cumbre Plaza and Paseo Nuevo are still grappling with multiple vacancies, while grocery-anchored centers and Goleta's "big box" properties are retaining more stable tenancy.

In Santa Barbara, Q2 was marked by ample transactions that tended to be smaller spaces. Alpha Thrift leased the 6,000 SF former Sears Auto building at 3845 State St to use for donations and sorting. The 70,000 SF upper floor of the main building is still for lease. In the Funk Zone, the former paint store at 132 E Montecito St was leased, reportedly by an electric bike retailer.



Tamsen Gallery leased the storefront at 911.5 State St, a block that continues to have more than its share of vacancies..

State Street's retail storefront vacancy on the 400 to 1300 blocks decreased from 14.7% in Q1 to 12.9% at midyear. There have been five State Street leases to date in 2022, which is more than we have seen in recent years. In notable deals from Q2, Vuori leased the former Wendy Foster space at 833 State St, and Tamsen Gallery leased 911.5 State St. Despite the latter, the 900 block continues to struggle, with seven spaces currently available. (By comparison that is more available spaces than Coast Village Road, the Funk Zone, the Waterfront, and Milpas Street combined.)

While the number of vacant spaces on State Street has decreased, there remains a surplus of large spaces on the corridor, including former Macy's, Forever 21, Staples, Rite Aid, and most recently, the former Samy's Camera space at 530 State St came back on the market, adding another 11,450 SF to the inventory. In terms of square footage, the vacancy rate on the State Street corridor is 18.7%.

At the recommendation of an advisory committee, the City Council recently voted to hire another consultant to study State Street and provide recommendations. In practice, that means any measures taken by the City will be piecemeal for a few more years until the consultant presents findings, and most would agree the challenges facing downtown are beyond the reach of piecemeal initiatives. Meanwhile several factors—including rebounding tourism, ongoing efforts by local entrepreneurs, the arrival of a few national brands like Vuori and Havianas, plus busier pedestrian and bike traffic—have combined to give State Street a bit more pep lately.

In Goleta, vacancy remains very low at 1.9%, following plentiful leasing during Q1. The lone Q2 lease was F45 Training's signing of 3,762 SF in Magnolia Shopping Center. Isla Vista has more vacancy than usual with five available spaces totaling 10,300 SF, and that's after the Farmacy subleased 6555 Pardall Rd in Q2.

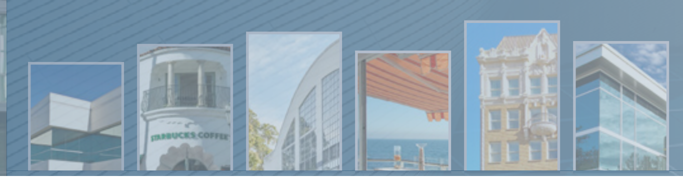
INDUSTRIAL LEASING

Q2 was relatively active in Santa Barbara, where 6 transactions totaled 31,450 SF. In the largest Santa Barbara industrial lease in eight years, Katz-Moses Tools leased 15,674 SF at 4183 State St. Katz-Moses simultaneously subleased 5,000 SF of that space was to Spracher Engineering. A few doors down, American Indian Health & Services leased 4,216 SF of warehouse space at 4129 State St. Five new spaces came to market so far in 2022, but the vacancy rate remains very low at 0.6%. The existing inventory is on East Haley Street and various Eastside locations, with asking prices ranging widely from $1.75 to $4.63 gross per SF.

At midyear, Goleta had seen fewer transactions than usual, but a few large transactions resulted in above-average gross absorption. Most recently, Curvature leased 49,276 SF of shell space at 7418 Hollister Ave, part of the former LogMeIn campus purchased vacant by Majestic Asset Management in 2020. Vacancy has increased since the beginning of the year to a rate of 3.8%. Recently added spaces include 24,000 SF of warehouse at 80 Coromar Dr (a portion of the building recently purchased by the FoodBank), and a 7,900 SF warehouse/R&D suite at 320 Storke Rd.

Carpinteria had four industrial leases at midyear, including just one small space leases in Q2: 1,980 SF at 1020 Cindy Ln signed by Hall Contracting Corp. The largest current availability is the 28,800 SF warehouse building at 6385 Cindy Ln, previously leased by Procore, which hit the market in Q2. The other large available space is a 24,000 SF shell condition warehouse at 6384 Via Real, for sublease from Procore. As with the current office vacancy in Carpinteria, it will likely take time to find tenants for these buildings.

4183 State St is fully leased after Katz-Moses Tools signed 15,674 SF with 5,000 SF sublessee Spracher Engineering in tow.



LEASING MARKET DATA

Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE								
Santa Barbara	**9.57%**	+2%	**59**	+11%	**216,341**	+26%	**$3.20**	+7%
Goleta	**5.15%**	-2%	**12**	-23%	**69,753**	-46%	**$2.06**	-2%
Carpinteria	**3.47%**	+178%	**1**	-80%	**3,467**	-77%	**$1.75**	-5%
RETAIL								
Santa Barbara	**3.93%**	-18%	**24**	+2%	**138,934**	+196%	**$3.54**	-6%
Goleta	**1.92%**	+0%	**8**	-20%	**13,094**	-66%	**$3.77**	+26%
Carpinteria	**6.70%**	-11%	**1**	+0%	**1,994**	+31%	**$4.01**	+87%
INDUSTRIAL								
Santa Barbara	**0.61%**	-6%	**8**	-6%	**40,665**	-8%	**$2.19**	+21%
Goleta	**3.78%**	+36%	**8**	-36%	**171,919**	+32%	**$1.81**	+10%
Carpinteria	**3.65%**	+33%	**4**	+14%	**24,580**	-38%	**$1.38**	+18%

Change percentages are compared to 2021 values, annualized where appropriate.