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2022Q3 Market Report
South Coast Commercial Real Estate

HIGHLIGHTS

- Commercial sales activity decelerated in Q3, but is still on pace for record transactions and dollar volume for the year.
- Rising interest rates, along with other economic factors, are complicating underwriting and increasing pricing friction in the sales market.
- As office tenants grapple with remote work, inventory has been expanding, met by modest demand and leasing activity. Gross absorption is down 36% compared to the 5-year average.
- Retail leasing has kept pace with recent historical levels, and average rents have seen a modest increase.
- Strong industrial leasing has produced YTD dollar consideration twice the prior 5-year average.

A local investor purchased the 8.6-acre Riviera Park campus, which features 92,000 SF of commercial space.

COMMERCIAL SALES – Throttling Down

Following record-breaking commercial sales production in Q2, deal volume returned to more typical levels in Q3, as interest rate hikes began to create pricing friction in the South Coast market. Nevertheless, 2022 is already a banner year for sales. The 92 transactions completed through three quarters is the largest year-to-date count on record. And dollar volume to date (excluding hotels) was a staggering $484 million, more than twice the prior 5-year average.

Office, retail and industrial property sales to date have all doubled their 5-year average dollar volumes, but industrial property stands out with $99 million in transaciton value, an unprecedented total. While most of the larger deals closed earlier in the year, during Q3 a hotel developer purchased 926 Hutash St, a 12,000 SF building on 0.9 acre just off Milpas Street, for $7.4 million. In addition, a self-storage property at 2165 Ortega Hill Rd in Summerland was purchased by an investor for $4.3 million.

As an interesting side note, Q3 South Coast industrial sales averaged $547 per building SF, while office property sales averaged $526 per SF. This is an anomaly based on one quarter's transactions, which included exceptional prices for a few industrial properties. Office property still trades for at least $100 per SF above industrial. However, remote work is an unmistakable trend, and the resulting decrease in demand for office space will impact the value of many South Coast office properties. The duration and extent of the remote work phenomenon remains a matter of debate, but potential office property buyers are weighing risk to a degree we haven't seen before.

Having said that, the largest sale of Q3 was an office property, the Riviera Park at 2020-2064 Alameda Padre Serra in Santa Barbara, purchased off-market by a local investor for $27 million. The historic campus comprises 92,000 SF of mostly office space on 8.6 acres and had been

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part of the Michael Towbes portfolio for decades. Another historic office property, the 17,000 SF building at 12-14 E Carrillo St in downtown Santa Barbara, was purchased in Q3 by an investor for $5.0 million. Medical offices near Santa Barbara Cottage Hospital have become a premium commodity, which over the past two years have fetched $930 per SF on average. Most recently, the 4,100 SF building at 2416 Castillo St was purchased by an owner-user for $3.9 million.

On the retail front, there were three medium-sized sales to note in Q3. The 8,100 SF Big Brand Tire building at 225 S Milpas St in Santa Barbara was purchased by an investor for $5.9 million (5.1% cap rate). The 7,300 SF Rite Aid building at 801 Linden Ave in Carpinteria traded for $4.8 million (4.5% cap rate). And the 7,000 SF Mission Laundry building at 1911 De La Vina St was purchased by an investor for $3.7 million. The Whole Foods building on upper State Street is back on the market for $67.5 million, which is a 54% markup from the price the sellers paid at the end of 2019.

Commercial land is the one property type that has lagged behind the historic sales trend so far this year, resulting in only 6 sales to date. In a notable Q3 deal, S&S Seeds in Carpinteria bought 6175 Carpinteria Ave, an undeveloped blufftop parcel next to the existing S&S Seeds building, for $4.8 million.

Hospitality property has also been a popular asset type this year with eight transactions to date. Three of these were Motel 6 properties, as the parent holding company G6 Hospitality liquidates locations. Most recently, the Blue Sands Inn at 421 S Milpas St sold for $6.0 million.

Investor acquisitions continue to lead the market, representing 68% of transactions and 88% of dollar volume to date, while owner-user purchases have become less prevalent. One intriguing owner-user sale in Q3 was the retail & restaurant building at 730 State St, purchased by a regional hostel business.

Approaching the end of 2022, signs of a hot market throttling down are evident, including growing inventory, fewer offers from buyers, more price reductions, and more negotiations during escrow. The inventory of properties for sale has expanded 72% during the past two quarters and is nearing the historic high. Off-market transactions dipped nearly 40% in Q3, compared to the prior 12-month average, which likely reflects both softening demand and increasing inventory.

There has been a lot of economic news to digest this year, including stark inflation and bearish stock markets, but the primary factor hindering sales activity is rising interest rates, which have profoundly diminished the purchasing power of leverage buyers over the past six months. Sellers will need to adapt to new financing realities, hold out for a cash buyer, or postpone selling until the market works through this phase of the cycle. In the near term, the gap between sellers' expectations and the current pricing environment is likely to cause a substantial decrease in sales activity for the rest of the year and likely well into 2023. On top of that, uncertain tenant demand for office (especially tech office) and retail (especially destination retail) will create additional pricing stress for sales of those property types. There are still plenty of sellers and buyers in the market, and the current friction in pricing expectations will resolve to new benchmarks, but it may take a few more quarters for the market to stabilize. Meanwhile, the present conditions favor 1031 Exchange and all-cash buyers who are less impacted by interest rates.

OFFICE LEASING

South Coast office vacancy (with sublease space factored in) is 8.8%, its highest level since 2011, as the ripple effects of remote work continue to undercut demand for physical office space. The growing list of tenants taking steps to reduce their physical footprint includes AppFolio, Invoca, Yardi, Procore, Bragg Live Food, Lull, Carpe Data, Apeel Science, FastSpring, Evidation Health, and Vitamin Angels. However, achieved rents have not shown a significant correction so far, and in fact have increased 8% year to date.

Goleta has seen very limited office leasing volume this year, resulting in the lowest Q3 year-to-date gross absorption in at least 15 years. Transactions are 32% below the 5-year average, and the average lease size is under 5,000 SF for the first time on record. In the largest lease of Q3, Santa Barbara Imaging Systems renewed 11,268 SF

Mixmode has subleased 6,150 SF at 111 W Micheltorena St from Bragg Live Food Products.

at 340 Storke Rd. Serimmune also signed a Q3 renewal, retaining 6,471 SF at 150 Castilian Dr. Goleta's vacancy rate has been on the rise since hitting a historic low of 4.9% in Q1, and reached 7.1% at the end of Q3. The entire 46,400 SF building at 6750 Navigator Way in Cabrillo Business Park is available for lease (or sale). Two buildings totaling nearly 80,000 SF at 50 and 90 Castilian Dr are up for sublease, as is the 23,000 SF building at 425 Pine Ave. The 17,750 SF second floor of 859 Ward Dr is also for lease. Virtually all the space listed above has come to the market this year. Based on current requirements in the market, demand has waned for pure office spaces, while office/R&D spaces with a lab component are attracting more attention. Given current market conditions, the trend of rising vacancy and below-average leasing activity is likely to persist into 2023.

In Santa Barbara, the strong leasing momentum through midyear did not carry into Q3, which saw a modest volume of 20 transactions totaling 52,000 SF. Of these, the most notable were H2 Clipper's lease of 7,600 SF at 1101 Anacapa St and Davinci Energy & Power's signing of 6,360 SF on the third floor of 820 State St. There were also some Q3 renewals, including 5,935 SF at 924 Chapala St by Hidden City Studios and 5,290 SF at 801 Garden St by FastSpring. Mixmode subleased two suites totaling 6,150 SF at 111 W Micheltorena St from Bragg Live Food Products. The number of available spaces grew by 18% during Q3, and vacancy continues to float around 9%, not including the planned office conversion of the 165,000 SF former Nordstrom building, which is not yet being publicly marketed, though demolition is underway. Although Invoca is offering its entire 27,774 SF building at 419 State St for sublease, Santa Barbara's current sublease inventory—nine spaces totaling 59,000 SF—is almost exactly the same as the sublease inventory at the end of 2019. With many office tenants reportedly seeking to reduce their premises, it will be interesting to see if the sublease inventory increases in coming quarters.

Available space in Carpinteria has more than tripled since the beginning of the year to a rate of 16.7%. Procore recently added the first floor of 6267 Carpinteria Ave for sublease, thereby making the entire 50,000 SF building available. In addition, AGIA decided not to renew its lease at 1155 Eugenia Pl, which added an 18,000 SF class A office building to the market. Given the scarcity of large office requirements in the market, vacancy is likely to remain elevated for the foreseeable future. There have only been two lease transactions to date, well below typical volume in Carpinteria. The lone Q3 lease was 5,589 SF at 1180 Eugenia Pl signed by Channel Islands YMCA.

RETAIL LEASING

South Coast retail inventory for lease is near the higher end of the historical spectrum, with 89 spaces available and a vacancy rate of 3.5%. Leasing velocity has been on par with the recent trend, and average achieved rents have increased 8% compared to the prior 5-year average. Fitness and activity businesses have figured prominently in the leasing, as many locals shift from home-based workouts during the pandemic back to brick-and-mortar gyms.

Santa Barbara's retail vacancy rate is 4.0% with 35 lease transactions to date, which is consistent with the prior 5-year average. Among the leases signed in Q3, a martial arts gym leased 5,000 SF at 122 E Gutierrez St. On the downtown State Street corridor, the former Wine Therapy space at 732 State St was leased by Longoria Winery, 2,500 SF at 1021 State was leased by O' My Sole, and the Axe Club leased 427 State. One of State Street's longstanding tenants, the Relaxing Station, renewed its 2,400 SF storefront at 521 State.

This renewal presents a case study of State Street rents over time. Back in 2008, at the peak of State Street retail and five months before the stock market crash, 521 State was leased by Retroville. At the time, storefront vacancy was 6.1%. Retroville ran its course, and four years later the space was leased by the Relaxing Station in 2012, which has occupied the space since. The tenant just renewed at market value in July 2022. Adjusted for inflation, the 2022 rent was 31% lower than ten years ago when they first leased the space, and 56% lower than Retroville's 2008 rent. In other words, the current market rent for this storefront is less than half of what it rented for 14 years ago. This example is indicative of the pricing trend that has allowed local retailers and restaurateurs to afford space on State Street; however, it has come at the expense of State Street property owners.

Storefront vacancy for 400-1300 blocks of State Street has been lodged between 13% and 15% for nearly two years, while vacancy on the central 600-1000 blocks has hovered around 20%. The 500 block continues to be a relatively popular stretch of the corridor, especially for beverage and food establishments. Nevertheless, after 30 years the Natural Café has decided to close their location at 508 State St next spring. The new Drift hotel and restaurant in the former Scientology building at 524 State is scheduled to open in December and should bring additional traffic.

Goleta's retail vacancy rate is 1.9%, remarkably low compared to the national rate of 10.3%. A steady deal flow has produced 13 transactions to date, though they have tended to be smaller spaces, resulting in a 55% dip

The Pad Climbing gym plans to "raise the roof" for a 35' wall in one of its two spaces in Magnolia Center at 5110-5198 Hollister Ave.

in gross absorption of space compared to the prior 5-year average. Recent leasing has helped to tighten up vacancy in several grocery-anchored centers. Most recently, at Magnolia Shopping Center a climbing gym called The Pad leased two spaces, one of which will have its roof raised to accommodate 35' walls within. This deal, combined with the F45 Training gym lease earlier in the year have left the center with 6,400 SF available, its lowest vacancy in years. The vacant former Santa Barbara Motorsports property at 5955 Calle Real came to market under new ownership in Q3 and is the largest lease offering in Goleta, comprised of the existing 12,700 SF building plus conceptual plans for a new 2,700 SF restaurant pad closer to the road.

INDUSTRIAL LEASING

South Coast industrial leasing—in parallel with industrial sales—has been transacting above the recent historical trend, with dollar consideration to date more than double the 5-year average. Industrial property has a lot going for it these days, compared to office and retail. For one thing, it was the commercial type least impacted by the pandemic, since employees in industrial spaces could often safely keep working through lockdowns. Secondly, in contrast to office users, industrial employees are not typically working remotely, so spaces are more likely to be fully utilized. Thirdly, South Coast industrial space is perennially in short supply, which tends to amplify demand. South Coast vacancy is 2.4% and average achieved rental rates to date are up 12% compared to 2021.

In Goleta, there were six leases in Q3, including 24,000 SF leased by Jordano's in the Foodbank's warehouse building at 80 Coromar Dr; 7,500 SF at 99 Aero Camino leased by Rabbit; and 6,000 SF at 163 Aero Camino leased by Laxmi Therapeutic Devices. Achieved rents to date are 18% higher than the prior 5-year average. About half of the current availability is in two properties: 42,600 SF at 326 Bollay Dr (formerly Inogen) and 31,400 SF at 30 S La Patera Ln.

Santa Barbara's inventory is very tight, with only five properties available and 0.5% vacancy. All of the available space came to market this year, which reflects strong

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demand and deal flow. The most recent addition is the former Pure Order brewing building at 406-410 N Quarantina St, which is also for sale. There is high-end industrial space at 126 E Haley St (aka The Platform) and 35 N Calle Cesar Chavez, both of which are priced above the average asking rate for office space in Santa Barbara. There were only three leases in Q3, but two of them were for large spaces: the Tent Merchant leased 12,600 SF at 402 E Gutierrez St, and Bella Vista Designs nearly doubled its space at 1 N Calle Cesar Chavez, signing an 11,945 SF renewal and expansion.

Carpinteria saw above-average industrial leasing in Q3, with four transactions totaling 50,250 SF. Gigavac renewed 40,275 SF at 6382 Rose Ln, a building they have occupied for the past 10 years. Also of note, 6,300 SF at 1015 Mark Ave was leased by Pacific Resources for an 8-year term. Rents have been appreciating this year. The average achieved rent for spaces larger than 5,000 SF is $1.34 gross per SF, while smaller spaces have commanded rents over $1.50 gross. There are only three spaces available, but each is larger than 20,000 SF, and in a smaller submarket like Carpinteria that equates to a vacancy rate of 3.7%. Finding three large tenants in a similar size range for these spaces will likely take some time.

Gigavac/Sensata renewed the 40,275 SF building at 6382 Rose Ln in Carpinteria.

LEASING MARKET DATA

Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE								
Santa Barbara	**9.15%**	-3%	**82**	+3%	**287,072**	+12%	**$3.09**	+3%
Goleta	**7.14%**	+37%	**21**	-10%	**104,216**	-46%	**$2.06**	-2%
Carpinteria	**3.47%**	+406%	**1**	-87%	**9,056**	-60%	**$1.76**	-5%
RETAIL								
Santa Barbara	**4.01%**	-16%	**37**	+5%	**169,398**	+141%	**$3.36**	-11%
Goleta	**1.94%**	+1%	**13**	-13%	**33,622**	-41%	**$3.52**	+17%
Carpinteria	**6.70%**	-14%	**1**	-33%	**1,994**	-13%	**$4.01**	+87%
INDUSTRIAL								
Santa Barbara	**0.53%**	-18%	**11**	-14%	**63,951**	-4%	**$2.08**	+15%
Goleta	**3.38%**	+21%	**14**	-25%	**214,537**	+10%	**$1.81**	+11%
Carpinteria	**3.65%**	+51%	**8**	+52%	**74,850**	+27%	**$1.45**	+24%

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

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