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2024Q2 Market Report

South Coast Commercial Real Estate

HIGHLIGHTS

- Commercial sales dollar volume dropped 60% from the 5-year average, with office property showing a greater decrease than other types.
- There were only 4 sales with a closing price over $5 million, as higher-value purchases are more sensitive to current higher interest rates.
- Mirroring a national trend, South Coast office tenants are leasing more compact spaces, about 30% smaller on average, locally.
- South Coast retail continued to recover, though prominent shopping destinations in Santa Barbara are still struggling.
- A few large industrial leases in Goleta contributed to net absorption of 44,000 SF, tightening vacancy there to 1.4%.

The 101-key Hampton Inn at 5665 Hollister Ave was purchased for an estimated $30M by Gemini Hotel Group of New York.

COMMERCIAL SALES

Fed Up with Higher Interest Rates

The slowing of commercial sales that took hold in 2023 has deepened this year. Higher interest rates continue to stifle activity—especially at higher price points—and have been the primary factor in six quarters of very sluggish sales volume.

The 36 sales at midyear is not far below the recent trend, but dollar volume (excluding hotels) at midyear was just $86 million, a 60% drop from the 5-year average. In the past two decades, the only two midyears with lower volume were 2009 and 2020, which were both moments of historic economic disruption. In the present case, the economy has positive GDP growth, low unemployment, and stock markets near record highs. However, inflation is still concerning the Fed, which has not budged on its policy of high interest rates to address that concern.

To be fair, interest rates are not exceedingly high by historical standards, but their relatively rapid rise from record lows has left a stubborn price gap between sellers and buyers, as owners generally have not lowered their pricing expectations to reflect the borrowing environment most buyers are facing. South Coast owners typically have the latitude to wait for the market to turn, rather than sell below their target price.

The dip in transactions is far more dramatic for properties above $5 million, with just four closing in the first half of the year, two of which were hotels. Not surprisingly, that's the fewest midyear sales over $5 million we have on record. In contrast, the 32 sales below $5 million represent a modest 5% decrease from the 5-year average for that price tier.

Who's Buying (or Not)

Investor demand has weakened, or at least been sidelined, due to underwriting challenges. If financing is needed, current cap rates don't pencil for most investors. However,

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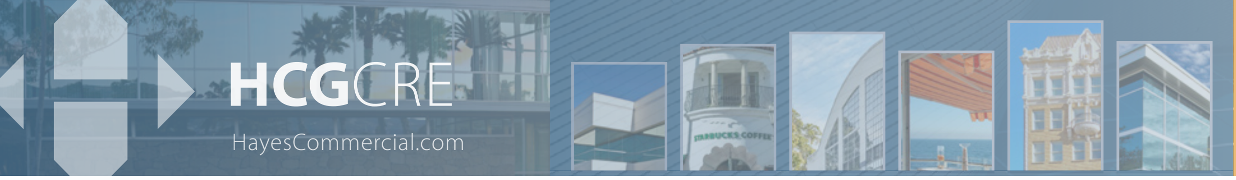
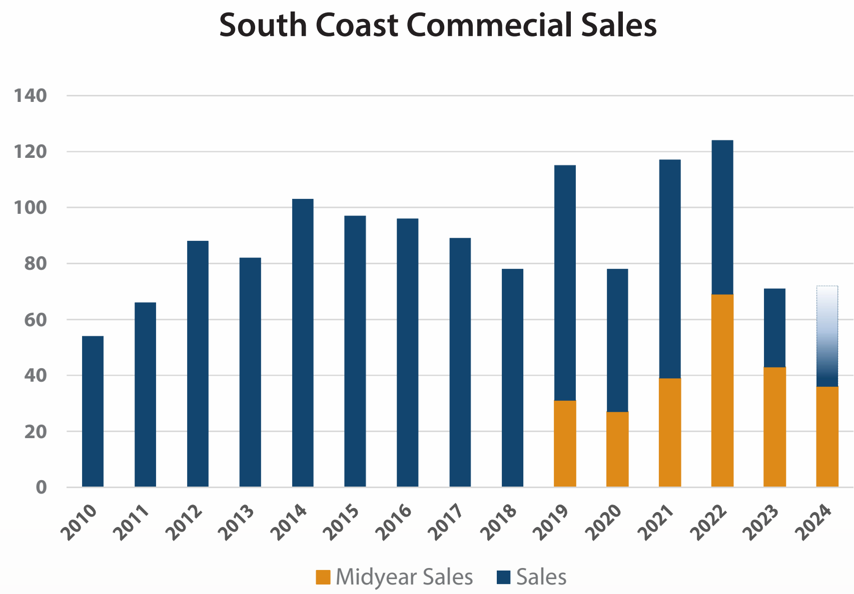
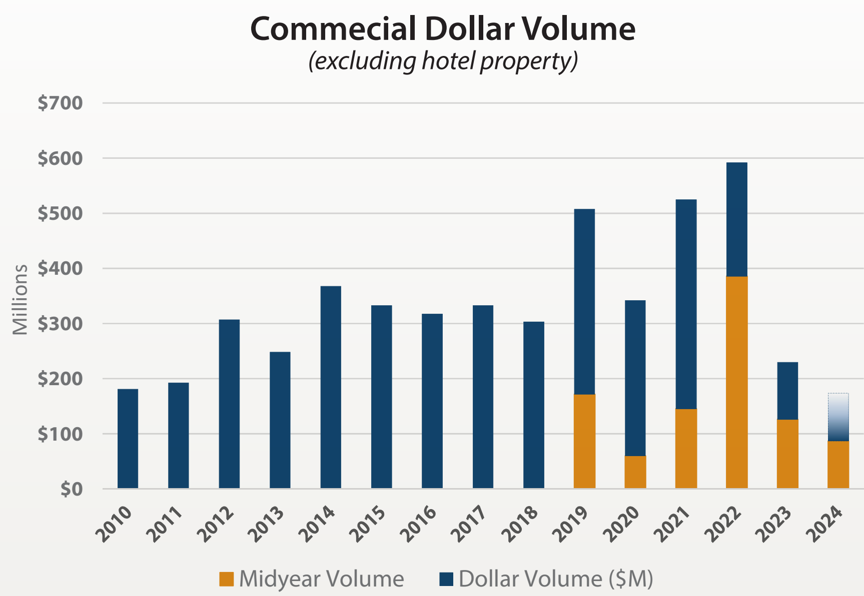


some have continued to pursue smaller properties that can be acquired with cash or a small loan burden. Through midyear, the average investment sale price was 56% lower than the 5-year average. All told, investment sales are on track for the lowest transaction count in five years and annualized dollar volume is trending 67% below the 5-year average. As a result, there were just a few investor sales of note in Q2. The 66,100 SF industrial building at 6338 Lindmar Dr in Goleta traded for $11.1 million. And the 101-room Hampton Inn at 5665 Hollister Ave was acquired by a private equity group based in New York, in a deal valued close to $30 million.



Owner-user sales transactions have not decreased as steeply as investment sales, but are still down 20% from the 5-year average, while dollar volume has dipped 46%. Rents for commercial property have not appreciated at the same rate as financing costs during the past few years. In many cases a potential owner-user may conclude that leasing is a more cost-effective path. The most notable owner-user sale to date was 3055 De La Vina St, a hotel acquired for $9.4 million by the Santa Barbara Housing Authority for conversion to low-income housing. The rest of the owner-user purchases were low-priced sales that could either be acquired with cash or without taking on a large loan.



Off-market sales are less common these days, having decreased 31% from the 5-year average. This trend suggests that potential buyers are biding time, rather than actively looking for property. This is especially true of investors, who made just five off-market purchases through midyear. One of these was 510 S Fairview Ave in Goleta, a 10,200 SF industrial property acquired off-market by an investor in Q2.

Property Types Diverge

Among the commercial types, office and medical properties are where the slowing sales market is most evident. On the positive side there were seven office condo sales at midyear, an unusually high number. On the other hand, just five office buildings traded, four of which were under $2 million. The fifth one is the 9,200 SF former industrial building at 425 N Milpas St, which has been converted to office/R&D and was purchased by an owner-user for $3.6 million. The combined value of the 12 office and medical transactions was $13.7 million, which is about 15% of the typical volume.

By contrast, retail and industrial sales are trending close to historical norms, both for transactions and value.

One of the few significant investor sales to date was the 66,100 SF industrial building at 6338 Lindmar Dr in Goleta, sold for $11.1M.

Retail transactions were actually 11% higher than the 5-year average, and clustered mainly in Santa Barbara's downtown area. The $19 million sale of a whole city block in the Funk Zone remains the most notable commercial transaction to date. Despite limited inventory available, six industrial sales closed in Q2, four of which were off-market. The 6338 Lindmar Dr sale mentioned previously was the most substantial of these. Industrial dollar value has already surpassed the annual total for 2023 and is on par with the 5-year trend.

Looking Ahead

While the market indicators paint a grim picture of the sales market, there continue to be reasons for optimism. First and foremost, sales below $5 million have retained decent momentum. This fact, along with our conversations with clients, informs our assumption that there is significant latent demand waiting for a change in the lending environment.

Speaking of which, the Fed seems inclined to cut interest rates in September for the first time in more than four years. While the initial rate cut is expected to be minor, it will likely give a psychological nudge to sellers and buyers who are waiting for the winds to change. Later on, assuming interest rates come down meaningfully, pent up supply and demand could drive a resurgence in sales. Realistically, though, sales activity is likely to remain slow well into next year. Meanwhile, cash and exchange buyers currently have the greatest advantage over leverage buyers that they will likely see for some time, so this is a prime moment for them to seek property

OFFICE LEASING

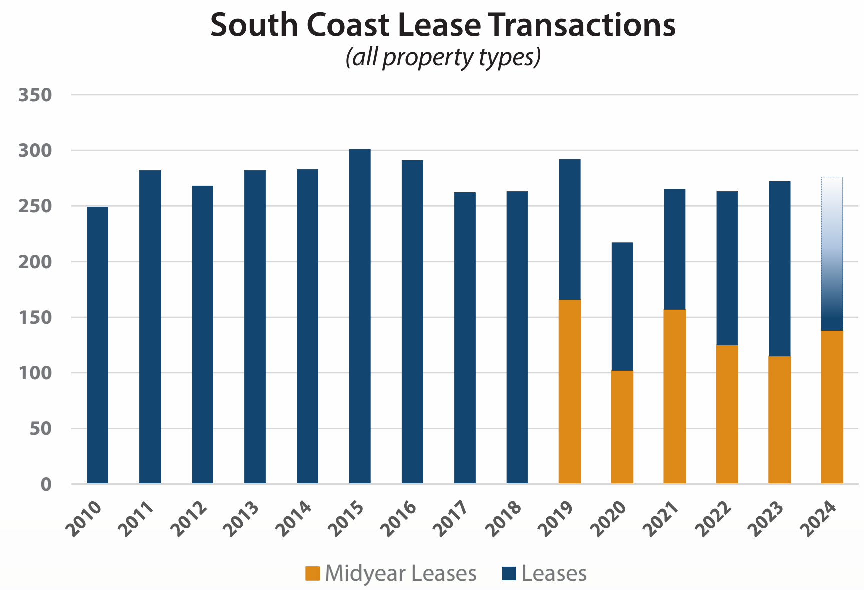
Nationally, the US office market is at peak vacancy. Moody's recently pegged the vacancy rate at 20.1% and projected it to climb until 2027, as long-term leases continue to time out. Costar tracked over 200 million square feet of net vacancy added since April 2020, concluding that tenants are leasing 15-20% less space than they were before the pandemic. For South Coast office, the trends are similar in shape but less grim in scale. The vacancy rate peaked at 11.4% in early 2023 and has eased to 9.2% currently. For comparison, average vacancy for the five years before the pandemic was 6.8%.

Lease transactions have held steady but, mirroring the national trend, tenants do appear to be taking smaller spaces. Through midyear, the average office space leased was 30% smaller than the prior 5-year average. Smaller leases mean lower gross absorption of space, which at midyear was down 29% compared to the 5-year average. On the other hand, the average achieved rental rate has continued to gradually climb. Some of that increase is likely due to the average space leased being smaller, but even so, rents broadly speaking have not come down, despite the upheaval in office use due to remote work.

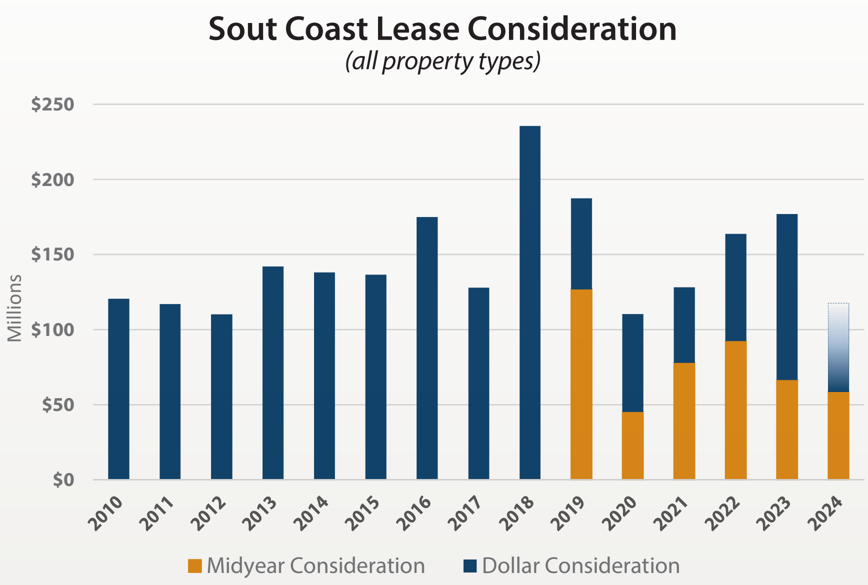
CommUnify leased 11,500 SF at Anacota Plaza. The balance of the 24,800 SF building is now available for lease as well.

Santa Barbara

Santa Barbara's available office inventory expanded by about 5% during the first half of the year, ticking the vacancy rate up to 10.5%. That rate includes the former Nordstrom building at Paseo Nuevo, which is in shell condition; omitting that building, the vacancy rate would be 8.3%. Lease transactions kept pace with the recent historical trend through midyear, but gross absorption is down 18% compared to the 5-year average. The largest new availability is 13,000 SF for sublease on the ground floor of 27 E Cota St.



The South Coast's biggest office lease to date in terms of dollar consideration was signed by the non-profit CommUnify, which leased the 11,500 SF third floor of Anacota Plaza (602 Anacapa St) for 10 years. The rest of the building, previously occupied by Antioch University, just came to market in July, adding 13,300 SF of available space, primarily aimed at institutional or non-profit tenants.



Creative office space, favored by tech businesses, was profoundly affected by the shift to remote work, and many of these spaces continue to be underutilized in Santa Barbara. Sonos's move to Goleta has made 80,700 SF available at 25 E Mason St in the Funk Zone and 600-614 Chapala St in the downtown core. These are included in the office inventory but are being marketed for other uses in addition to office. (Creative office spaces that were converted from other types can often relatively easily be repurposed for retail showroom, fitness, winery/brewery, or other industrial uses.) While the overall trend seems to be less demand from tech tenants, there have been several creative office signings to date. Michael Wyrsta subleased 9,600 SF at 819 Reddick St for R&D use. Jackpocket moved to 4,280 SF at 104 E Haley St in Q1, and then leased an additional 1,210 SF of flex space at 126 E Haley St in Q2. In addition, Impact Tech recently renewed 11,500 SF at 223 E De La Guerra St for another year, as did FastSpring at 801 Garden St.

Leasing of professional office suites has proceeded at a steady pace, though there have been very few large spaces leased. Among the notable deals in Q2, Tempest Telecom leased 5,000 SF at 136 W Canon Perdido St, shortly before 9,100 SF came to market for lease in the same building. HUB Financial leased 4,102 SF at 205 E Carrillo St. Last but not least, Momentum Dance Company signed 5,900 SF at 12 E Figueroa St, presumably changing the use from office to studio/fitness.

Goleta

Solid leasing activity in Goleta yielded 18 office transactions as of midyear, half of which were renewals. Goleta's available office space has contracted by 31% from a year ago, and the current vacancy rate looks much leaner now at 6.5%.

However, like Santa Barbara, Goleta has seen a decrease in gross absorption of space, as the leasing of large office spaces becomes rarer, particularly spaces above the ground floor. With smaller footprints more in demand, many landlords are exploring ways to demise floor plates to suit the trend.

The standout lease of Q2 was 13,000 SF of ground-floor R&D at 175 Cremona Dr, signed by Aptitude Medical. This space was previously held by Surgical Eye Expeditions, prior to their right-sizing move to 6500 Hollister Ave. For Aptitude, right-sizing has meant expansion. In addition to the lease at 175 Cremona, they renewed their 7,800 SF space in the same campus, at 125 Cremona Dr. The other notable new Q2 lease was signed by Dimer Instruments, a medical science startup, who secured a 7,150 SF ground-floor R&D space at 6500 Hollister Ave.

Renewals during Q2 included 15,000 SF at 115 Robin Hill Rd by Raytheon, and 7,000 SF at 5383 Hollister Ave by Microsoft. These followed Q1 renewals by Resonant, CACI and others that kept an additional 37,000 SF under contract.

Aptitude Medical expanded into a second space at Majestic's Cremona campus, leasing 13,000 SF at 175 Cremona Dr.

Carpinteria

The excess of available office space in Carpinteria, currently at 17.7% vacancy, continues to be met with very limited demand. As of midyear there was just one small office lease in Carpinteria, and one small office/retail lease in Summerland. Procore's 79,500 SF of space for sublease across two buildings on the bluffs constitutes the bulk of the vacancy. In Q2 the 10,167 SF first floor of 6398 Cindy Ln came up for sublease as well, offered by Agilent. All told, 82% of Carpinteria's availability is sublease space.

RETAIL LEASING

South Coast retail transactions were up 18% at midyear, and vacancy tightened further to 2.66%, the lowest vacancy rate in seven years. It also represents a 36% contraction of inventory from the peak three years ago, a remarkable recovery given how dismal the prospects for brick-and-mortar retail appeared during the pandemic.

At the same time, demand for larger spaces has been very limited, especially in Santa Barbara's two shopping malls. The South Coast has only had five retail leases over 5,000 SF during the past two years (compared to 13 leases during the two years before that, which was the pandemic). To date this year, the average leased space was 1,850 SF, which is 46% smaller than the 5-year average, and consequently, gross absorption was down 27%.

Downtown retail leasing on State Street, contrary to appearances, is seeing a bit of rebound. By midyear, 14 leases were signed along the 400 to 1300 blocks, which matches the average annual count for the past five years. The storefront vacancy rate on the corridor decreased to 12.4%, which amounts to a 12% reduction of vacant storefronts over the past year.

"Athleisure" clothing remains a booming retail phenomenon, and the two biggest State Street leases so far this year are tenants that sell a lot of spandex. Vuori has been on State for a few years in temporary locations, but finally secured a long-term lease of 4,350 SF at 636 State in Q1. More recently, ALO Yoga leased 3,325 SF at 821 State, which proved to be the standout retail lease of Q2. A third brand, Venture Apparel, also recently opened for business at 428 State following their Q1 signing.

Other recent leases along the corridor include the former Turkish Bazaar space at 1015 State claimed by the Yes Store, and the former Swarovski storefront at 819 State leased by Tilly Timms, a T-shirt/souvenir shop originating in Lahaina, Hawaii. After many years of unclear tenancy, the former Chipotle space at 723 State is now officially home to Bungalow West, another soft-goods retailer. In fact, soft-goods retail dominated the leases through midyear, while the lone food-use lease was 413 State, signed by the proprietors of Aperitivo.

The level of leasing activity was surprising and provides cause for optimism, given that State Street's future still hasn't been determined. When the overdue Master Plan is finally implemented, the lifting of that layer of uncertainty will allow tenants and property owners alike to make more informed real estate decisions, hopefully contributing to a phase of revitalization. State Street is a complex challenge with no perfect solution, but at this point remaining in limbo is worse than choosing a course of action. The recent vote among downtown owners to establish a community business improvement district is a welcome development that promises to help restore some luster to downtown.

Turning to other parts of town, a few large Q2 deals were signed in Montecito. A spacious storefront at 1155 Coast Village Rd was leased by yet another soft-goods purveyor, Faherty Brand clothing. Sotheby's Realty leased 4,300 SF at 1286 & 1290 Coast Village Rd, a building long occupied by Coldwell Banker.

The Funk Zone currently has plenty of real estate available. There are seven retail spaces for lease totaling 23,000 SF, plus five commercial properties for sale representing another 35,000 SF, much of which is, or could be, retail use. By all appearances the area is still a thriving retail destination, but tenants and buyers are not flocking to current inventory, possibly due to some fairly aggressive pricing.

The Upper State area had seven transactions by midyear totaling 13,800 SF, signed by a range tenants that reflects the diversity of commerce in this part of town, including a gym, a dentist, cell phone repair, a nail salon, and a smoke shop.

ALO Yoga is the newest athleisure clothing shop on State, having leased the 3,325 SF storefront at 821 State St.

Goleta retail has been in a phase of low vacancy and limited leasing activity for over two years. The current vacancy rate of 1.9% is as low as we have seen, and most of the leases were small spaces, leading to below-average gross absorption. One sizeable lease was Finney's signing of the 4,962 SF Hollister Brewing space in Camino Real Marketplace. The former Bed Bath & Beyond space in Fairview Center remains the only big-box available, while the rest of the vacancy is primarily in-line space in daily-use centers.

INDUSTRIAL LEASING

Goleta

After a slow start to the year, Goleta industrial leasing picked up considerably, generating 86,000 SF of gross absorption in Q2. This contributed to Goleta's vacancy rate drawing down to 1.4%, which is near the low end of its historical range.

The most notable of the Q2 deals proved to be Goleta's largest lease transaction in more than two years: Redwire Space Enterprises leased the 42,600 SF flex building at 326 Bollay Dr, which had been vacant since Inogen moved out in 2019. Redwire will continue to occupy 47,000 SF at 7418 Hollister Ave and expand its operations to Bollay Drive. With this lease, Majestic Asset Management's "Engage" campus at Storke and Bollay is fully leased.

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Redwire Space Enterprises is expanding into the 42,600 SF flex building at 326 Bollay Dr in Goleta.

In another Q2 deal that took a whole building off the market, the medical device company Arthrex leased 17,200 SF at 749 Ward Dr, one of the three buildings formerly occupied by Herbl. Like Redwire, Arthrex is expanding to its newly leased space, and will continue to occupy its existing space across the street at 460 Ward Dr. These two companies are great examples of the engineering and bioscience sector that is propelling Goleta's economy.

There were also two renewals to mention. In Q2, American Medical Response renewed 7200 Hollister Ave for 7 years. This followed the 5-year renewal by Mammoth Moving & Storage of 42,700 SF at 5390 Overpass Rd in Q1.

Santa Barbara

Santa Barbara industrial inventory has grown considerably since the beginning of the year, with eight new offerings coming to market. The largest of these are the 12,700 SF "Hangar" building at 201 W Montecito St, and 11,600 SF at 1 N Calle Cesar Chavez. In addition, three spaces totaling 8,500 SF have become available for sublease, which is notable since industrial sublease space is uncommon in Santa Barbara. After these additions to available inventory, the vacancy rate is still only 1.6%.

Santa Barbara's industrial leasing has been light, especially compared to the robust activity seen in 2023. Gross absorption is down 50% from the 5-year average, in part because all five Q2 leases were smaller than 2,000 SF.

Carpinteria

The excess of available office space in Carpinteria, currently at 17.7% vacancy, continues to be met with very limited demand. As of midyear there was just one small office lease in Carpinteria, and one small office/retail lease in Summerland. Procore's 79,500 SF of space for sublease across two buildings on the bluffs constitutes the bulk of the vacancy. In Q2 the 10,167 SF first floor of 6398 Cindy Ln came up for sublease as well, offered by Agilent. All told, 82% of Carpinteria's availability is sublease space.

LEASING MARKET DATA

	Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE	Santa Barbara	**10.5%**	+5%	**48**	-5%	**139,740**	-25%	**$3.22**	-4%
	Goleta	**6.5%**	-17%	**18**	+9%	**114,754**	-56%	**$2.35**	+5%
	Carpinteria	**17.7%**	+129%	**2**	-43%	**4,035**	-73%	**$2.16**	-5%
RETAIL	Santa Barbara	**3.0%**	-7%	**34**	+19%	**64,093**	-6%	**$3.86**	-3%
	Goleta	**1.9%**	-19%	**10**	+11%	**17,049**	+6%	**$3.25**	+0%
	Carpinteria	**4.6%**	-49%	**4**	-11%	**6,804**	+7%	**$3.99**	-15%
INDUSTRIAL	Santa Barbara	**1.6%**	+101%	**9**	-25%	**24,356**	-73%	**$2.59**	+33%
	Goleta	**1.4%**	-41%	**11**	+5%	**145,855**	+42%	**$2.12**	+21%
	Carpinteria	**4.0%**	+6%	**2**	+100%	**14,032**	-15%	**$1.37**	+22%

Change percentages are compared to 2023 values.

Congratulations, Steve!

After 42 years of service, our founder Steve Hayes has retired. We thank him for his vision, dedication, and the countless ways he built and strengthened this company over his decades of excellence.

Stephen H. Hayes

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