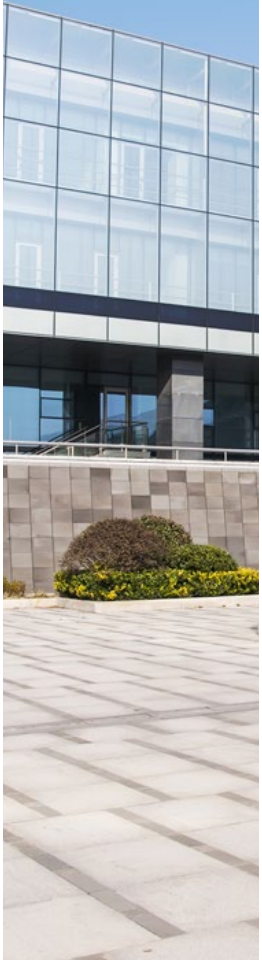
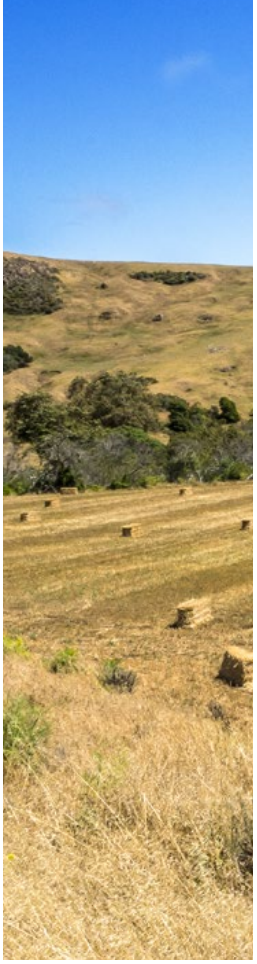



The Lee Central Coast Brief

Q3 2016

LEE & ASSOCIATES®
COMMERCIAL REAL ESTATE SERVICES

Lee & Associates Overview

155%
increase
in transaction volume over 5 years

$12+ billion
transaction volume
2015

870
agents
and growing nationwide

Ranked 2nd

June 2016, Commercial Property Executive
(2016 Top Brokerage Firms)

OFFICE
INDUSTRIAL
RETAIL
INVESTMENT
APPRAISAL
MULTI-FAMILY
LAND
PROPERTY MANAGEMENT
VALUATION & CONSULTING

LOCAL EXPERTISE.
NATIONAL REACH.
WORLD CLASS.

At Lee & Associates® our reach is national but our expertise is local market implementation. This translates into seamless, consistent execution and value driven market-to-market services.

Our agents understand real estate and accountability. They provide an integrated approach to leasing, operational efficiencies, capital markets, property management, valuation, disposition, development, research and consulting.

We are creative strategists who provide value and custom solutions, enabling our clients to make profitable decisions.

NATIONWIDE LOCATIONS

Columbus, OH · Houston, TX · Denver, CO · Cleveland, OH · Long Island-Queens, NY · Chesapeake Region , MD · Charleston, SC · Edison, NJ · Orlando, FL · Fort Myers, FL · Manhattan, NY · Greenville, SC · Atlanta, GA · Greenwood, IN · Indianapolis, IN · Long Beach, CA · Elmwood Park, NJ · Boise, ID · Palm Desert, CA · Santa Barbara, CA · Antelope Valley, CA · Dallas, TX · Madison, WI · Oakland, CA · Reno, NV · San Diego, CA · Ventura, CA · San Luis Obispo, CA · Southfield, MI · Los Olivos, CA · Calabasas, CA · St. Louis, MO · Chicago, IL · Victorville, CA · Temecula Valley, CA · Central LA, CA · Sherman Oaks, CA · West LA, CA · Pleasanton, CA · Stockton, CA · Las Vegas, NV · Phoenix, AZ · Carlsbad, CA · Industry, CA · Los Angeles, CA · Riverside, CA · Ontario, CA · Newport Beach, CA · Orange, CA · Irvine, CA, · Vancouver, CANADA

LEE & ASSOCIATES CENTRAL COAST

3
offices
within the tri-counties

11
agents
and growing

Ranked #1

Lee-Associates Central Coast ranks #1 in the Region
Pacific Business Times ~ 9/2016

Market Snapshots

GLOBAL ECONOMY

In the past two quarters we have been describing the global economic outlook as troublesome. The International Monetary Fund must agree, as it has twice reduced its estimate of global growth this year. The stakes remain high and the outcome of the current global economic conundrum is largely unknown. Energy exporting nations are reeling from the sharp decline in oil prices, but they can't seem to get on the same page on production levels to support a price recovery. Iran is back in the oil business, which has added unneeded supply and Saudi Arabia keeps pumping to keep the price down in an effort to squeeze out US and Canadian production, which is more expensive. That strategy has worked, but every nation that exports oil has taken a huge hit as a result. Venezuela, Brazil and Russia have been hit particularly hard. Venezuela is near complete collapse economically and politically, while Brazil is grappling with runaway inflation and government scandals. Nations that export other commodities have also suffered from price collapses relating back to slower growth in China, the world's largest manufacturer. When the UK made its surprise decision to vote for an exit from the European

Union, the long term survival of the EU became a major topic. Few gave the Brexit vote a chance and the shock wave from the vote was felt immediately. Europe's political union in constant crisis mode these days and there is no governing body with the real authority to enforce anything. Sovereign debts are mounting, unemployment is persistently high and GDP growth in Europe is nearing recession territory. Calls for austerity from nations swimming in debt have been largely ignored, and the ongoing refugee crisis has whipped up nationalist fervor throughout Europe. The Euro and British Pound have taken a beating of late, and central bankers are taking drastic steps to stimulate business and consumer spending. Oil-rich Middle-Eastern countries, including Saudi Arabia, are burning through cash reserves to cover revenue shortfalls precipitated by the falling price of oil. China is issuing sovereign bonds to help it cope with its massive transition from total dependence on the exportation of manufactured goods.

None of this sounds like good news and that is undeniably correct. However, the US economy is in much better shape relatively speaking. Once again, the world views the US as the safe haven of choice. That keeps capital moving into the US and much of that finds its way to the commercial real estate market. In fact, foreign demand for US real estate assets continues to contribute to gains in asset prices, as it increases competition in all product types. Foreign investors are willing to pay a premium to assure the preservation of their capital.

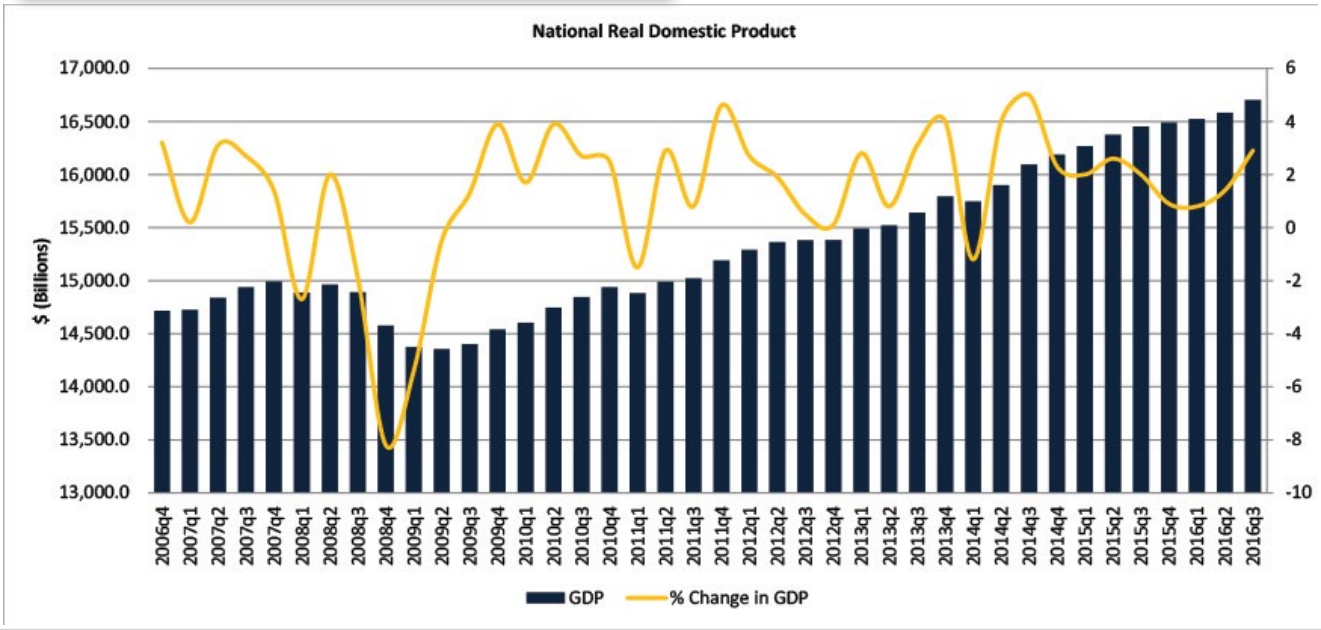
GDP GROWTH

US GDP, the benchmark that tracks the total output of US goods and services, is perhaps the most closely watched statistical barometer in the world. Our economy is the largest on the planet and we consume more foreign goods and services than any other nation. So, the fortunes of those nations who depend on exporting goods and services to the US are inextricably linked to our own. Unfortunately, US GDP growth over the past several quarters has been dismal, running just above stall speed despite massive intervention by our central bank. In the fourth quarter of 2015, the US economy grew at an annualized rate of just .8%. In Q1, the economy expanded by just .9%, followed by a 1.4% rate in Q2. Even if things pick up in the second half of the year, it is unlikely that the US will achieve even a 2% rate of growth. In 2015, GDP grew at a 2.4% clip.

The current estimate of Q3 growth offered by the Atlanta Fed's GDP Now tracker, is at 2.9% and has been trending down each week. As poor as our economic growth is, it's better than it is in Europe and Japan, where governments are resorting to drastic measures to keep their economies from sliding into recession. The central banks of the EU and Japan have resorted Negative Interest Rate Policy (NIRP) and massive bond-buying programs to encourage corporate borrowing. Political turmoil, civil unrest and economic challenges around the world have dampened expectations here at home. There is no denying the effects of globalization and things are not going well outside our borders. So, only die hard optimists are predicting much near term improvement in the US GDP growth rate. The bigger question now is whether or not US companies and consumers will acclimate to a lower growth model and accept it as the "new normal."

Volatility in equities has been on the rise in 2016, as US companies grapple with sluggish market conditions. Corporate earnings have declined repeatedly the last six quarters and companies have been resorting to cost-cutting and stock buyback programs to increase profits and earnings per share. Reducing operating costs means job cuts and that means reduced consumer spending, which accounts for roughly 70% of GDP. As we pointed out the last two quarters, US consumers have become more cautious. Retail sales growth, a large component of consumer spending, has been spotty at best. Sluggish wage growth remains a problem. Income growth is running just above the rate of inflation, which remains stubbornly below the Fed's target of 2%. Even auto sales, which have been very strong in the past couple of years, are seeing a drop-off, further evidence that consumer confidence could use a boost.

QUARTER-TO-QUARTER GROWTH IN REAL GDP



EMPLOYMENT

Job growth, which was running at over 200,000 per month on a rolling twelve month average, has slowed down and become more volatile in recent months. Q3 started strong with a total new job count of 252,000. However, August and September were both disappointing, posting job counts of 167,000 and 156,000, respectively. The low point for 2016 came in May when only 11,000 new jobs were recorded. The best month of the year thus far came in June, when 271,000 new jobs were created. Wild swings in job growth is certain to affect consumer spending and that makes CEOs more cautious and less inclined to implement aggressive growth strategies. If that is so, then we can expect job growth to stay on its current trajectory.

Despite erratic job growth numbers, the U3 unemployment rate (the index most widely used) has only ticked up slightly from its low of 4.7% back in May. As Q3 closed, the U3 unemployment rate stood at 5%, which historically is indicative of a fully employed economy. However, that number is deceiving because so many of the jobs being created are either part time or at the lower range of the wage scale. The U6 unemployment rate, which accounts for part-time workers who would prefer to work full time in their field, is still at 9.7%. This index perhaps more telling of our employment picture because it makes clear the fact that too many people are working at jobs that don't pay the bills. This reduces discretionary income and negatively impacts consumer expenditures. Concerns over slowing domestic growth and the prospect of recessions abroad is prompting employers to hire more part time and temporary workers. The cost of health care pursuant to the Affordable Care Act (ACA) is also contributing to part time employment problem, as employers are inclined to hire workers just under the 30 hour per week threshold that would require them to provide health benefits.

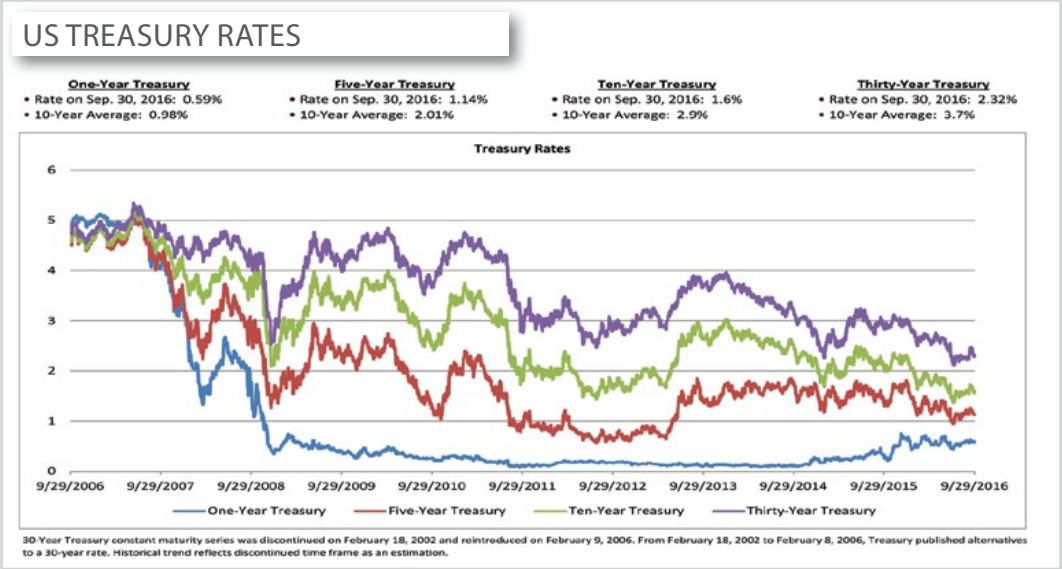
The Labor Participation Rate, the metric that measures the percentage of those eligible for employment between the ages of 16 and 64 who are currently working, also remains stagnant. Choppy job growth reports and the early exit of Baby Boomers, have combined to keep just 62.9% of potential workers in active production. It is important to note that Labor Participation has moved of a five decade low, but it may begin to move back down in the coming quarters as the rate of retiring Baby Boomers increases. Wage growth is another problem that has dogged the US economy. Full-time, high-paying jobs are in short supply and wage growth overall is tracking at a rate of approximately 2.6%, marginally above the current rate of inflation. That kind of wage growth offers little relief to workers at or near the minimum wage level who are struggling to make ends meet. It's no wonder that so many middle class workers are disillusioned with a recovery that they feel has left them on the outside looking in. Many of them come from the manufacturing sector, which has been steadily shedding jobs for the past year. Layoffs in the energy sector has not helped the job picture, either. Upwards of 700,000 full time positions have been eliminated since oil prices declined sharply back in 2014. Many of these jobs are high-paying technical positions that are not easily replaced in other business sectors. Until oil prices move much higher than current levels, we can expect more of the same kind of job losses.

NATIONAL UNEMPLOYMENT

MONETARY POLICY

In December of last year, the US Federal Reserve Bank finally pulled the trigger and boosted the Fed Funds rate by 25 basis points to .5%. Since that time, our central bankers have chosen not to take further action, citing any number of reasons to sit on their hands and continue the longest monetary stimulus in Fed history. Some believe our central bankers were caught off guard when their first move on rates roiled world markets and sent the US Dollar soaring. A strong dollar makes US exports more expensive and raises the cost of paying back dollar-denominated loans from around the world. That first move on rates also sent US equities markets into a slide that many had been predicting. But, the Fed walked back their plans for regular rate hikes throughout 2016 and yield-chasing investors poured back into the equities markets, driving up stock prices back up despite six consecutive quarters of earnings declines. Now the chatter about another rate hike this December is getting louder and most experts believe there is at least a reasonable chance for a single rate hike after the Presidential election but before the end of the year. However, few will be surprised if the Fed kicks the interest rate can again. While the talk here is about when to raise rates, central bankers around the world have been going in the opposite direction.

The European Central Bank (ECB) has taken its benchmark rate into negative territory, as has the Bank of Japan. That means that borrowers get paid for borrowing money, which has raised legitimate concerns within the business and investment communities. Both those central banks are buying corporate bonds in addition to their own sovereign debt, raising further concerns over the long term consequences of actions that are based on unproven economic models. The most outspoken critics of central bank policy are calling out individual central bankers they believe are panicking by doubling down on failed policies to save their academic reputations. Given the current state of economies around the world, that argument is sounding more reasonable all the time.



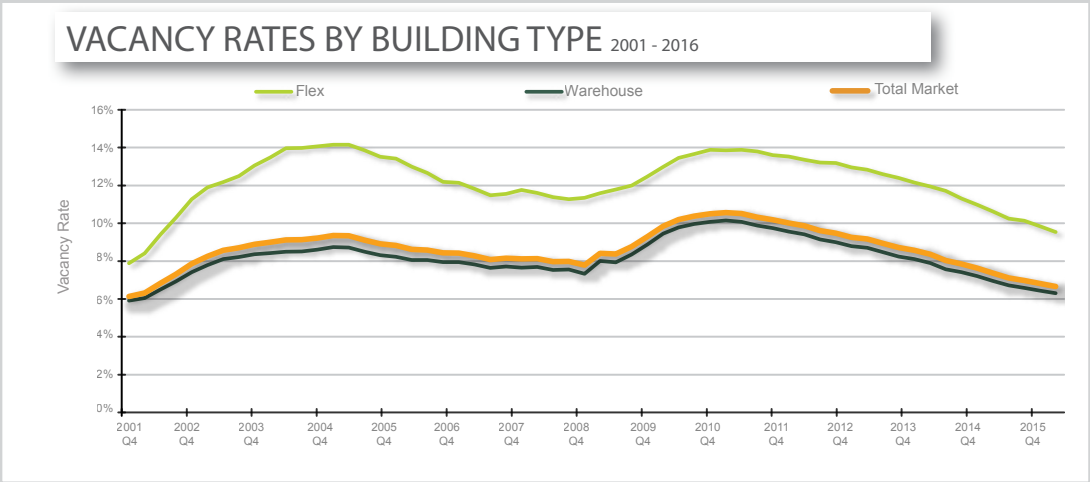
Back here in the US, Fed Chairman Janet Yellen and her Board of Governors have slowly but surely been painting themselves into a corner by continuing their current easy money policy. With GDP growth near stall speed, concerns over what action the Fed can take if we fall into recession. With a Fed Funds rate of .5%, just two 25 basis-point decreases take it to 0%. If that doesn't adequately stimulate GDP growth, then there may be no place to go but into negative territory, which is completed uncharted territory. That will send economic uncertainty to new levels and cause declines in consumer spending and business investment. If that happens, the Fed may be out of ammunition and may leave the federal government with no other choice but to increase spending to stimulate the economy. That means bigger federal deficits that are already on the rise and on their way back to over $1 Trillion per year. Bottom line: the Fed has itself in a pickle and is running out time and ideas to get the economy back on a track of healthy growth.

Real estate borrowers are still reaping the benefits of the Fed's current monetary policy direction. Mortgage rates have remained at historic lows, and borrowers are in a position to lock in those low rates for up to 25 years. Most lenders use a spread over the yield on the 10 Year T-bill (now at approximately 1.7%) to set mortgage rates. So, long-term loans are still readily available in the 4% range. Until the Fed does more than talk about raising rates, it will still be a good time to borrow money. Clearly, keeping a close eye on what central bankers are up to around the world is a good idea. More drastic measures are being taken every day somewhere around the world, including the newest tool, negative interest rates. Imagine paying for the privilege of loaning someone else money. Sound crazy to you? If it does, you are not alone.

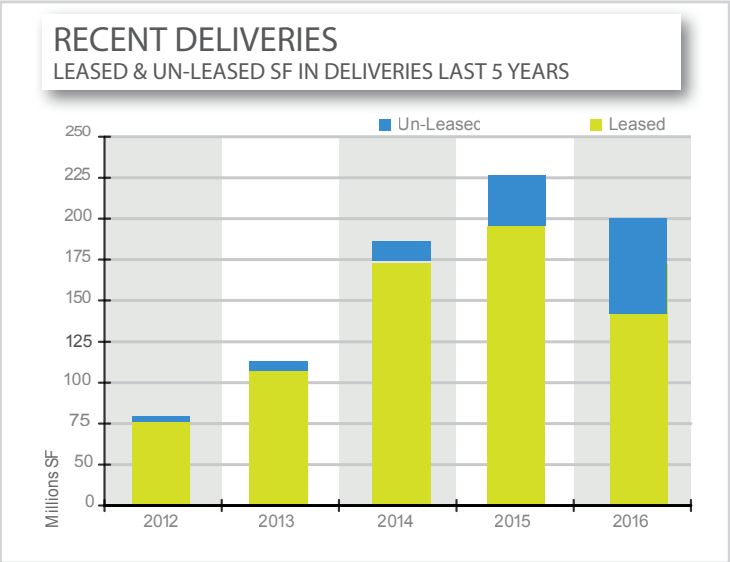
US INDUSTRIAL MARKET

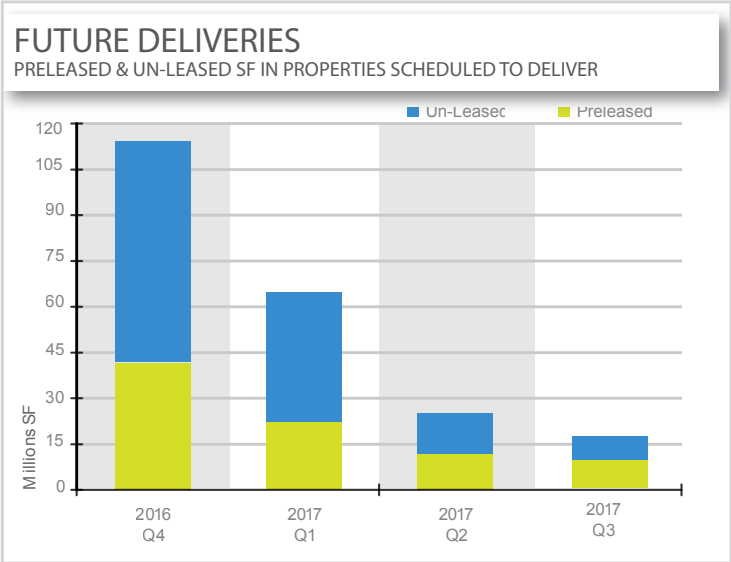
For owners and developers of industrial real estate, the third quarter of 2016 was cause for celebration. Just when the experts were starting to wonder about the market getting long in the tooth, it took off again. Net absorption was sharply higher, rent growth was strong, vacancy declined and new deliveries were way up. What makes it even more remarkable is the fact that US and global economic growth is anemic and concerns over a real estate correction are spreading. Major US corporations have reported declining earnings for six straight quarters, and central banks across both oceans are printing money and experimenting with negative interest rates to keep their economies from slipping into recession. Our own central bankers have repeatedly threatened to tighten up on their cheap money policy by raising interest rates, but that has been nothing but talk since they made a single rate hike late last year. Domestic GDP growth has slowed substantially in the past year. But, despite all of it, the industrial market just keeps on exceeding expectations quarter after quarter.

If you're a tenant, owner/user buyer or investor, you are having a tough go of it. With vacancy declining in almost every primary and secondary market, quality space offered for lease is getting tougher to find, and many tenants are forced to settle for older properties, many with elements of functional obsolescence. For those tenants fortunate enough to secure first generation space, rates are up and landlords are demanding longer terms and stronger credit.



Owner/user buyers are frustrated in every market we track. Property values have skyrocketed and the supply has dwindled to zero in some markets. Still, they keep hunting for the rare opportunity to buy with as little as 10% down with long term loans with fixed interest rates in the low 4% range. Many markets have recorded double-digit appreciation for owner/user buildings the past three or four years. Yet, demand keeps moving higher. For investor buyers, the odds for successful acquisitions are not much better. Competition for industrial investment property is fierce and trades are being made above asking prices at cap rates running as low as 4%.

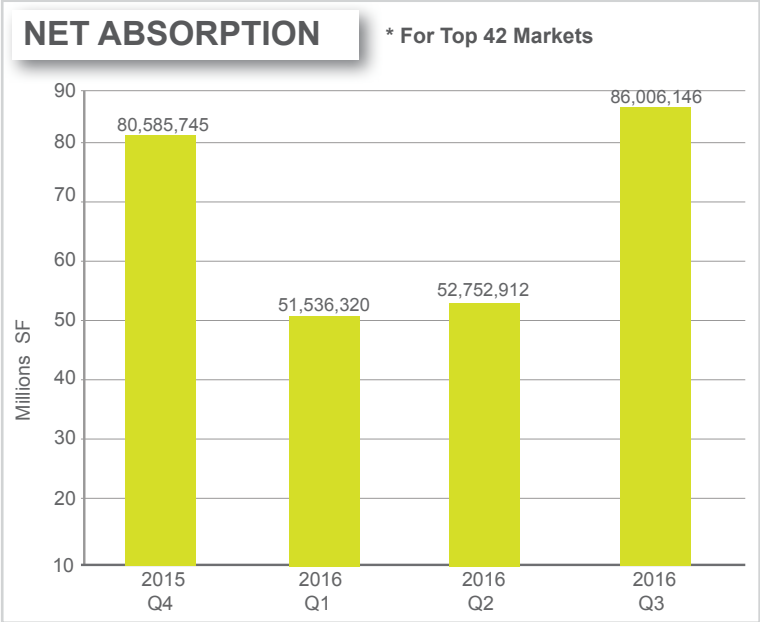




Even secondary markets are experiencing a huge imbalance of supply and demand. All industrial product types are in high demand. The institutional players are focused on big distribution buildings occupied by strong credit tenants. They also like multi-tenant business parks, but have to compete with local and regional players for those assets. Add value deals are also in play. Those deals are often the target of developers who are having their own troubles securing quality sites for ground-up development, as land becomes more expensive, scarce and harder to get entitled. So, with all that in mind, let's take a look at the numbers for Q3.

Net absorption, the key driver that makes it all go, was way up in Q3. Over 112 million square feet of positive net absorption was recorded nationwide. That is an increase of 37% over Q2's total and the biggest quarterly gain in net occupancy in years. E-commerce players, the big shippers and 3PL operators are the biggest contributors, along with major retailers. The big push for "Last Mile" locations is making a difference in markets big and small. Amazon.com has been opening multiple major fulfillment centers each quarter, with many of them near or over 1 million square feet. Walmart is also making a push to do the same, as the world's largest retailer ramps up to compete with Amazon, the goliath of the e-commerce movement. Without the e-commerce boom, the market would have a very different look and feel. But, the sector may be at just the beginning of its expansion phase, as online sales are still only a small fraction of overall retail sales across the country.

New deliveries for both speculative and build-to-suit projects for Q3 reached 81.5 million square feet in 475 buildings. That is a 48% increase over the previous quarter and the highest total in the past year. That brings total US industrial property inventory up to 21.85 billion square feet. As the quarter ended, another 234.4 million square feet was still in the construction pipeline. Development activity is far from evenly distributed. Infill markets like Los Angeles and Long Island New York, have virtually no construction, while land rich markets like Dallas, Houston, Atlanta, Philadelphia, Chicago and Southern California's Inland Empire have up to 20 million square feet underway at the same time.



A good balance between spec and build-to-suit construction has helped keep market metrics in balance. New deliveries are running just short of net absorption, which bodes well for continued equilibrium in most markets around the country. At this time, no primary or secondary market in the US is considered overbuilt. That gives developers the confidence to keep on building without fear of being overextended if the market finally does cool off. In the markets with high levels of speculative construction, tenants are able to expand quickly if needed. They may have to pay more, but they continue to show a willingness to do so, as long as they get space that helps improve efficiency. For the past two quarters we reported that a disproportionate amount of market activity was concentrated in big deals by big tenants in big buildings. That didn't change much in Q3. The warehouse sector accounted for 104 million of the 112 million square feet of net absorption recorded in Q3. Most of that was in bulk distribution deals. Think Amazon. However, that doesn't mean every big deal is a big e-commerce player. The biggest building under construction right now is a manufacturing plant for Volvo in Charleston, South Carolina. The national vacancy rate for warehouse and flex space combined has been falling steadily, and that trend continued in Q3 with another 20 basis point drop to finish the period at 5.6%. In the past four quarters, the vacancy rate has fallen by 40 basis points, but several major market areas have vacancy rates in the 2% range, including Central Los Angeles, Long Island, New York and California's Orange County.

US INDUSTRIAL MARKET

Not coincidentally, those markets have nominal amounts of new construction. The base inventory of industrial product is actually shrinking in some mature markets, as land is being repurposed to so-called higher uses. asking rate continued its five year long move up. In Q3, rents rose another $.08 to $6.01 per square foot. Markets with the most construction are experiencing more rapid rent growth, as tenants continue to pay a premium for first generation space that offers greater efficiency. That includes major distribution hubs like Atlanta, Dallas, and Southern California's Inland Empire.

LOOKING AHEAD

The US industrial market should finish 2016 as it began; high demand, low supply, rising prices and declining vacancy. Weak economic growth, confusing monetary policy and political theater around the globe is yet to put the brakes on US industrial market growth. But, if interest rates don't move up soon, our central bankers will have little room to maneuver in the event of market correction. When the Fed Funds Rate moves up, cap rates may move in the same direction, if not in lockstep. That means that even markets with the strongest rent growth would see valuations decline. That possibility is not lost on investors, expanding businesses and developers who will take pre-emptive action to protect their interests.

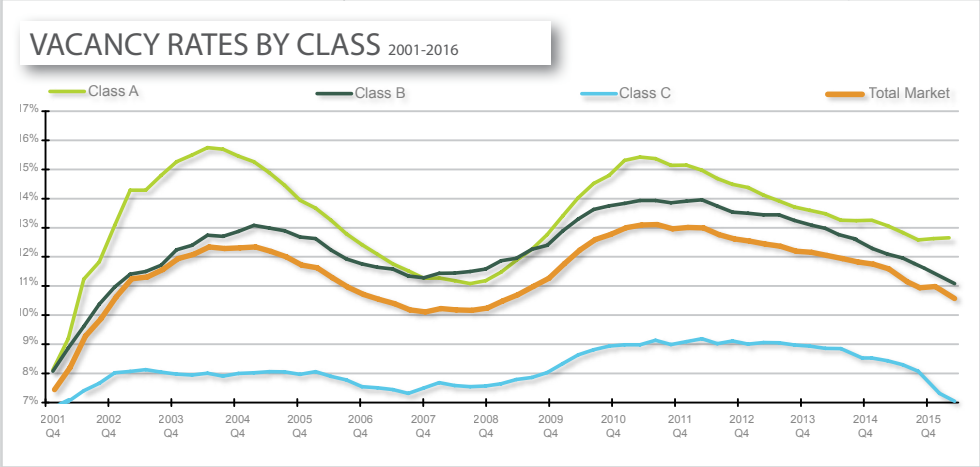
Internationally, there is no good news. Period. The global economy is on its heels right now and there is little indication that things will get better before they get worse. Post-Brexit impact on the EU is still a big unknown. China and other emerging economies are struggling. The US economy is doing better, but only by comparison. GDP numbers are falling behind 2015 levels, job creation is trending down and our manufacturing sector is struggling to keep from sliding backward. Is this enough to slow the industrial market down? To date, the answer is no. The market has a head of steam that will be hard to cool down. Barring a "significant" economic event, we should all expect the industrial sector continue to expand. Even at half its current pace, market growth would be significant.

The US is still the preferred safe haven for foreign investment and owning US Dollar-denominated assets is a good bet. So, capital will keep flowing into the US, which would mitigate the impact of a slowdown in industrial market activity.

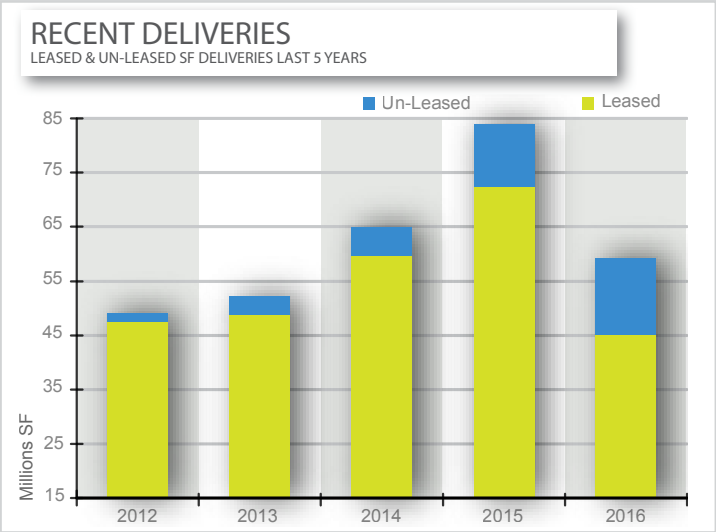
Vacancy will keep moving lower and more markets will look Central Los Angeles where vacancy is running at 2% and construction is essentially non-existent. Net absorption should stay near record levels in most markets, but may moderate in markets that lack quality options for expanding tenants. More tenants will be forced to renew and average lease rates will continue to move higher, especially in those markets with the first generation space. Construction will stay at current levels in areas with ample supply of land, but will decline in markets with fewer available sites and higher levels of regulatory controls. Expect the entitlement process to become longer and more expensive.

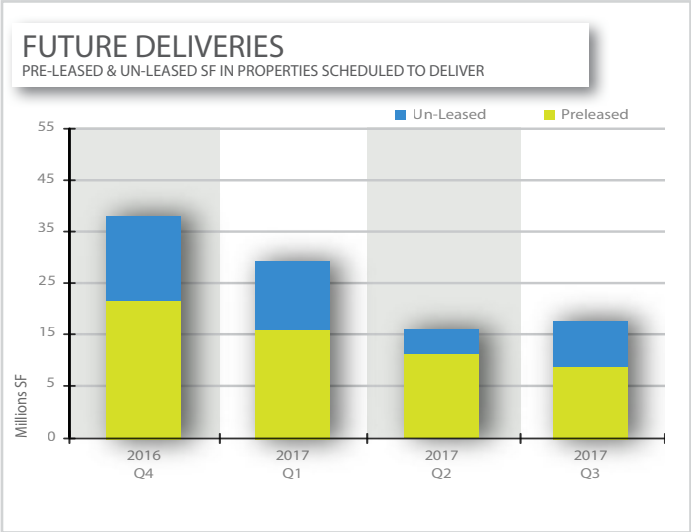
US OFFICE MARKET

After a lackluster start to the year, the US office market surged in Q2, and followed up with another strong showing in Q3. Vacancy continued to decline, rents kept moving higher and net absorption remained well into positive territory. New deliveries maintained momentum, as well. In many ways, the second and third quarter numbers are mirror images of one another. On the other hand, a handful of other hub markets for the tech industry like San Francisco, Seattle and Raleigh/Durham made big gains in Q1. The similarities are most evident in the absorption numbers. In Q3, a gain in occupied space of 36,110,000 square feet was realized, a scant 20,000 square foot difference from Q2's total. That is more than double Q1's total and back in line with the 38 million square feet of net gains tallied in Q4 of last year. This clearly indicates the ongoing demand for office space nationwide.



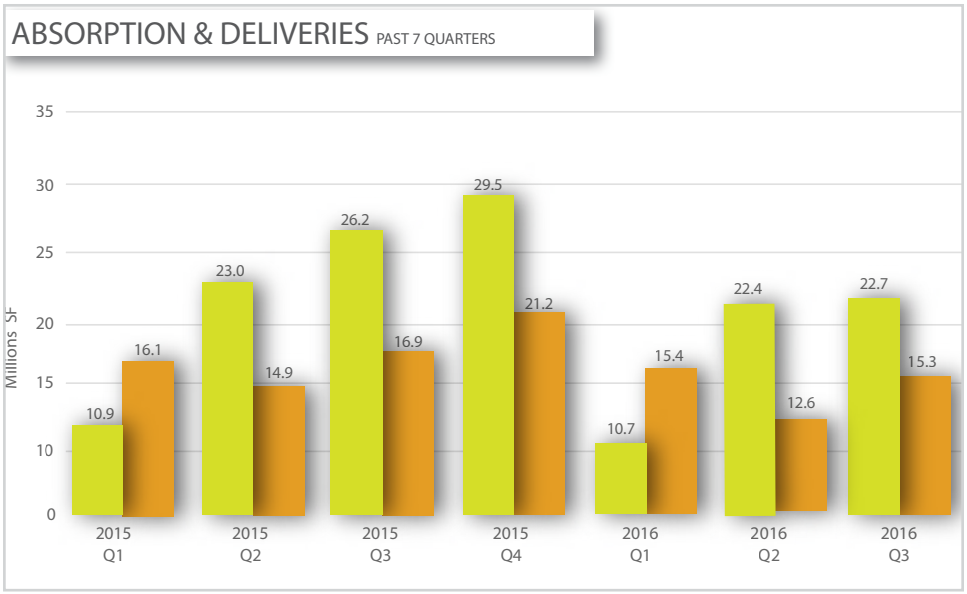
Of note, however, is the fact that two of the country's largest office markets, New York City and Chicago, have each posted close to 1 million square feet of negative net absorption this year. Almost every other primary and secondary market coast-to-coast, has experienced net gains in occupied space. Market leaders in absorption include Boston at 3.9 million square feet, Seattle/Puget Sound at 3.5 million square feet, Dallas/Fort Worth at 3.4 million square feet, Greater Los Angeles at 3.3 million square feet and Detroit at 3 million square feet. Even Houston, has positively absorbed space year-to-date, but momentum there is still declining due to the ongoing energy sector slowdown. Massive amounts of sublease space pouring onto the market in the nation's energy capitol are certain to impact market performance there going forward. The San Francisco/Silicon Valley market, superheated over the past several years due to tech sector job growth, may finally be cooling off as job gains moderate and low vacancy limits absorption gains. By building class, net absorption remains in balance, as Class A, B and C product all reported strong Q3 and year-to-date gains.





US OFFICE MARKET

In terms of Suburban versus CBD performance, over 90% of the Q3 net absorption was recorded in the suburbs. However, many suburban submarkets around the country are developing urban hubs that are attracting a growing number of employers who are intent on being close to millennial workers who prefer higher density areas because it allows them to live, work and play within walking distance. Average asking lease rates for the US moved sharply higher in Q3, up $.40 to $23.97 per square foot. That is a 1.7% increase in just three months. Rents are moving up in most office markets around the country, but there are significant differences in the trajectory of rent growth within local markets as tenants move between building classes and submarkets to realize operational efficiencies.

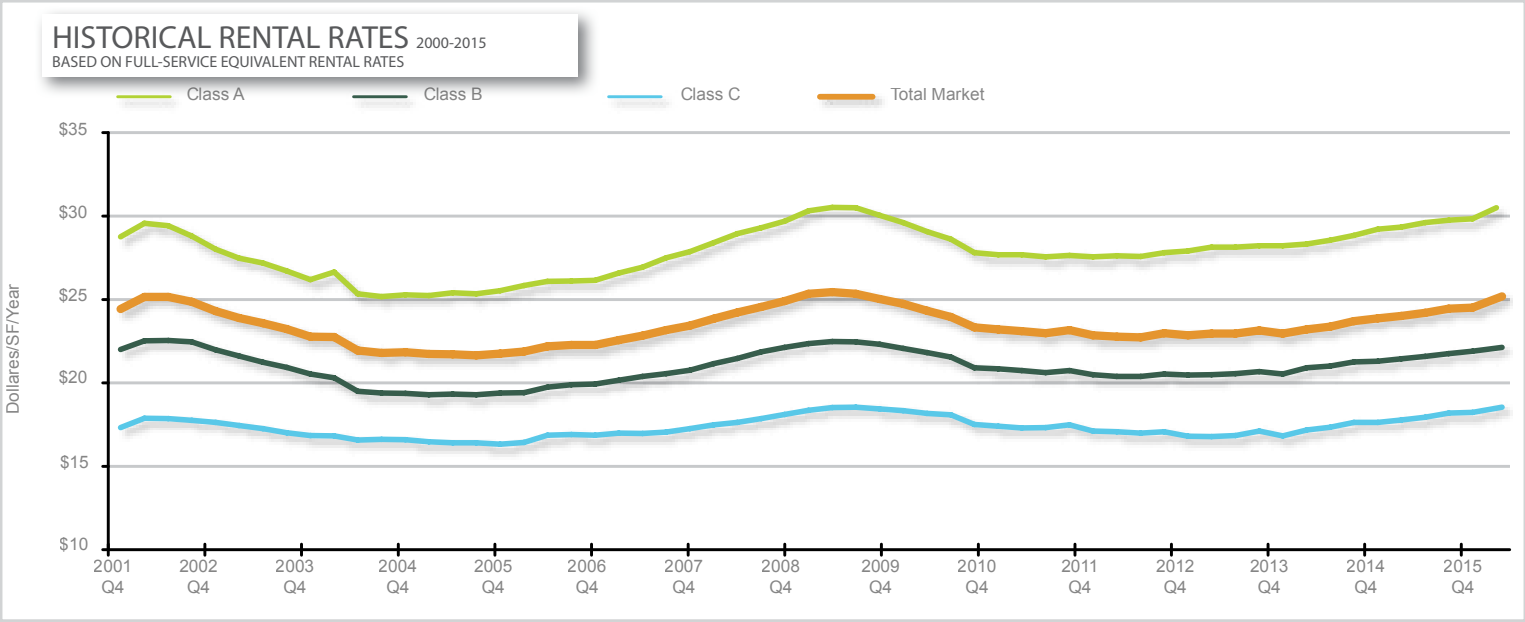


The quest to do more with less is ongoing. Tenants across all sectors are looking for ways to leverage advances in communication and computing technologies to occupy less space. If space is going to keep getting more expensive, savvy business owners and CEO's are sure to continue looking for ways to shrink their facilities footprints. Markets with more active tech and healthcare sectors tend to see bigger rent gains. Energy markets are finally seeing rent declines. The looming problem there is the large blocks of space that have been coming back on the market for sublease. That pressure on rents and net absorption, is likely to persist until the slack in demand caused by under-utilization tightens back up. The level of new deliveries remained steady in Q3 at just over 20.1 million square feet in 424 new buildings, after the delivery of 19.4 million square feet in Q2. The amount of space under construction rose by 5 million square feet in Q3. The quarter ended with 147.5 million square feet of space in the construction pipeline, with more than half of that total concentrated in the nation's ten largest markets. New York City is at the top of that list with nearly 13.5 million square feet underway. Dallas/Fort Worth is not far behind at 11.8 million square feet, followed by Washington DC at 10.7 million square feet and South Bay/San Jose (Silicon Valley) at 10.1 million square feet. Another tech-heavy market, Seattle/Puget Sound, rounds out the top five at 8 million square feet.

The largest project underway in Q3 was the 3 World Trade Center tower in Manhattan. That building is set for delivery in early 2018. Developers continue to focus on mixed-use projects in urban core areas that are near public transit and entertainment venues, which are high priorities for millennials. However, high land prices, rising construction costs and more cautious loan underwriting is keeping speculative development in check, which limits the risk of overbuilding. Institutions and private investors, both large and small, have been chasing short supply of office product for sale.

Cap rates remain compressed to record lows and core assets are trading hands below 5%. Although there are signs of a change in market trajectory, and investors are well-advised to increase efforts to underwrite local market metrics before paying the current premium. Some markets may be peaking in terms of rent growth and if cap rates begin to move higher, that combination poses significant risk, as the rise in cap rates may not be mitigated by growth in net operating income. Foreign buyers keep pouring capital into US assets in their ongoing efforts to protect capital that they see as being at greater risk around the world. Investors everywhere still see the US as the safest of safe havens to stash capital as prospects for global economic growth become more uncertain.

Another Win for the Office Market



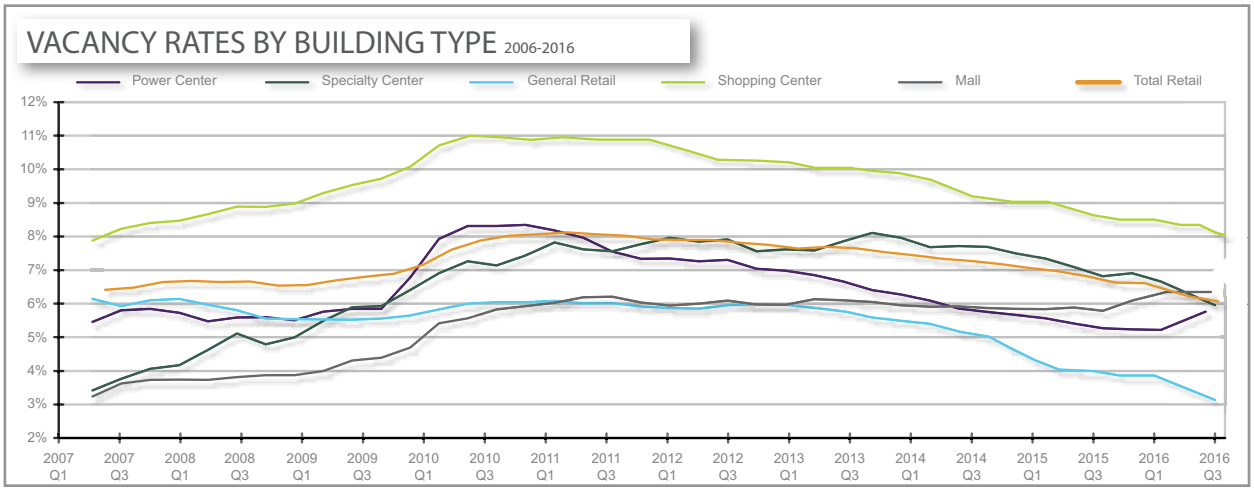
LOOKING AHEAD

The US office market has a good head of steam for the time being but US employment growth has been slowing on a twelve-month rolling average basis. Over 100,000 new jobs need to be created each month just to keep up with new entries into the workforce. With monthly job growth averaging just over 150,000 new positions, the impact on net absorption in 2017 should be measurable. Fortunately, a good percentage of the jobs being created are generated by office-using tenants, but recent results indicate a disproportionate number of jobs being generated in the retail, healthcare services and restaurant sectors. Many of these positions pay less, are offered on a part time basis and do not increase the need for office space. Wage gains have also been lackluster, running just ahead of core inflation, which is currently hovering at 1.7%. Poor wage growth is a drag on consumer spending, the key component of the GDP equation.

Rent growth will continue, especially in major markets where big employers continue their efforts to upgrade their workplace designs to attract and retain a workforce that is getting younger each quarter as baby boomer retirements increase. Without a substantial increase in construction, which is not expected in 2017, vacancy should continue to decline in 10-20 basis-point increments in the next several quarters. Markets more dependent on the energy sector will see vacancy move in the other direction, as more sublease space hits the market.

US RETAIL MARKET

The US retail property market kept pace in Q3, duplicating Q2's strong performance after a disappointing start to the year. Net absorption nearly equaled the Q2 tally, the vacancy rate declined further and average asking rents rose again. Construction activity was little changed. Still, the retail industry continues to experience significant change, as traditional department stores struggle to right-size and giant brick-and-mortar retailers like Walmart make big moves to compete more effectively with e-commerce behemoth, Amazon, which continues to expand at an extraordinary pace. In a huge mid-year move, Walmart acquired Jet.com to enhance its online capabilities and it is leasing major distribution facilities around the country to increase "last mile" efficiency.



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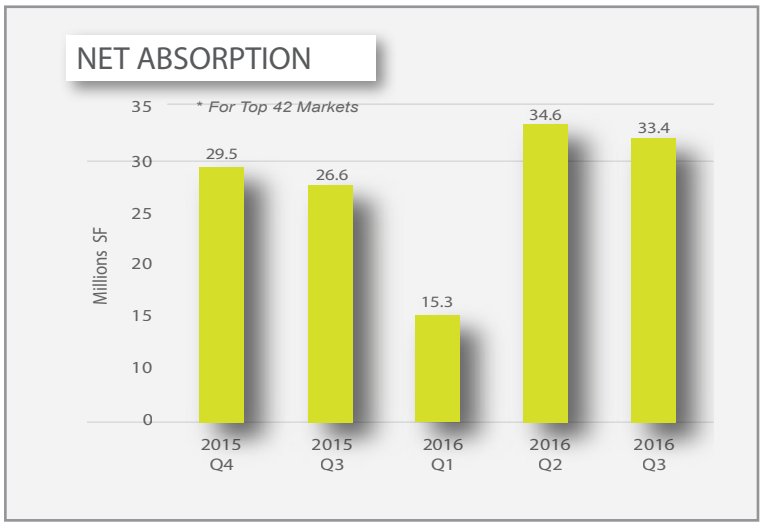
US retail sales in September rose by 2.7% compared to the same period last year, but combined Q3 results were very disappointing. September sales rose .6%, but that came after a decline of -.2% in August and a modest gain of .1% in July. None of the 13 major retail categories posted significant gains in September. Although, gas station sales rose by 2.4% after experiencing major declines in recent months. Overall consumer spending was very strong 4.1% in Q2, but slipped by half in Q3, according to the first of three estimates of Q3 US GDP. Uneven results in both consumer and retail sales is making it tough on retailers to plan for expansion.



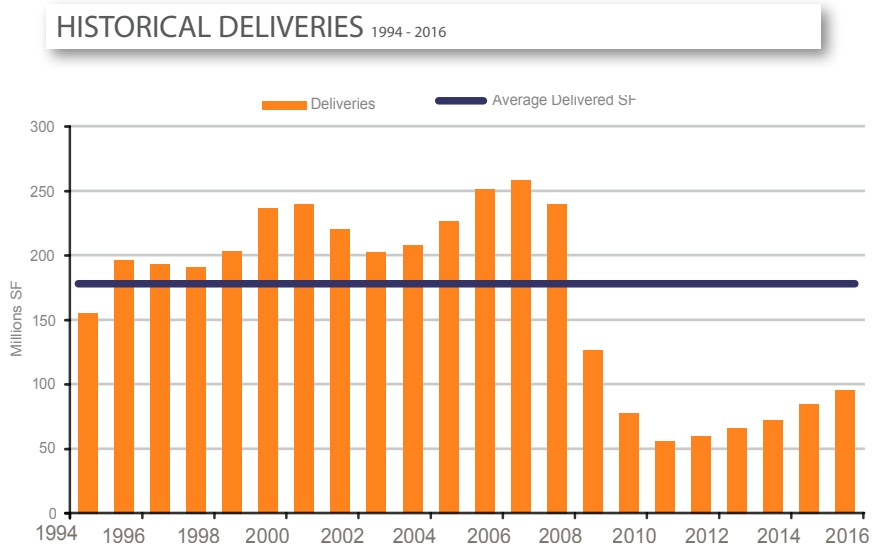
The vacancy rate declined again in Q3, shedding another 20 basis points to settle at 5.0%. In the past year, vacancy has moved 40 basis points lower. As reported last quarter, vacancy is sharply higher in secondary submarkets. General retail (freestanding, general purpose properties) posted the lowest vacancy of all retail property types at 3.0%, down 30 basis points in the quarter, followed closely by Power Centers at 4.7%, up 20 basis points in Q3 due to big box closures in the sporting goods industry.

RETAIL SECTOR KEEPS PACE IN Q3

Shopping Center (neighborhood, community and strip centers combined) rates are still highest at 8.0% despite another 30 basis point decline in Q3. Excess supply in this category is concentrated in suburban submarkets that have fallen out of favor with expanding retailers. Though it is important to note that the shopping center category is the least vulnerable to the growth in the e-commerce sector.

Urban areas continue to account for a greater share of net absorption performance as more retailers look to younger consumers for sales growth. This group prefers multifamily housing near public transportation, hip restaurants, cool bars and entertainment venues over the "sleepier" suburban submarkets they grew up in. They are less enamored with home and automobile ownership, opting instead for the convenience of living closer to work and amenities within walking distance or a short Uber or cab ride. Q3 net absorption marginally outpaced a robust Q2 performance, finishing the period with a net gain in occupied space of just over 43 million square feet. In the past four quarters, 122.5 million square feet of net absorption has been recorded, which is impressive considering choppy retail sales numbers in the same period. Wage growth has picked up slightly and that may portend further absorption gains going forward.

The overall average asking rate moved up another $.17 to $15.66 per square foot in Q3. Over the past four quarters, retail rents across all product types and locations moved up by 2.68%, but rent growth remains concentrated in urban locales. Suburban retail centers, especially mid-block strip centers that cater to mom and pop retailers, have seen weaker growth and more persistent vacancy. The rate of rent growth suffers as distance from an urbanized core increases, a trend that has been ongoing for the past several years. New deliveries for the quarter totaled 19.5 million square feet, bringing the total of completed inventory in the past four quarters to 85.5 million square feet. Another 79.3 million square feet is currently under construction, a significant rise over Q2's construction queue. Construction activity in urban locales and mixed use projects remains on the rise. As we have been reporting over the past two years, brick and mortar and online retailers continue to move toward greater balance to boost sales. Online retailers are adding physical locations just as more traditional retailers are boosting their online presence and closing stores. Macy's, Walmart and Sears have all announced major store closings, while big sporting goods retailers Sport Chalet and Sports Authority decided to call it quits in the first half of the year. Office Depot is also feeling the pinch from increased online competition. The office products giant has decided to consolidate operations by closing 300 more locations across the country.



US RETAIL MARKET

LOOKING AHEAD

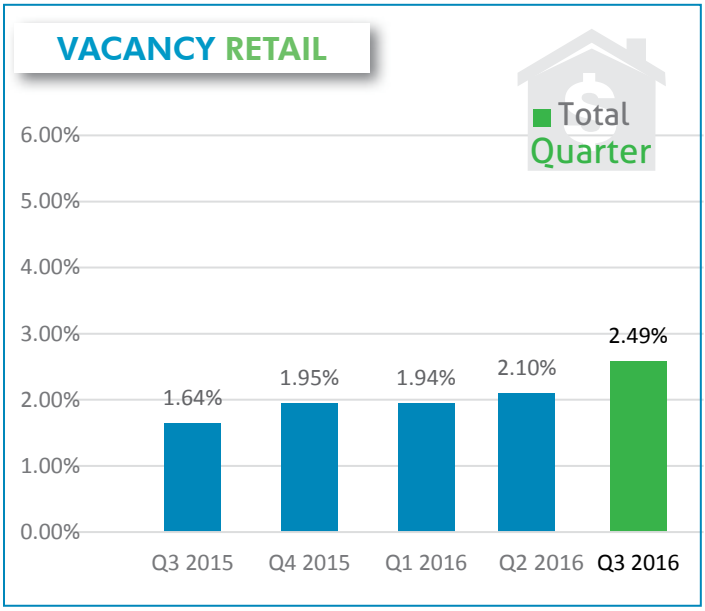
The US retail market will keep growing, but further gains will be hard fought. Weak GDP and wage growth are an ongoing drag on retail sales volume. Consumer spending and retail sales growth are choppy at best, moving up and down significantly one reporting period to the next. Imported goods will remain cheap due to the strength of the US dollar, and that will keep the discounters opening new locations. Central banks around the world have resorted to negative interest rate policies to reduce the risk of a deflationary cycle, but results continue to disappoint. The US central bank has maintained its own cheap money campaign, and that should keep interest rates on loans for major purchases like autos, homes, furniture and appliances low. Import prices have been falling consistently since the dollar spiked at the end of the year when the Fed made its lone rate
hike. Markets around the world were rocked and it took most of Q1 to get things settled down. That spooked the Fed into holding off on further planned rate hikes.

Low oil prices have been with us for more than two years, but the expected boost in retail sales has been disappointing. Job growth is decelerating in terms of the 12 month rolling average. Q3 earnings were down for the sixth straight quarter. Some of the best profit results came from companies that were focused on cost cutting rather than top-line revenue growth. Without bigger gains in retail sales, vacancy, net absorption and rental rates are likely to track on their current course for the next few quarters. Little has been said about projections for 2016 sales growth. Port delays due to the Hanjin bankruptcy did not give the season a good start.

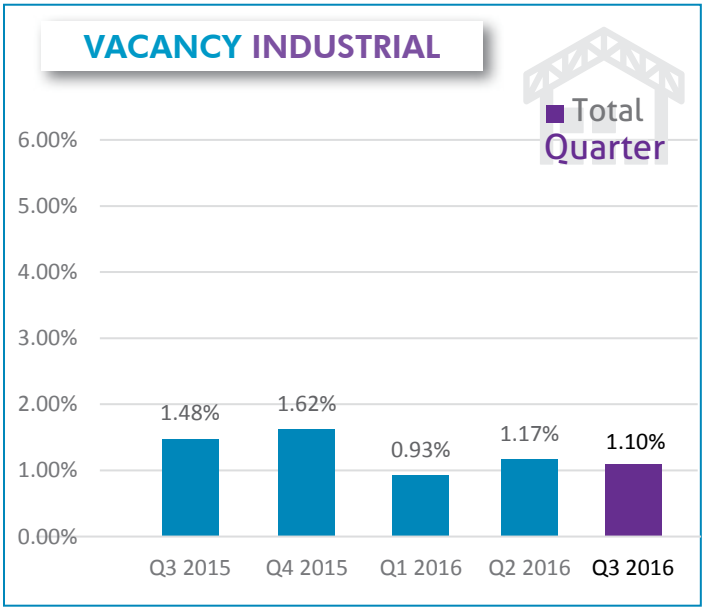
Demand for retail investment properties continues to run well ahead of demand. Cap rates are compressed to record lows, but there is a lot more talk about an investment market that is getting long in the tooth. Expect lenders to get more cautious, especially for shopping centers in secondary suburban submarkets. Foreign investors will keep giving demand a boost, as they look for a place to preserve capital.

SANTA BARBARA

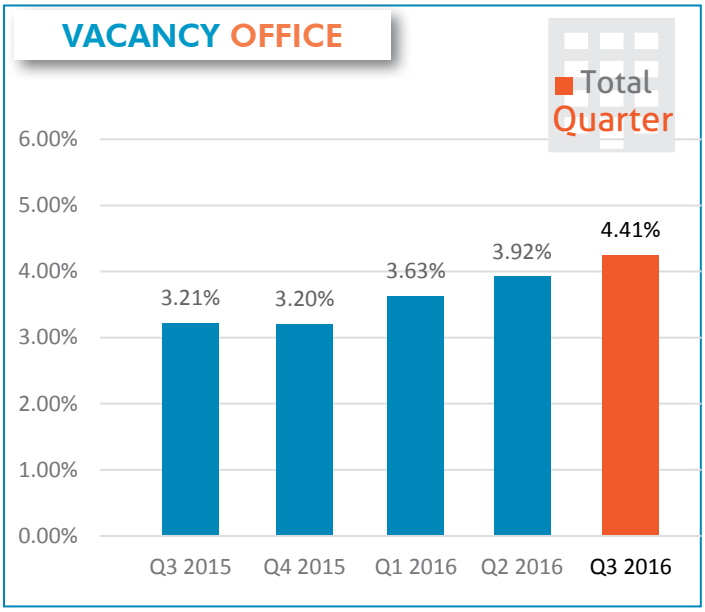
VACANCY RETAIL



VACANCY INDUSTRIAL



VACANCY OFFICE



MARKET HIGHLIGHTS

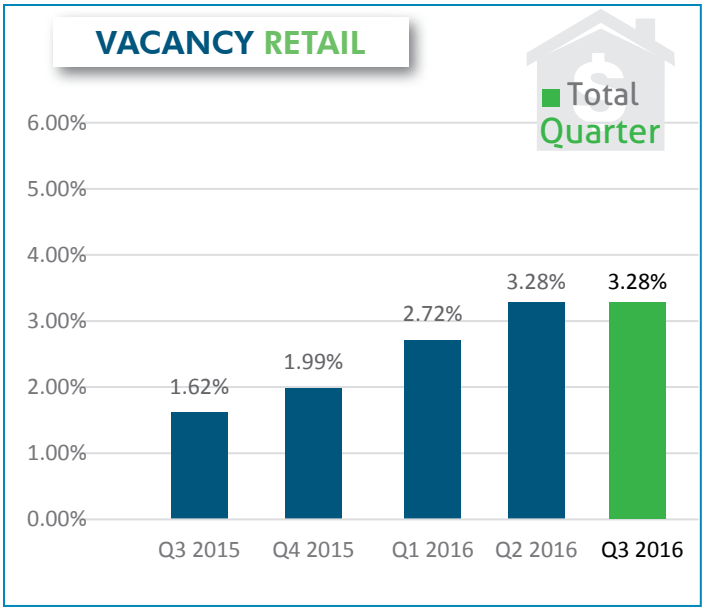
- The Multi-Family/Student Housing market continues to see high demand. Inventory remains low with quality properties receiving multiple all-cash offers.
- Downtown Santa Barbara retail remains weak as department stores and smaller shops work to compete with online retailers. Landlords are largely resistant to lower asking rents, but will need to adjust expectations in order to fill vacancies.
- Paseo Nuevo and La Cumbre Plaza Mall both have remodel and renovation plans in process with hopes of renewing vibrancy to these stagnant properties.
- Office rents have stabilized after a slight uptick in the second quarter. More subleases are coming available as companies downsize or shift to upgraded space. Subleases consist of approximately 25% of all new inventory.

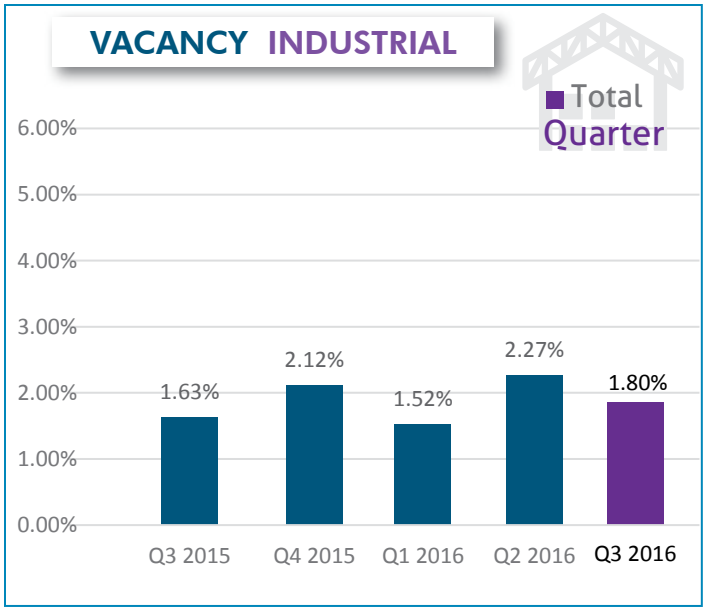
RETAIL
VACANCY RATE
2.49%

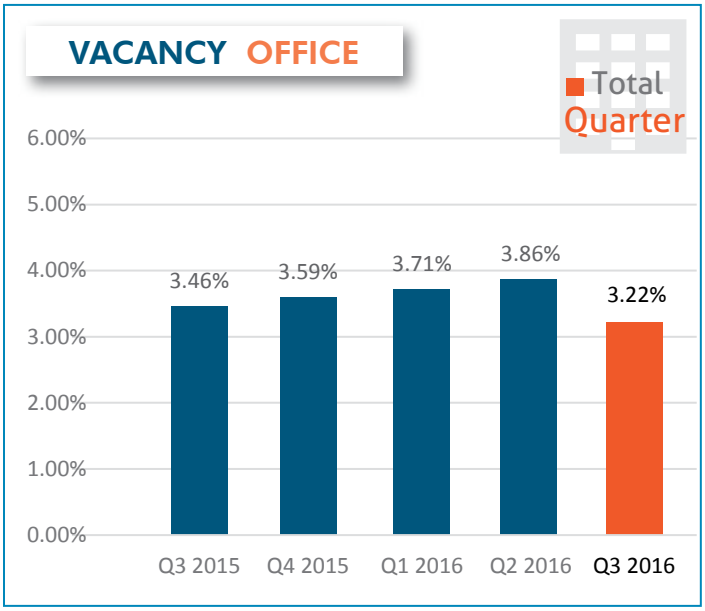
OFFICE
VACANCY RATE
4.41%

INDUSTRIAL
VACANCY RATE
1.10%

SAN LUIS OBISPO







MARKET HIGHLIGHTS

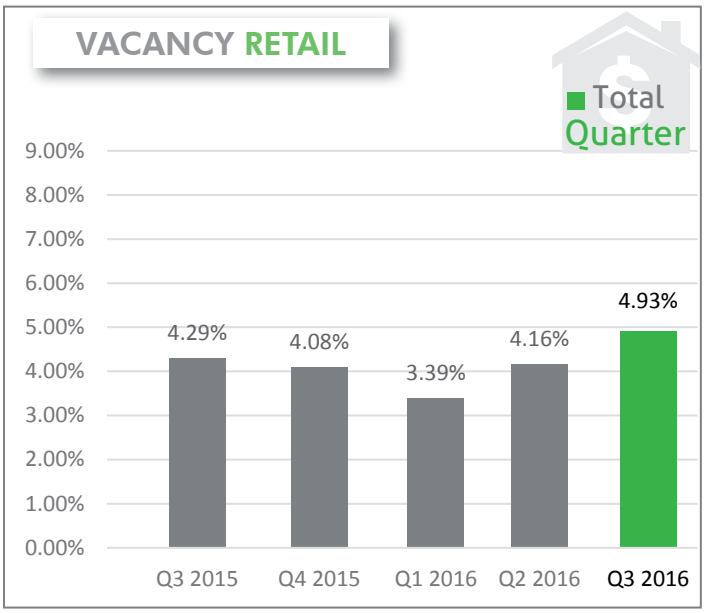
- The San Luis Obispo industrial market remains supply constrained. With low inventory, many Commercial Service and Manufacturing users are unable to secure vital space.
- A 20-acre commercial service land parcel located on Tank Farm Road was purchased mid-quarter by an out-of-area buyer. The new owner intends to offer land parcels for sale and or build-to-suits to meet area demand.

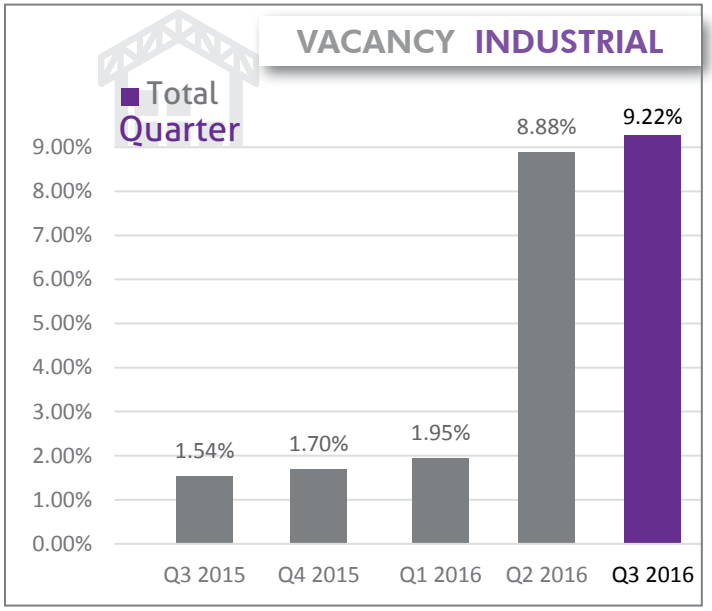
RETAIL
VACANCY RATE
3.28%

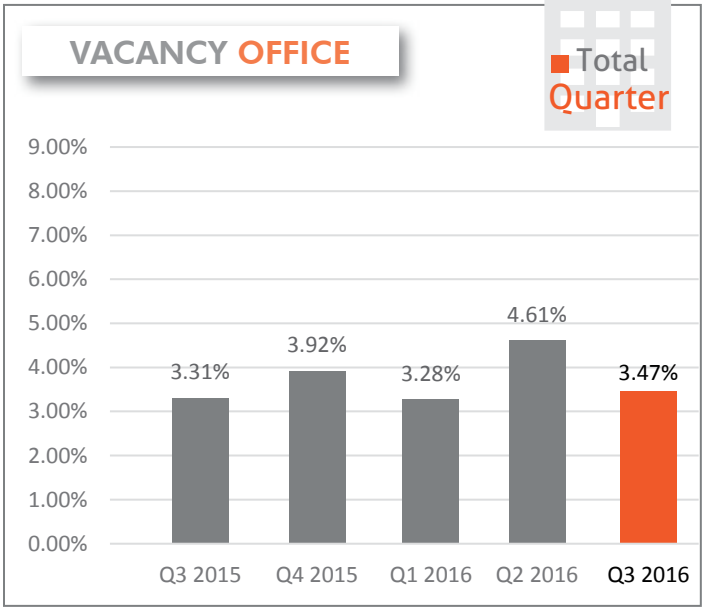
OFFICE
VACANCY RATE
3.22%

INDUSTRIAL
VACANCY RATE
1.80%

PASO ROBLES







MARKET HIGHLIGHTS

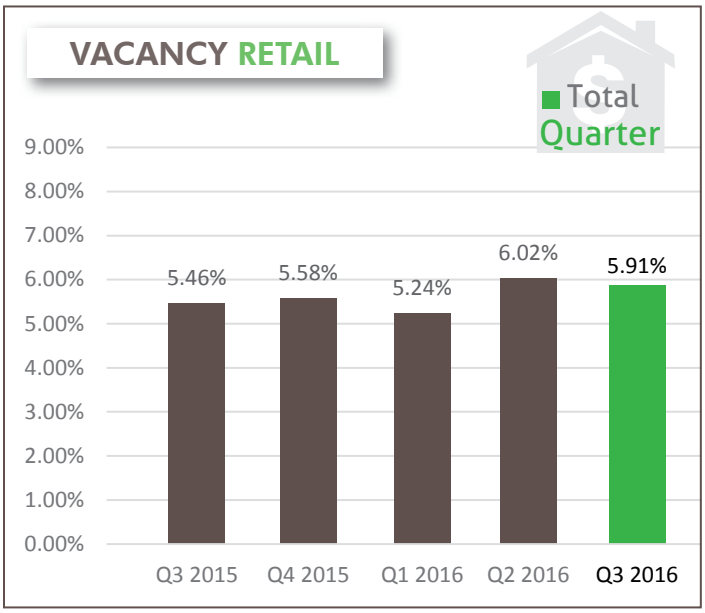
- Paso Robles vacancy remains high with a sizeable 220,000-sqaure-foot industrial remaining vacant.
- The office and retail sectors have healthy demand from tenants with vacancy rates in the 4-6% range.
- The service station on the corner of Spring Street and 24th was one of the highest grossing transactions in the Tri-Counties with a sale price of $10,280,000. The former Valero was sold to 7-Eleven as a part of a 78 property portfolio.
- Paso Robles' vineyard land is still the area's prominent asset. The Robert Hall winery, complete with a 160 acre vineyard and winery, sold for $16,952,000.

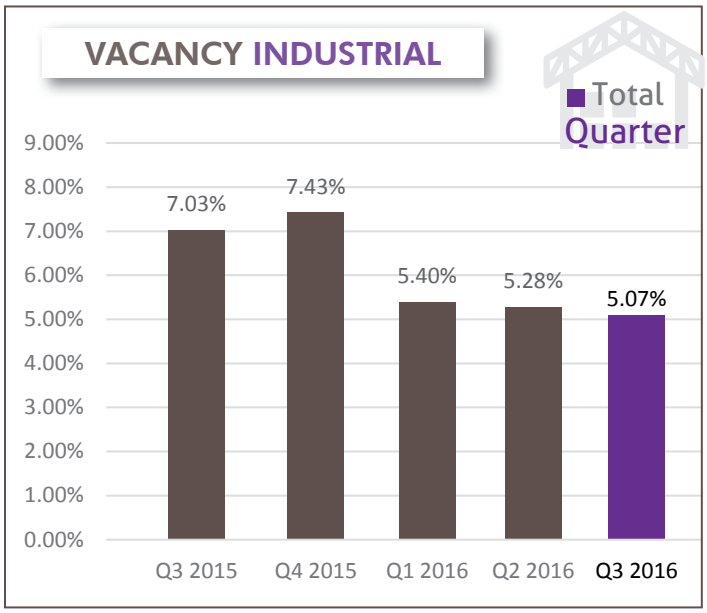
RETAIL
VACANCY RATE
4.93%

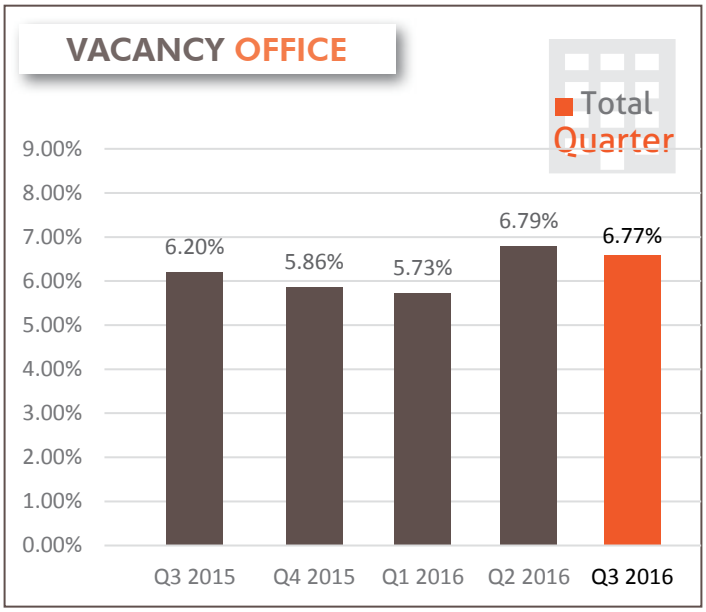
OFFICE
VACANCY RATE
3.47%

INDUSTRIAL
VACANCY RATE
9.22%

SANTA MARIA





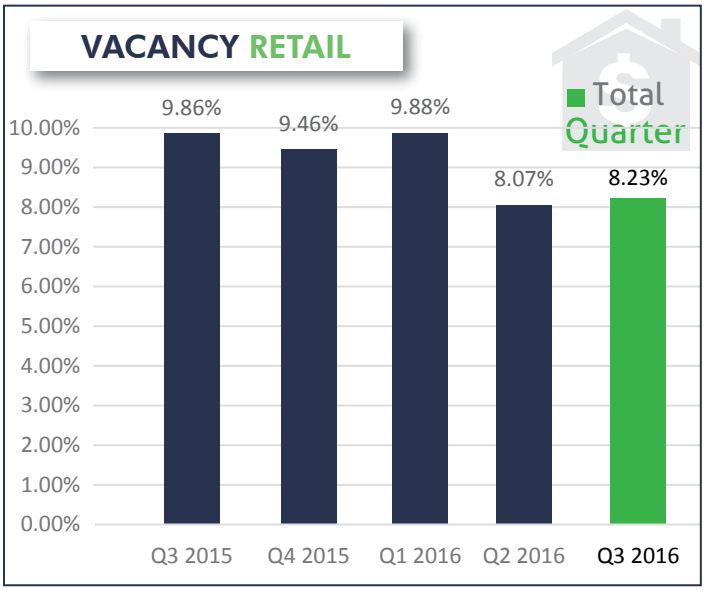


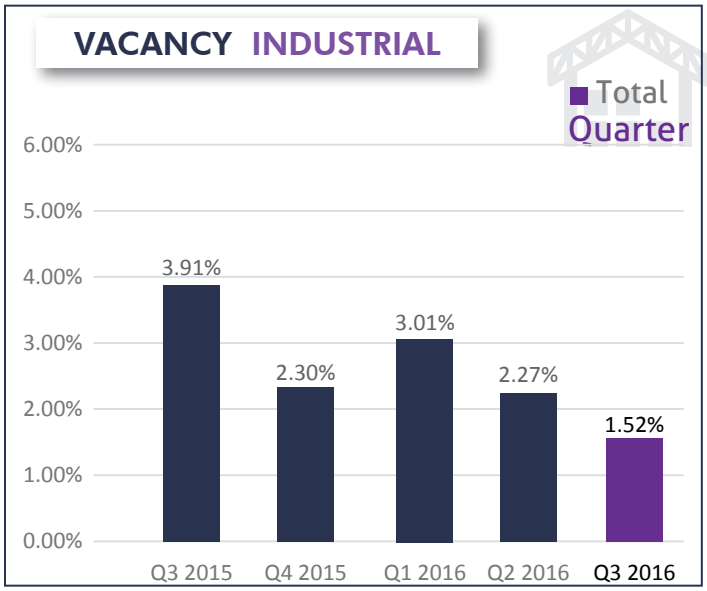
RETAIL
VACANCY RATE
5.91%

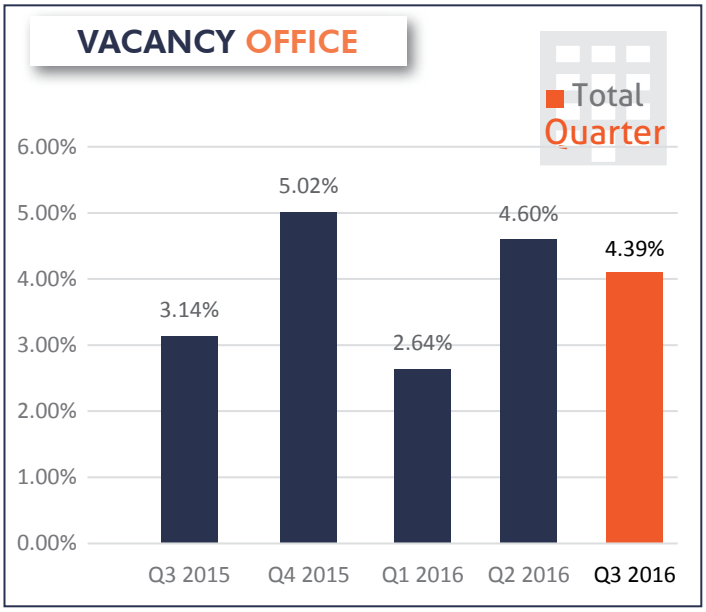
OFFICE
VACANCY RATE
6.77%

INDUSTRIAL
VACANCY RATE
5.07%

LOMPOC







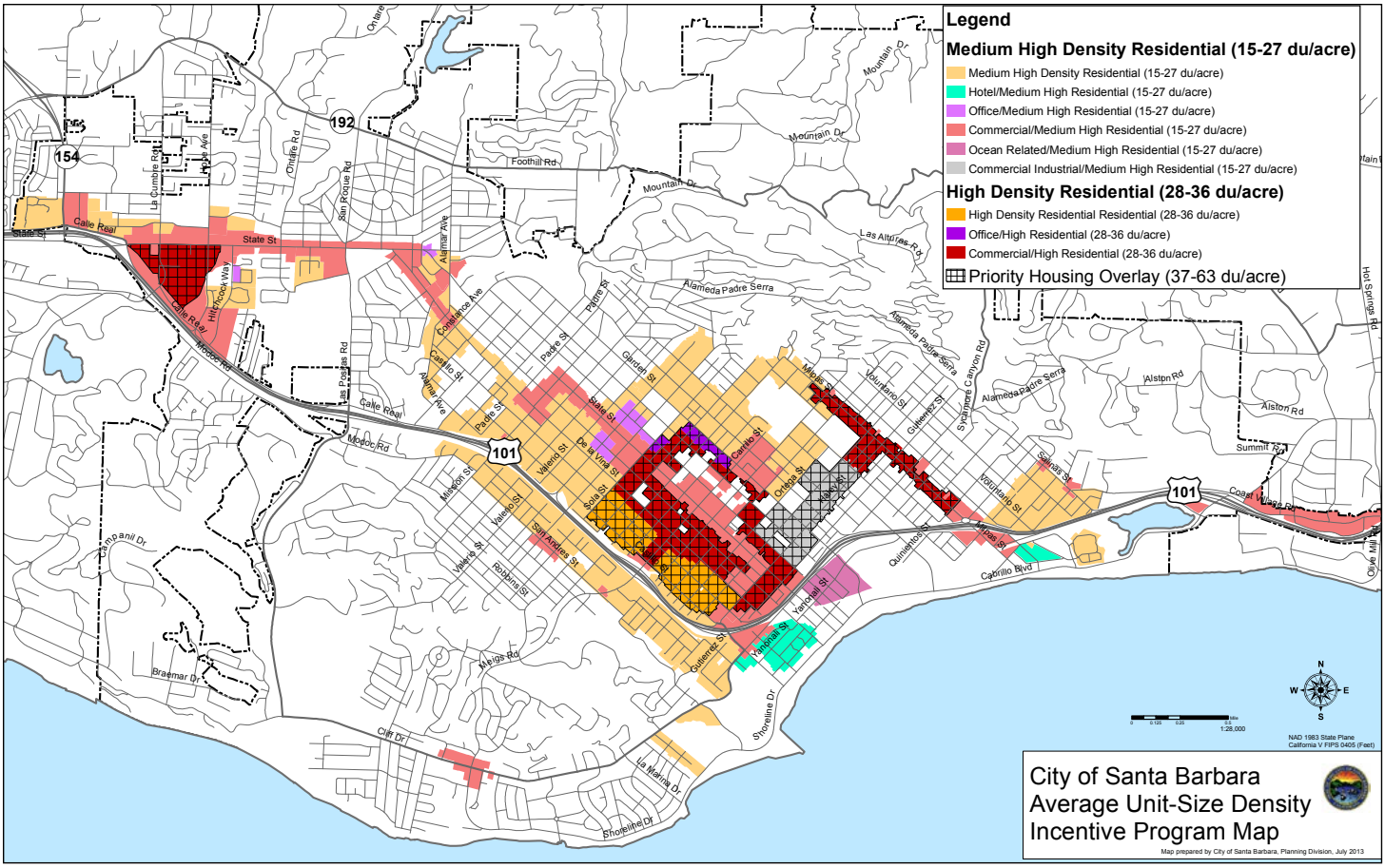
RETAIL
VACANCY RATE
8.23%

OFFICE
VACANCY RATE
4.39%

INDUSTRIAL
VACANCY RATE
1.52%

Development Projects Central Coast

Average Unit-Size Density Incentive Program



In 2013, Santa Barbara City Council approved the Average Unit-size Density (AUD) Incentive Program Ordinance. The intent of the Program is to support the construction of smaller, more affordable residential units near transit and within easy walking and biking distance to commercial services and parks. Increased densities and development standard incentives are allowed in most multi-family and commercial zones of the City to promote additional housing. The AUD Program has an initial duration of eight years or until 250 new units under the Program have been constructed in the High Density Residential or Priority Housing Overlay areas, whichever occurs first.

Housing Element Implementation

- **38,393 Existing Units in 2014**
- **+1,208 Units Projected by 2023 = 39,601 Units by 2023**

At the end of Q3, the following residential units are pending, or have been approved or constructed under the AUD Program. Residential units that are pending, or have been approved or constructed under the AUD Program.

	PENDING UNITS*	APPROVED UNITS	BUILDING PERMIT ISSUED UNITS	COMPLETED UNITS**
Medium-High Density Area* **	72	41	11	4
High Density/Priority Overlay	340	164	151	0

*Includes all pending projects that have an application with the planning division. Some projects may not have been deemed complete.
**Projects that have received a certificate of occupancy. ***Units located in the medium-high density area are shown for informational purposes only.

1 Hotel Californian ~ Santa Barbara The 247,953-sq. ft. Entrada Hotel project is located on three parcels of land at the corners of Mason and State Streets. The 114-room 4-star luxury hotel has nine vacation units and ±20,000-square-feet of Commercial space with 264 parking spaces. Originally built as The Hotel California in 1925, the La Entrada will restore the original front façade designed in the Spanish Colonial Revival style.
Completion Date: Summer 2017

2 The Marc ~ Santa Barbara The Marc is a 136,000-square-feet Mixed-Use development featuring eighty-nine residential apartments and 2,500-square-feet of ground floor commercial space. This will be the first completed project under the city of Santa Barbara's new **Average Unit Density Program**. Adjacent to The Marc is a new condominium development project located at the old Sandman Hotel site. The new area projects will bolster the commercial activity in the upper state street sub-market.
Completion Date: November 2016

3 1298 Coast Village Road ~ Montecito The old 76 gas station located at 1298 Coast Village Road has been demolished and work is nearing completion of a new three story mixed-use building featuring 5,000-square-feet of highly desirable ground floor retail space and eight luxury hotel units above. While the project was met with much opposition from residents, the development will be beneficial to restauranteurs and retailers looking to relocate to the highly sought-after Coast Village Road.
Completion Date: Winter 2017

4 Miramar Hotel ~ Montecito The property was purchased over 10 years ago. Only Five-Star Hotel directly on the sand in Southern California. Operated by Rosewood Hotels.122 guest rooms and 48 suites, many of which will be in single-story cottages and bungalows with as many as four bedrooms. Site Size: 16 acres of land. Estimated Construction costs: $200 Million.
Open Date: Summer 2018

5 Hilton Garden Inn ~ Goleta Construction is underway at the new 138-room Hilton Garden Inn. Located at th[e corner of Hollister Avenue and Storke Road in Goleta. This hotel sits on one of the main thoroughfares to University of California at Santa Barbara. The new 95,678-square-foot hotel sits on a three acre parcel.
Completion Date: Spring 2017

6 Enos Ranchos ~ Santa Maria New retail development located at the intersection of Betteravia Road and Highway 101 adjacent to the Cross Roads Center. Santa Maria Ranch is a 350,000-square-foot power center featuring a California contemporary design. In all, the project will consist of 350,000-square-feet of retail space comprised of several anchor tenants along four in-line stores, seven pad buildings and an outdoor seating area. Confirmed tenants include Costco Wholesale, Lowe's Chick-fil-A, Buffalo Wild Wings and The Habit Burger. In addition to the 156,000-square-foot building, Costco plans to install a 24-pump gas station.
Completion Date: ???

7 Chinatown Project ~ San Luis Obispo Construction is nearing completion at the mixed-use project located in the heart of downtown San Luis Obispo. The new development will feature 46,000-square-feet of retail space with additional office and residential units. Tenants joining the new development include a Lululemon Athletica, H&M, Williams-Sonoma and Paso Robles Bistro.
Completion Date: Summer/Fall of 2016.

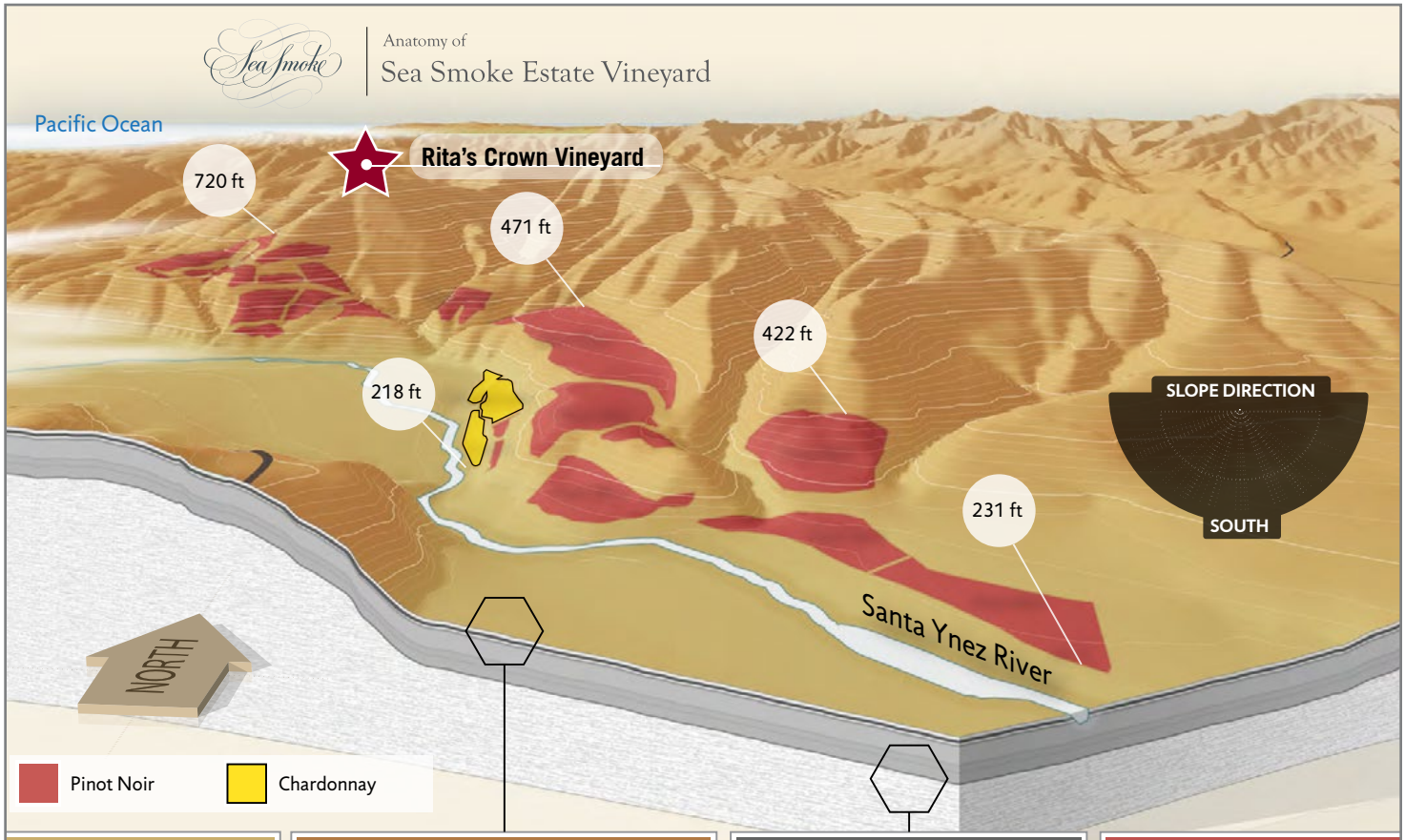
8 San Luis Ranch ~ San Luis Obispo San Luis Ranch, a 131 acre master planned project in San Luis Obispo, is moving through the entitlement process. The development will feature 90,000-square-feet of retail, residential, hotel and office components.
Ground Breaking: June 2017.

9 Pine Street Promenade ~ Paso Robles After a one-year hiatus, the Pine Street Promenade is proceeding with phase one. The master-planned project is located on a 2.4-acre lot in downtown Paso Robles, the former site of the Hayward Lumber yard. The project will include retail components in addition to a 120-room hotel. The master-plan, which originally included a public market, parking structure and performing arts center, have since been refined with details pending. According to architect *Steven Puglisi,* **construction is expected to begin within a year.**

WINE COUNTRY

The fall harvest is in full swing. In California the majority of harvesting occurs in late August to early October with some grapes being harvested throughout the autumn. The overall state crop was estimated to be near the historical average of 3.9 million tons by the California Department of Food and Agriculture as of August 2016. While activity has tapered off due to the harvest, there are a few notable transactions that occurred during the quarter.

In mid-August, Sea Smoke purchased the 201-acre State-of-the-art, high-density **Rita's Crown Vineyard** for $3,290,000. The vineyard is located on the southwest slopes of Santa Rita Hills AVA and includes 61 acres of planted grapes suited for producing world-class Pinot Noir and Chardonnay. This cool–climate site is adjacent to the biodynamic Sea Smoke Estate & Vineyard. Sea Smoke will transition Rita's Crown to organic farming, and will continue to be a source for a number of wineries, including wines made by Babcock, Ken Brown and Sandhi.



The Terrain	
Elevation:	220 - 650 feet
Slope:	8.75% (5°) to 36.4% (20°)
Aspect:	South (189.4°)

The Soil	
Depth:	6 - 20 inches
Base:	Semi-siliceous shale with calcareous strata, diatomite
Top:	Botella, Gazos and Lopez clays, Ballard, Metz

The Geology	
Formation:	Monterey/Sisquoc
Age:	14 Million Years
Epoch:	Upper-Middle Miocene

The Grapes	
Variety	Acres
Pinot Noir:	135.6
Chardonnay:	8.4
Total	144.0

On August 7th, The Alcohol and Tobacco Tax and Trade Bureau (TTB) the Federal wine regulatory body approved the application to expand the Santa Rita Hills AVA by 2,296-acres on the eastern border, about 4 miles west of Highway 101 in Buellton. The controversial expansion will bring Santa Rita Hills AVA to a total acreage of 35,676. The petition to expand the Sta. Rita Hills AVA was filed by the owners of John Sebastiano and **Pence Ranch** vineyards. The original eastern boundary of the Sta. Rita Hills split **Sebastiano** and **Rio Vista** vineyards. While Pence Ranch, owned by Blair Pence, planted just outside the eastern border of the AVA.

The expansion approval was finalized on Sept. 21, 2016.

Transcendence Wines has opened a new tasting room in the Santa Rita Hills Wine Center, located at the corner of Highway 246 and Highway 1 in Lompoc. Transcendence offers cool-climate Syrah, Pinot Noir and Chardonnay from some of the finest vineyards in Santa Barbara County's Santa Ynez Valley and Santa Rita Hills wine growing regions.

Robert Hall Winery located east of Highway 46 in Paso was purchased by O'Neill Vinters & Distillers for $16 million. The sale includes 160 acres of vineyards, 19,000-square-foot caverns, hospitality center and inventory producing approximately 60,000 cases per year.

The buyer, **O'Neill Vinters & Distillers** was founded in 2004 by Jeff O'Neill, former CEO of Golden Vintners and a third generation California wine maker. O'Neill Vintners contracts over 15,000 acres of vineyards in the premier wine growing regions of California. O'Neill, which is the seventh-largest wine producer in California by volume has grown to be one of the premier custom wine producers in the industry.

Spear Vineyard is constructing a new winery using a historic 1930's barn emulating the original Pierce Ranch barn. Owner, *Ofer Shepher* designed a structure that would maintain the unique footprint and roof line of the original building. The new winery will feature an underground barrel storage area with an open tasting room overlooking the vineyard. Planted in 2014 along the Highway 246, this vineyard is among the highest elevation plantings in the St Rita Hills appellation with 32 acres in production representing **six different grape varieties.**

"RECOVERED SIDING WILL ULTIMATELY BE THE FINAL TOUCH ON THE EXTERIOR, ESSENTIALLY BRINGING THE ORIGINAL BACK TO LIFE TO FOR COUNTLESS GENERATIONS IN THE FUTURE."

Spear Winery

1. **PINOT NOIR 14.4 ACRES**
   CLONES: 943, SWAN, 115, 2A, 667, 777, POMMARD
2. **CHARDONNAY 9.5 ACRES**
   CLONES: 4, 96, WENTE, MOUNT EDEN, 95
3. **GRENACHE 3.9 ACRES**
   CLONES: 362
4. **SYRAH 2.6 ACRES**
   CLONES: 470, ALBAN, 383
5. **GRUNER VELTLINER .9 ACRE**
   CLONES: 1
6. **VIOGNIER .5 ACRE**
   CLONES: ALBAN

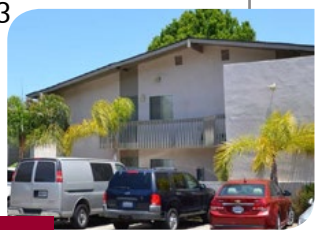
NOTABLE SALES **Q3** 2016

333 E ENOS, SANTA MARIA
Property: Multi-Family
Size: 156,590 SF
Sale Price: $37,000,000
Sale Price/SF: $236.29
Sale Date: 08/2016

1

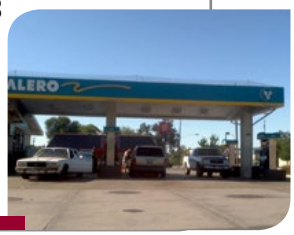
536 W CARRILLO ST., SANTA BARBARA
Property: Multi-Family
Size: 33,500 SF
Sale Price: $14,875,000
Sale Price/SF: $444.03
Sale Date: 09/2016

2



2340 SPRING ST., SAN LUIS OBISPO
Property: Retail
Size: 3,750 SF
Sale Price: $10,280,000
Sale Price/SF: $2,741.33
Sale Date: 07/2016

3



6100 HOLLISTER AVE., GOLETA
Property: Land
Size: 629,878 SF
Sale Price: $8,704,000
Sale Price/SF: $13.82
Sale Date: 08/2016

4

29 ANAPAMU ST., SANTA BARBARA
Property: Office
Size: 18,200 SF
Sale Price: $6,950,000
Sale Price/SF: $381.87
Sale Date: 07/2016

5

265 MEISSNER LANE, SAN LUIS OBISPO
Property: Land
Size: 853,776 SF
Sale Price: $6,400,000
Sale Price/SF: $7.50
Sale Date: 08/2016

6

SANTA BARBARA	
NUMBER OF SALES	27
PRICE/SF AVG	$586.93
PRICE/SF HIGH	$1,170.79
PRICE/SF LOW	$170.83

SAN LUIS OBISPO	
NUMBER OF SALES	9
PRICE/SF AVG	$472.11
PRICE/SF HIGH	$907.11
PRICE/SF LOW	$218.57

LOMPOC	
NUMBER OF SALES	8
PRICE/SF AVG	$460.67
PRICE/SF HIGH	$1,851.85
PRICE/SF LOW	$142.81

SANTA MARIA	
NUMBER OF SALES	9
PRICE/SF AVG	$179.41
PRICE/SF HIGH	$285.00
PRICE/SF LOW	$100.00

PASO ROBLES	
NUMBER OF SALES	7
PRICE/SF AVG	$598.86
PRICE/SF HIGH	$2,741.33
PRICE/SF LOW	$59.94

NOTABLE LEASES **Q3** 2016

7402 HOLLISTER AVE., GOLETA

Tenant: inTouch Health
Property: Office
Size: 28,025 SF
Lease Date: 07/2016

1

7406 HOLLISTER AVE., GOLETA

Tenant: inTouch Health
Property: Office
Size: 24,254 SF
Lease Date: 07/2016

2

760 MCMURRAY RD., BUELLTON

Tenant: Platinum Performance
Property: Industrial
Size: 13,251 SF
Lease Date: 06/2016

3

3977 S. HIGUERA ST., SAN LUIS OBISPO

Tenant: Trader Joe's
Property: Retail
Size: 12,000SF
Lease Date: 08/2016

4

10 E. YANONALI ST., SANTA BARBARA

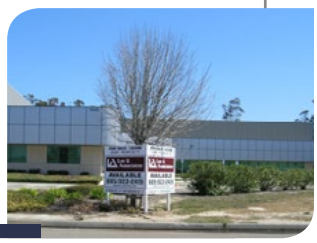
Tenant: Impact Hub
Property: Office
Size: 10,044 SF
Lease Date: 09/2016

5

3042 INDUSTRIAL PKY. SANTA MARIA

Tenant: Atlas Copco Mafi Trench Inc.
Property: Office
Size: 7,650 SF
Lease Date: 07/2016

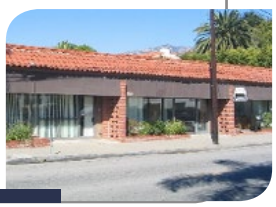
6



122 W. FIGUEROA ST., SANTA BARBARA

Tenant: US Government GSA
Property: Office
Size: 7,650 SF
Lease Date: 07/2016

7



AVERAGE ASKING RATES (GROSS)

SANTA BARBARA	**$2.87**
SAN LUIS OBISPO	**$1.85**
LOMPOC	**$1.03**
SANTA MARIA	**$1.23**
PASO ROBLES	**$1.51**

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*Please contact individual managers for information in specific markets.

The Lee Central Coast Brief

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Q3

2016

Third-party data sources: CoStar Group, Inc., The Economist, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Congressional Budget Office, European Central Bank, GlobeSt.com, CoStar Property, o City of Santa Barbara, Spear Vineyard, TTB, Sea Smoke and Lee Propriety Data.

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