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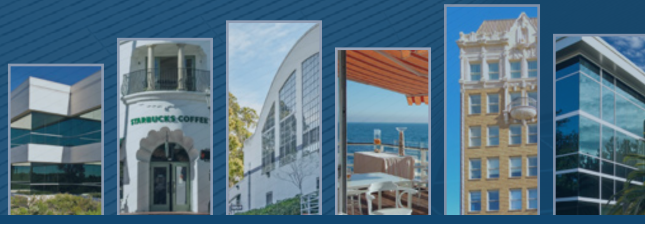

2020**Q2** Market Report

South Coast Commercial Real Estate

Adapting to the coronavirus economy and the "new abnormal"

Against the backdrop of the coronavirus pandemic, South Coast commercial real estate—like the economy in general—is in low gear. Transaction volume is down significantly compared to previous years, providing limited data to re-establish pricing for the market. In addition, the variability in the economy—with cycles of opening and closing—creates a rollercoaster effect that keeps property values in flux. Here are the highlights:

- Transaction value decreased 68% for sales and 44% for lease consideration, compared to the prior 5-year averages.
- Transactions hit a trough in April and May, but recovered momentum in June and into July.
- Since the beginning of the year, for sale inventory expanded 19% while total available space for lease stayed level.
- Prices and rents have not decreased significantly, so far.
- Demand is soft and will likely remain so for the foreseeable future.
- However, deals are happening and there is opportunity in the current market.

It will be interesting to see how the resurgence of coronavirus infections in July will affect both the economics and psychology of commercial real estate transactions. The impact of drawing down the economy again will be substantial, but the shock mentality that prevailed in the spring months will be less of a factor, as consumers and businesses have more experience with pandemic conditions. On the other hand, if PPP loans dry up, children aren't able to consistently attend school, and people continue to stay home, this fall could bring a rash of business closings, increased unemployment, and a widening gap between supply and demand in the commercial real estate sector. On the bright side, the activity we are seeing—new requirements, showings, and deals in negotiation—is cause for optimism and a reminder that the pandemic will not go on forever. In addition, as with any major inflection point in the economy, there will be opportunities in the market, particularly for owner-users and tenants.

COMMERCIAL SALES

Following a record year in 2019, South Coast commercial sales dollar volume was very low through midyear. This is not surprising, given the devastating impact of COVID-19 on the local economy. However, dollar volume in January and February—before the pandemic took hold—was down 66% year-over-year compared to 2019. Activity remained sporadic in the subsequent months, yielding the lowest midyear totals for both transactions and dollar value since 2009.

On the positive side, after hitting a low of just one transaction in May, sales activity gathered momentum in June that has continued into July. Most notably, the oceanfront office campus that serves as Procore's headquarters with an asking price of $48 million was purchased by an

This 24,772 SF office building at 1145 Eugenia Pl in Carpinteria was one of the few notable investment sales, trading for $9 million.

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investor at the beginning of July, by far the largest sale of the year to date. Our brokers report that there is noticeably more happening compared to April and May when the market seemed to be in shock.

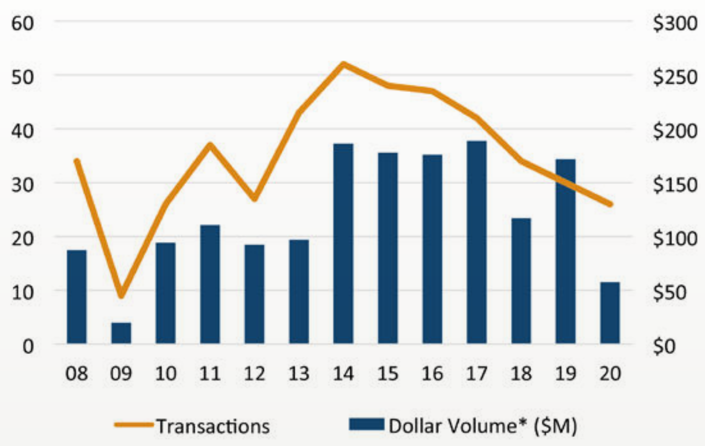
The low deal volume provides scant data to indicate the extent to which the pandemic is affecting property values. The handful of investment sales suggests cap rates have not moved meaningfully. We know anecdotally that buyers have been seeking a "COVID-19 discount," and some sellers are conceding. However, such discounts have been relatively modest, and if there are buyers trying to exploit the crisis to get a great deal, they haven't succeeded so far. The prices of off-market transactions are also in line with recent historical values.

Off-market deals represented 58% of transactions to date, whereas the typical ratio is well below half. This may be a statistical aberration due to limited data, but off-market transactions typically correlate with strong demand. The most notable off-market sale was 5551 Ekwill St in Goleta, an 11,200 SF industrial/office building purchased by an owner-user for $3.7 million in June.

Owner-users have not played as prominent a role in the market as in recent years. Through midyear, 42% of sales were purchased by owner-users, a typical ratio historically but a decrease from the past two years, during which more than half of sales were owner-user purchases. In 2018-2019 investor demand contracted somewhat, while owner-user demand surged. So far this year, both buyer types have retreated, while returning to their typical ratios with about 60% of transactions to investors and 40% to owner-users. The standout investment sale of the first two quarters was 1145 Eugenia Pl, a 24,772 SF office building in Carpinteria that sold for $9 million in March. A mixed-use building in Summerland, 2560 Lillie Ave, was the highest-value owner-user sale to date, trading for $4.2 million in February.

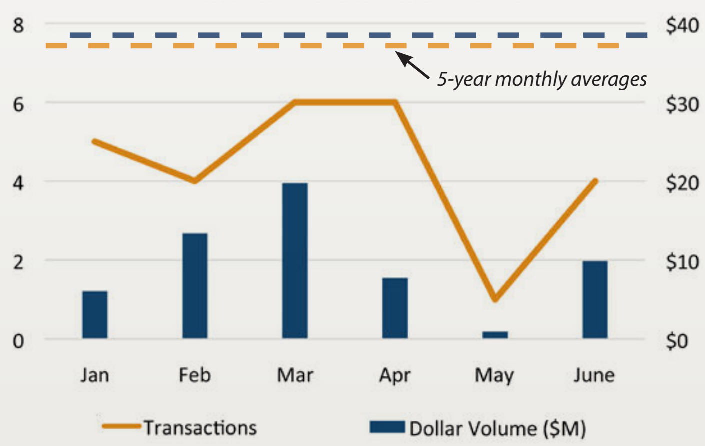
In times of economic stress, uncertainty clouds property values, and buyers and sellers both take a cautious approach to pricing. There are 75 properties for sale, which is a historic high for the South Coast and represents a 19% expansion since the beginning of the year. There is ample property for sale, and there are a decent number of buyers in the market. The main factor inhibiting deals is price. Investors are building significant risk into their offers, since there are so many economic unknowns, and seem content to wait for sellers to blink. Sellers appear willing to accept a small discount to make a deal, but most would prefer to ride out the storm rather than accept a major price cut. In this environment, owner-users may find opportunities to purchase vacant property at relatively low prices. Barring a major breakthrough in the public health crisis, such as a vaccine, we expect the gap between investors and owners on pricing to constrict transaction volume for the remainder of 2020.

South Coast Sales at Midyear
(all property types)



*Excluding hotel property

2020 Sales by Month
(all property types)

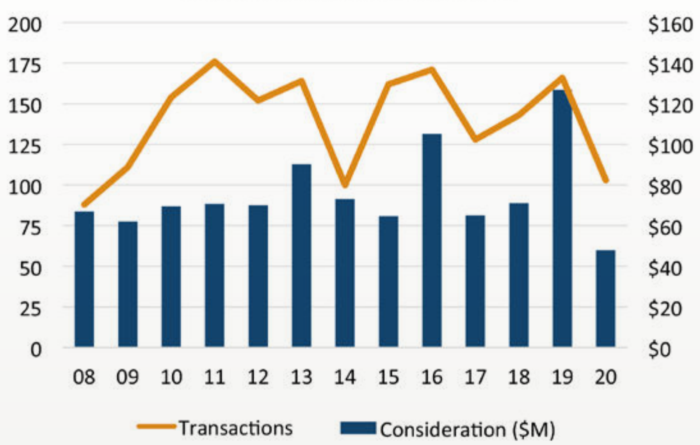


LEASING

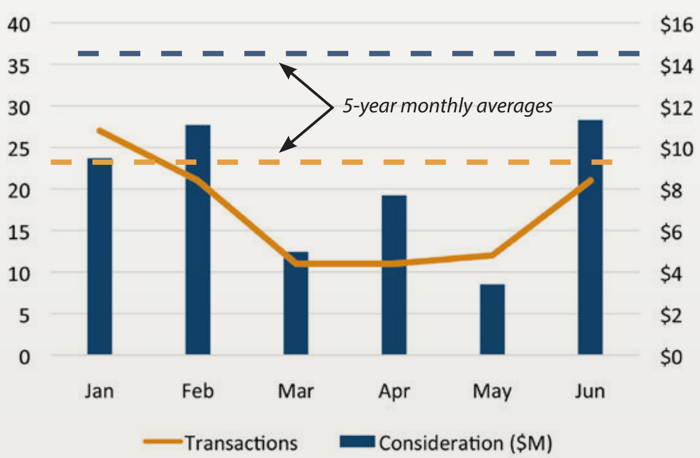
In general, the leasing markets progressed through a profound dip in transaction activity from March through May, producing some of the lowest monthly volumes on record. Transactions and consideration were less than half of the prior 5-year monthly average (as seen in the graph). In June, leasing activity rebounded to the more typical level seen in the first two months of the year, as more businesses started opening back up.

Midyear gross absorption for all property types was about 40% below the prior 5-year average. As a new surge of coronavirus cases flares up in July, there will likely be some slow leasing months again in the third quarter, and fits and starts in the market may be expected throughout the course of the pandemic.

South Coast Leases at Midyear
(all property types)



2020 Leases by Month
(all property types)



OFFICE

Office leasing volume is down on the South Coast, but the combined vacancy rate since year-end has been flat. By and large, tenants have continued paying rent while many if not most of their employees work from home. Uncertainty about what comes next makes forecasting demand for office property especially tricky. What percentage of workers will shift to working from home long-term? For those who return to the office full-time, what will the employee density expectation be? The time horizon is also uncertain. If a reliable vaccine or instant testing emerges to give workers confidence working in close proximity, the office environment could rapidly return to pre-COVID configurations. However, if contagion remains a persisting concern over a longer term, office tenants will be faced with a combination of workspace partitioning, distancing, and other measures affecting how space is used. The answers to these questions could have enormous impact on the office market.

Santa Barbara
Santa Barbara's office market has been in a cycle of elevated inventory for the past few years, with vacancy around 6%. Despite relatively low leasing volume, the first half of the year brought only a slight expansion to a 6.1% vacancy rate, the highest rate on record. About half of the available space has been on the market for more than a year, reflecting some stagnancy in the inventory. There are five spaces larger than 10,000 square feet available downtown. The largest, 26,000 SF at 402 E Gutierrez St, is creative space geared for tech. The other four are professional offices in named buildings—the Semler, Lyon, Freitas, and Grayson buildings—totaling 62,000 SF. Professional office, with a higher proportion of individual offices to facilitate distancing, could attract relatively high demand over the next few years, compared to the open, collaborative areas long favored by creative office tenants. Still, given current demand, these large vacancies will take some time to absorb.

Leasing activity as measured by gross absorption was 28% below the prior 5-year average. Also telling, 42% of the transactions were renewals, compared to 20% in 2019, indicating the drop in demand among tenants looking for a new space. Both asking and achieved lease rates have held steady, so far, and in fact achieved rates are actually up about 8% compared to 2019, thanks to a handful of high-rent leases on Coast Village Road and near Cottage Hospital. If competition for tenants heats up, asking rents in Santa Barbara—which are 40% higher than in Goleta—will come under increasing pressure. Notable transactions in the second quarter were American Riviera Bank's renewal of 12,939 SF at 1033 Anacapa St, Mercer Advisors' renewal of 10,935 SF at 1801 E Cabrillo Blvd, and a new lease of 4,993 SF at 2400 Bath St by Santa Barbara Cardiovascular Group.

Two leases totaling 31,500 SF were signed at 125 Cremona Dr in Goleta, a building recently vacated by Medtronic.

Goleta

Following relatively typical deal volume in the first quarter, Goleta saw a sharp decrease in activity, producing only three transactions totaling 17,000 SF in the subsequent three months. As of midyear, gross absorption was trending 50% below the prior 5-year average. Notable deals included 23,458 SF at 125 Cremona Dr, the former Medtronic building, leased by Digital Surgery Systems. Nearby, Toyon Research leased 23,400 SF at 25 Castilian Dr on a long-term basis.

After hitting the lowest vacancy rate on record of 4.6% in the first quarter, Goleta's vacancy rate remains relatively low at 5.0%, and so far there hasn't been a substantial increase in new spaces coming to market. The largest availability on the market is the balance of the former Medtronic building, 32,900 SF at 125 Cremona Dr. The lull in transactions is cause for concern, but it bears reminding that Goleta currently has half the available space that it had just 24 months ago.

Carpinteria

Leasing activity was minimal in Carpinteria during the last two quarters. There were five lease transactions as of midyear, all of which were smaller leases. Gross absorption to date is trending 60% below the prior 5-year average on an annualized basis. Despite low volume, the vacancy rate in Carpinteria has remained stable and below 5% for the past two years.

RETAIL

The pandemic has accelerated the shift in consumer spending to e-commerce. Brick-and-mortar retail, which was already struggling to attract and retain shoppers, has been decimated, with national retailers—including department stores, clothing and other soft goods, fitness, even drug stores—announcing bankruptcies or massive store closings almost daily.

On the South Coast, the list of retailers and restaurants closing during the pandemic continues to grow: national tenants like Nordstrom, Forever 21, Subway, Sur La Table, and Coffee Bean & Tea Leaf, along with locals like Plum Goods, Zizzo's Coffee, and Chuck's Waterfront Grill. The news isn't all bleak. There have been some openings as well, such as Ca' Dario and Mesa Burger on Coast Village Road, Corner Tap at 1905 Cliff Dr and Lighthouse Coffee at 711 Chapala St. And there was a major lease by a national retailer, the 21,577 SF anchor space at 7127 Hollister Ave in Goleta claimed by LA Fitness in June.

The second quarter brought just a handful of leases in Santa Barbara, including Aqua-Flo's signing of 7,386 SF at 18 S Milpas St, Alpha Resource Center's lease of 3,661 SF at 1911 De La Vina St, and the former Wildwood Kitchen space at 410 E Haley St was leased by Feast Kitchen. Along the downtown retail corridor, the novelty of outdoor dining and blocks of State Street closed to vehicles have created a lively scene for locals looking to go out, while providing

LA Fitness leased 21,577 SF at 7127 Hollister Ave in Goleta in June.

an impromptu test run for the promenade concept that many have been advocating in recent years. This action by the City has helped give restaurants a chance to stay in business during the pandemic, which is much needed because the downtown corridor is struggling. Since the beginning of the year, the 400 to 1300 blocks have seen 15 spaces become vacant or come to market, eight of which were occupied by food and beverage tenants. The storefront vacancy rate has grown from 10% at the beginning of the year to 15% currently. Additional vacancies are likely to arise in the second half of the year, as more businesses are expected to close permanently.

Local consumers, the City, and landlords are all playing a part to help local businesses, and we applaud the ingenuity and perseverance of so many proprietors and their employees in very challenging times. The pandemic will eventually pass, but its impact on stores, restaurants, gyms and bars will reverberate for many years to come.

INDUSTRIAL

Nationally, industrial markets have been more stable than other commercial property types during the pandemic, largely because warehouses are essential to corporate e-commerce. Although Amazon has reportedly sniffed around for warehouse space on the South Coast in recent years, there aren't any distribution centers here. However, our market's limited supply of industrial space protects against excess vacancy during an economic downturn. Available space has expanded slightly since the beginning of the year, but the vacancy rate is still below 3% for the South Coast.

Santa Barbara's vacancy rate remains very low—below 1%—and average achieved lease rates to date were above $2.00 per SF gross, a very high average, historically. The largest space leased to date was 14,368 SF at 415 N Salsipuedes St leased by Kamran & Co in the first quarter. Santa Barbara saw a surprising seven transactions in the second quarter, including the lease by Andros Floor Design of three new buildings totaling 9,292 SF at 35 N Calle Cesar Chavez.

Goleta's vacancy rate is relatively high at 5.4%, largely due to the 102,000 SF space vacated by Powell Skate One at 30 S La Patera Ln. April and May were very active for Goleta industrial leasing, producing six transactions totaling 53,000 SF. Among those, Farm and Ranch Management Services leased 20,794 SF at 5756 Thornwood Dr, and Cox Communications secured 17,703 SF at 149 Castilian Dr, the two largest spaces leased year to date.

In Carpinteria, there were only two transactions as of midyear, both in the second quarter, including 5,224 SF at 1115 Mark Ave leased by Inevifit. Despite the scarcity of deals, the vacancy rate held level and relatively low at 1.9%. However, more than 50,000 SF of industrial space is scheduled to hit the market in the third quarter, which is projected to increase the vacancy rate to approximately 5%.

Farm and Ranch Management leased 20,794 SF at 5756 Thornwood Dr in Goleta in April, the South Coast's largest industrial lease to date.

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MULTIFAMILY SALES

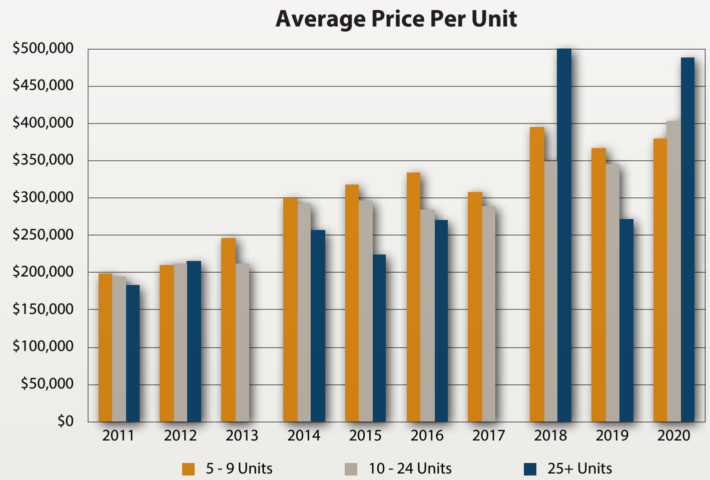
With half of 2020 behind us and uncertain times ahead, given the global health crisis, the local multifamily market stands to fare as one the strongest sectors of the real estate investment markets. Throughout the South Coast, the feedback from owners and property managers of apartments is that rent collections have remained virtually unaffected by the pandemic, unlike sectors such as retail and office. At worst, collections were no less than 95% of a landlord's gross scheduled rents. As we navigate the months ahead with increasing unemployment and unknowns regarding government aid, it's an open question whether this high collection rate will continue.

The apartment sales market started the year slowly, recording only four sales in the first quarter. And the second quarter, during the newly-implemented "shelter in place" orders, produced only two sales. Although the pandemic certainly stalled activity while sellers and buyers settled into the new "normal," the lack of activity was driven largely driven by a shortage of supply. As is normally the case for South Santa Barbara County, a limited inventory of apartment product prevailed for most of the first half of 2020. Toward the end of the second quarter, several new listings were introduced to the market as sellers realized that buyer demand remained for apartments and that prices were holding, despite the pandemic. The arrival of new inventory has continued into the third quarter, and several of these newer offerings have gone into escrow. Expect more product to hit the market in the second half of 2020, which will be met with buyer interest as long as the property is well located and offers a market return.

	Sales	Price per Unit	Cap Rate*	GRM‡
2016	32	$312,011	3.69%	16.63
2017	20	$299,036	3.93%	16.50
2018	20	$354,424	4.03%	15.97
2019	22	$352,349	4.21%	15.50
2020 ytd	6	$415,649	3.73%	19.35

Which leads to the million-dollar question: what is a market return in a COVID world? Looking at the six sales to date and the inventory that has come to the market recently, the market cap rate appears to be 4%, or greater, on properties where rents are already close to market. For valued-add opportunities, where the property requires some repositioning and increases to existing rents, limited by AB 1482 of course, buyers are looking to see a trajectory to a 5% cap rate, or greater, on realistic market rents.

Interest rates remain at historic lows, buttressing the justification for lower returns on apartment investments. However, certain major lenders are more cautious about lending, given their exposure in other real estate sectors that have been negatively impacted by the pandemic. As such, expect some lenders to offer attractive rates but require higher debt coverage ratios, lower loan to value ratios, and other limitations that may make obtaining leverage more difficult. There are several lenders still offering great lending terms, so it will behoove buyers to shop their loans before committing to a lender. Despite this, as long as interest rates remain low and rent collections remain strong, the attractiveness of the lower—but more stable—cap rates offered by apartment investments will keep prices trending in a seller's favor.



* *Capitalization (Cap) Rate:* net operating income divided by value or price. ‡ *Gross Rent Multiplier (GRM):* value or price divided by annual gross operating income.

LEASING MARKET DATA

Market	Vacancy Rate		Transactions		Gross Absorption		Achieved Rent	
OFFICE								
Santa Barbara	**6.13%**	+3%	**37**	-21%	**140,577**	-11%	**$3.11**	+3%
Goleta	**5.04%**	-4%	**15**	-42%	**143,008**	-55%	**$1.93**	-2%
Carpinteria	**3.99%**	+28%	**5**	+100%	**15,157**	-15%	**$1.80**	+3%
RETAIL								
Santa Barbara	**3.78%**	+1%	**15**	-57%	**42,125**	-57%	**$3.20**	-11%
Goleta	**1.81%**	-20%	**5**	-44%	**26,874**	-37%	**$2.53**	-8%
Carpinteria	**6.54%**	-10%	**1**	-33%	**2,772**	-16%	**$3.14**	-1%
INDUSTRIAL								
Santa Barbara	**0.73%**	-20%	**11**	+120%	**41,536**	+228%	**$2.12**	+15%
Goleta	**5.44%**	+15%	**12**	-33%	**72,273**	-41%	**$1.60**	+6%
Carpinteria	**1.89%**	+2%	**2**	-33%	**7,184**	-74%	**$1.05**	-16%

Change percentages are compared to 2019 values, annualized where appropriate.