The Lee Central Coast Brief

Q1 2017

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LEE & ASSOCIATES®

COMMERCIAL REAL ESTATE SERVICES

62%
increase
in transaction volume over 5 years

$11.6 billion
transaction volume
2016

890
agents
and growing nationwide

Ranked 2nd
June 2016, Commercial Property Executive
(2016 Top Brokerage Firms)

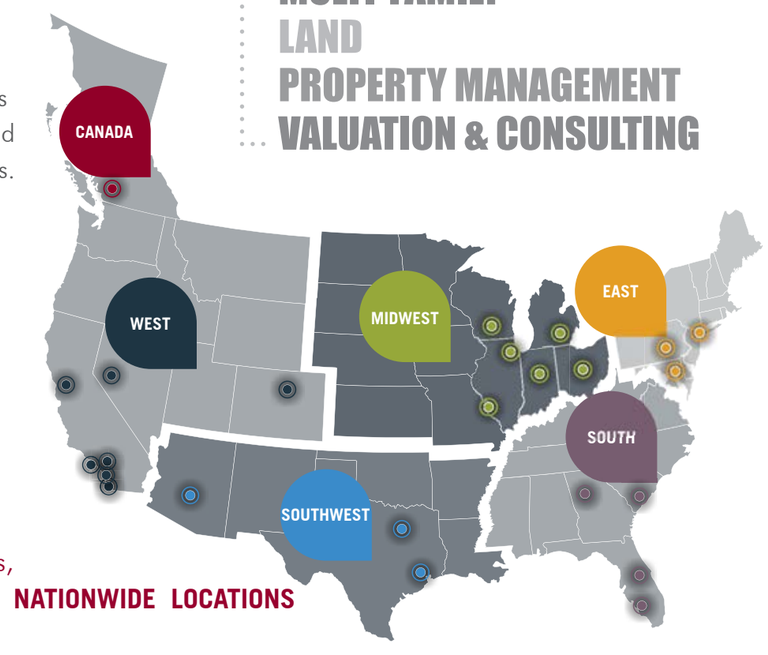
LOCAL EXPERTISE.
NATIONAL REACH.
WORLD CLASS.

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.

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



NATIONWIDE LOCATIONS

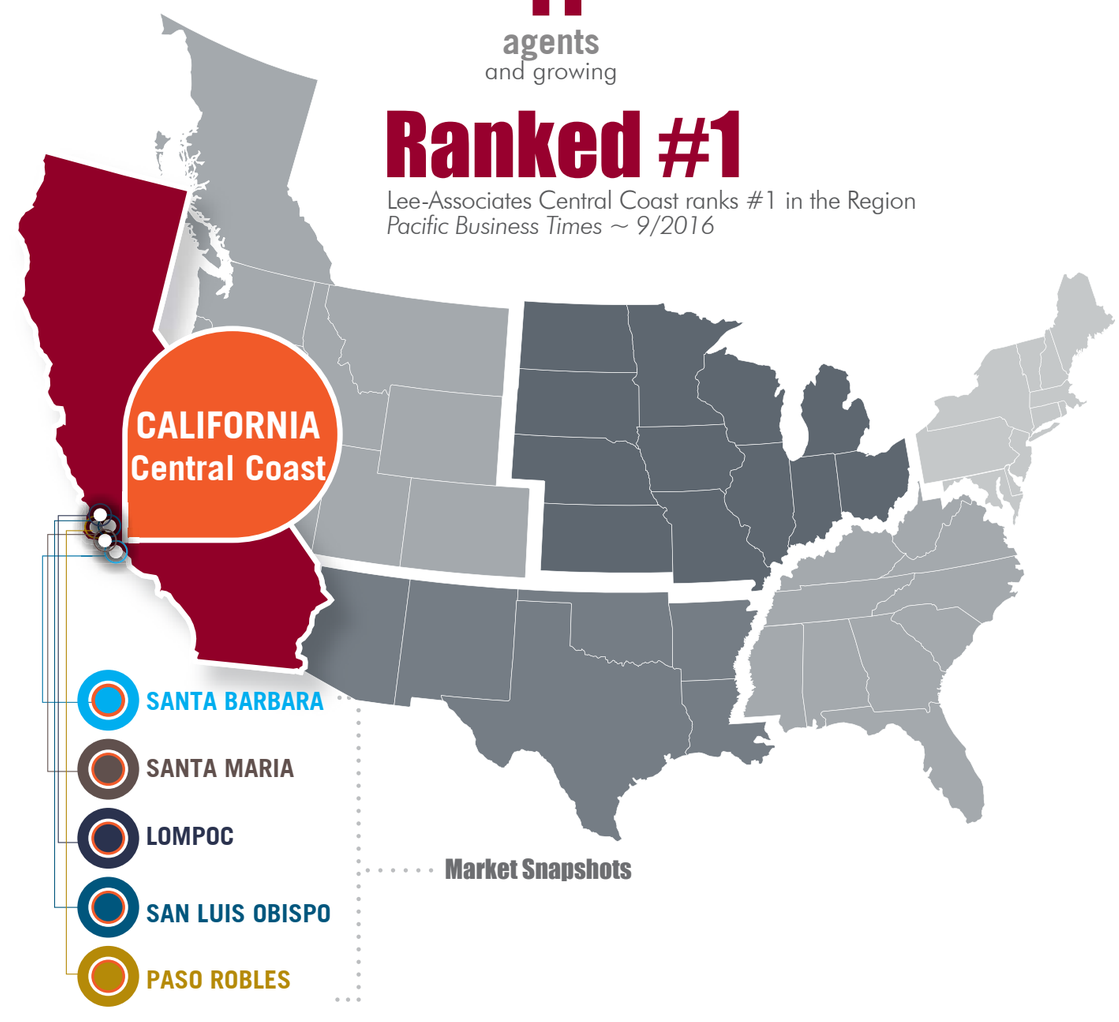
Columbus, OH · Houston, TX · Denver, CO · Cleveland, OH · Long Island-Queens, NY · Chesapeake Region , MD · Charleston, SC · Edison, NJ · Orlando, FL · Fort Myers, FL · Manhattan, NY · Greenville, SC · Atlanta, GA · Greenwood, IN · Indianapolis, IN · Long Beach, CA · Elmwood Park, NJ · Boise, ID · Palm Desert, CA · Santa Barbara, CA · Antelope Valley, CA · Dallas, TX · Madison, WI · Oakland, CA · Reno, NV · San Diego, CA · Ventura, CA · 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

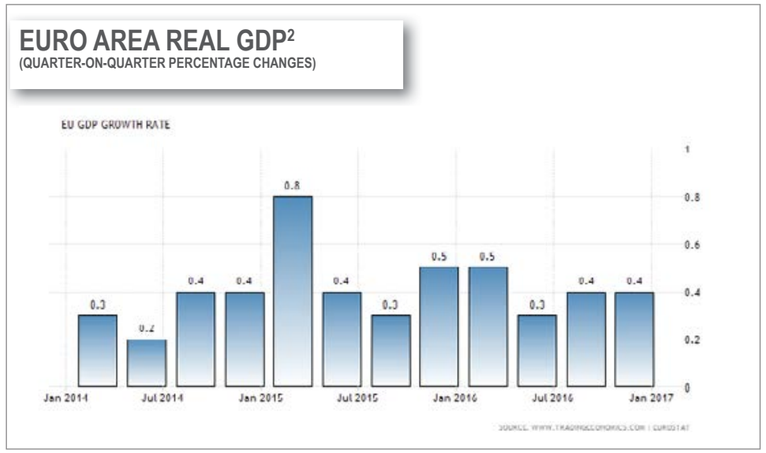
Ranked #1
Lee-Associates Central Coast ranks #1 in the Region
Pacific Business Times ~ 9/2016



Market Snapshots

GLOBAL ECONOMY

In the past two quarters we have been describing the global economic outlook as troublesome. We still do, but we can point to at least some improvement around the world. The panic over the Brexit vote was short-lived. It didn't take long for world markets to absorb the news. There's a long way to go, but the UK's exit from the EU is drawing much less attention now. The British Pound took a beating, but that may also be short-lived, once the actual process ramps up this spring.



When the UK made its surprise decision to leave the EU, the long term survival of the union was called into serious question. However, while Europe's political union is still in doubt, GDP growth across the pond has picked up. EU GDP growth for 2016 bounced back up to 1.8%, 20 basis points higher than the US growth rate. Yet the aggressive monetary policy of the European Central Bank continues and calls for fiscal austerity fall on deaf ears. That, and the ongoing nationalist fervor whipped up by a huge influx of refugees from the Middle East, leaves a lot of unanswered questions on the continent.

The recent OPEC agreement to cap production helped to stabilize the price of a barrel of oil above $50 in Q1 of 2017. Even non-OPEC players like Russia and Venezuela cut production to help bring reduce supply. But, US producers have increased output to fill a perceived gap, and the active rig count continued to rise through the first three months of the year. Supply is still running ahead of demand and without more robust economic growth around the world, oil prices are not likely to rise much beyond current levels.

Oil-rich Middle-Eastern countries, including Saudi Arabia, are still burning through cash reserves to cover oil revenue shortfalls. Even China is issuing government debt to help it cope with its ongoing transition from an export based economy to one more reliant on domestic consumption. But, a recent spike in import/export activity in the Asia Pacific region is cause for cautious optimism that world

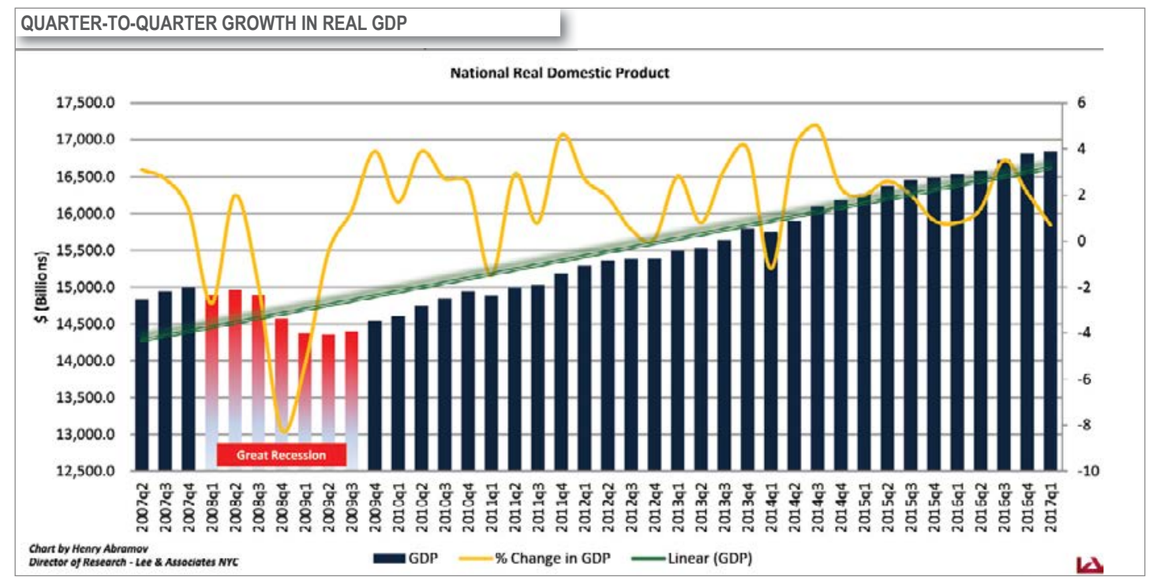
GDP GROWTH

The US economy is, by far, the largest on the planet and we also consume more foreign goods and services than any other nation. Whatever happens here at home, is felt and observed the world over. So, US GDP, the primary metric for tracking the total output of goods and services, is closely watched around the globe. Annualized US GDP growth in Q4 of last year topped 2.1% on the third and final revision. However, total growth for all of 2016 was just 1.6%, well short of the 2.4% growth rate recorded in 2015. Unfortunately, the US economy is off to another slow start in 2017, with the preliminary estimates of annualized GDP growth coming in under 1%. The question that still remains is whether or not US companies and consumers will accept a slower growth model as the "new normal" and press forward in a way that promotes further growth.

GDP GROWTH

Until 2016, the US looked relatively good compared to Europe, as growth across the pond had been flat at despite drastic monetary and fiscal measures to keep the European Union member countries from sliding into recession. The European Central Bank is even experimenting with Negative Interest Rate Policy (NIRP) and it continues with a massive bond-buying program to keep the cost of capital near historic lows. In 2016, the European Union grew at 1.8%, besting the US for the first time in recent memory, but that fact leaves a lot of experts wondering what the result would have been without all the meddling by central bankers.

Political turmoil, civil unrest and economic challenges around the world still weigh heavy on the minds of central bankers, and the US Fed is among those keeping a close eye on global goings-on. Changes here at home are also on the radar of those who follow GDP closely. The Trump Bump after the election surprised the world and equities markets have soared on the expectation of lower corporate and personal income tax rates, reduced regulations and a huge infrastructure spending program. But, GDP growth received no boost at all from the enthusiasm that followed the November election. Turning campaign promises into real changes in the law is no small feat, as evidenced by the recent failure of the legislation to repeal and replace the Affordable Care Act. Our political system is designed to have big change occur over time, and checks and balances built into the US Constitution protect the party in the minority. Tax reform is next on the legislative priority list, and it stands to face significant opposition from Democrats and some Republicans in both houses of Congress. So, GDP growth will remain dependent on current laws for the foreseeable future. Though, the psychology of decision making appears to be more positive, as the prospects of a more business-friendly economic environment are still on the rise.



Corporate earnings anally bounced back in Q4 and kept momentum in the 1st Quarter of 2017. For much of 2015 and 2016, companies were resorting to cost-cutting and stock buyback programs to increase profits. In Q4 of 2016, that seemed to turn around and more companies reported revenue increases, which would ordinarily contribute to GDP growth. However, ongoing cost cutting means more job cuts and lower consumer spending, which accounts for roughly 70% of GDP. If earnings growth continues, we should see a positive impact on GDP growth later in the year.

Perhaps the biggest concern relative to GDP growth is the performance of the automotive sector, which significantly impacts manufacturing output, job growth and consumer spending. In the final quarter of 2016, incentive-driven car sales accounted for a disproportionate share of GDP growth. That did little for bottom line profits in the sector, but did give GDP a badly needed shot in the arm. Slow sales of non-SUV vehicles are likely to weigh heavy on automobile manufacturers in Q1 and, most likely, throughout 2017, which will negatively impact GDP growth.

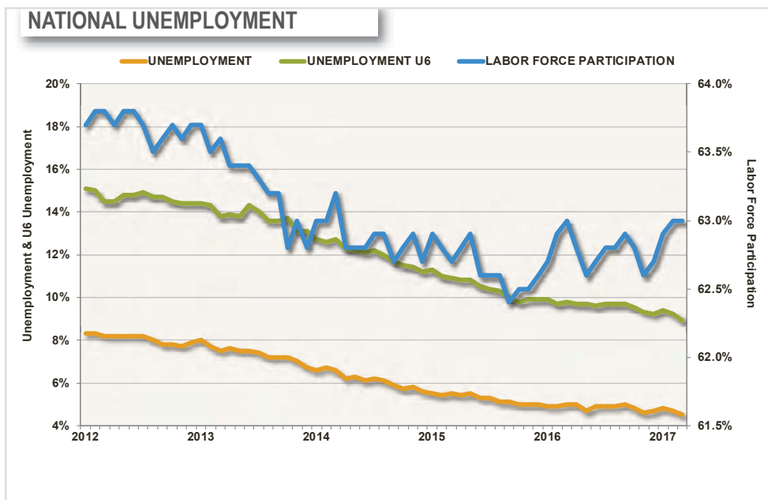
EMPLOYMENT

Job growth statistics are a moving target because of the rather odd way they are compiled. The U3 unemployment rate, the most widely quoted in the media, includes those who are employed and those of the unemployed who have actively sought employment in the most recent five weeks. We are still not sure who came up with U3, but we wish they hadn't because it quite often produces counter-intuitive results. When job creation is good, those who have not been looking for work, re-engage in their search and are added to the total of those who are actively looking, increasing the number of unemployed workers and thereby raising the unemployment rate. March 2017 numbers make a good example. A dismal 98,000 jobs were created in March (well below the number needed to keep up with new entrants to the workforce) yet the unemployment rate went down 20 basis points. Conversely, 235,000 jobs were created in February of 2017 and the U3 20% 64.0% unemployment moved just 10 points bases lower. These anomalies happen with some 16% frequency and have caused many to discount the validity of 14% 63.0% the Bureau of Labor Statistics' 12% U3 metric that removes from the calculation those workers who have not been actively seeking employment in the most recent five week period.

The U6 unemployment rates counts those working part time in their field of choice, who would prefer to be working full time, as unemployed. Many believe U6 offers a more accurate employment picture. It does make clearer the frustration of many in the middle class who still feel like the recession never ended. They are technically employed, but don't feel the impact of higher income. The U6 unemployment rate is still double that of U3, at 8.9%.

Job creation slowed in 2016, but did get off to a good start in Q1 of 2017. The 12 month rolling average of new positions had fallen by over 50,000 in the past year, but the pace picked up again in the first two months of the year. Then came March when an unexpectedly low 98,000 new jobs were created. Some say February stole from March due to a higher level of construction jobs coming early due to warmer weather. Wild swings in job growth impact consumer spending and business expansion. Companies large and small tend to more cautious in making long term decisions that have a big impact on hiring.

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 near a four-decades low. A loss of job growth momentum and the early retirement of Baby Boomers, have combined to keep just 63% of potential workers in active production.



Lagging wage growth remains a problem that has kept a lid on US economic growth. Full-time, high-paying jobs are available, but too few applicants are qualified. Lower-skilled workers are relegated to jobs that make it difficult to get ahead. Wage growth has seen some improvement having tracked at an annualized a rate of just under 3% for the past several months.2.9%. But, for workers earning a middle income wage, a 3% increase may not change spending habits enough to move the needle on economic growth. Roughly two-thirds of that increase goes to cover current inflation, leaving little for new purchases that would boost GDP. As a direct result, many middle class workers feel like they have been left on the economic sidelines.

MONETARY POLICY

After years of sending cryptic mixed signals, the Fed finally stepped up in December of 2016 and again in March of 2017 by sending its benchmark Fed Funds rate by a combined 50 basis points to 1%. By historical standards, that is still low, and it will take a sustained series of quarter-point increases to fully neutralize the activist posture of our central bank. Since the financial crisis that began at the tail end of 2007, the Fed has been aggressively manipulating the cost and flow of capital to the point that it has drawn heavy criticism for taking a more active role than it should have. Some believe our central bankers are largely responsible for what could be a bubble in the equities and commercial property markets, as both have seen disproportionate gains throughout the economic recovery.

Fed rate hikes generally strengthens the US dollar making exports more expensive and effectively raises the debt service on dollar-denominated loans for borrowers around the world. However, the spike in the dollar has quieted some in recent months and its impact on the rest of the world found on the front page less often. What may become big news soon is the potential impact of reducing the Fed's balance sheet, which swelled to over $4.5 trillion after several years of bond-buying known as quantitative easing (QE). That money, created in a computer on an as-needed basis, has to go back into the computer to be removed from circulation. Speculation from some Fed officials indicates that the balance sheet problem will be addressed sooner than later. To date, the Fed has been reinvesting proceeds from maturing T-bills by buying more T-bills. When that changes, bondholders will be watching carefully just in case the market doesn't take the adjustment in stride. For many who fear the inflationary impact of the dilution of the US dollar associated with QE, the Fed's decision to clean up its balance sheet will be welcome news.

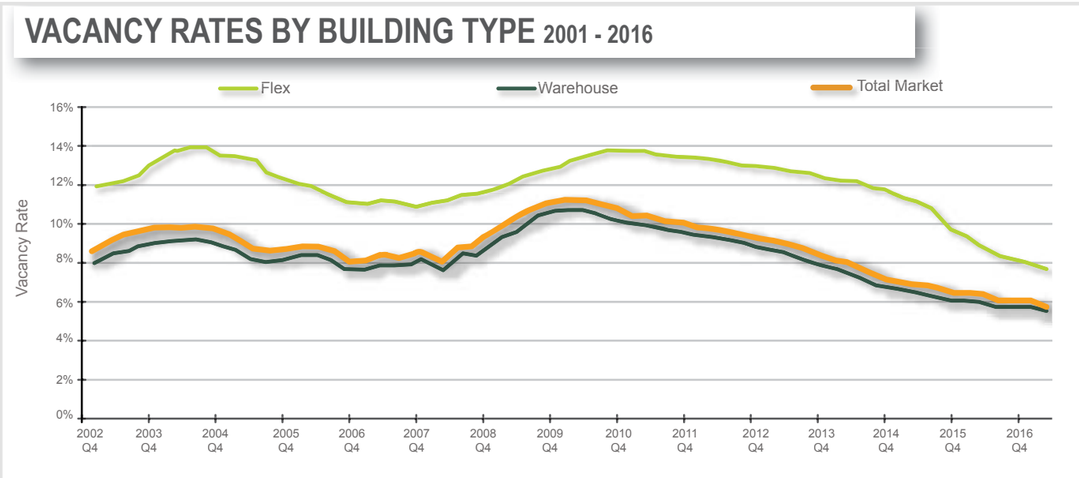
Despite the Fed's more robust monetary stance, central banks around the world are still at full throttle in terms of monetary stimulus. The European Central Bank and the Bank of Japan are still toying with negative rates, which certainly doesn't telegraph a bullish outlook for economic growth. Both banks continue to buy corporate bonds in addition to their own sovereign debt. The Bank of Japan is running out of government debt to buy back and have resorted to buying individual stocks, which is against the law here in the US. Critics are not bashful in criticizing these drastic measures, which are largely untested and could have consequences down the line.

Concerns of a near term recession here in the US have subsided, at least for now. The surprise election of Donald Trump as President sent markets on a tear and drowned out the voices of the economic naysayers who predicted a bursting of a stock bubble and the beginnings of an economic correction. If such a thing did occur, at least the Fed has extricated itself from the corner it painted itself into by keeping rates at the zero bound for so long. With Q1 GDP growth so weak, having some room to maneuver is probably not a bad thing. It only takes two consecutive quarters to be in recession, and first quarter growth under 1% lends little comfort.

Trump's promise of a big infrastructure investment has buoyed hopes that the Fed will get a little help from Congress and the White House. But, the deficit hawks on the political right are loathe to let deficits move higher on their watch. If the recent failure to repeal and replace the Affordable Care Act is any indication, it could be a long year for Mr. Trump, Speaker Ryan and Majority Leader McConnell. At the end of the day, the Fed may not get the assist and will opt to keep its foot on the economic gas pedal.
If that turns out to be the case, borrowers will continue to enjoy low interest rates. Mortgage rates have begun to move up, but remain near historic lows Most commercial property lenders use a spread over the yield on the 10 Year T-bill to set mortgage rates, and that yield is currently stabilized in the 2.4% range, which mortgage rates will remain slightly under 5%. For the moment, it's still a good time to borrow money.

US INDUSTRIAL MARKET

After putting in another strong performance to finish the year, the industrial market took a bit of a breather in Q1, but kept moving in the same direction. Supplies of quality space are declining across the country and rents keep moving higher. Construction activity is robust, but concentrated in a handful of major distribution hubs. Supply in more mature markets is running thin as industrial land is being repurposed to higher uses despite dangerously low vacancy and strong demand from expanding businesses. The post-election surge of optimism continues, but cooled noticeably after the failed attempt to repeal and replace

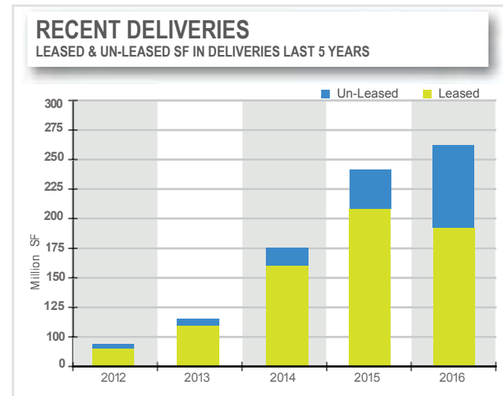


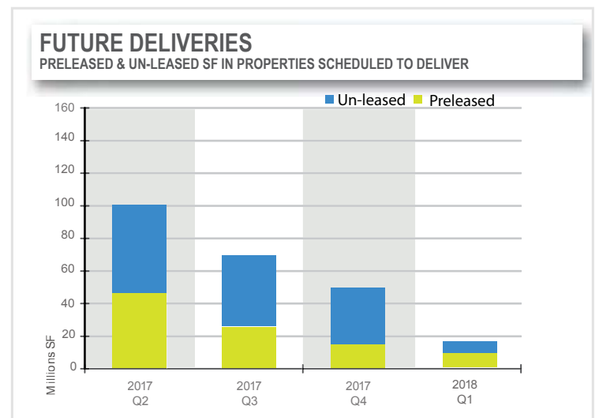
the controversial Affordable Care Act. All things considered, the industrial market kept its momentum and should continue on current trend lines for the rest of 2017. The Fed made another move on interest rates during Q1, the second adjustment in just three months, after inching closer to hitting its targets for inflation and employment. Markets took the move without the global economic hiccup its initial rate hike caused back in December of 2015.

This time around, the Fed's moves seem to have come as welcome news, as industrial business owners and commercial real estate investors see the tightening of monetary policy as a sign of a strengthening economy. The recent rate hikes did push mortgage rates higher, but not by enough of a margin to dampen the enthusiasm for acquiring industrial properties. Demand from owner/users and third-party investors has pushed prices to record levels, and supply continues to run at a fraction of current demand. Lenders are underwriting deals with closer scrutiny, but there are enough highly qualified buyers out willing to be under the microscope.

Caution has its place, especially so many years into the market up cycle. At this point, no one knows how much further rates will need to rise to initiate the cap rate decompression so many experts have been talking about. For the time being, owner/user buyers, are still lining up to pay record prices, but even though owners can reap windfall profits by selling, the tax consequences of cashing out are significant and exchanging is seen by many as just kicking the tax can down the road.

NET ABSORPTION COOLS - RENTS KEEP MOVING HIGHER





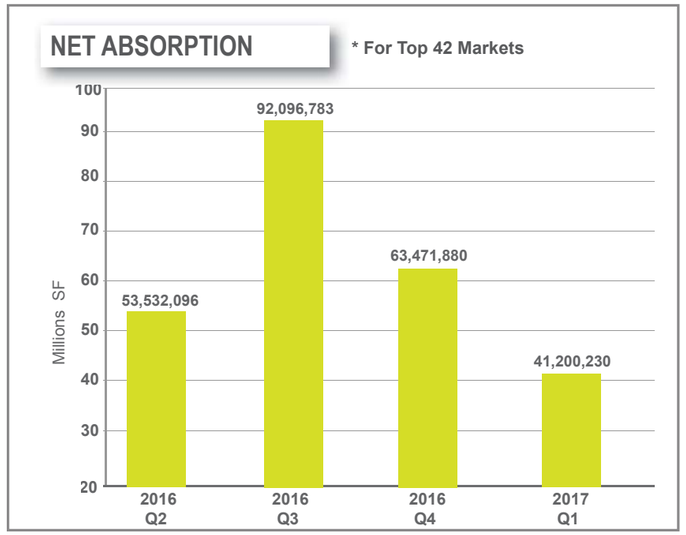
Still, buyers remain aggressive, especially user buyers who can take advantage of SBA financing at 90% of a property's value. They like the idea of keeping occupancy costs at for up to 25 years with fixed rate mortgages that are still in low 5% range despite the recent increase.

In Q1, net absorption was positive, but tepid compared to the last several quarters. Rent growth was strong and vacancy held steady as new deliveries stayed in relative balance with leasing action. GDP growth for 2016 came in at a disappointing 1.6%, and the preliminary estimate for Q1 growth is under 1%, which doesn't seem to sync up with current market sentiment and metrics. Fourth quarter earnings season brought generally good news from corporate America. Profits were up and so were revenues, which indicates that there is still room for industrial sector growth. In the past several reporting periods, much of the growth was in profitability caused more by cost-cutting than top line revenue gains. So, the increase in top line revenue was welcome news.

Vacancy was unchanged in Q1, but has been in steady decline in almost every primary and secondary market for the past few years. The shortage of quality space offered for lease has forced tenants to renew in place, relocate to inefficient space or pay the premium for first generation space. Rent growth is being driven by the increased efficiency offered in new projects where the latest in materials handling technology can help tenants think more three dimensionally. Owners of new space are demanding longer terms and stronger credit on top of higher rents.

Developers in low-vacancy markets are unable to find land suitable for ground-up development, and repurposing properties to multifamily and mixed-use retail/office projects is often the only way to make projects pencil out. Land is getting more expensive to acquire, projects are taking longer to get entitled and buildings are getting more expensive to construct, which is keeping significant amounts of spec building concentrated in major land-rich markets like Dallas/Fort Worth, Atlanta, Phoenix, Philadelphia, Chicago and Southern California's Inland Empire.

US INDUSTRIAL MARKET



Net absorption cooled off in Q1 but remained firmly in positive territory with a total gain in occupied space of 57.8 million square feet after posting a total gain of 80 million square feet in the final period of 2016. The e-commerce sector, big shippers and 3PL operators are still the market makers, taking down space in enormous chunks. Until recently, is was just the major distribution hubs getting most of the action, but the push for "Last Mile" locations to speed up shipping time has given secondary and tertiary markets a big boost. Amazon.com continues its massive expansion by leasing multiple fulfillment centers each quarter, some over 1 million square feet. Walmart is expanding in a similar fashion as part of its long term strategy to take the battle to Amazon. E-commerce is here to stay the need for state-of-the-art distribution space will be ongoing for years to come.

New deliveries for both speculative and build-to-suit projects for Q1 reached 63.3 million square feet in 517 buildings, nearly equaling Q4's totals. That brought total US industrial property inventory past the 22 billion-square-foot mark. As the quarter ended, another 268 million square feet was still in the construction pipeline. Development activity is focused primarily in distribution hubs like Dallas, Chicago, Philadelphia and Atlanta where land is still available at prices that allow projects to pencil at today's rents. That is not the case in mature markets like Los Angeles where what little land remains is too expensive for conventional industrial development. Infill markets like LA are losing industrial inventory to repurposing to other product types that make more economic sense.

As we reported last quarter, the balance between spec and build-to-suit construction has helped keep market metrics in balance. New deliveries continue to run comfortably short of net absorption, which has maintained market equilibrium even in markets with substantial construction. Speculative buildings are leasing quickly to fast growing tenants who like not having to wait for build-to-suit space. The national vacancy rate for warehouse and flex space was unchanged in Q1 at 5.3%. In the past four quarters, the vacancy rate has fallen by 40 basis points, and several major market areas still have vacancy rates in the 2% range, including Central Los Angeles, Long Island, New York and California's Orange County.

Average asking lease rates across the country moved higher again in Q1, ending the period up $.10 to $6.14. Markets with the highest levels of construction are still seeing the most rent growth, as tenants will pay a premium for efficient, first generation space with higher clearance and more sophisticated fire suppression systems. However, rising development costs are driving up the rents required to make projects pencil, and that has developers and their lenders wondering whether the current pace of rent growth will cover those additional costs by the time projects are built.

The global economic growth picture still isn't good, but it has improved substantially. GDP growth in the European Union trumped the US for the first time, but the European central bank is still printing money to buy sovereign and corporate bonds and continues to experiment with negative interest rates to stimulate further economic growth. The Asia Pacific region is picking up the pace, as well. Port activity was way up in the first quarter, in part driven by higher commodity and oil prices. In all, we started 2017 on a much more positive note than we did in 2016, when the world economy got spooked by the Fed's first rate hike in December of 2015.

2
National Economic Overview
US INDUSTRIAL MARKET

LOOKING AHEAD

High demand, low supply, rising prices and declining vacancy will continue to drive market dynamics. However, economic growth is still stubbornly sluggish and there is a fair amount of uncertainty from a macroeconomic perspective. Monthly swings in job and wage growth are sending a mixed message about the rest of the year, yet our central bankers are optimistic enough to raise interest rates twice in three months and send a strong signal of further near term hikes. The yield on 10-Year Treasuries, the benchmark for setting commercial mortgage rates, spiked to over 2.6% during Q1, but has settled in the 2.3% range of late, which means the markets have already factored in the Fed rate hikes.

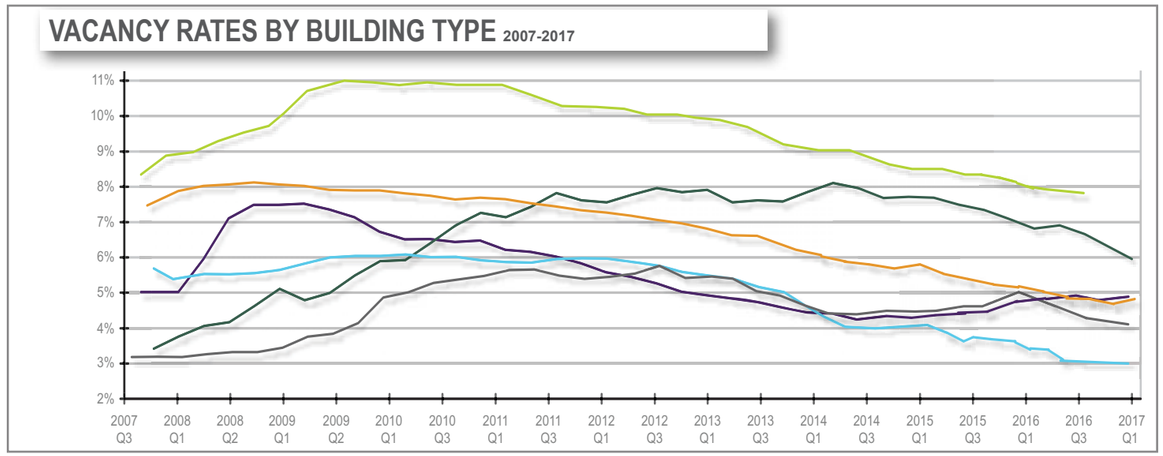
The global economy looks to improve further going forward. The Brexit scare was short-lived, and the markets have gotten used to the idea of an EU without the United Kingdom. China and other emerging economies are still facing big challenges, but talk of global recession has subsided in the wake of improved economic indicators around the world.

US economic growth is perhaps more of a mystery. With GDP getting such a slow start in 2017, it's hard to say where the year will end up. However, the industrial market is largely driven by rapid growth in e-commerce and third-party logistics operators. So, current activity levels are maintainable in the near term. Barring a significant economic event, the industrial property market should continue to expand at the current pace.

Vacancy will keep moving lower in small increments, as the bulk of new construction is concentrated in distribution hub markets with strong, ongoing positive net absorption. Net absorption should remain positive and healthy in 2017, but may moderate in markets that have very low vacancy. Landlords will keep pushing for longer terms and stronger credit, while tenants will look for shorter terms that provide strategic flexibility and the chance for lower rental rates when the market finally corrects. Construction will remain at current levels in areas with ample supplies of land, but will decline further in markets like Los Angeles where land is either unavailable or too expensive for industrial development. Lenders still have money to loan, but will continue to tighten up on underwriting to mitigate potential downstream risk.

US RETAIL MARKET

The US retail property market kept pace in Q4. Vacancy and construction activity were relatively unchanged, rents rose modestly and net absorption remained solidly in positive territory. Even though the numbers point to market consistency, the retail industry continues to experience significant change as traditional department stores struggle to adjust to the massive challenge presented by growth in online sales and the demographic shift from baby boomers to millennials. Sporting goods operators Sport Chalet and Sport's Authority shuttered all their stores in 2016, as did women's apparel giant The Limited, which will remain in business as an online-only retailer. But there was more bad news for national chains in the first quarter, as another 11 name brands filed for bankruptcy protection, including Eastern Outfitters, Wet Seal, Gander Mountain, HHGregg, General Wireless Operations (Radio Shack) and Payless Shoe Source. While reorganization efforts are ongoing, some retailers may end up in liquidation if their reorganization plans come up short.



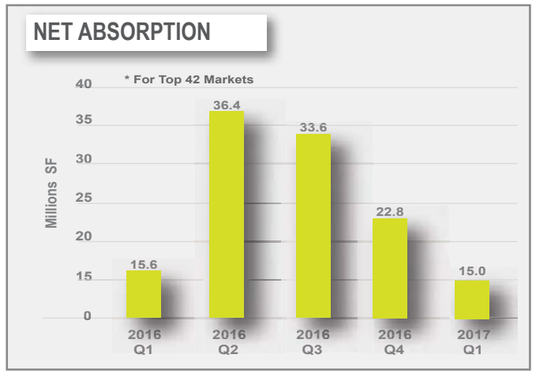
Store closings have also become a much larger problem tore closings have also become a much larger problem for mall owners. Major department stores announcing big store closure plans this year include (160 Sears & Kmart stores), JC Penny (138 stores) and Macy's (68 stores). Mall-based chains are also closing stores, including Abercrombie & Fitch (60 stores), American Apparel (110 stores), Wet Seal (171 stores), Crocs (160 stores) and Guess (60 stores). Most of the struggling retailers point mainly to increased online competition for their woes. More bad news is expected, as experts keep adding other big name retailers to the list of those who may not make it through the year. The vacancy rate was unchanged in Q1 at 4.8%, but it has fallen 20 basis points in the past four quarters. But, reported vacancy in secondary submarkets ranges much higher. General retail (freestanding, general purpose properties) maintains the lowest vacancy of all retail property types, followed closely by malls and power centers.

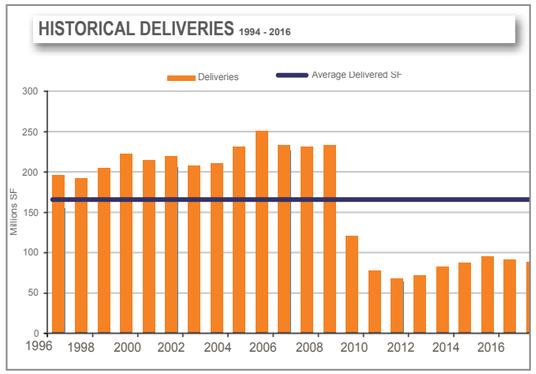
Shopping center (neighborhood, community and strip centers combined) rates are still highest, but excess supply in this category remains concentrated in unanchored centers in traditional suburban submarkets that generally have a higher concentration of local tenants on their rent rolls. Urban areas continue to account for a greater share of net absorption as retailers continue to shift their marketing focus onto millennial consumers. This group prefers multifamily housing near public transportation, trendy restaurants and cool bars over the suburbs they grew up in. They are more inclined to rent than own their homes, prefer public transportation over car ownership and like being close enough to work and amenities to walk. As a result, mixed use projects near public transportation tend to have the lowest retail vacancy.

RETAIL SECTOR HOLDS THE LINE IN Q1

Q1 net absorption topped 13.6 million square feet in the fi rst quarter, bringing the net gain in occupied space in the last four periods up to just over 134 million square feet. The general retail category accounted for the biggest slice of that gain, followed by the shopping center category and then malls. Power center absorption has been light in the past year, which is indicative of several 300 current trends in retailing: department stores closing, big-box retailers reducing 250 store size and count and the shift to urbanized areas with the most millennial population growth.

The overall average asking rate still managed another increase in Q1, up another $.29 to $16 per square foot. Over the past four quarters, retail rents across all product types and locations moved up by just over 3.3%, but rent gains are generally steeper in urban locales. Suburban retail centers, especially those that are not grocery-anchored, continue to see weaker growth, higher vacancy and the need for landlord concessions to secure new leases. The rate of rent growth suffers as distance from urbanized cores increase, which reflects the ongoing shift in lifestyle priorities. New deliveries for the quarter topped 18 million square feet, down from 24 million square feet in the previous period. In the past four quarters, 85 million square feet of new space has been added to the base inventory, which now stands at 13.15 billion square feet. Another 86.7 million square feet currently under construction, up 9% over Q4 of 2016.





LOOKING AHEAD

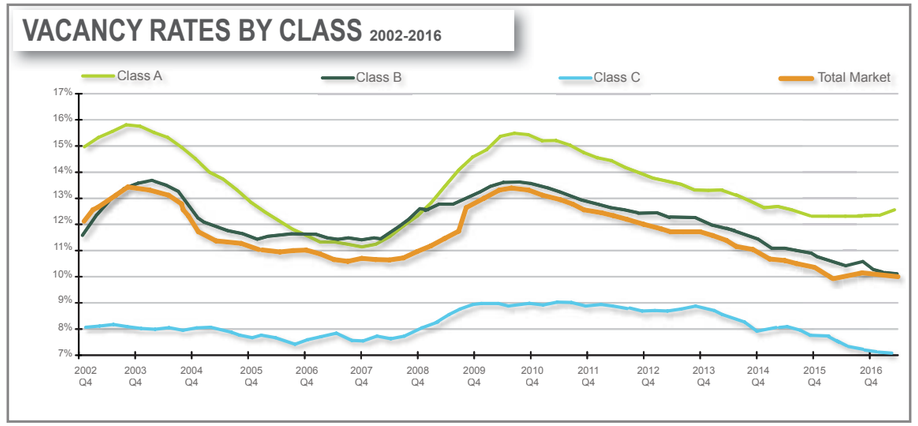
The US retail market will keep growing, but that growth will remain concentrated in more densely populated areas that have been or are undergoing the gentrification process. GDP and wage growth picked up late last year and that may give retail sales a welcome boost. But, consumer spending and retail sales growth have been uneven and the monthly rate of job creation has slowed from 229,000 a year ago, to just 180,000. If post-election optimism becomes reality in the form of stronger job growth, retail sales could gain momentum. Amazon recently announced that it would be adding another 100,000 full time employees to its ranks by 2018. Other large US corporations have also announced new investment in plant and equipment that will create more jobs.

Imported goods will remain cheap due to the strength of the US dollar, and that will keep the discounters busy expanding their footprints. Central banks around the world have resorted to negative interest rate policies to reduce the risk of a deflationary cycle, but Europe and Asia are showing signs of increasing stability. The US central bank made a move to raise rates In December, but the cost of capital is still relatively low. Further rate hikes are likely and they may impact business expansion later in 2017 and into 2018.

Low oil prices, with us for more than two years now, did not produce the boost in retail sales that was hoped for, and oil prices rebounded somewhat in the last half of the year, which may help energy market economies in 2017. Job growth will need to pick back up again to expect further increases in retail sales. For the time being, vacancy, net absorption and rental rates trends are unlikely to change significantly. 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. Through the first nine months of 2016, cap rates for retail investment properties fell another 11 basis points to 7.06%. However, well-located, prime retail properties are trading at cap rates under 5%. Foreign investors will keep giving demand a boost, as they continue to move capital to US markets for safety.

US OFFICE MARKET

The US office market showed signs of fatigue in the first quarter of 2017. Vacancy was unchanged, rent growth slowed, deliveries were fl at and net absorption, while still positive, declined substantially. Sublease inventory also moved higher. Altogether, it has experts wondering whether the long steady recovery in the office sector is showing signs of fatigue. Major markets including New York City, Los Angeles and even tech-darling San Francisco posted significant negative net absorption as did Atlanta, Houston and Hartford.



Taking a closer look at net absorption, which is the key indicator of market expansion, the first quarter total of 10.8 million square feet was a bit of a surprise. In Q4, over 23 million square feet of net gain was recorded, after gains of 37 million and 36 million square feet in the previous two quarters. In fact, more than 40 markets tracked by CoStar posted net losses in occupied space for the quarter. It is too early to say what long term significance poor absorption for the quarter has, but multiple quarters of declining market growth is worth noting. Downsizing caused by changes in workplace design may be partly to blame for the reduction in net absorption. No sector is immune from the trend in open space design precipitated by demographic shifts in the workforce and the leveraging of advances in mobile technology. Only four markets posted net absorption in excess of 1 million square feet. Leading the way was Washington, DC at 2.75 million square feet, followed by Chicago at 2.5 million square feet, Dallas/Ft. Worth at 1.5 million square feet and Boston at 1.1 million square feet. Major market posting disappointing Q1 results included New York City at negative 1.6 million square feet, Los Angeles at negative 1.3 million square feet and Hartford at negative 803,000 square feet. By building class, net absorption remains relatively well-balanced, as Class A, B product reported gains of 5.9 million and 5 million square feet respectively. In terms of Suburban versus Central Business District (CBD) performance, the difference is stark. Absorption 1.25 million square feet to the negative in CBD markets and 12 million square feet to the positive for Suburban markets. It's the suburban submarkets featuring urbanized hubs that appeal to employers most, as they choose locations that will attract and retain workers who are increasingly in to the live, work and play lifestyle. Millennials are redefining the workforce by way of their strong lifestyle preferences, and landlords who don't or can't respond accordingly are being caught out.

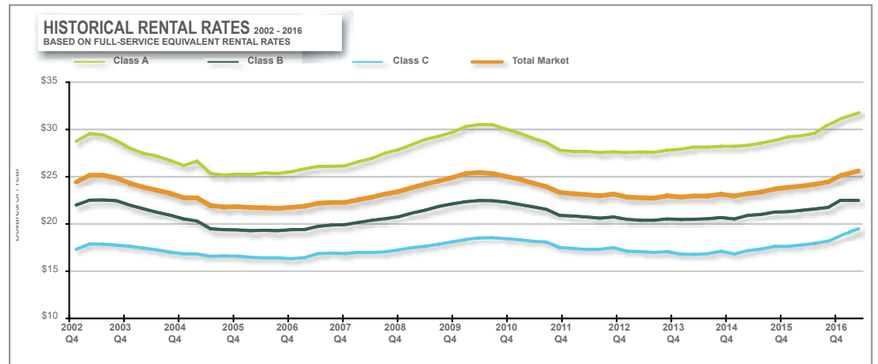
The vacancy rate, which stood at 9.7% as Q1 ended, was unchanged for the second consecutive period, but it is down 20 basis points in the last four quarters. By building class, it is a story of opposites. Vacancy for Class A is up 20 basis points over the past four quarters, while Class B vacancy has declined in each of the last four periods to end Q1 at 9.7%. Suburban and CBD vacancy is just 10 basis points apart at 9.7% and 9.8%, respectively.

Average asking lease rates for the US moved up again in Q1, adding another $.13 to $24.44 per square foot. That is a .5% increase for the period. Asking rents keep 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.

OFFICE MARKET TAPS THE BRAKES IN Q1

Office occupiers across all sectors are finding new ways to leverage advances in communication and computing technologies in order to use less space. Markets with more active tech and healthcare sectors tend to see bigger rent gains, but energy markets are still seeing rent declines and bigger concessions, mainly to due to large blocks of long term sublease space that compete with direct space offerings.

The level of new deliveries has been within 1 million square feet for the past four quarters. In Q1, 21.3 million square feet of new office space was delivered, compared to 20.3 million square feet in Q4 of 2016, 20.9 million square feet in Q3 and 20.1 million square feet in Q2. This has allowed the market to expand with minimal risk of overbuilding. The quarter ended with another 154.4 million square feet of space under construction, with most of that total concentrated in the nation's ten largest markets. New York City is at the top of that list with over 15.75 million square feet underway. Dallas/Fort Worth is not far behind at 11.9 million square feet, followed by Washington DC at 11 million square feet, South Bay/San Jose (Silicon Valley) at 9.9 million square feet and San Francisco at 8.1 million square feet. Another tech-heavy market, Seattle/Puget Sound, rounds out the top five at just under 8 million square feet. The largest project underway in Q1 is still 3 World Trade Center, a 2.86-million-square-foot tower in Manhattan. That building is set for delivery in the first quarter of 2018 and is 37% preleased. Five of the six largest projects currently under construction in the US are located in Manhattan.



Average asking lease rates for the US moved up again in Q1, adding another $.13 to $24.44 per square foot. That is

Developers to focus on mixed-use projects in urbanized, amenity-rich areas that will bring the highest rents. Land and construction costs have been steadily rising and the entitlement process is more expensive and takes longer to navigate through. Lenders are tightening up on underwriting and preleasing requirements make purely speculative projects harder to make happen. Unlike their industrial counterparts who can rely on the e-commerce and 3PL sectors to keep expanding in large space increments, office builders don't have a particular user type to count on to gobble up large blocks of space. Institutional and private investors still have good quality office buildings at the top of their wish lists. That, and the appetite of foreign capital for US office property assets, has driven cap rates to historical lows. However, as a tighter monetary policy matures, yields in other asset classes should rise. A 50 basis point rise in the going-in cap rate in a 5%-cap world really moves the value needle and that is weighing heavier on the minds of prudent investors. If rent growth slows as it has in some markets across the country, the loss in property values could be substantial. Foreign buyers are the wild card, as their motivation lean toward capital preservation over yield.

LOOKING AHEAD

The US office market lost some momentum in the last two quarters, and needs some good news in Q2 to get back on track. US employment growth has been sporadic of late and that has experts wondering if the market expansion can be sustained going forward. Job growth in office-using sectors drives net absorption and the twelve month rolling average of jobs created each month has declined. After two good months to start the year, March job growth fell significantly to just 98,000, well below the threshold needed to absorb new entrants into the workforce. Wage growth has improved somewhat over the past year, but the increase in inflation, touted by our central bankers, is neutralizing those gains.

Rent growth will continue, but probably at a more tepid pace going forward. Tenants will keep looking for new ways to do more with less by leveraging communication technologies and preference for open floor plans preferred by their employees. They will trade higher rental rates for space efficiency. Owners of older properties not in proximity to preferred amenities and public transportation, will be under pressure to upgrade their buildings or be forced to lower rents and boost concessions.

SANTA BARBARA

Q1

RETAIL VACANCY RATE 5.54%

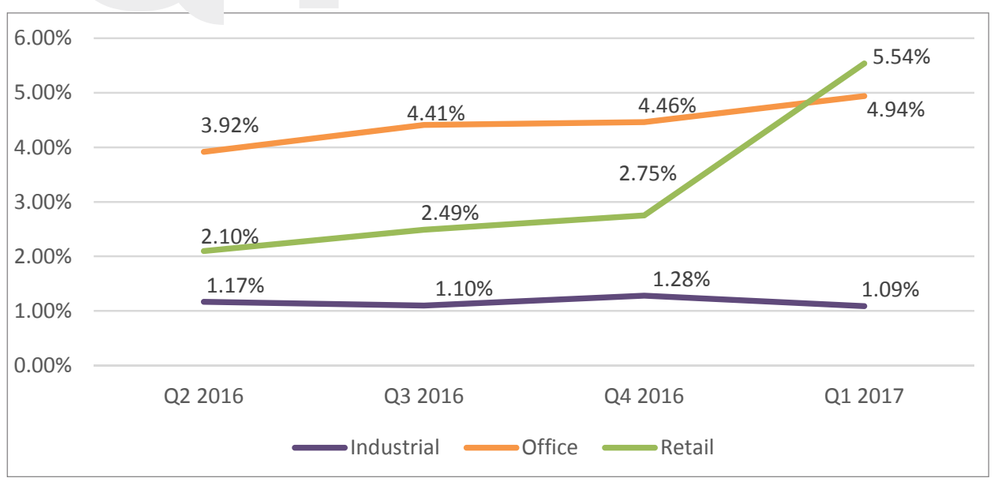
INDUSTRIAL VACANCY RATE 1.09%

OFFICE VACANCY RATE 4.94%

36
AVAILABLE
Store fronts for Lease or Sale in Downtown Santa Barbara.

3
NOTABLE SALES
1. 35 Anacapa St. 22,216 SF $3,500,000
2. 29 E. Cabrillo Blvd. 9,526 SF $7,200,000
3. GRANADA TOWER 15,146SF $8,635,000

2
NOTABLE VACANCIES:
1. 1001 State St. Available: 20,575 SF
Saks Fifth Avenue
2. 701 State St. Available: 150,000 SF
PASEO NUEVO



ISLA VISTA

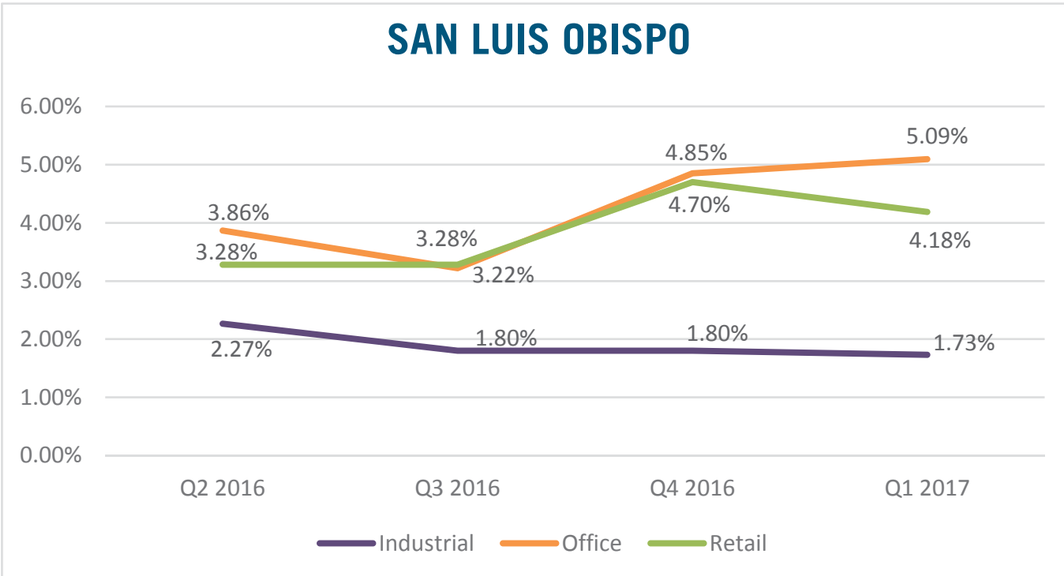
The Hive at Breakpointe and the Coronado Apartments, two multi-family properties, located at 6672 Abrego and 6626 Picasso Rd, in Isla Vista sold for a combined purchase price of $51 million.

The 151-unit student housing project was acquired by The Carlyle Group, a Washington D.C. based institutional investor. The Carlyle Group, was the majority partner in the deal, while Manda Partners-a national owner/operator with over 30 properties, served as the minority and operating partner in the transaction. Manda Partners now owns or operates eight properties in Isla Vista under its umbrella known as "The Hive IV." Located in the unincorporated community of Isla Vista, adjacent to the University of California at Santa Barbara (UCSB), the multi-family properties are positioned within walking distance to the beachside campus.

BREAKPOINTE 96 UNITS | $351K PER UNIT

CORONADO: 55 UNITS | $329K PER UNIT

SAN LUIS OBISPO



Q1

RETAIL VACANCY RATE 4.18%

INDUSTRIAL VACANCY RATE 1.73%

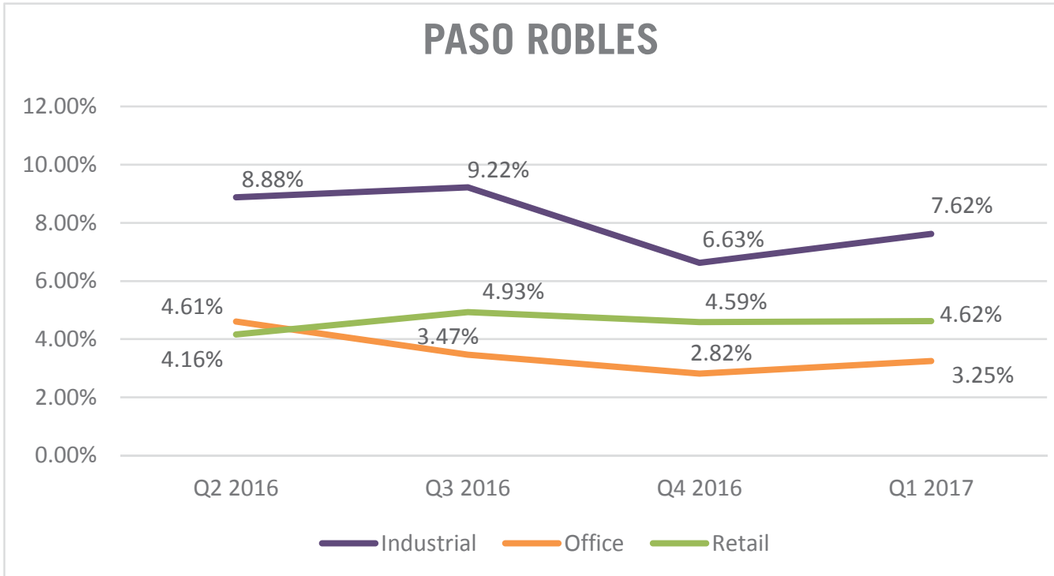
OFFICE VACANCY RATE 5.09%

MARKET HIGHLIGHTS

- Pacifica Investments acquired an industrial building at 705-709 Fiero Ln for $11,250,000. The fully leased investment property occupied by Fedex, Underwriters Laboratories, and Apria Healthcare, is suitably located near the San Luis Obispo Airport in the South Broad Street corridor.
- The largest lease transaction of the quarter was the 32,000 square feet industrial lease at 3580 Sueldo Lane to Empirical Systems Aerospace, Inc., an aerospace design and manufacturing company. They will be using the facility for testing, design, and manufacturing of their products.
- The area continues to see high construction and labor costs leading to lofty TI allowance requirements; making it harder for tenants and landlords to make agreements.

3
Key Market Snapshots

PASO ROBLES



Q1

RETAIL VACANCY RATE 4.62%

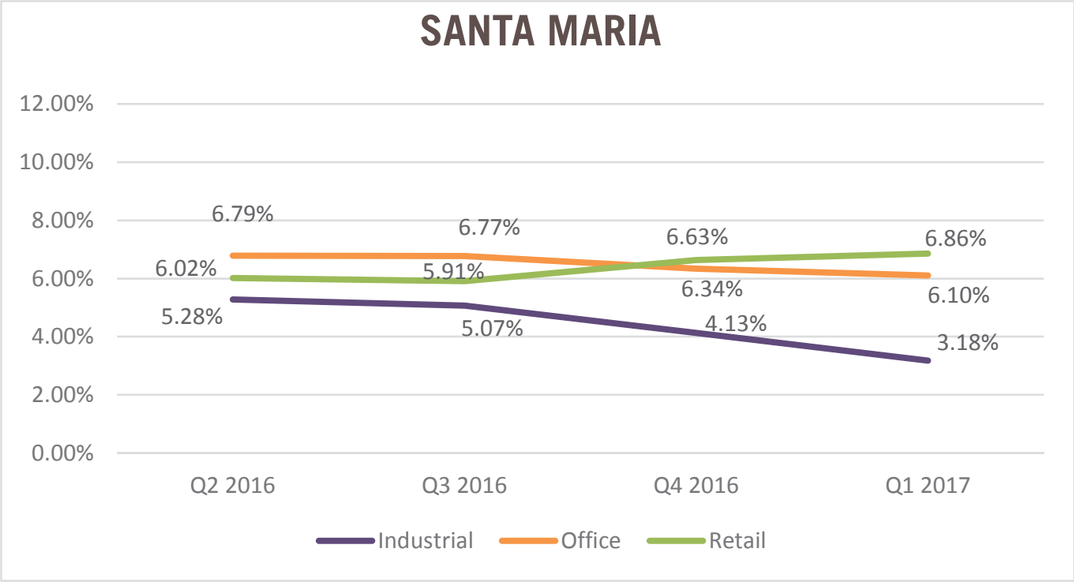
INDUSTRIAL VACANCY RATE 7.62%

OFFICE VACANCY RATE 3.25%

MARKET HIGHLIGHTS

- 145,000 SF of industrial space remains available at Ramada Drive in Paso Robles. The rumored conclusion is that the space will be absorbed for beer or wine processing.
- Office vacancy has contracted. Smaller office suites in the 1000-2000 SF range are being leased consistently.

SANTA MARIA



Q1

RETAIL VACANCY RATE 6.63%

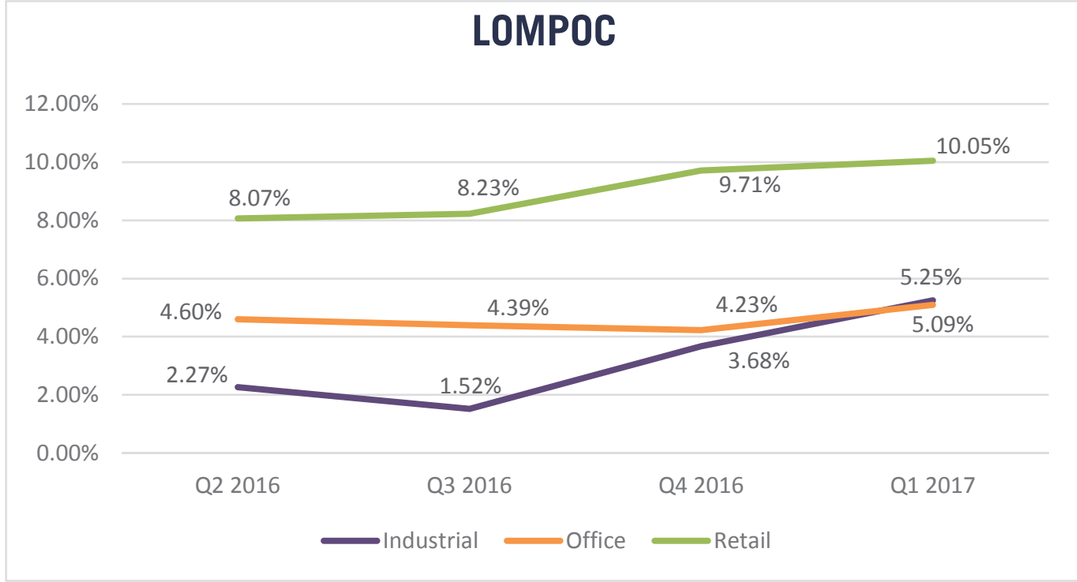
INDUSTRIAL VACANCY RATE 4.13%

OFFICE VACANCY RATE 6.34%

MARKET HIGHLIGHTS

- Santa Maria Industrial Vacancy has declined further in Q1 2017. Oxnard based AgRx, a supplier of agricultural products, leased 12,240 square feet of industrial/warehouse space at 939 W. Boone St in Santa Maria.
- Two 25,000 SF Office/R&D buildings are proposed for construction next to the airport at 2811 Airpark Dr. in Santa Maria. The existing building on site already houses San Luis Obispo based health-tech company MindBody and the addition of the two Class A buildings will form the first corporate tech campus of its kind in Santa Maria. The proposed buildings are currently under environmental review and are estimated for delivery in Q4 of this year.

LOMPOC



Q1

RETAIL VACANCY RATE 9.71%

INDUSTRIAL VACANCY RATE 3.68%

OFFICE VACANCY RATE 4.23%

MARKET HIGHLIGHTS

- Woodstone Apartments, A 204 unit complex located at 401 W Pine St in Lompoc, was sold for $33,000,000. The property was purchased at the end of the quarter by Vintage Housing- a Newport Beach based investor and operator specializing in affordable housing for seniors and families.
- Lompoc industrial vacancy has increased slightly due to 20,000 SF of vacant space at 1637 W Central Ave and approximately 12,000 SF of vacancy at 1641 W Central Ave. 1637 W. Central Ave is a 20,000 SF building formerly used by a cabinet manufacturer, and 1641 W Central Ave is a larger 50,000 SF steel framed industrial building. Both buildings are located on the west end of Lompoc. The "Wine Ghetto" remains quite strong with close to zero vacancy.

3
Key Market Snapshots

WINE COUNTRY

As expected, California wine sales are poised for another prodigious year with trends suggesting a 7% increase in wine production fueled by the premium wine sector. Silicon Valley Bank annual State of the Wine Industry Report predicts sales of premium wine in the US to grow between 10% to 14% in 2017. The higher sales bode well for major producers like E & J Gallo, Foley Family Estates & Constellation Brands.

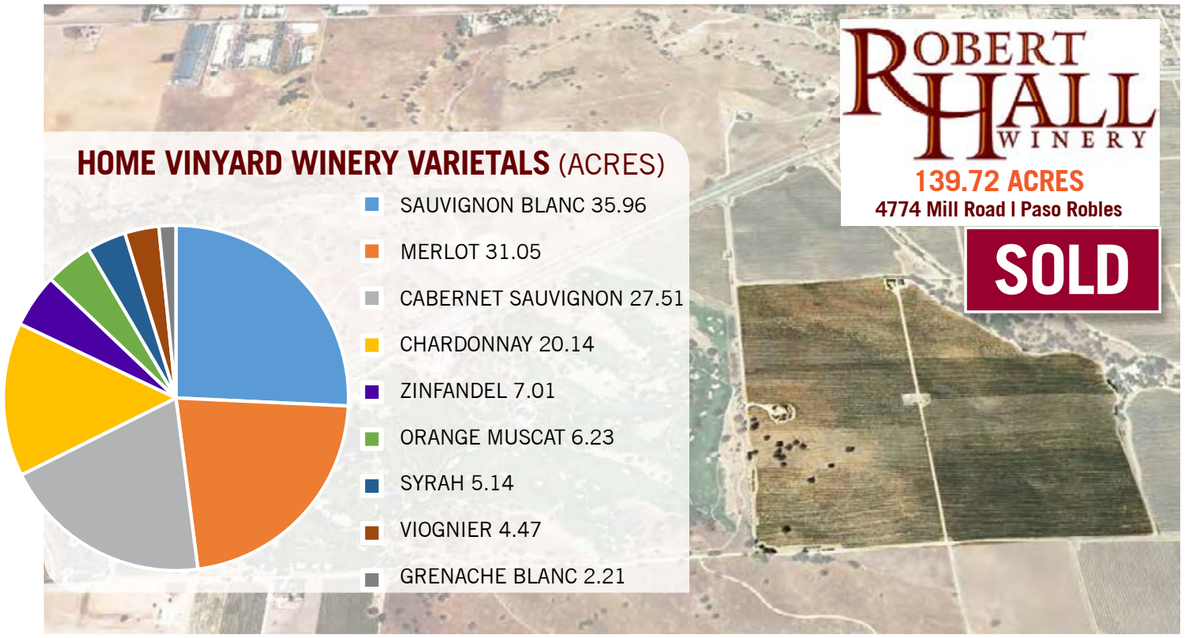
1,300 Acre | 175 Individual Parcels **SOLD**

Gallo FAMILY

E & J Gallo, the world's largest family-owned wine company announced the purchase of **Stagecoach Vineyards,** the largest contiguous vineyard in the Napa Valley for an undisclosed amount. The 1,300-acre site is uniquely located in Foss Valley, overlooking Napa Valley on the westernmost region of the Atlas Peak appellation. The site is situated on 600 acres of vines in 175 uniquely individual blocks among four designated regions. Known for its Cabernet Sauvignon and Bordeaux varietals, the acquisition highlights the wine industry's move to "premiumization," bridging ultra-premium wines and function to the mass market. Stagecoach will continue to be a source to over ninety wineries, including wines made by **Fess Parker/Epiphany, Orin Swift and Caymus Vineyards.**

We continue to see vineyard acquisitions in the North San Luis Obispo County area. Paso Robles based Sran Vineyards Inc., purchased the 159-acre Home Vineyard from Robert Hall Winery for $4 million. The Paso Robles site is located off Highway 46, just above the Estrella Plain adjacent to Hunter Ranch Golf Course. The site was Halls largest and most mature vineyard, producing Cabernet Sauvignon, Merlot, Zinfandel, Grenache Blanc, Chardonnay, and a variety of others.

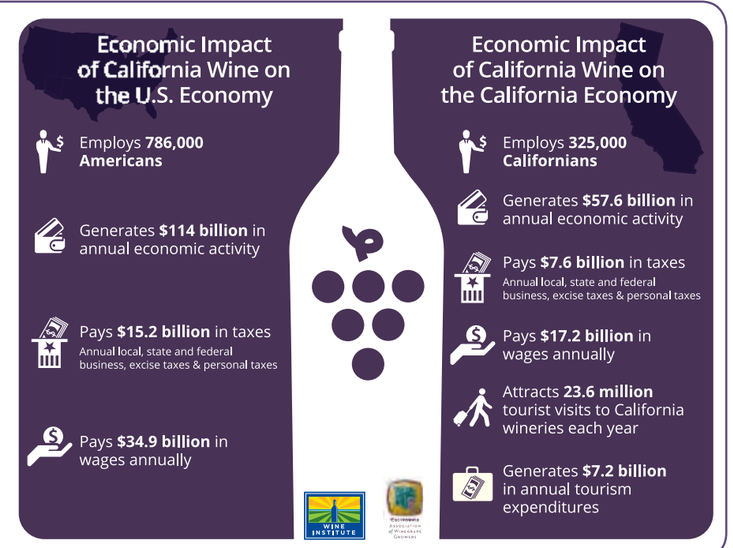
Falcon West Vineyards & Winery, has sold their 149 acre vineyard to 3IN Winery Inc. for $2.1 million. The land parcel located on Union Road, in Paso Robles is comprised of 55.5 acres of planted grapevines producing Cabernet Sauvignon, Merlot, Syrah.



Despite the projected sales growth, labor shortages continue to be a pressing issue for wineries. The wine industry currently employs 325,000 jobs in California with **$17.2 B** in annual wages.

In addition to the growing labor concerns, wineries are faced with the legalization of marijuana; potentially offering consumers an alternative to alcoholic beverages.

Currently, eight states, including California have legalized marijuana for recreational use, with a total of twenty-eight states approved for medical use. The wine industry potentially stands to lose field workers to the growing cannabis industry; luring laborers with higher wages, primarily in cash.



*Employment statistic provided by the USDA California Growers Association
California Wine Institute 2015 Economic Impact Report on Wine prepare by John Dunham & Associates, New York

CANNABIS

The passage of Prop. 64 allowing for adult recreational use, has the cannabis industry gearing up for California's state licensing program, set to begin issuing licenses by January 1, 2018. The anticipation of the recreational cannabis measure has created an increased demand for both greenhouse and industrial space. This is particularly true in the small oceanside city of Carpinteria. Located in southern Santa Barbara County, Carpinteria has historically been home to a number of thriving greenhouse operations; several of which have already been converted to an unknown number of medicinal cannabis farms. In late 2016, Carpinteria City Council approved an ordinance regulating commercial growing for recreational use. The outcome accelerated the demand for outdoor grow space, especially by veteran growers, as outdoor grow operations tend to be more affordable than urban warehouse spaces.

In the last twelve months, over **68 acres** of greenhouse space has been sold, totaling **$26 million in transaction volume**, with a remaining available inventory exceeding **55 acres**. On average, area greenhouse space is trading at **$14 per-square foot**.

CARPINTERIA GREENHOUSES ON-MARKET

TOTAL ACRES ON MARKET	**55.35 AC**
TOTAL ASKING PRICE	$38,800,000.00
ASKING PRICE PER ACRE (AVERAGE)	$637,252.19
ASKING PRICE (AVERAGE)	$9,700,000.00
TOTAL GREENHOUSE LAND IN CARPINTERIA	**624.04 AC**
% OF GREENHOUSE LAND TRADED IN LAST YEAR:	10.96%
% OF GREENHOUSE LAND ON MARKET:	8.87%

CARPINTERIA GREENHOUSE SALES
5/1/2016 - 3/31/2017

TOTAL ACRES SOLD	**68.41 AC**
TOTAL SALES VOLUME	$26,024,000.00
SOLD PRICE PER ACRE (AVERAGE)	$522,707.96
SOLD PRICE (AVERAGE)	$4,337,333.33

GREEN HOUSE **SOLD** IN CARPINTERIA:

1. **5601 Casitas Pass Rd., Carpinteria, CA 93013**
ACRES: 4.83 SALE PRICE: $4,000,000
2. **3804-3890-3982 Via Real, Carpinteria, CA 93013**
ACRES: 17.98 SALE PRICE: $6,324,000
3. **5360 Foothill Rd., Carpinteria, CA 93013**
ACRES: 9.85 SALE PRICE: $3,800,000
4. **5775 Casitas Pass Rd., Carpinteria, CA 93013**
ACRES: 4.83 SALE PRICE: $2,000,000
5. **5138 Foothill Rd., Carpinteria, CA 93013**
ACRES: 6.0 SALE PRICE: $6,000,000
6. **5300 Foothill Rd., Carpinteria, CA 93013**
ACRES: 24.92 SALE PRICE: $3,900,000

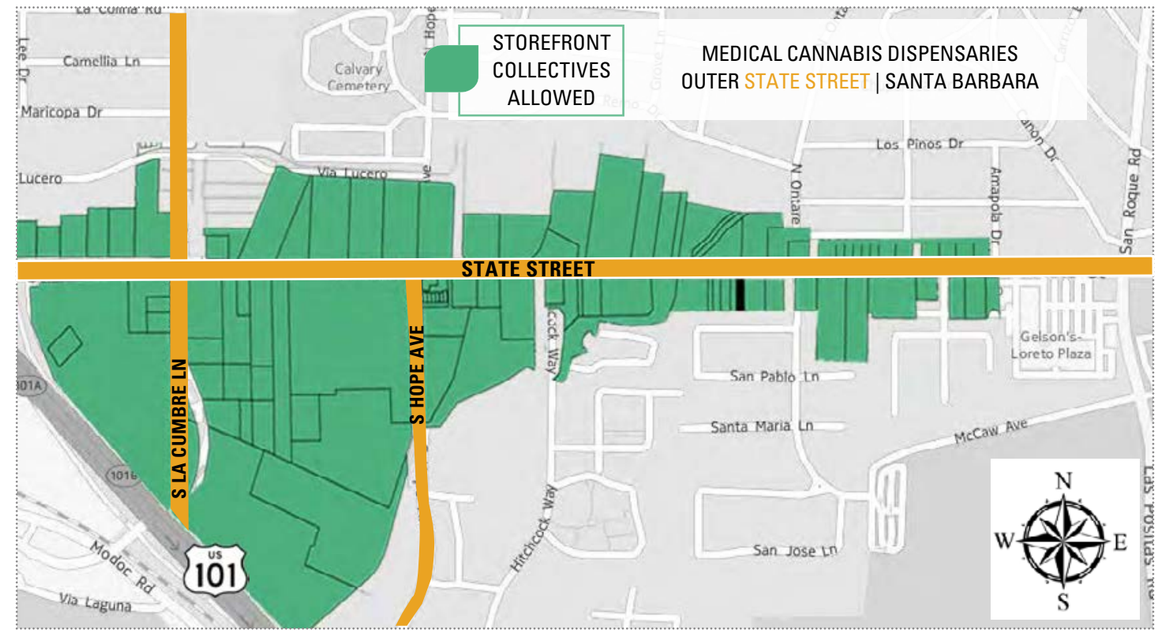
GREEN HOUSE **AVAILABLE** IN CARPINTERIA:

1. **3804-3890-3982 Via Real, Carpinteria, CA 93013**
AVAILABLE ACRES: 17.98 SALE PRICE: $21,000,000.00
2. **4920 Foothill Rd., Carpinteria, CA 93013**
AVAILABLE ACRES: 7.42 SALE PRICE: $2,800,000.00
3. **4711 Foothill Rd & 1495 Sterling Ave. Carpinteria, CA 93013** AVAILABLE ACRES: 14.77
SALE PRICE: $8,500,000.00
4. **4098 Via Real, Carpinteria, CA 93013**
AVAILABLE ACRES: 15.18 SALE PRICE: $6,500,000.00

3
Key Market Snapshots

MEDICAL MARIJUANA STOREFRONT COLLECTIVE DISPENSARIES PERMITS

Meanwhile, surrounding municipalities are developing their own local zoning ordinances for medical marijuana storefront dispensaries. The ordinances major provisions commonly drive storefront locations to heavy industrial zones causing limited availability, driving market prices up. As of March 6, 2017, the **City of Santa Barbara** has two approved medical marijuana dispensaries; one in the upper State Street area, located at *3617 State Street*, and the other at *118 N. Milpas Street*. In addition to, the City also has two pending applications; Upper De la Vina area at *2609 De la Vina Street*, and one at *128 W. Mission Street*.



TO SEE ALL CITY STOREFRONT ALLOWED PLEASE **CLICK HERE:**

Industry concerns are overwhelmingly focused on local bans followed by restrictive zoning ordinances. The lack of available real estate, a dominating barrier to entry, will continue to be a common theme across the commercial real estate market.

Commercial real estate brokers routinely field inquiries from the cannabis industry seeking available sites. The surging demand for marijuana cultivation and distribution space may put further pressure on an already compressed market.

*Employment statistic provided by the USDA California Growers Association
California Wine Institute 2015 Economic Impact Report on Wine prepare by John Dunham & Associates, New York

NOTABLE SALES **Q1** 2017

1

Property: Multi-Family

6672 & 6690 ABREGO RD. GOLETA
Size: 71,534 SF
Sale Price: $33,700,000
Sale Price/Unit: $351,041.67
Sale Date: 01/2017

6626 PICASSO RD. GOLETA
Size: 42,275 SF
Sale Price: $18,100,000
Sale Price/Unit: $329,090.91
Sale Date: 01/2017

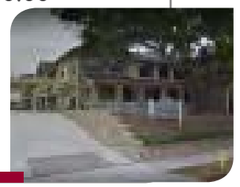
TOTAL PRICE: $51,800,000
TOTAL UNITS SOLD:151
TOTAL AVERAGE PRICE/UNIT: $343,046

401 W. PINE AVE., LOMPOC
Property: Multi-family
Size: 146,580 SF
Sale Price: $33,100,000
Sale Price/Unit: $162,254.90
Sale Date: 03/2017

2

1826 DE LA VINA ST., SANTA BARBARA
Property: Multi-family
Size: 24,128 SF
Sale Price: $18,600,000
Sale Price/Unit: $465,000.00
Sale Date: 02/2017

3



26 CASTILIAN DR., GOLETA
Property: Office
Size: 75,237 SF
Sale Price: $13,625,000
Sale Price/SF: $181.09
Sale Date: 01/2017

4

3025 DE LA VINA ST., SANTA BARBARA
Property: Retail
Size: : 18,436 SF
Sale Price: $12,500,000
Sale Price/SF: $678.02
Sale Date: 01/2017

5

705-709 FIERO LN., SAN LUIS OBISPO
Property: Industrial
Size: 57,858 SF
Sale Price: $$11,250,0000
Sale Price/SF: $194.44
Sale Date: 03/2017

6

SANTA BARBARA
RETAIL **$757.00** INDUSTRIAL **$200.02** OFFICE **$420.00**
MULTI-FAMILY (P/UNIT) **$342,454.55**

IOMPOC
RETAIL **$277.00** INDUSTRIAL **$150.00**
MULTI-FAMILY (P/UNIT) **$124,699.00**

PASO ROBLES
RETAIL **$158.69** OFFICE **$227.00**

SANTA MARIA
RETAIL **$139.00** OFFICE **$275.00**
INDUSTRIAL **$166.00** MULTI-FAMILY (PRICE/UNIT) **$199,909.09**

SAN LUIS OBISPO
RETAIL **$406.67** OFFICE **$290.00**
INDUSTRIAL **$194.00** MULTI-FAMILY (PRICE/UNIT) **$177,777.78**

4
Significant Transactions

NOTABLE LEASES **Q1** 2017

3580 SUELDO ST., SAN LUIS OBISPO

Tenant: Empirical Systems Aerospace, Inc.
Property: Industrial
Size: 32,400 SF
Lease Date: 01/2017

1

SANTA MARIA TOWN CENTER MALL

Tenant: Rockin Jump
Property: Retail
Size: 17,550 SF
Lease Date: 02/2017

2

460 WARD DR., SANTA BARBARA

Tenant: Arthrex, Inc.
Property: Industrial
Size: 13,500 SF
Lease Date: 03/2017

3

939 W. BOONE, SANTA MARIA

Tenant: Ag Rx
Property: Industrial
Size: 12,240 SF
Lease Date: 02/2017

4

5531 EKWILL ST., SANTA BARBARA

Tenant: The Regents of the University of California
Property: Industrial
Size: 11,200 SF
Lease Date: 03/2017

5

4675 THREAD LN., SAN LUIS OBISPO

Tenant: Barnick Wood Design
Property: Industrial
Size: 10,000 SF
Lease Date: 03/2017

6

AVERAGE ASKING LEASE RATES (GROSS)

SANTA BARBARA (per/SF)		SAN LUIS OBISPO (per/SF)		LOMPOC (per/SF)	
RETAIL	$4.21	RETAIL	$2.47	RETAIL	$1.40
OFFICE	$3.00	OFFICE	$1.89	OFFICE	$1.13
INDUSTRIAL	$1.90	INDUSTRIAL	$1.05	INDUSTRIAL	$0.76

SANTA MARIA (per/SF)		PASO ROBLES (per/SF)	
RETAIL	$1.94	RETAIL	$1.32
OFFICE	$1.41	OFFICE	$1.60
INDUSTRIAL	$0.77	INDUSTRIAL	$1.01

THE LEE & ASSOCIATES CENTRAL COAST TEAM

PRINCIPAL TEAM


CLARICE CLARKE


STEVE LEIDER


MARTY INDVIK

BROKER TEAM


ALLEN SEGAL


TOM DAVIDSON


CHRISTI VIOR


JEFF ALLEN


ANTHONY KUHNS


ROB ADAMS


NATALIE V. WAGNER


PAUL DAVIES

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2017

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, City of Santa Barbara, and Lee Propriety Data. Employment statistic provided by the USDA California Growers Association California Wine Institute, 2015 Economic Impact Report on Wine prepare by John Dunham & Associates, New York.

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