HCG CRE

HayesCommercial.com

2023 Q4 Market Report

South Coast Commercial Real Estate

HIGHLIGHTS

- Higher interest rates contributed to a 43% YOY drop in sales transactions.
- Dollar volume of sales was 49% below trend. Nearly all of the decrease was in the price range above $5 million, as higher-value sales are more dependent on financing.
- An abundance of large office leases, many signed by tech companies in Goleta, drove over $106 million of consideration.
- Large retail leases were scarce on the South Coast, but robust leasing of smaller spaces yielded 84 transactions, tightening the vacancy rate to 3.0%.
- Industrial leasing was flush with renewals, especially in Santa Barbara, which fueled a 38% increase in dollar consideration.

The largest sale of Q4 was the ~$14 million investor purchase of 101 W Canon Perdido St & 102 W De La Guerra St in Santa Barbara.

COMMERCIAL SALES

Interest Rates Sink In

The other shoe finally dropped. Having had little impact in 2022, higher interest rates hobbled commercial real estate sales nationwide in 2023, and the South Coast was no exception. One analysis determined U.S. commercial dollar volume decreased 51% from 2022. For the South Coast, the drop was even steeper at 61%. The 71 sales is the lowest count since 2011. True, 2022 was a record-high year, but by nearly every metric 2023 was a subpar year for commercial sales.

Prior to 2023, cheap financing fueled a four-year stretch of unprecedented sales activity on the South Coast, despite the pandemic and other stressors on the economy. To curb inflation, the Fed raised interested rates in 2022 a total of 4% from May to December, putting an end to the easy-money lending era. In 2023, the average interest rate for commercial loans in our market climbed to approximately 6.7%, which substantially weakened the purchasing power of leverage buyers. Meanwhile, most sellers were not lowering their price expectations to accommodate new financing realities and, not surprisingly, fewer transactions came together.

As discussed in our previous report, most of the decrease in sales occurred in the higher price range. For properties with a sale price of $5 million or lower, 2023 was only a slightly below-average year. For sales above $5 million, however, transactions and dollar volume cratered 46% and 67% respectively, compared to 10-year averages.

Elevated interest rates had a disproportionate effect on higher-priced property sales because buyers in that tier are more likely to require financing. In addition, at higher interest rates both lenders and borrowers tend to be more cautious about signing off on a big loan. On the other hand, buyers in the lower price tier are more

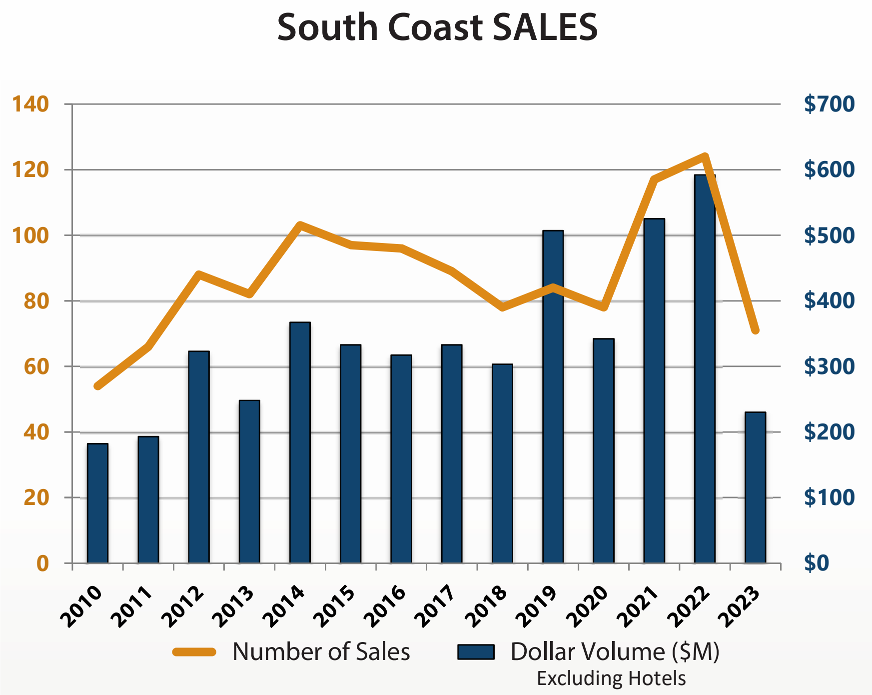
222 E Carrillo Street, Suite 101
Santa Barbara, CA 93101

805.563.2111
HayesCommercial.com

30 YEARS 1993 - 2023

Hayes COMMERCIAL GROUP

likely to pay cash, and if they do need a loan, the financial and psychological hurdles may be less daunting. Based on 2023 public records, 54% of South Coast sales above $5 million involved financing, compared to 31% for sales below that price threshold.



Who's Buying?

The decline in sales was more pronounced among owner-users than investors. Owner-user transactions dropped 38% from the prior 5-year average, compared to a 15% decrease for investments. High-price investors (including institutional investors) largely withdrew from the market. The average price for an investment sale was $3.4 million, 45% below the 5-year trend. The year's highest-priced investment was 101 W Canon Perdido St & 102 W De La Guerra St in Santa Barbara, which traded for around $14 million in November.

The data we have indicates capitalization rates held steady across all property types, clustering in the 4.5% to 5.5% range during 2023. When you compare that to commercial interest rates over 6.5%, not to mention the yield on the 10-year treasury approaching 5% during 2023, it's not hard to see why investors were less active.

Opportunistic buyers may be expecting higher interest rates to bring some "distressed" properties to the market, especially assets that need to refinance but don't have sufficient income to secure a new loan at today's rates. In that scenario, the owner may have to sell the property, and do so at a relatively low price. In the years following the 2008 financial crisis, properties occasionally sold at a discount under this type of duress. However, back then the entire economy floundered, and more tenants had difficulty paying rent. The economy is comparatively strong this time around, despite high interest rates and inflation, and so far the South Coast is not seeing distressed assets.

Off-market sales were down 35% from the 5-year average, resulting in only 29 transactions. Since off-market sales generally correlate with demand, does that mean demand is down too? Yes, and no. Economists often distinguish between "effective demand" and "latent demand." In our market, interest rates have weakened most buyers' purchasing power and confidence, meaning effective demand is down. However, in our view there are willing buyers ready to purchase if and when interest rates come down, so latent demand is still fairly strong.

What's Your (Property) Type?

Land sales proved to be the only property type to produce higher transactions and dollar value in 2023 than 2022. This was largely due to the repeat sale of 355 Coromar Dr, a 7.6-acre parcel in Goleta's Cabrillo Business Park, which a developer purchased for $12.36 million in February and then sold to an owner-user for $16.8 million in October. (This is a clear example of an owner-user being willing to pay more for a property than an investor/developer.)

Office sales finally stopped defying expectations and came down to earth in 2023. The prior four years—which included the global pandemic and resulting shift to work from home—produced the four highest annual dollar volumes on record for South Coast office sales. The first three quarters of 2023 saw very limited activity, but in Q4 there were two notable sales over $10 million. One was 101 W Canon Perdido St, mentioned earlier, which included 28,500 SF of office along with excess land. The other was 559 San Ysidro Rd in Montecito, a 9,600 SF

801 S Kellogg Ave in Goleta was purchased by an owner-user in Q4, which proved to be the largest industrial sale of the year.

building with abundant parking that traded off-market for around $1,200 per SF.

Industrial sales dollar volume in 2023 was the lowest since 2017, and there were no sales over $4 million. The most notable industrial sale of the year was the 13,000 SF building at 801 S Kellogg Ave in Goleta, purchased by an owner-user in Q4 for $3.6 million. In Santa Barbara, the industrial sales were small properties with an average price of only $1.5 million. Smaller buildings typically cost more per square foot, and the average price for industrial in Santa Barbara was $646 per square foot, which was higher than the average for office and retail property.

Compared to historical trends, retail property showed less of a decrease in sales than office or industrial property. The largest retail sale of the year was the neighborhood retail center at 3905-3917 State St in Santa Barbara, purchased by a local investor. There were four sales along the State Street retail corridor, two of which closed in Q4 as 801 State St was acquired by an investor, and 921 State St was purchased by an owner-user.

Looking Ahead

In all likelihood, 2024 is on track to be another below-average year for commercial sales. Whether it's a bit below average or far below average will depend on interest rates. Inventory for sale has decreased 28% since the beginning of 2023, indicating that fewer sellers are inclined to test the current market. Commercial property owners on the South Coast tend to be well-capitalized and able to hold off until rates come down and more buyers can approach their target price. So far, sellers have not given ground on pricing. In fact, our analysis of office, industrial and retail sales in 2023 indicates that prices per square foot increased 12%, adjusted for inflation and compared to the 5-year trend.

Commercial sales activity typically takes a few quarters, at least, to respond to changes in interest rates, which is why high sales volume persisted through the end of 2022. The flip side of that, unfortunately, is that unless the Fed starts dropping rates substantially and soon, sales activity is unlikely to recover much momentum before the end of the year. On the bright side, our perception is that latent demand for commercial property is still present from both investors and owner-users, waiting for either interest rates or sellers' price expectations to ease. Meanwhile, those buyers not dependent on financing (i.e. 1031 Exchange or cash buyers) will continue to enjoy an even greater advantage than usual. The other silver lining of a slower sales market is the correlated increase in leasing activity, which we will explore next.

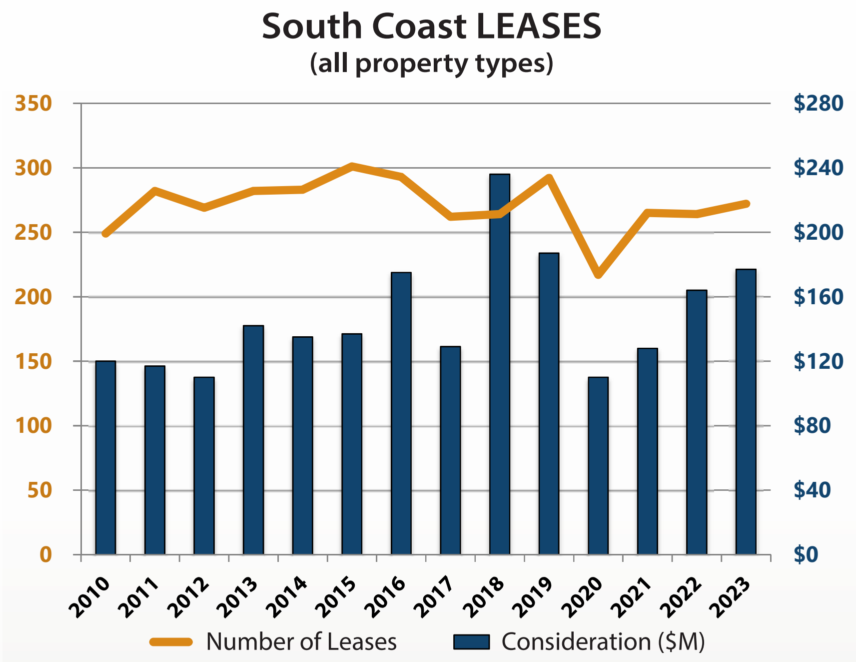
OFFICE LEASING

The South Coast generated pre-pandemic-level office leasing volume in 2023, propelled by an unusual number of large leases, mostly in Goleta. Over $100 million of consideration was transacted, the highest total since 2019, and a 71% rebound from 2022. This was somewhat surprising given utilization of office space has not returned to pre-pandemic levels. Also surprising, most of the large leases were signed by technology tenants, the sector most transformed by remote work and presumably creating less demand. South Coast office vacancy ended the year at 8.8%, not quite back to the rates we saw before the pandemic, but compared to the 25% vacancy recently reported in greater Los Angeles, we are in relatively good shape.

Goleta

Goleta office vacancy peaked at 10.7% in Q1, before a sequence of large leases by tech and biotech companies brought vacancy down to 7.9% by year end, yielding a net absorption of 128,000 SF of office space in nine months. For the year, gross absorption was 519,000 SF, the third-highest total in the last 10 years. Achieved rents increased 9.5% YOY to $2.23 gross per SF, the highest annual average yet.

There were 14 transactions over 10,000 SF, more than double the 5-year average. It's worth noting, though, the seven largest transactions consisted of five renewals and two subleases. The sublease deals were 50,500 SF at 301 Coromar Dr, signed by Sonos, and 36,000 SF at 90 Castilian Dr. Even after these transactions there are still a lot of sublease offerings, comprising 40% of the total space on the market. Apeel recently brought 17,000 SF of immaculate office/R&D to market for sublease at 71 S Los Carneros Rd. And sublease vacancies totaling 95,000 SF remain at 50 Castilian Dr, 6500 Hollister Ave, and 425 Pine Ave.



All told, renewals accounted for more than half of the total leased area. The five largest renewals were signed by three tenants. Teledoc (formerly InTouch) Health signed two deals totaling 57,300 SF at 7402 & 7406 Hollister Ave. Transphorm also signed twin renewals at 75 and 115 Castilian Dr to secure 27,800 SF combined. And finally, Toyon Research completed a renewal/expansion covering 37,000 SF at 26 Castilian Dr. While renewals don't reduce vacancy, they do prevent new vacancies, and these transactions are encouraging examples of companies making commitments to maintain their operations in Goleta.

Santa Barbara

Santa Barbara office leasing finished the year strong, with more than 125,000 SF transacted in the fourth quarter, including the year's largest office deal: Tri-Counties Regional Center's renewal and expansion totaling 39,600 SF at 520 E Montecito St and 201 N Calle Cesar Chavez. There were nine other Santa Barbara renewals in Q4 totaling 41,600 SF. Renewals were abundant throughout the year, amounting to 33 transactions, which is 35% above the 5-year mean. Not all the Q4 deals were renewals, though. Geosyntec Consultants leased the 10,600 SF former Wells Fargo building at 118 E Carrillo St in December.

For the year, both gross absorption and transactions were slightly above their 5-year averages. And achieved rent bumped up 10.5% YOY to a new high mark of $3.34 gross per SF. Before you call your broker to raise your asking rent, consider that this average was skewed upward by nine leases along Coast Village Road in Montecito that averaged over $5.50 gross per SF. Another factor was

At 26 Castilian Dr in Goleta, Toyon Research renewed 37,000 SF in Q4, and MOS Equipment leased 11,100 SF earlier in 2023.

the unusual prevalence of renewals, which during 2023 averaged $3.80 gross rent.

Vacancy has come down from the peak levels during the pandemic but is still well above historic norms. 701 State St (formerly Macy's) was recently taken off the market, as the potential redevelopment of Paseo Nuevo and other considerations made converting the building to office impractical. The former Nordstrom building—marketed as 817 State St—is under different ownership than the mall and is still for lease as office space, though it remains in shell condition. Setting aside these buildings, Santa Barbara office vacancy is 7.7%, which still relatively high but reflects a substantial decrease from the peak of 9.2% at midyear 2021. At that time there were a dozen availabilities larger than 10,000 SF, twice as many as there are currently.

Sonos's move from downtown Santa Barbara to Goleta had a see-saw effect on vacancy in the two cities. In Goleta, as mentioned above, 50,500 SF of vacant (sublease) space was removed from the market. For Santa Barbara, the move added 80,700 SF of available space at 25 E Mason St and 600-614 Chapala St, though both properties are being marketed for other potential commercial uses in addition to office.

For Santa Barbara and those who care about its downtown, the departure of Sonos is another wake-up call. This is a company whose local leadership once said they would never leave downtown. They saw the State Street area as a lifestyle amenity for employees and the best setting for their company culture. We don't know all the factors leading to the move, but the deterioration of State Street as a vital commercial hub surely played a role. This case underscores the obvious need to bring changes to downtown, but is also a reminder that time isn't on our side. Even passionate proponents and supporters of downtown can run out of patience if remedies are ineffective or slow to arrive.

201 N Calle Cesar Chavez was part of the 39,600 SF renewal and expansion signed by Tri-Counties Regional Center in Q4.

While the future of creative office has drawn more attention due to high rates of remote work among tech employees, traditional office buildings are also carrying more vacancy now than before the pandemic. There are a dozen professional office buildings downtown that each have over 5,000 SF available. Among those, The Julia (924 Anacapa St) and La Torre (104 W Anapamu St) buildings combined have over 33,000 SF on the market. In the Upper State Street area, there are six traditional office properties totaling over 32,000 SF available. While most employees in professional offices are back most of the time, there has been some consolidation and "right-sizing" of office space among these tenants that has led to a relative surplus of vacancy.

Carpinteria

Carpinteria's office market has been in a prolonged phase of modest leasing activity, averaging 22,000 SF of leasing per year for the past five years, compared to 84,000 SF per year during Procore's expansion the five years prior.

There were seven transactions in 2023 comprising 30,000 SF. The two largest deals were the renewal of 8,700 SF at 1001 Mark Ave by Brown & Brown Insurance, and 7,400 SF at 1145 Eugenia Pl signed by Edward Jones financial advisors. Even with this space leased, 1145 Eugenia Pl and neighboring 1155 Eugenia Pl combined have 28,800 SF available. These are traditional "class A" office buildings built about 30 years ago, a type of product proving difficult to lease in the current market.

Procore recently removed all of its sublease space from of the market—28,500 SF at 6307 Carpinteria Ave and 50,000 SF at 6267 Carpinteria Ave. However, it appears these spaces are still unoccupied, and Procore still has three years of lease term remaining, so they may be on the market again before long, either for sublease or perhaps direct lease. Either way, finding tenants seeking 25,000 SF or more in Carpinteria to fill these vacancies will remain a challenge in the near term.

RETAIL LEASING

Dynamic demand for retail space produced an impressive 84 transactions on the South Coast during 2023 and tightened vacancy to 3.0%. However, large leases were rare, and dollar consideration came in 35% below the 5-year average.

In Santa Barbara, net absorption of 200,000 SF over the past two years has whittled vacancy down from a peak of 4.8% at the end of 2021 to 3.2% currently. Nevertheless, significant pockets of vacancy persist, predominantly within the Paseo Nuevo and La Cumbre Plaza malls, as well as on State Street.

A resurgence of activity along the State Street retail corridor resulted in 19 deals signed in 2023, the highest count since 2019. This increased leasing reflects demand primarily from local and regional tenants, bolstered by stronger consumer spending, softer asking rents, and reduced competition from national retailers.

Despite the higher transaction volume, however, the overall impact on State Street vacancy was minimal, due to relatively high turnover. State Street vacancy on the 400 to 1300 blocks has remained consistent and stubbornly high over the past two years, ending 2023 with a storefront vacancy rate of 13.7%. The corridor continues to struggle both to attract and retain long-term tenants in sufficient numbers to break the cycle. However, some available storefronts are occupied by “pop-up” stores or tenants with ongoing lease terms, so the percentage of storefronts that actually appear vacant is a less daunting 8.1%.

Food and beverage establishments were prominent in 2023 leasing activity, representing over half the year’s transactions on State Street and bringing new entrants to invigorate the culinary scene. Notable Q4 signings included Best BBQ at 716 State, Tandoori Kingdom at 1026

Vuori has moved into the 6,150 SF former Athleta space at 733 State St, a much larger space than their previous location on the 800 block.

State, and Santa Playa Mariscos at 1230 State, offering fresh dining experiences to downtown.

Vuori, a popular activewear brand, expanded its presence by relocating to a larger space at 733 State St, formerly occupied by Athleta. While Vuori is reportedly committed to remaining on State, as of this writing a long-term lease on the space had not been signed, and for now their tenure there remains fluid. Restoration Hardware signed a one-year extension at 710 State and is still operating there, but the store will close soon as the new location ramps up on East Valley Road.

The City of Santa Barbara’s master plan for downtown is scheduled for release this year. A recent survey conducted by consultants found overwhelming public support for a permanent pedestrian promenade with a bike path on State Street. Whether this conversion will be a net positive for surrounding landlords and tenants remains a matter of debate, but it promises to bring new focus to State Street as a destination for residents and visitors to stroll and ride. A few grocery tenants have reportedly been looking around downtown, perhaps anticipating increased residential density in the area as new multifamily developments take shape. The first grocer to claim a space was the Isla Vista Food Co-op, which leased the Cantwell’s building at 1533 State St to operate a market and deli. And speaking of markets and delis, Tino’s Italian Grocery

The Isla Vista Food Co-op leased the 5,900 SF Cantwell's Deli building at 1533 State St in Q4.

next to Starbucks at 210 W Carrillo St signed a long-term renewal in Q4.

In Montecito, leasing activity was relatively subdued in 2023, with only three retail leases completed on Coast Village Road. There are no spaces currently on the market in Montecito, although Via Vai's lease will not be renewed at 1483 East Valley Rd, and the space is available.

Looking ahead longer term, Santa Barbara has several projects on the horizon with the potential to bring new vitality to the retail landscape. The Runyan Group is looking to make a splash this year with the unveiling of The Post on Los Patos Way, while they are simultaneously laying groundwork for a new upscale shopping center at Garden and Yanonali. Facing the same intersection, the Wright property is slated for a 250-room hotel that promises to bring more foot traffic to the Funk Zone. Speaking of that trendy neighborhood, a group led by local development veteran Brian Kelly just purchased an entire block there, presumably to create a large-scale, multi-tenant project and bring the Funk Zone up another notch. For the beleaguered downtown, the City and the owners of Paseo Nuevo are negotiating an complete rebuild of the mall, including hundreds of residential units and a lot less retail. Similarly, Matthew Taylor's team has proposed to transform the Macy's end of La Cumbre Plaza, including 640 apartments whose occupants would be primed to patronize restaurants and retail amenities on site and in the Upper State Street area. These developments, combined with other multifamily projects prescribed by the new housing element, are on course to change the "look and feel" of Santa Barbara over the next 10 years, while almost certainly bringing economic growth to the city, especially the retail sector.

Goleta's retail transaction volume was solid in 2023, but the spaces tended to be small, resulting in a total of only 32,100 SF leased. Nevertheless, the vacancy rate remains very lean at 2.3%, with most of the available space concentrated in grocery-anchored shopping centers east of the airport. At Calle Real Shopping Center, for example, four leases totaling 6,400 SF were signed in 2023, yet over 20,000 SF remains available. Similarly, 4,400 SF leased at Fairview Center, leaving 30,700 SF available, including the 24,000 SF former Bed Bath & Beyond space. Isla Vista has four properties totaling 8,800 SF available which, on average, have been on the market for more than two years.

INDUSTRIAL LEASING

South Coast industrial transactions were below average in 2023, but dollar consideration was $37 million, outpacing the 5-year average by 31%.

Santa Barbara saw a huge upswing in industrial leasing in 2023, dominated by signings at 1 N Calle Cesar Chavez, where nine leases totaling 120,000 SF yielded two-thirds of the total area leased in the city. Seven of those nine deals were renewals or expansions by existing tenants, including Winning Makes, Downtown Storage Partners, and Andros Floor Design, which signed over 74,000 SF combined. The 17,200 SF expansion by Winning Makes was the largest space leased in Santa Barbara during Q4. Just down the street at 30 S Calle Cesar Chavez, the Rosewood Miramar Beach leased 10,600 SF for a 10-year term, which proved to the be the highest-value lease of Q4.

Santa Barbara's vacancy continues to be very limited and has hovered at or below 1% since early 2021. Recently, the inventory has also been marked by high turnover. Five of the seven properties available at year-end had just come to market in Q4, including 10,700 SF at 430 E Gutierrez St. It is unusual to have that many spaces put

Nine leases or renewals totaling 120,000 SF were signed at 1 N Calle Cesar Chavez in Santa Barbara (The Vercal Building).

on the market during one quarter, but demand continues to be strong enough to absorb most vacancies relatively quickly. Achieved rents in Santa Barbara averaged $1.94 gross per SF, virtually unchanged from the 5-year average.

Goleta vacancy was trimmed down to 2.4% at year end, its lowest rate since 2017. This represents a 26% contraction of inventory since midyear, resulting mainly from leases by Karl Storz Imaging at 149-151 Castilian Dr, Hill Road Venture at 30 S La Patera Ln, Soilmoisture Equipment at 601 Pine Ave, and MOS Equipment at 26 Castilian Dr that totaled 80,000 SF combined. Renewal activity was heavy as well during the second half of the year. Toyon Research renewed 44,700 SF combined at 6800 Cortona Dr and 25 Castilian Dr. And there were two renewals totaling 18,600 SF at 5737 Thornwood Dr, signed by SAFE Laboratories and Mahneke Enterprises. All told, dollar consideration for 2023 was 22% higher than the 5-year average.

Half of Goleta's available spaces came to the market in 2023, including well-appointed former Herbl spaces at 839 Ward Dr and 749 Ward Dr, in addition to 11,500 SF at 30 S La Patera Ln, and 5,200 SF plus yard at 82 Aero Camino. The other four available properties have been on the market for an average of 18 months, which indicates that demand has been sufficient to keep the inventory from becoming overly stagnant.

In Carpinteria, there were no leases through September, but Q4 brought substantial renewals of 18,700 SF at 1035 Cindy Ln signed by ZBE, Inc, and 14,400 SF at 6385 Cindy Ln by Big Sale Group. Procore recently terminated their lease at 6384 Via Real. As a result, the 24,000 SF building is no longer for sublease but is still for sale. That leaves three available properties and a vacancy rate of 4.0%, which is only slightly above the historical average.

LEASING MARKET DATA

	Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE	Santa Barbara	**9.79%**	-6%	**101**	-6%	**374,406**	+2%	**$3.34**	+11%
	Goleta	**7.86%**	-8%	**33**	+22%	**519,836**	+336%	**$2.23**	+10%
	Carpinteria	**7.74%**	-60%	**7**	+250%	**30,236**	+324%	**$2.26**	-8%
RETAIL	Santa Barbara	**3.22%**	-17%	**57**	-8%	**136,668**	-41%	**$3.98**	-4%
	Goleta	**2.32%**	+0%	**18**	-10%	**32,186**	-33%	**$3.24**	+3%
	Carpinteria	**3.01%**	+54%	**9**	+800%	**12,749**	+539%	**$4.67**	+16%
INDUSTRIAL	Santa Barbara	**0.81%**	+628%	**24**	+71%	**181,127**	+135%	**$1.94**	-10%
	Goleta	**2.41%**	-15%	**21**	+11%	**205,121**	-26%	**$1.74**	-5%
	Carpinteria	**3.36%**	+18%	**2**	-82%	**33,100**	-73%	**$1.13**	-26%

Change percentages are compared to 2022 values.

Our expertise keeps you ahead of the market.

Rob Adams 805.898.4386	Greg Bartholomew 805.898.4395	Christos Celmayster 805.898.4388	Francois DeJohn 805.898.4365	Toni Floyd 805.898.4369	Steve Hayes 805.898.4370	Caitlin Hensel 805.898.4374
Jason Liehr 805.898.4387	Michael Martz 805.898.4363	Dan Moll 805.898.4380	Liam Murphy 805.898.4385	Kristopher Roth 805.898.4361	Nolan Tooley 805.898.4383	Dylan Ward 805.898.4392

COMMERCIAL REAL ESTATE
& INVESTMENT SERVICES
SINCE 1993 BRE #02017017

Hayes
COMMERCIAL GROUP

HayesCommercial.com
222 E Carrillo St, Suite 101
Santa Barbara, California