2020**Q1** Market Report

South Coast Commercial Real Estate

Effects and implications of the coronavirus pandemic

In addition to its alarming toll on health and human life, the COVID-19 pandemic has disengaged the gears of the South Coast economy, as the statewide shelter-in-place policy gutted consumer spending at local businesses while vacating many, if not most, workplaces. Business revenue has collapsed, leaving thousands of South Coast workers furloughed or unemployed. California's unemployment rate spiked to 22 percent by mid-April, and Santa Barbara County has reportedly lost 22,000 jobs. Along with most sectors, commercial real estate activity has dropped dramatically, as tenants and landlords scramble to respond to the shutdown, while most investors and owner-users put buying plans on hold. The daily communication and inquiries we receive about available property have slowed dramatically.

While this is fundamentally unlike any previous crisis, it bears revisiting the lessons of the last economic disruption for guidance. Following the Wall Street crash in the fall of 2008, South Coast commercial real estate markets first lapsed into a "shock" phase, in which pervasive uncertainty triggered about 12 months of very low transaction volume. The shock phase evolved into a "new normal" phase, once corrected market pricing was established and transaction volume regained momentum. This second phase lasted about two years, and actually produced lower pricing indicators than the initial shock. A variation on this sequence is likely to repeat in the current crisis, though the duration of the phases could be very different. It's impossible to know what lies ahead, but we expect this market cycle will take years, rather than quarters, to play out.

This stretch of Embarcadero del Norte in Isla Vista would normally be bustling with college students on a sunny spring day.

COMMERCIAL SALES

Based on our own experience to date and what we hear from title companies, parties under contract on commercial property have not been reflexively canceling escrow due to the pandemic, which is heartening. Nevertheless, the economic turmoil has thrown a cloud of uncertainty over property values. What will the economy look like in 12 months? In 24 months? Investors will want a discount for the added risk, which tends to push sellers and buyers farther apart on price.

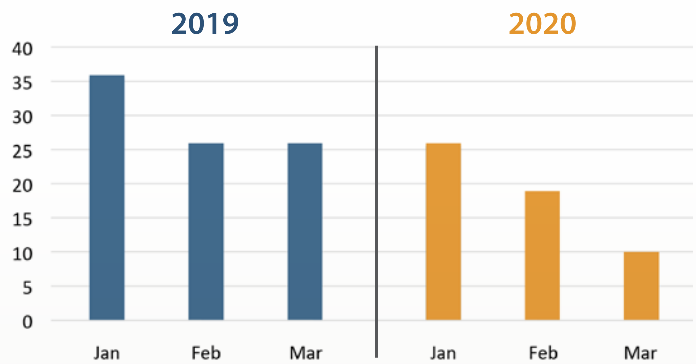
On the other hand, there are two forces working in favor of demand. First, interest rates are at a record low, which will encourage leverage buyers and some owner-users to stay in the market. Second, during this time of economic upheaval – including volatile stock markets, bottoming oil prices, and lean bond yields – some investment capital will likely migrate from other asset classes to the relative stability of real estate.

Over the next two quarters, we expect a major decrease in sales transactions. Depending how long it takes to reach a "new normal" for business activity and sales prices, the slowdown in sales could last much longer. Along with lower transaction velocity, we anticipate a contraction of inventory, as some sellers decide to pull listings and fewer new listings come to market.

LEASING

With the obvious exception of Zoom, which has an office in downtown Santa Barbara, virtually every tenant in the area has suffered an immediate (and often profound) loss of revenue. For many, especially restaurants and retail, paying rent has been difficult or impossible. Some landlords proactively deferred rent for April and are negotiating with tenants various forms of relief in the short-term. In turn, banks have deferred some portion of landlords' mortgage payments on a case-by case basis.

Q1 Lease Transactions by Month
(all property types)



The above graph shows a year-over-year comparison of first quarter South Coast leases by month. The difference between the two years is stark, indicating that concerns about the pandemic began to affect leasing decisions in February of 2020 and led to a dramatic decline in March. The data for asking rental rates and vacancy do not show substantial impacts as of the end of Q1, because these indicators will take longer to respond to the effects of the coronavirus economy. Q2 is almost certain to bring decreases in rental rates – both asking and achieved – and increased vacancy. Landlords will feel increased urgency to make concessions in order to get spaces filled. The degree of change will vary by sector, with retail (including restaurants) obviously expected to undergo the most profound correction.

For the South Coast's restaurant and retail businesses, the shelter-in-place policy has proved devastating. State Street and other retail destinations have been eerily quiet, and as the weeks pass, businesses that were already operating on thin margins may find this crisis too difficult to weather. Government bailouts can help in the near term, but consumer spending at brick-and-mortar retail and restaurants may take years to recover. The California Restaurant Association estimates up to 30 percent of restaurants may not re-open when dine-in restrictions are lifted. Early predictions for retail stores by national experts are similarly dire. Brick-and-mortar retailers were already struggling to reinvent the shopping experience in response to the growth of online retail; they will have to dig even deeper now to achieve viability during and in the wake of this pandemic. One silver lining is that as a tourist destination within easy driving distance of Los Angeles, the South Coast is well positioned to attract visitors when people start to travel. And nearly everyone is feeling cooped up and suffering screen fatigue already, so as soon as locals feel safe to frequent stores and restaurants there will be pent-up demand.

Most office buildings in the area have been vacated due to shelter-in-place restrictions, judging by the nearly empty parking lots visible at business parks on weekdays. We assume a significant number of tenants and landlords are negotiating some form of short-term rent relief or deferral, but leases are still in place on these temporarily unoccupied offices. For people who normally work in office buildings, the crisis has proved to be an unplanned foray into working from home. There is speculation that this event may accelerate the long-term trend toward remote work, as employees and employers get a better sampling of its pros and cons, which could potentially lower demand for office space over time. On the other hand, social distancing norms may trigger new standards to give employees more room in office environments, which could potentially increase demand for space. Either way, in the near term office leasing volume will proceed well below the levels seen in recent years.

Industrial users, in general, have so far experienced less disruption than those of other property types. Social distancing is easier to maintain in an industrial workplace, such as a warehouse or shop. These businesses still have to negotiate potential supply chain shortages and fluctuations in customer demand. Construction trades have continued to hammer away, though sources in the industry have told us that the pipeline of new residential jobs is below normal as contractors head into summer. For many tenants in R&D space, this is a fortunate time to have the US government as a customer. The South Coast's 100-plus government contractors are likely to receive stable revenue from public sector contracts, at least in the near term.

"BUCKLE UP"

Until there is a vaccine against coronavirus, or worse, gradual assumption of "herd immunity," social interaction will be more cautious and distant, which will affect how all types of commercial property are used. Pervasive testing and/or development of a treatment of symptoms are other goals that would meaningfully shift public behavior. Since the public health trajectory of the pandemic can't be accurately predicted, the depth and duration of its economic impacts are a matter of speculation. Most economists warn that a V-shaped recovery is unlikely, and we should expect a more gradual L-shaped thawing of the economy. We would echo that caution in regard to commercial real estate. This doesn't mean there is nothing to be done. Every turn in a market will create opportunities. But we will all be working in conditions of elevated uncertainty for the foreseeable future. Buckle up. We are in for a long ride.

Summary of Q1 market activity

Following a remarkably high-volume year in 2019, South Coast commercial real estate activity got off to a slow start at the beginning of the year and then hit a wall as the effects of the worldwide coronavirus pandemic seized the local economy.

COMMERCIAL SALES

	Q1 2020	vs 2019	vs 5-yr Avg
Sales Transactions	13	- 38%*	- 37%
Volume (excl. hotels)	$38 M	- 70%*	- 63%
Properties For Sale	74	+ 17%	+ 40%

* Annualized

There was not a "coronavirus effect" on sales during Q1, in which each month produced less volume than the previous. In fact, sales activity was sluggish through all three months. Q1 dollar volume, $38 million, was the lowest single-quarter total since 2011, and 63% below the average of the prior five Q1s. Sales transactions were also far below trend, 37% under the prior 5-year average.

The drop in activity could simply indicate a market lull following huge volume the previous quarter, which capped off an unprecedented year for sales in 2019. The remarkable surge of owner-user sales during 2018 and 2019 did not carry into Q1, as owner-users returned to a more historically consistent 38% of buyers.

The relative lack of transactions contributed to elevated inventory, which at the end of Q1 had increased to 74 offerings for sale, which represents a 40 percent expansion compared to the prior 5-year average.

Q1 SALES OF NOTE:

- 1155 Eugenia Pl, Carpinteria. $9 million 24,772 sf office building on 1.1 acres purchased by an investor
- 524 State St, Santa Barbara. $5.7 million 13,241 sf retail building purchased by an investor
- 115 E Micheltorena St, Santa Barbara. $5.6 million 8,706 sf office building purchased by an investor
- 2560 Lillie Ave, Summerland. Off-market $4.2 million 5,700 sf mixed-use building purchased by an owner-user

OFFICE LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	6.0%	4.6%	3.6%	5.3%
Available Space	+ 1%	- 12%	- 7%	- 5%
Transactions*	- 11%	- 15%	+ 60%	- 10%
Achieved Rents	+ 7%	- 4%	+ 8%	+ 8%
Gross Absorption*	- 3%	- 41%	- 42%	- 29%

Change percentages are compared to 2019 (* annualized).

South Coast office vacancy reached its lowest rate in 12 years, driven by continued contraction of space in Goleta, where the rate of 4.6% is a historic low.

Leasing momentum waned through the quarter as the coronavirus crisis emerged. There were 17 transactions in January, 10 in February, and 7 in March.

SANTA BARBARA

- The vacancy rate held steady in Q1 but at 6.0% is still very high by historical standards and is cause for concern going into an economic downturn.

- 20% of current inventory came to the market in Q1, including 13,000 sf at 29 W Anapamu St.

- Digital marketing firm Conversant renewed the 28,350 sf building at 530 E Montecito St, the largest lease transaction of the quarter.

- There are 52 properties for lease downtown – the largest inventory on record – totaling more than 216,000 sf and including three spaces larger than 10,000 sf.

- Achieved rental rates continued to rise in Q1, reaching an unprecedented average rate of $3.24 gross per square foot.

GOLETA

- Goleta's 4.6% vacancy rate is the lowest on record and represents a remarkable rebound from 11.8% vacancy three years ago. The largest available space is 42,000 sf at 125 Cremona Dr, recently vacated by Medtronic.

- Q1 leasing activity included signings by IBM, Google, and Toyon Research totaling 45,000 sf.

- Asking rental rates in Goleta are in new territory, averaging $2.17 gross per square foot across the current inventory. This reflects both healthy demand by tenants as well as increased landlord investment in improvements in recent years.

CARPINTERIA

- The office market in Carpinteria and Summerland has been calm, with just two transactions to date and no known tenants actively looking in the area.

Q1 OFFICE LEASES OF NOTE:
- 28,350 sf renewed at 530 E Montecito St in Santa Barbara by Conversant
- 16,172 sf leased at 5425 Hollister Ave in Goleta by IBM
- 15,034 sf renewed at 6868 Cortona Dr in Goleta by Google
- 10,200 sf leased at 111 Castilian Dr in Goleta by Soraa Laser Diode

RETAIL LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	**3.8%**	**2.3%**	**5.7%**	**3.5%**
Available Space	**+ 2%**	**+ 3%**	**- 12%**	**+ 2%**
Transactions*	**- 42%**	**- 78%**	**- 100%**	**- 51%**
Achieved Rents	**- 14%**	**- 17%**	**n/a**	**- 8%**
Gross Absorption*	**- 51%**	**- 96%**	**- 100%**	**- 66%**

Change percentages are compared to 2019 (* annualized).

South Coast retail leasing was robust in 2019, and transaction velocity in January was consistent with monthly averages for the prior five years. Not surprisingly, deal flow declined dramatically as the coronavirus shutdown loomed. Just three transactions were signed in the latter seven weeks of the quarter.

It will take time for market vacancy rates to reflect the effects of the pandemic. The vacancies in the table above are based on spaces being marketed for lease at the end of Q1 but should be considered pre-pandemic values. Projections that up to 30% of restaurant and retail businesses will not re-open portend a glut of space coming available over the next few quarters. Fortunately, South Coast vacancy prior to the crisis was approximately one-third the national average.

Isla Vista may be the retail district hardest hit so far by the shutdown as a large proportion of students left town when the university suspended activities on campus in March. And unlike other areas, summer is normally a slower season for businesses in Isla Vista, which will be even more true this year. There were four spaces on the market in Isla Vista at the end of Q1, and that number is likely to jump during the next few quarters.

The City of Santa Barbara hired an economic development director, who began April 1, to help address the challenges facing downtown. For the new director, and for downtown retail, this economic crisis comes at a terrible time. State Street was already struggling with a sustained period of high vacancy. For the five-year period from 2011 through 2015, quarterly storefront vacancy on the 600 to 1000 blocks averaged 6.4%. Since then, the average rate has been 14.1%. This cycle of elevated vacancy forced landlords to lower rental rates to secure tenants. The average inflation-adjusted rent on the 600 to 1000 blocks since the beginning of 2018 is 23% lower than the average for 2011-2015.

As for Q1 activity downtown, there were three storefronts leased on State Street, including Hempwise at 1103 State St and clothing store Poppy at 911 State St. Just off the main corridor, leases were signed by the restaurant Scarlett Begonia at 21 W Victoria St, and Crossfit at 120 W Canon Perdido St.

Goleta's retail vacancy rate of 2.3%, though remarkably low by national standards, is actually a 5-year high. Availabilities contributing to this inventory include the 21,577 sf space behind Costco at 7127 Hollister Ave and about 18,000 sf for lease at Magnolia Shopping Center.

Q1 RETAIL LEASES OF NOTE:
- NextGen Wellness leased 1,240 sf at 1046 Coast Village Rd
- Crossfit Pacific Coast leased 6,130 sf at 120 W Canon Perdido St
- Poppy leased 2,175 sf at 911 State St
- Proform Fitness & Training leased 3,650 sf at 2605 De La Vina St

INDUSTRIAL LEASING

	Santa Barbara	Goleta	Carpinteria	All
Vacancy	**0.9%**	**7.1%**	**2.2%**	**3.6%**
Available Space	**+ 1%**	**+ 49%**	**+ 17%**	**+ 39%**
Transactions*	**+ 60%**	**- 33%**	**-100%**	**- 23%**
Achieved Rents	**+ 6%**	**+ 18%**	**n/a**	**+ 25%**
Gross Absorption*	**+199%**	**- 70%**	**-100%**	**- 54%**

Change percentages are compared to 2019 (* annualized).

South Coast industrial has been very sluggish over the past two quarters, posting just 63,000 sf of leasing, which represents a 68% decrease year-over-year. Available space expanded 39% during Q1, accumulating the largest inventory in nearly eight years. Gross absorption was down in all cities, compared to 2019. There was only one transaction in March, a renewal by Pacific Pickle Works at 718 Union St in Santa Barbara.

GOLETA

- 102,000 sf came to market at 30 S La Patera Ln. The space is being vacated by Skate One (Powell) skateboards, which is relocating to a 12,400 sf office space at 6860 Cortona Dr in Goleta and a 72,000 sf industrial space in Ventura. The space on La Patera contributed to a 49% expansion of availability since the beginning of the year.

- Other large vacancies remain at 80 Coromar Dr (36,000 sf vacated by Curvature), 149-151 Castilian Dr (35,298 sf in Santa Barbara Research Park), and 6338 Lindmar Dr (25,940 sf).

- There were six transactions in Q1 totaling a modest 18,000 sf, including 3,750 sf leased by an individual at 5730 Thornwood Dr.

SANTA BARBARA

- With four transactions completed, Santa Barbara maintained the trend of low leasing activity seen throughout 2019. Lack of inventory is likely the primary cause.

- The South Coast's only notable industrial lease in Q1 was Kamran & Company's signing of the 14,368 sf building at 415 N Salsipuedes St, which had previously been leased by Capitol Hardware, and Sonos prior to that.

- Four properties came to market in Q1, adding 17,000 sf to the inventory, but the vacancy rate is still under 1%.

CARPINTERIA

- There hasn't been an industrial lease transaction in Carpinteria for nearly a year (since April 2019).

Q1 INDUSTRIAL LEASE OF NOTE:
- 14,368 sf leased at 415 N Salsipuedes St in Santa Barbara by Kamran & Company

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