The Lee Central Coast Brief

Q2

2017

LEE & ASSOCIATES

COMMERCIAL REAL ESTATE SERVICES

62%
increase
in transaction volume over 5 years

$11.6 billion
transaction volume
2016

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

890
agents
and growing nationwide

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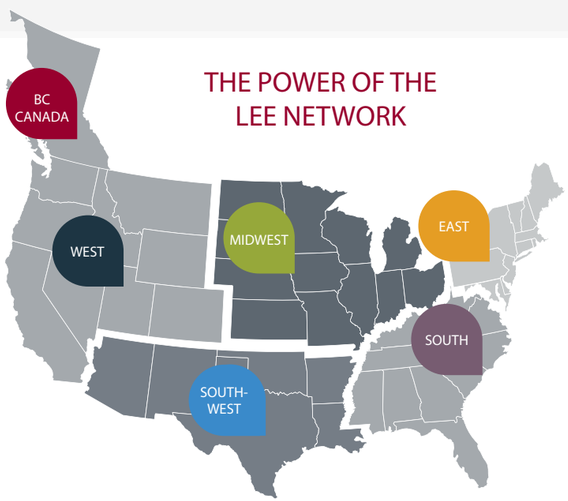
At Lee & Associates® our reach is national but our expertise is local market implementation. This translates into seamless, consistent execution and value driven market-to-market services.

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

THE POWER OF THE LEE NETWORK



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Charleston, SC
Valuation, Atlanta

Elmwood Park, NJ
Manhattan, NY
Edison, NJ
Chesapeake Region
LI/Queens , NY
Eastern Pennsylvania

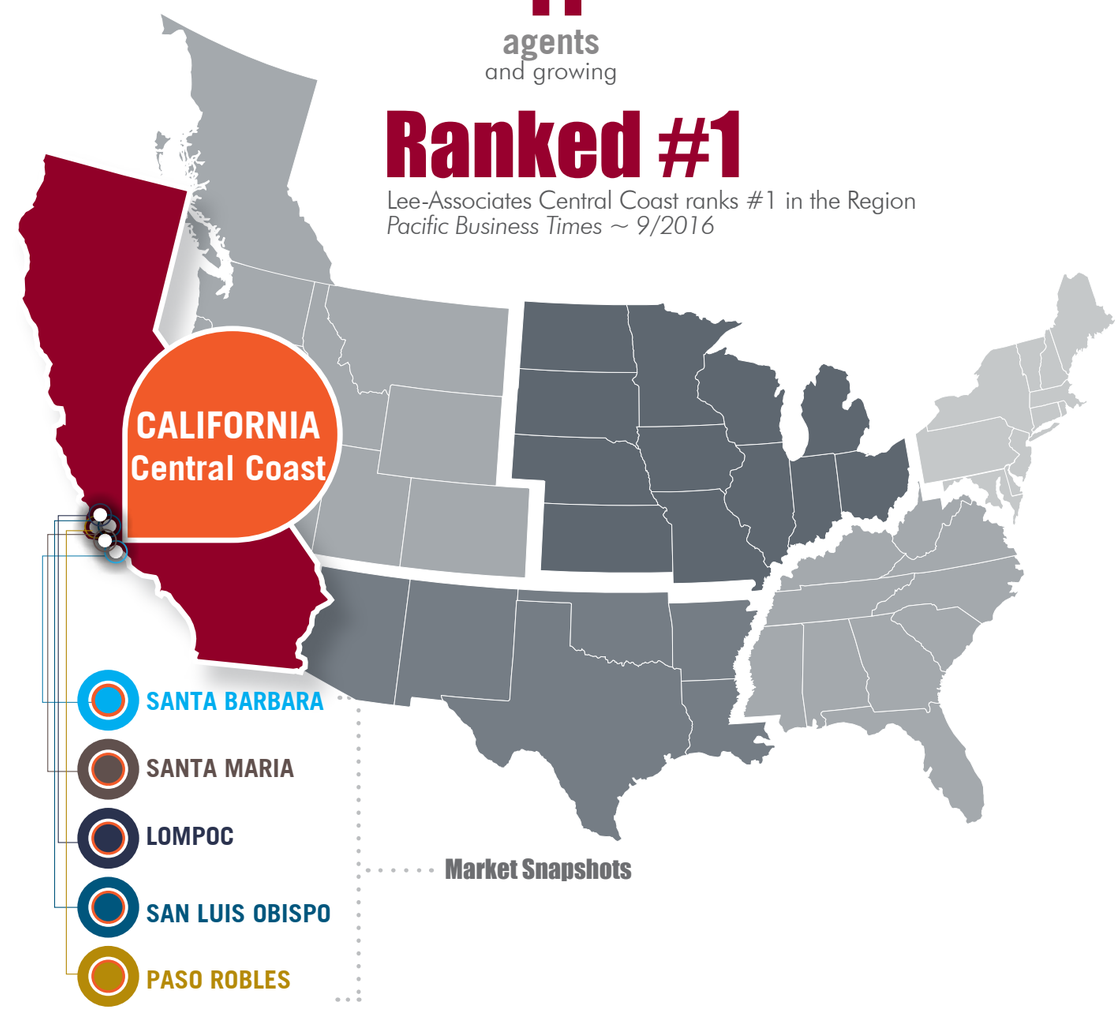
Vancouver, BC
Canada

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



GLOBAL ECONOMY

Until the end of last year, we were describing the global economic outlook as troublesome. We still remained concerned, but the global picture has definitely brightened in the first half of 2017. The panic over the Brexit vote is over, though the UK is still in for some rough road ahead. The actual process of extricating itself is now underway, and it should make for some interesting sausage making before it is complete. The British Pound remains under siege and other players will be making their plays to replace the UK as a financial services hub, but there is no clear indication of that happening in the near term

EURO AREA REAL GDP[2]
(QUARTER-ON-QUARTER PERCENTAGE CHANGES)

While Europe's political union is still not certain, GDP growth there is steadily improving. In 2016, GDP was up 1.8%, 20 basis points higher than the US growth rate, and that has more experts questioning why Mr. Draghi and his fellow central bankers at the ECB still have the monetary throttle wide open.

China's economy has stabilized and its stock markets have become less volatile. In fact, trade throughout Asia has improved in 2017 despite the fact that the US pulled out of the Trans Pacific Partnership trade agreement after Donald Trump took the reins as President. The recent OPEC agreement to cap production helped to stabilize the price of a barrel of oil above $50 in Q1, but an increase in US oil production in recent months sent the price of oil back into the low $40 range again by the end of Q2. Supply is still running ahead of demand and without more robust economic growth around the world, oil prices are likely to remain near current levels.

In June, Qatar, still a big oil player, was snubbed by other Middle Eastern countries for alleged ties to financing terror-related groups, and that has frayed nerves throughout the region that is already tense over the conflict with ISIS in Syria and Iraq. The fact that so much attention is on the Middle East right now without a resulting spike in oil prices is proof positive that there is more oil coming out of the ground than is currently needed. Fears over "peak supply" have given way to the potential global impact of "peak demand" instead.

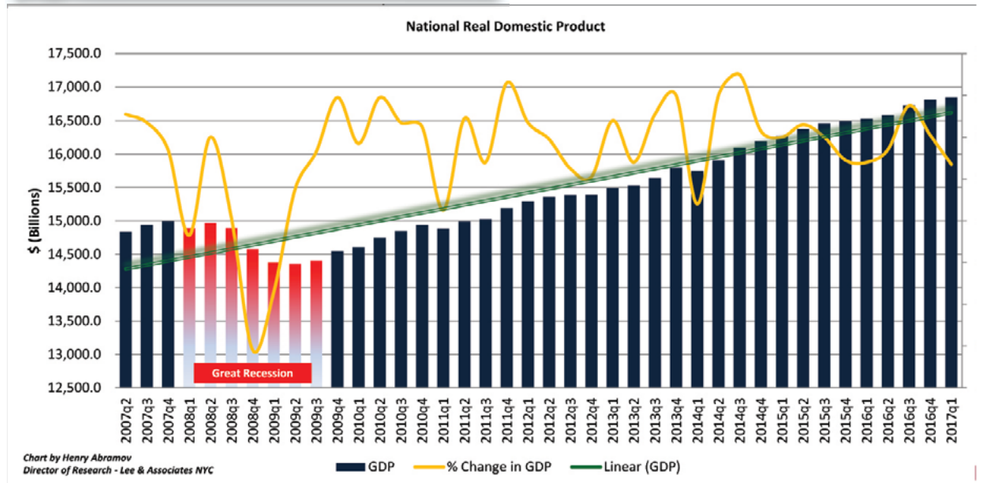
2
National Economic Overview

GDP GROWTH

US GDP, the primary metric for tracking the total output of our country's goods and services, is closely scrutinized by economists around the world who saw more of the same out of the US economy in Q2. After another disappointing first quarter that saw US growth at an annualized rate of just 1.2%, growth picked up as it has in Q2 as it has been doing in recent years. The first estimate for the period came in at 2.6%, compared to 2.1% in the same period last year after a weak first quarter. That has given rise to more talk about taking a new look at the current GDP model to more accurately reflect seasonal changes.

Total GDP growth for all of 2016 was up just 1.6%, and it looks like the US economy is in for another year in the same range. Once thought to be anemic, 2% growth seems to be the new normal these days, and the Trump administration's goal of sustained 3% growth is looking lofty, at least until a tax reform or infrastructure bill becomes a reality. The prospects for either or both remain questionable.

QUARTER-TO-QUARTER GROWTH IN REAL GDP



Corporate earnings in the first quarter of 2017 were mixed, but generally good. More companies reported revenue increases rather than cost-cutting measures as a reason for improved profitability. That means more hiring, more consumer spending and hopefully, a bump in GDP performance going forward.

Concerns regarding the performance of the automotive sector continue. After several years of robust sales increases, consumers have put the brakes on auto purchases, especially small sedan-type cars. With gas prices down, consumers are opting for expensive trucks and SUV's, but fewer consumers can afford to make those purchases. In the final quarter of 2016, incentive-driven car sales accounted for a disproportionate share of GDP growth, but through the first half of the year, sales are down, and inventories are swelling, and that is having a negative impact on GDP. Automotive manufacturers have responded with production cutbacks of slow-selling models, but have not yet resorted to deep discounting to rental companies as a means of reducing over-supply as they have done in the past. Overall sales volume is down substantially through the first half of the year, and used car lots are swelling with formerly leased vehicles, which is exacerbating the problem. Also, auto loan defaults have been rising as of late.

GDP GROWTH

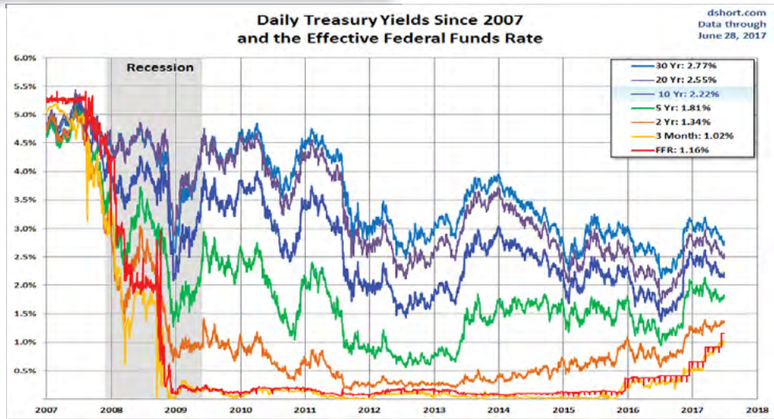
Ongoing aggressive monetary policy in Europe has kept the EU growing faster than the US. The EU posted another decent quarter of 2.2% growth in Q2, after Q1's 2.1% mark. The European Central Bank has been running full steam ahead with its bond-buying program and has taken drastic monetary and fiscal measures to keep the European Union member countries from sliding into recession. The European Central Bank is even experimenting with NIRP (Negative Interest Rate Policy) 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.

As we reported last quarter, the "Trump Bump" after the election sent equities markets soaring on the expectation of lower corporate and personal income tax rates, reduced regulations and a huge infrastructure spending program. But, the nation waits while Republicans and Democrats in both houses of Congress continue to do battle with little or no result. That might not be all bad in terms of GDP growth, however. Businesses dislike uncertainty and will live with a less than optimum economic environment, as long as they know what to expect in terms of laws and regulations. If that remains the case, GDP growth should chug along near current levels for the rest of the year.

MONETARY POLICY

As the saying goes, "be careful what you wish for." Calls for the Fed to reverse its easy money policy were finally heeded and after a preliminary move back in December of 2015, our central bankers have clearly changed their tune. In the past six months, the Fed has moved its Fed Funds rate up three times, with the most recent in the middle of June. Currently, that benchmark rate is set in a range of 1% to 1.25%, still low by historical standards. However, Ms. Yellen and friends have clearly drawn the line in the sand in terms of their intentions, despite up-and-down job numbers, tepid inflation and weak wage growth. It will take a sustained series of quarter-point increases to fully neutralize the activist posture of our central bank, which began ten years ago. As we have been reporting for the past two year, critics are vocal in their belief that Fed policy is 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.

US TREASURY RATES



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, dollar gains have been pared back recently, as economic growth around the world has gained momentum. 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. Money created in a computer on an as-needed basis, has to go back into the computer to be removed from circulation at some point or inflation will be sure to spike. In recent weeks, the Fed has been discussing plans to gradually reduce its holdings by not reinvesting in maturing US Treasuries and Residential Mortgage Backed Securities. It is unknown how the bond markets will react to the change, but many are concerned that it will drive up bond yields, which would exacerbate the effects of expected further rate hikes by pushing borrowing costs up too quickly.

Despite the Fed's more robust monetary stance, central banks around the world are still in activist mode. The European Central Bank is still buying bonds at a 65 billion euro-per-month clip and holding interest rates in the zero bound. Though, there is more talk of backing off that aggressive stance given the recent improvements in European Union GDP and employment metrics. The Bank of Japan can't seem to wean itself off of central bank meddling. Its appetite for bond purchases is so voracious, it is running out of government debt to buy back.

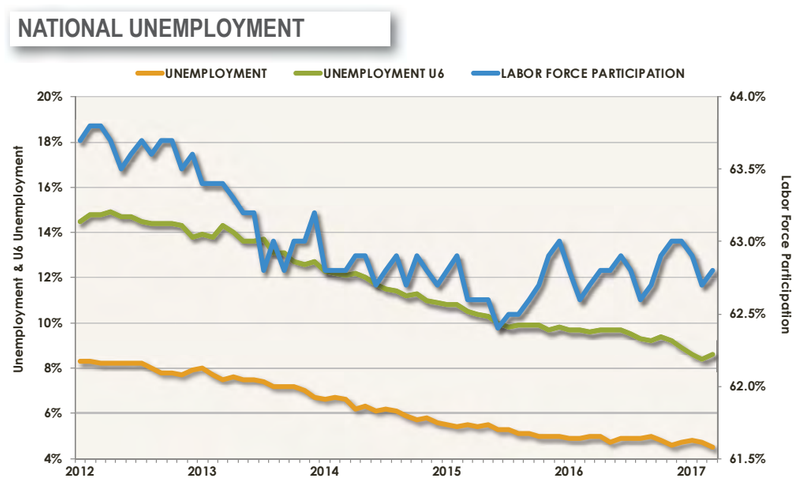
Concerns of a near term recession here in the US remain muted, but other than a low unemployment rate, the Fed has little to point to support the case for a more robust recovery. The surprise that was Donald Trump is now a daily reality and not much has changed since he was sworn in as our President other than a daily dose of juicy headlines.

Trump's promises of a big infrastructure investment and tax reform would give the Fed a little help if either came to pass, but that is not likely. Deficit hawks on the political right are pushing back and Democrats appear united in blocking anything and everything the new President puts on the negotiating table.

Mortgage rates started to move higher as T-bill yields, the benchmark for commercial property loans, made a move up. However, the Fed has made two interest rate moves this year, and the yield on the 10 Year T-Bill has actually fallen. Clearly, that anomaly reflects further uncertainty about the US economy going forward, as investors are willing to pay more for the safety of US sovereign debt. So, it remains a good time to borrow, but borrowers are facing stricter loan underwriting from increasingly cautious lenders.

EMPLOYMENT

Job growth statistics remain difficult to make sense of. Here's what we said last quarter, and we stand by it in Q2: 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. June of 2017 is a great example. Over 222,000 jobs were created, one of the best months in over a year, yet the unemployment rate rose by 10 basis points to 4.4%. These anomalies have caused many to discount the validity of the Bureau of Labor Statistics' U3 metric.



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 that 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 8.6%.

Job creation slowed in 2016, with the 12 month rolling average of new positions falling by over 50,000. But that pace has picked up again through the first half of 2017, as the 12 month average is back on the rise. The second quarter of 2017 ended with a strong performance in June, when over 222,000 private sector jobs were added, much better than in March when an unexpectedly low 98,000 new jobs were created to end Q1. Wild swings in job growth impact consumer spending and business expansion. Companies large and small tend to be more cautious in making long term decisions that have a big impact on hiring. Of significant import is the fact that tech sector job growth, which had been leading the way in terms of job creation, has slowed substantially this year. Even tech hotspots like San Francisco are cooling off, raising concerns over the impact on commercial real estate occupancy going forward.

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 62.8% of potential workers in active production.

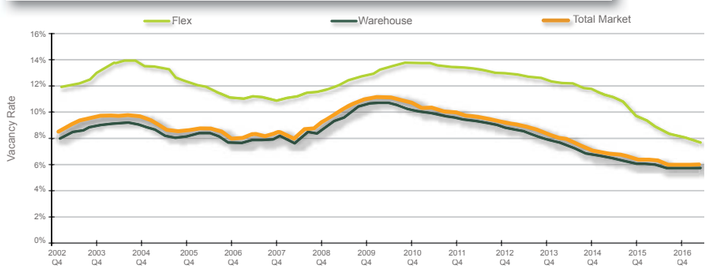
Lagging wage growth is still tightening the drag on US economic growth. Full-time, high-paying jobs are available, but remain unfilled for lack of qualified applicants. Lower-skilled workers are still having a harder time getting ahead. Wage growth has seen some improvement, but remains under 3%. In June, wages grew by 2.8% on a year-over-year basis. For workers at the lower end of the wage scale, where most of the new jobs are, income growth in the low single digits has little impact on their spending habits.

US INDUSTRIAL MARKET

Net Absorption Steady - Rents Up - Vacancy Declines

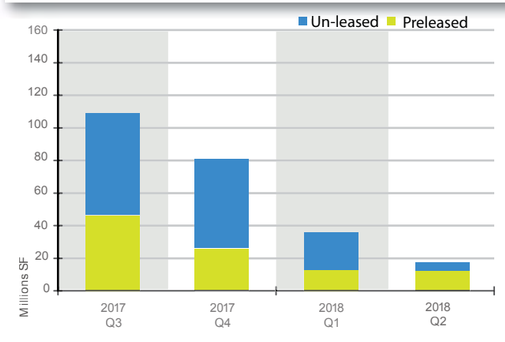
Despite robust levels of new construction, the supply of quality industrial space continues to thin in markets large and small across the country. Major distribution hubs continue to see the most construction and state-of-the-art distribution facilities account for the lion's share of the new space being built. Supply in mature, infill markets like Los Angeles and the New York area are running at critically low levels, which is forcing big users to look outside preferred areas in order to expand. The industrial base is actually shrinking in some markets, as older product is being repurposed to so-called higher uses. On the other hand, big hubs with land to spare like Dallas/Fort Worth and Atlanta are experiencing record levels of new construction and absorption, along with strong rent growth.

VACANCY RATES BY BUILDING TYPE 2002 - 2016



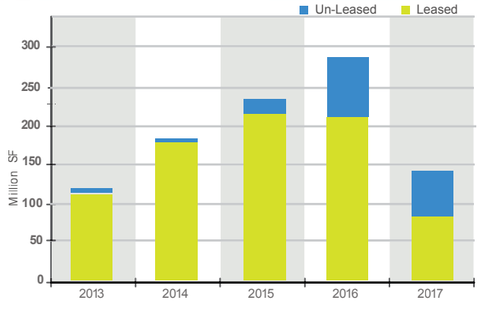
There is good news coming out of markets of all sizes, though, as the e-commerce, shipping, retail and 3PL distribution boom has spread to "last mile" facilities from coast-to-coast. The Amazons and Walmarts of the world continue to gobble up space closer to customers to speed delivery and compete for online sales. The biggest of these players are accounting for a disproportionate share of gross and net absorption and that masks ongoing challenges for manufacturers and smaller users who are left to pick from a dwindling supply of aging inventory that is less efficient but still expensive. Vacancy in the tightest markets has fallen to as low as 1%.

FUTURE DELIVERIES
PRELEASED & UN-LEASED SF IN PROPERTIES SCHEDULED TO DELIVER



Clearly, it is a good time to be an industrial landlord. With supply and demand in such a state of imbalance, they are demanding longer lease terms and stronger credit without offering much in the way of tenant improvements or rent abatement. In many markets, even tenants who renew in place are getting sticker shock, as their landlords insist on rents that are often more than 50% higher than their current rates.

RECENT DELIVERIES
LEASED & UN-LEASED SF IN DELIVERIES LAST 5 YEARS



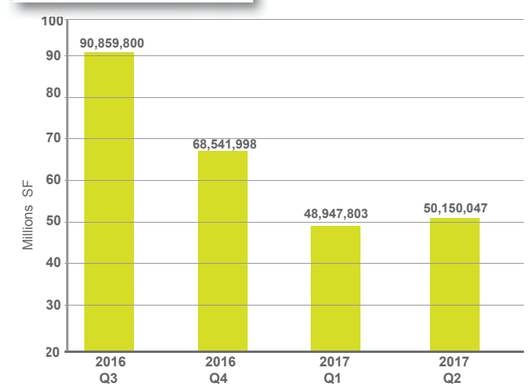
The Fed made another move on interest rates in June, its third rate hike in six months, yet targets for inflation and wage growth are still not being met. Mortgage rates did increase late last year in anticipation of tighter monetary

policy, but not enough to dampen demand for owner/user properties fi nanced through the SBA's 504 and 7A programs. Supply of owner/user product continues to run short, yet developers continue to focus on large distribution projects that attract the big credit tenants preferred by the institutional buyers who remain willing to pay cash for their projects at historically low cap rates. Though rates remain low, construction lenders, who are increasingly concerned over the potential for a market correction, are tightening up on their underwriting standards, including higher equity requirements. So far, cash buyers are still lining up to pay top dollar for new projects and cap rates remain compressed. Talk of tax reform coming out of Washington is still just that, talk. However, investors and developers will be following more closely as legislation takes shape, especially new rules on expensing, depreciation and 1031 exchanges.

Let's take a closer look at the numbers for Q2:

Net absorption in Q2 was 71.76 million square feet, slightly ahead of 70.65 million square feet recorded in the fi rst period. That brings the total gain in occupied space for the past four periods up to a whopping 361.82 million square feet. The e-commerce sector, big shippers and 3PL operators are still the most active tenants, and they have increased their infl uence with the push for "Last Mile" locations to speed up shipping times, even in secondary and tertiary markets. Amazon.com continues to employ its enormous revenues into expanding its distribution network. The e-commerce giant is expanding its distribution footprint by millions of square feet each quarter, forcing its major competitors into doing the same. Walmart's recent acquisition of e-commerce player Jet.com is a good example. The world's largest brick-and-mortar retailer has made known its intention to compete head-to-head with Mr. Bezos' amazing machine. Amazon is also ramping up its own shipping capabilities, as evidenced by its recent announcement to deploy of fleet of its cargo aircraft. It is fair to say that without Amazon and the competition it has fueled, industrial market would not be flying as high as it is today.

NET ABSORPTION * For Top 42 Markets



The national vacancy rate for warehouse and flex space across the country was down another 10 basis point to 5.1% in the second period, but in the past four quarters, the vacancy rate has fallen by 30 basis points, and several major market areas still have vacancy rates in the 2% range with little or no construction to relieve tight supplies.

New deliveries for both speculative and build-to-suit projects in all markets for Q2 reached 64.24 million square feet in 537 buildings, as compared to 71 million square feet of new deliveries in the first period. That brought total US industrial property inventory up to almost 22.2 billion square feet. At the end of Q2, another 272.36 million square feet was still in the construction queue. Development activity remains focused primarily in the largest distribution hubs like Dallas, Chicago, Philadelphia, Atlanta and Southern California's Inland Empire where land is still available at a price point that pencils. However, the two largest projects under construction are being built for manufacturing operations. The second phase of Elon Musk's Gigafactory near Reno, Nevada totals 3.8 million square feet, and Volvo's new automotive plant, totaling 2.3 million square feet is underway in Charleston, South Carolina.

US INDUSTRIAL MARKET

Average asking lease rates of all markets across the country moved higher again in Q2, ending the period up $.10 to $6.22. Markets with the highest levels of construction continue to see the most rent growth, as fi rst generation space, with its greater effi ciencies, commands higher rates. However, higher land and construction costs are pressuring developers to push for higher rates. Thus far, the advantages of first generation space have tenants willing to pay a premium to get it.

LOOKING AHEAD

The current dynamics of the industrial market are not expected to change significantly in the coming quarters. The primary drivers of industrial demand remain firmly in place, even though overall economic growth in the US remains stubbornly slow. The shift to e-commerce retailing continues and that will benefit the bulk distribution market to the detriment of brick-and-mortar retail properties. Job and wage growth run hot and cold one month to the next, but overall job creation is strong enough to absorb new entries into the workforce. Concerns over the types of jobs are probably greater than worries over how many jobs are being created. Part time and full time positions at the lower end of the wage skill is good cause to be skeptical, as consumer spending and retail sales growth are directly depend on wage growth.

The yield on 10-Year Treasuries, the benchmark for setting commercial mortgage rates, spiked early in the year, but has settled in the 2.3% range of late, which means mortgage rates should remain near current levels for the balance of the year. No one knows how many more Fed rate hikes it will take to send mortgage rates high enough to put the brakes on construction and long term lending for industrial real estate.

The threat of global recession has been reduced in the wake of improved economic conditions around the world. Oil prices have rebounded from declines early in the year, which is good news to big oil producing nations that have been suffering since prices fell back in 2014. Prices have come up enough to stimulate more drilling activity in the US, as well, and that is welcome news for energy dependent regions of the nation.

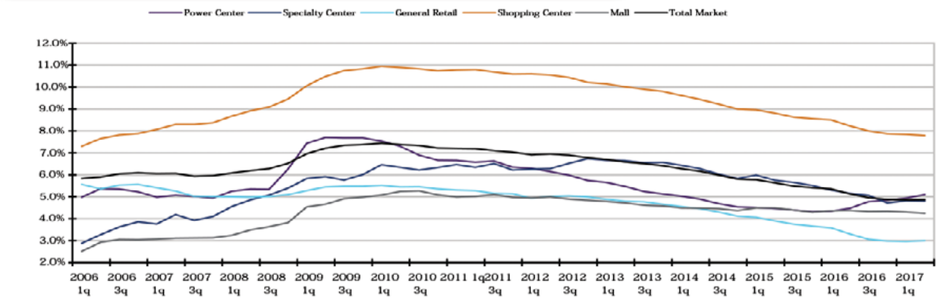
We expect more of the same in terms of industrial market conditions for the balance of the year. Leasing activity, vacancy, net absorption, construction and rent growth should stay in relative balance to one another as long as current trends in e-commerce continue. Risk of overbuilding is minimal and construction lenders are already becoming more cautious. Perhaps the greatest risk is in the potential for cap rate decompression precipitated by a rise in capital costs that would accompany more aggressive monetary policy.

2
National Economic Overview

US RETAIL MARKET

While the retail market metrics for the US still indicate relative good health, retailers and retail property owners across the country are facing significant headwinds as they adjust to emerging consumer spending trends. Large department store operators like Macy's, Sears, JC Penny and others are grabbing headlines with major store closing announcements, and that has also put the spotlight on the struggles of major regional malls that, for decades, have depended on these anchor tenants to attract shoppers. Declining mall foot traffic has also impacted sales for other retailers, particularly in the clothing industry, who are also scaling back on brick-and-mortar locations. Some property owners have responded by shifting to alternate uses to fill empty anchor spaces and find a new formula that will bring

VACANCY RATES BY BUILDING TYPE 2007-2017



Source: CoStar Property® * Select markets included in this historical chart - see Methodology page.

NET ABSORPTION

shoppers back to their malls, while some are giving up and looking to redevelop their properties to non-retail uses. Not all malls are struggling, though, as those in prime demographic areas are still thriving and operating near full occupancy.

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. Another 11 national chains filed for bankruptcy just in the first quarter of 2017, some for the purpose of reorganization and others for liquidation.

The elephant in the room is Amazon.com. The e-commerce giant is huge and getting bigger every day, and the big brick-and-mortar retailers have yet to build online platforms that put more than a dent in Amazon's numbers. The company's stock has soared, sales have risen sharply and profits are being reinvested into a massive expansion of its fulfillment center platform and last mile delivery network. In July, Amazon founder and CEO Jeff Bezos, briefly passed Microsoft's Bill Gates as the richest man in the world, when its stock hit a new high. Walmart is mounting the biggest challenge to Amazon. Its recent purchase of Jet.com and ongoing expansion of its own supply chain are clear indications that Walmart will not cede online dominance without a proper challenge.

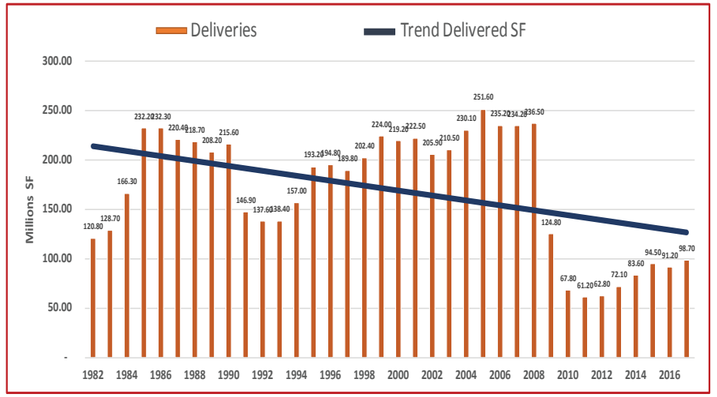
US RETAIL MARKET

Despite these industry woes, the US retail property market metrics still indicate a relatively stable retail property market. Vacancy is low and stable, construction activity is moderate and consistent, average asking lease rates inch up each quarter and net absorption is positive.

The vacancy rate was unchanged in Q2 at 4.8%, where it has been for the last 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, just 2.9% at the end of Q2 on a base of base of 6.8 billion square feet. Mall and Power Center vacancy is at 4.5% and 5.0%, respectively. Shopping Center (neighborhood, community and strip centers combined) rates are still highest at 7.7%, but this category contains suburban, unanchored centers that cater to local credit tenants.

As we have been reporting, urban areas represent a greater share of net absorption as major retailers have shifted their marketing focus on younger shoppers. Millennials are migrating to multifamily housing near public transportation hubs, with preference to live and work in areas with walkable amenities. Indeed, as some studies and surveys suggest, Millennials are increasingly willing to forego the home and automobile ownership associated with a more traditional suburban lifestyle.

HISTORICAL DELIVERIES 1982 - 2017



Q2 net absorption was up slightly to 16 million square feet, and that brought total net absorption in the past year up to over 106 million square feet. Q2 net absorption was just over a third of what it was four quarters ago. But the aggregate numbers don't tell the whole story. In prime locations that allow retailers target their preferred demographic, net absorption is being held back by a lack of available space rather than a lack of demand.

The overall average asking rate has consistently moved higher in the last several years, and Q2 was no exception. The overall rate was up another $.26 to $16.13 per square foot. Over the past four quarters, retail rents across all product types and locations moved up by just over 3.47%, but urban locales are seeing much stronger rent gains compared to unanchored suburban retail centers, which is a direction of the shift in lifestyle priorities. Baby Boomers, the biggest group of retail consumers for decades, are turning 65 at a rate of approximately 10,000 per day, and are expected to spend less as transition into retirement.

New deliveries for the quarter also moved slightly higher in Q2, as over 19.2 million square feet was added to base inventory that now stands at 13.2 billion square feet. In the past four quarters, nearly 88.8 million square feet of new space has been delivered, while another 87 million square feet remains under construction.

2
National Economic Overview
US RETAIL MARKET

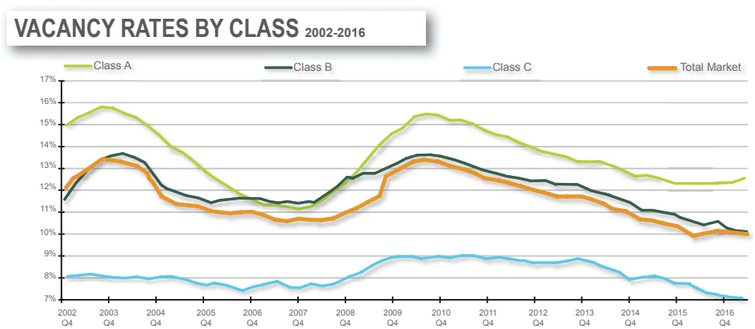
A LOOK AHEAD

US retail market growth will remain concentrated in more densely populated areas. Though total job creation is still cause for optimism, it's sluggish wage growth that presents more cause for concern. Too many of the jobs on offer are part time or at the lower end of the wage scale, and that does not bode well for consistent growth in retail sales. Post-election optimism has devolved into scandalous headlines and frustration over a lack of legislative action on key issues like healthcare, tax reform and infrastructure spending. If tax reform or infrastructure spending becomes a reality, retail sales would likely pick up, but, there is little evidence of progress on either of those fronts, so far.

Those who thought lower energy prices would boost retail sales, remain disappointed. Many consumers decided to pay off existing debt and save more cash rather than head to the malls to make new purchases. However, that trend may be reversing as there are preliminary reports that credit card debt and auto loan defaults are back on the rise, which indicates that the middle class is still not feeling the full effects of the economic recovery.

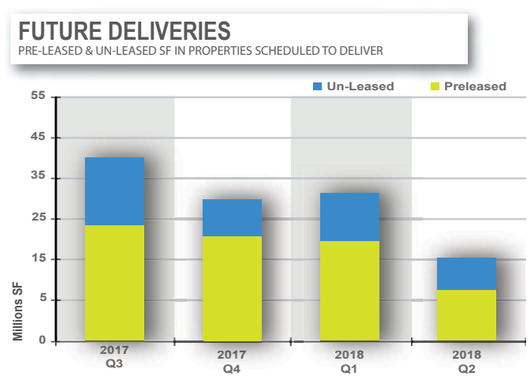
US OFFICE MARKET

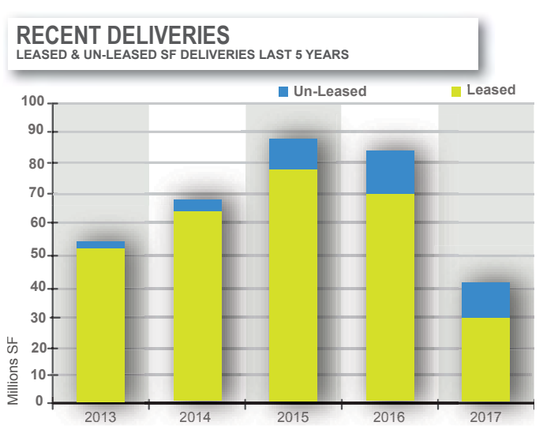
Last quarter we reported that the US office market was showing signs of fatigue, and from a macro perspective, things didn't change much in Q2. Vacancy was unchanged for the third straight quarter, average rental rates were done a penny, deliveries were flat and net absorption was just slightly higher than it was in Q1. Sublease inventory also moved up again, continuing its steady rise.



We also reported that major markets including New York City, Los Angeles and San Francisco posted significant negative net absorption in Q1, as did Houston and Hartford. Year-to-date, those same markets remain in negative territory at the mid-year point. The South Bay/San Jose market leads the pack in net absorption so far this year at over 3.5 million square feet of net gain in occupied space, but that has a lot to do with the fact that Apple moved into its new 2.8-million-square-foot headquarters in the second quarter.

Taking a closer look at net absorption, another 16.7 million square feet was added to occupied space in Q2, which is up from 14.7 million square feet in Q1, but well off the pace of the two preceding periods. Changes in workplace design may be partly to blame for the reduction in net absorption, as employers respond to higher rates and leverage new communications and mobile technologies that allow for higher employee density. It isn't just the tech startups who are jumping on this bandwagon, even our own commercial real estate services industry is looking for ways to attract and retain younger workers and save on occupancy costs at the same time. Only four markets posted net absorption in excess of 2 million square feet by the middle of 2017. Major markets posting

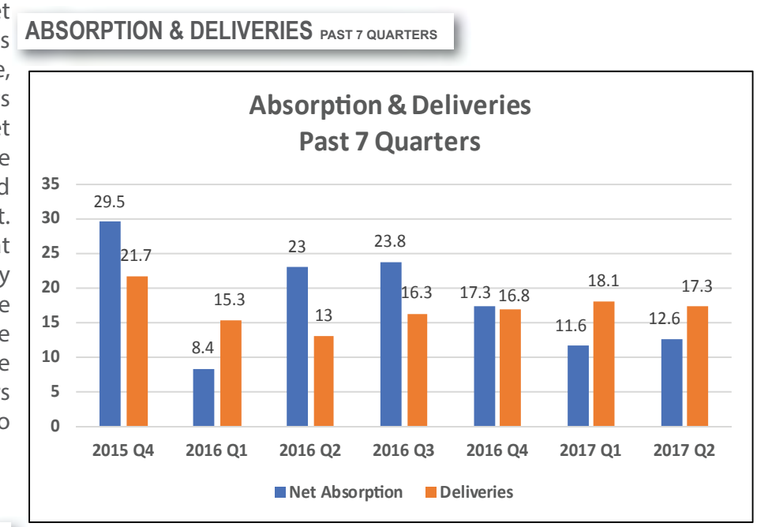


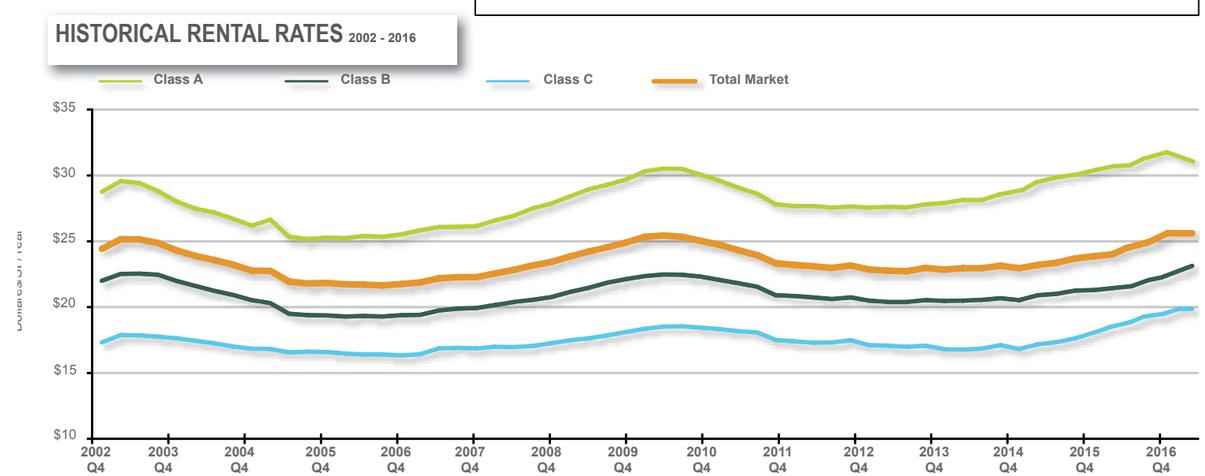


Office Market Treads Water in Q2

disappointing year-to-date results included New York City at negative 1.47 million square feet and Houston at negative 1.77 million square feet.

By building class, net absorption remains relatively well-balanced, as Class A and B product reported gains of 13.67 million and 16.65 million square feet respectively. In terms of Suburban versus Central Business District (CBD) performance, the difference is still huge. CBD markets have posted just 930,000 square feet of occupancy gains year-to-date, while suburban markets have increased occupancy by over 12.7 million square feet. Urbanized hubs in suburban areas that are amenity-rich and tout high-density housing near public transportation are outperforming traditional suburbs and core CBDs. Employers choose to locate in these areas to attract and retain younger workers who prefer the convenience of walking to work and entertainment venues.





The vacancy rate, which stood at 9.7% a year ago, finished just 10 basis points lower at 9.6%. Vacancy for Class A is up 30 basis points over the past four quarters, while Class B vacancy has declined by the same margin year-over-year. To really understand the vacancy trend requires a more local perspective, as separating the winners and losers becomes apparent at the individual market level. Owners of older office product further from amenities and public transportation are being hit particularly hard. Vacancy in those buildings tends to run higher, which makes it more difficult for those owners to reinvest in their properties to make them more competitive. Northern New Jersey, with its high concentration of legacy corporate headquarters properties located in suburban areas, is a good example of this phenomenon.

2
National Economic Overview

US OFFICE MARKET

Average asking lease rates were flat in Q2, losing a penny to $24.40 per square foot. However, looking at rents on average is misleading, as the disparity in rent levels and rent growth rates varies drastically depending on local amenities. Cost-conscious tenants who signed leases on Class A space early in the economic recovery, are facing stiff enough rent increases to consider migrating back to Class B properties.

Conversely, users looking to create top notch work environments are paying the premium for superior locations, but mitigate the cost by decreasing their space footprint and increasing employee density. Markets with more active tech sectors like San Francisco, Silicon Valley (San Jose/South Bay) and Seattle have experienced the steepest rent increases, but the slowdown in tech employment growth has flattened the rent growth curve. Tech hotspots also tend to have higher costs of living, especially for housing, which means employers have to pay more to find and keep good people.

The level of new deliveries has been remarkably consistent in recent quarters. In Q2, 20.97 million square feet of new office space was delivered, compared to 21.1 million square feet in Q1, 20.75 million square feet in Q4 of 2016 and 21.3 million square feet in Q3 of 2016. Throughout the recovery, net absorption has been strong enough to prevent overbuilding. A notable exception is the office market in Houston, but that's understandable given the high level of build-to-suit space that was committed to prior to the collapse of oil prices back in mid-2014. Many of those projects could not be stopped and a good chunk of that space showed up as sublease space once it was completed. However, the oil industry has responded by becoming more efficient and reducing the break-even price point for oil extraction.

The quarter ended with just under 159 million square feet of space under construction, with most of that total concentrated in the nation's major metro areas. New York City has the two largest projects under construction; the 3 World Trade Center building at 2.86 million square feet and the 30 Hudson Yards building at 2.6 million square feet. New York City has the highest amount of construction activity at 15.5 million square feet underway. Washington DC passed Dallas/Fort Worth in Q2 with a total of 11.67 million square feet of construction activity, compared to 11.3 million square feet. Development activity remain concentrated in mixed-use projects in urbanized, amenity-rich areas that will encourage tenants to pay the premium required to cover rising land, construction and entitlement costs.

A LOOK AHEAD

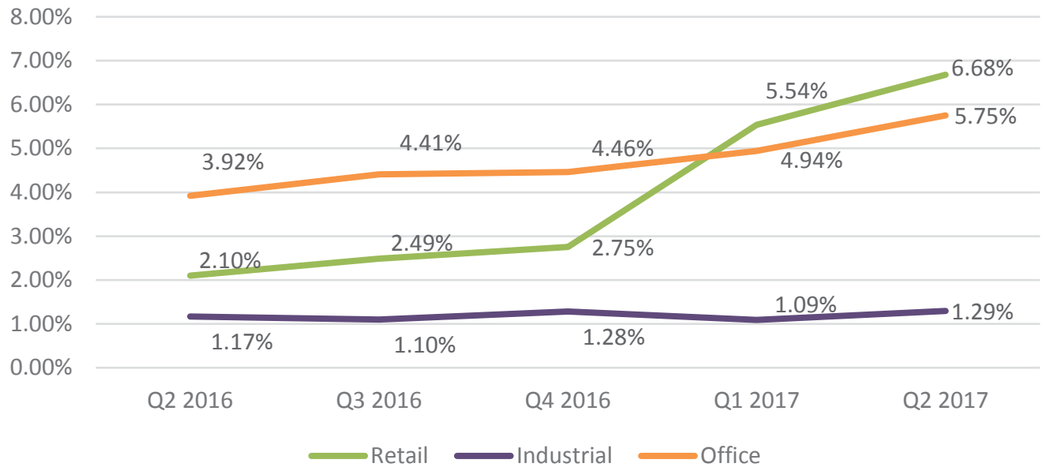
The US office market didn't get a needed boost in Q2, and conjuncture continues by some that the market might be reaching its peak in this real estate cycle. Office-using employment growth remains sporadic and its job growth that drives net absorption in all product types. While big industrial tenants are in expansion mode, many office tenants are looking for ways to further reduce their space footprints to offset high lease rates in prime submarkets. This is bound to limit net growth in occupied space going forward.

Rent growth will continue for prime space, but the rate of rent growth will continue to level off in the coming quarters. Owners of older properties not in proximity to preferred amenities and public transportation, will face further challenges as the age of the average worker continues to decline and the pressure on employers to provide a more exciting work environment increases.

Construction levels will remain near current levels, as lenders and developers grow even more cautious of a potential correction as the recovery moves into its ninth year

SANTA BARBARA

SANTA BARBARA



MARKET HIGHLIGHTS

- A favorable deal for the South County was **LinkedIn's** $16.95 million acquisition of 1000 Mark Avenue in Carpinteria. The sale included a newly remodeled 60,000 square-foot office building and adjacent parking lot. The company's doubling-down of its operations in the South Coast reaffirms desirability of the area for office operations, as well as its feasibility for high-profile tech companies like Microsoft-Owned **LinkedIn.**

- Industrial vacancy was unchanged in Q2 but has been in steady decline for the past few years. Notable transactions for the quarter include 411 N Quarantina, a 7,534 building, sold for $2.5 M; 333 E Haley, a 6,000 SF building, sold for $2.1 M; and 815 E Mason St, a 5,000 SF building, sold for $1.95 M.

- Retail vacancy in Santa Barbara remained elevated largely due to the **Macy's** vacancy. There is interest for space by entities with various types of projects, although coordinating with the city to overcome issues with the ground-lease and also gaining approvals will be a challenge. Retail leasing activity has continued to show some strength, but the emphasis has spread away from **State Street** and towards The **Funk Zone** and **East Haley** corridor. The city recently adopted a new zoning ordinance which sets the parking requirement at 1/250 for all food uses and removes the consideration for a number of seats as part of the parking criteria. The new ordinance has the potential to allow more food uses to migrate out of the CBD and into the above-mentioned areas.

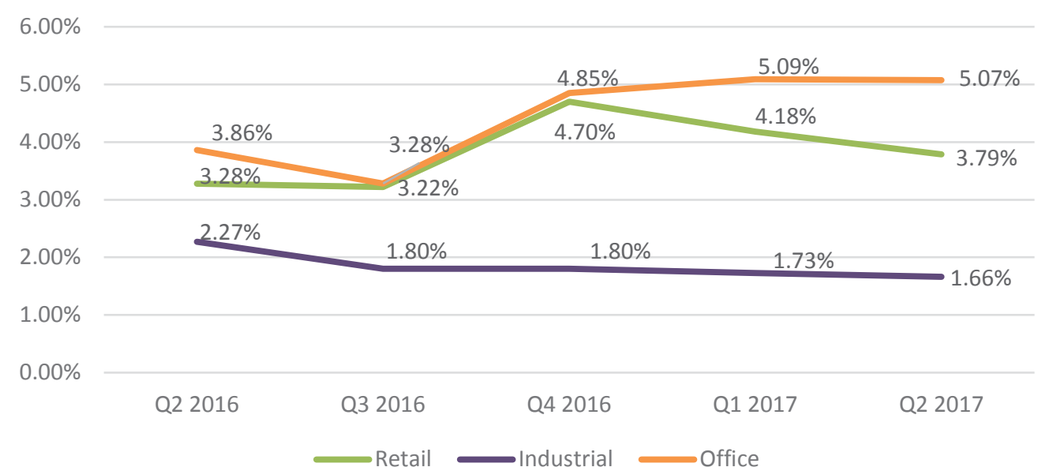
Q1

RETAIL VACANCY RATE	INDUSTRIAL VACANCY RATE	OFFICE VACANCY RATE
6.68%	1.29%	5.75%

LinkedIn | 1000 Mark Avenue | Carpinteria | CA

SAN LUIS OBISPO

SAN LUIS OBISPO



Q1

RETAIL VACANCY RATE	INDUSTRIAL VACANCY RATE	OFFICE VACANCY RATE
3.79%	1.66%	5.07%

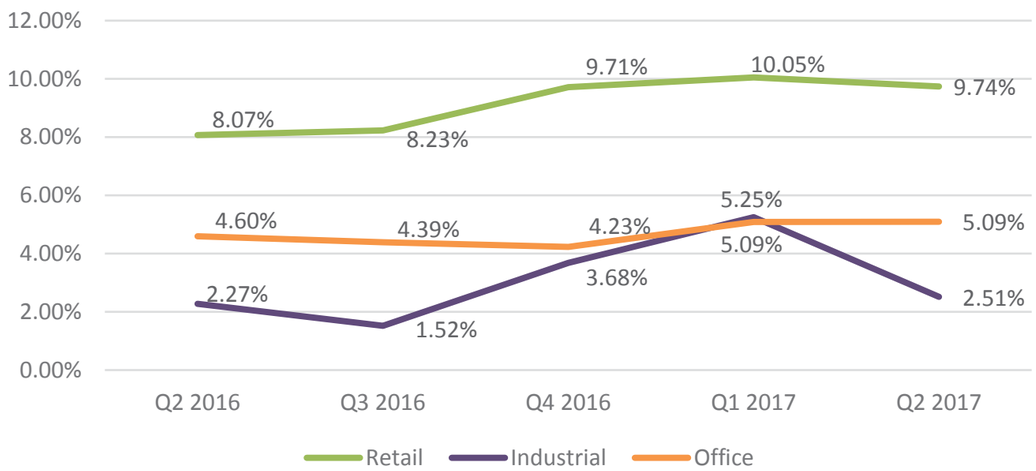
MARKET HIGHLIGHTS

- **Donahue Schriber** acquired the 174,000 SF **Marigold Center** from Kimco Realty Co. for $43.6 million. The center is anchored by Vons, Michaels, Big 5 Sporting Goods, and CVS.

- Designer Shoe Warehouse (**DSW**) back-filled the former 24,000-square foot Sports Authority space in Madonna Plaza.

LOMPOC

LOMPOC



Q1

RETAIL VACANCY RATE 9.74%

INDUSTRIAL VACANCY RATE 2.51%

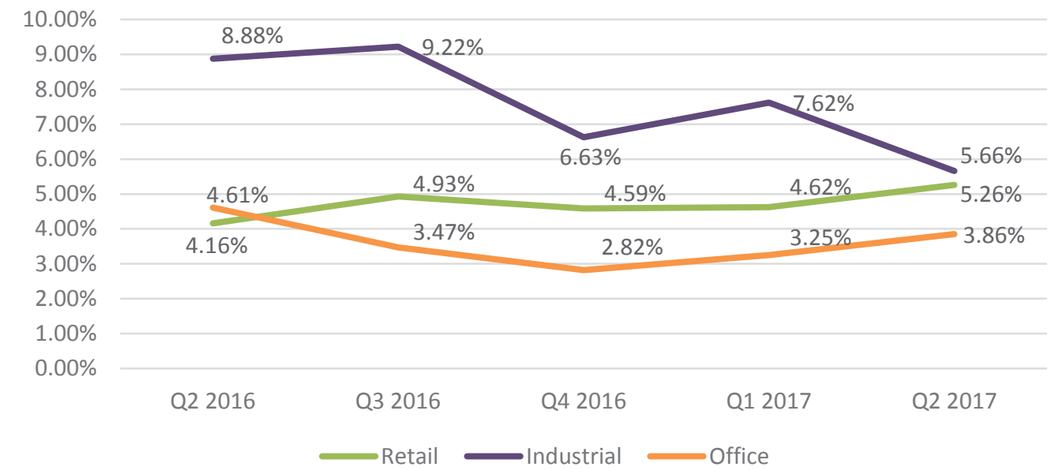
OFFICE VACANCY RATE 5.09%

MARKET HIGHLIGHTS

- Highlights include the sale of **Central Towne Square**, a 96,704 SF shopping center, anchored by Foods Co sold for $19 million. The seller was the Los Angeles-based Jade Enterprises purchased the property at a 6.13 % Cap rate. The net leased center boasts 15 tenants and is roughly 97% occupied with the majority of leases running through 2020.
- Cosmetic manufacturer, Den-Mat Holdings, LLC renewed their 81,687 square-foot office lease at 1017 W. Central Ave. The privately held company manufactures cosmetic dentistry consumables, including the brands known and trusted: Geristore®, Core Paste®, Tenure®, and Ultra-Bond®
- Virginia based defense contractor, ManTech Advanced Systems International, leased an 8,164 SF of industrial space at 300 N G St.

PASO ROBLES

PASO ROBLES



Q1

RETAIL VACANCY RATE 5.26%

INDUSTRIAL VACANCY RATE 5.66%

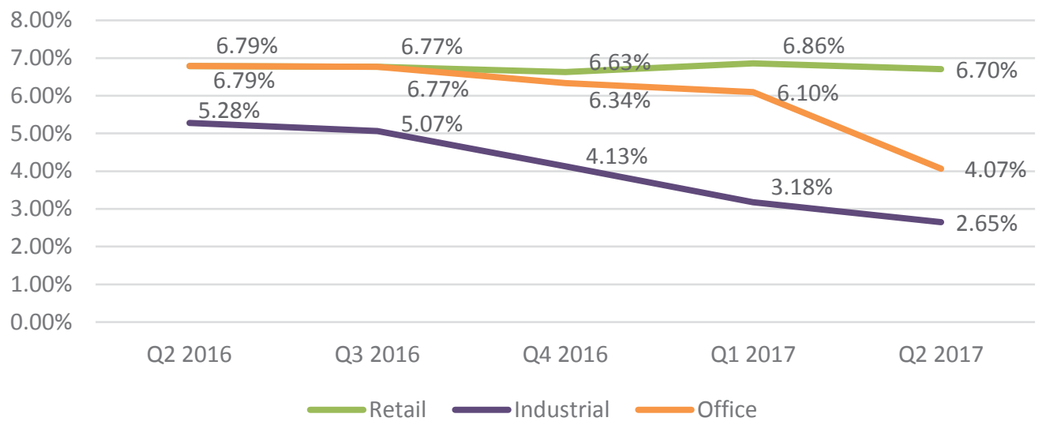
OFFICE VACANCY RATE 3.86%

MARKET HIGHLIGHTS

- Paso Robles' industrial market, fueled by wine and beer processing operations, saw decreased vacancy by nearly 2% during the quarter. Several smaller to medium sized spaces were leased, including a 9,000 square-foot lease at 3020 Propeller Drive to the boutique winery, Cholokian Wines.
- The wine industry also helped spark a 30,000 square-foot industrial sale at 6390 Monterey Road. The newly constructed industrial warehouse was purchased by trucking service, Pacific Coast Transportation Inc., for $2.6M.

SANTA MARIA

SANTA MARIA



Q1

RETAIL
VACANCY RATE
6.70%

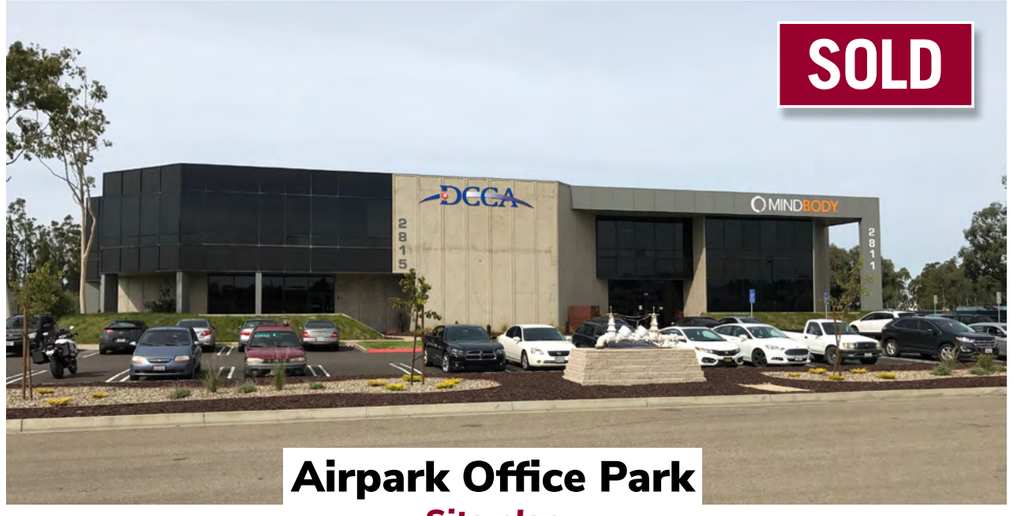
INDUSTRIAL
VACANCY RATE
2.65%

OFFICE
VACANCY RATE
4.07%

MARKET HIGHLIGHTS

- Significant sales during the period include NKT Development LLC's, $6.5 million purchase on Airpark Drive. The 36,300-square-foot premium office building is currently occupied by San Luis Obispo-based software company, MINDBODY, and engineering firm, Data Computer Corporation of America Inc. The property, which resides on a 7-acre parcel also includes plans are for the development of two additional office buildings, totaling 50,000 square-feet.
- Healthcare Trust of America, Arizona, acquired a multi medical office building portfolio totaling over 90,000 square-feet near Marian Medical Center for a total of $16.3 million. The purchase included two multi-tenant buildings at 116 S. Palisade Drive and 525 E. Plaza Drive.

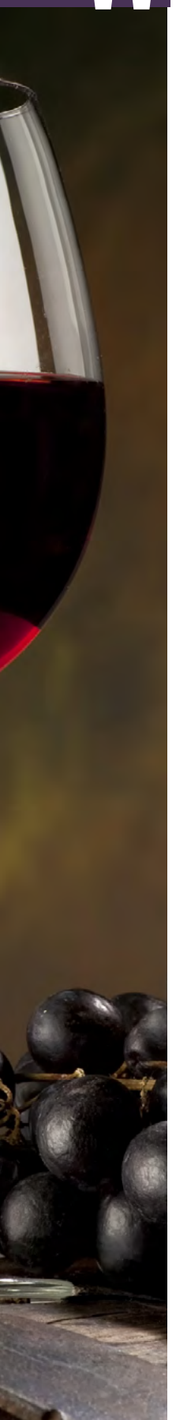
3
Key Market Snapshots
SANTA MARIA



Airpark Office Park

Site plan

WINE COUNTRY



Schrader

HISTORIC CABERNETS FROM THE NAPA VALLEY

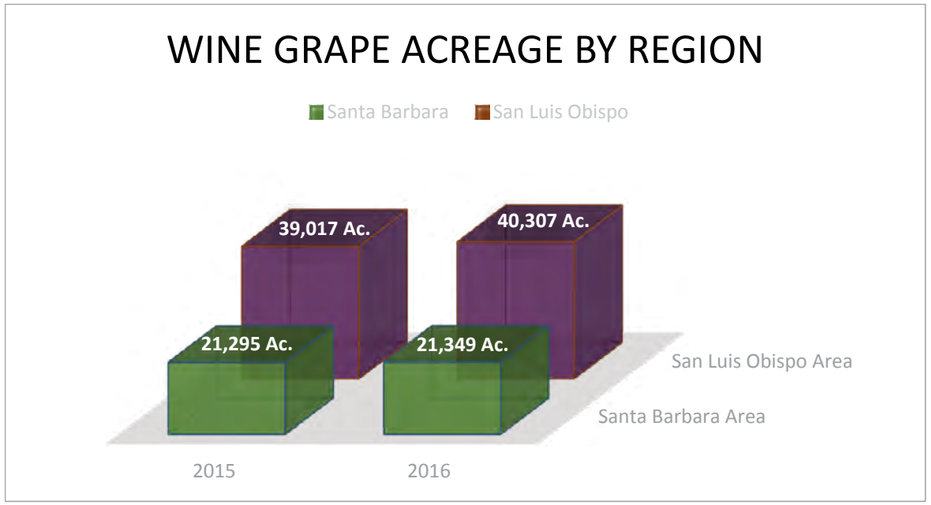
SOLD

High demand, low supply and rising prices will continue to drive vineyard acquisitions. Major producers are eager to attain premium labels and prestigious vineyards. **Constellation Brands** has made yet another move to grow their luxury wine portfolio with the recent acquisition of **Schrader Cellars**. Constellation Brands, the world's leader in premium wine, owner of **Robert Mondavi, Clos du Bois, Meiomi**, and others, announced in June, the purchase of luxury wine producer, Schrader Cellars for an undisclosed amount.

The Napa based winery is known for its premium cabernet sauvignon, with over a dozen 100-point wines that have developed a cult following. The sale includes eight cabernet labels, the last 2015 & 2016 vintages, as well as a portion of the winery's inventory. Schrader Cellars holds long-term leases on a number of prestigious Napa Valley sites, all owned and farmed by Beckstoffer Vineyards. The sale highlights the growing *premiumzation movement*.

The USDA's California grape report, released in April 2017, shows that California's 2016 wine grape acreage totaled 602,000 acres: 560,000 were bearing while only 42,000 were non-bearing. The leading varietals continue to be Chardonnay, Cabernet Sauvignon, Pinot Nior and Zinfindal.

According to the SB County Ag Commissioners 2016 Crop Report, **Santa Barbara** county is **ranked 13th** in the state for total agricultural production, with wine grapes ranked as the number two most valuable commodity, valued at $151 million. San Luis Obispo County wine growers also had an exceptional year with a total value of $242 million, a 66% increases from 2015. Overall, the Central Coasts' wine production remains a top economic contributor with 2016 gross wine production valued at $394 million.

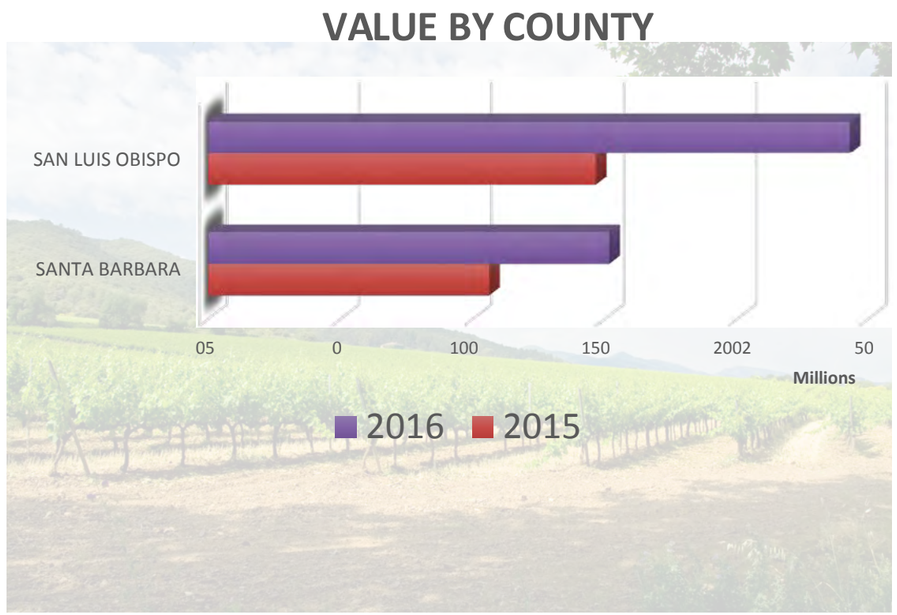


3
Key Market Snapshots

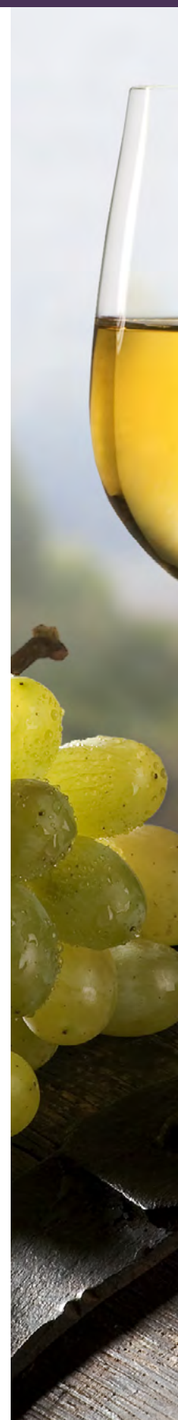
WINE COUNTRY

The Central Coast market kept pace in Q2 with moderate land sales concentrated in the Santa Rita Hills Appellation. Santa Rosa based, **Jackson Family Wines**, purchased Brewer-Clifton Winery, a boutique winery producing critically acclaimed Pinot Noir & Chardonnay. This marks Kendall-Jackon's third purchase of a Pinot-Noir based winery within a year. Chapel Vineyards LLC, purchased the 28-acre Huber Vineyard for $2.4 million. Planted in 1987, The Huber Estate, is one of the oldest vineyards in the Santa Rita Hills, producing Pinot Noir, Chardonnay, and the German red grape varietal, Dornfelder. Following suit was the sale of 143-acres in Gypsy Canyon, purchased by Clear Source, LLC. The $2.3 million sale included a 13-acre vineyard comprised of 7-acres of Pinot Noir, 4 acres of Chardonnay and 10 additional acres of flat useable land.

To the North, Templeton based winery, ONX Wines, has purchased a $2.9 million vineyard in Kiler Canyon, Paso Robles. The 50 acre parcel, located west of Highway 101 within the Willow Creek AVA has 25.5 acres of planted vines well-suited for producing Syrah, Viognier, Grenache and Tempranillo varietals. ONX Wines is owned by Los Angeles real estate developer, Steve Olson, Chairman & Founder of The Olson Company.



*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 **Q2** 2017

MARIGOLD SHOPPING CENTER
SAN LUIS OBISPO

Property: Retail
Size: 174,326 SF
Sale Price: $43,550,000
Sale Per/SF: $249.82
Sale Date: 06/2017

Cap: 5.5%

1

71 S. LOS CARNEROS RD., GOLETA

Property: Industrial
Size: 105,275 SF
Sale Price: $27,800,000
Sale Per/Unit: $264.07
Sale Date: 05/2017

Cap: 6.5%

2

CENTRAL TOWNE SQUARE, LOMPOC
Property: Retail
Size: 96,704 SF
Sale Price: $19,040,000
Sale Per/SF: $196.89
Sale Date: 05/2017

Cap: 6.13%

3

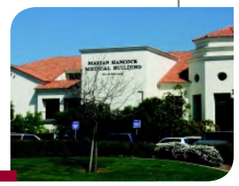
1000 MARK AVE., CARPINTERIA
Property: Office
Size: 59,605 SF
Sale Price: $16,953,000
Sale Per/SF: $284.42
Sale Date: 04/2017

4

116 S. PALISADES DR., SANTA MARIA

Property: Office
Size: : 40,300 SF
Sale Price: $10,400,000
Sale Per/SF: $258.06
Sale Date: 05/2017

5



2815 AIRPARK DR., SANTA MARIA
Property: Office
Size: 25,600 SF
Sale Price: $6,550,000
Sale Per/SF: $255.86
Sale Date: 05/2017

6

AVERAGE PRICE PER SF

SANTA BARBARA
RETAIL **$569.00** OFFICE **$587.33** INDUSTRIAL **$359.67**
MULTI-FAMILY (P/UNIT) **$320,845**

SAN LUIS OBISPO
RETAIL **$631.00** OFFICE **$411.00** INDUSTRIAL **NO SALES**
MULTI-FAMILY (PRICE/UNIT) **$172,728.00**

LOMPOC
RETAIL **$312.75** OFFICE **$119.00** INDUSTRIAL **NO SALES**
MULTI-FAMILY (P/UNIT) **$109,395.00**

SANTA MARIA
RETAIL **$228.00** OFFICE **$189.67** INDUSTRIAL **$84.72**
MULTI-FAMILY (PRICE/UNIT) **$98,058.00**

PASO ROBLES
RETAIL **NO SALES** OFFICE **$223.00** INDUSTRIAL **$90.00**
MULTI-FAMILY (P/UNIT) **NO SALES**

4
Significant Transactions

NOTABLE LEASES **Q2** 2017

71 S. LOS CARNEROS RD., GOLETA

Tenant: Apeel Sciences
Property: Industrial
Size: 105,275 SF
Lease Date: 04/2017

1

1017 W. CENTRAL AVE., LOMPOC

Tenant: Den-Mat Holdings
Property: Retail
Size: 81,687 SF
Lease Date: 06/2017

2

3985 HIGUERA ST., SAN LUIS OBISPO

Tenant: Food 4 Less
Property: Retail
Size: 49,725 SF
Lease Date: 06/2017

3

825 BUCKLEY RD., SAN LUIS OBISPO

Property: Office
Size: 35,546 SF
Lease Date: 04/2017

4

285 MADONNA RD., SAN LUIS OBISPO

Tenant: Designer Shoe Warehouse
Property: Industrial
Size: 24,000 SF
Lease Date: 05/2017

5

3020 PROPELLER DR., PASO ROBLES

Tenant: Cholokian Wines LLC
Property: Industrial
Size: 9,000 SF
Lease Date: 05/2017

6

AVERAGE ASKING LEASE RATES (GROSS)

SANTA BARBARA (per/SF)		SAN LUIS OBISPO (per/SF)		LOMPOC (per/SF)	
RETAIL	$4.44	RETAIL	$2.34	RETAIL	$1.24
OFFICE	$2.85	OFFICE	$1.97	OFFICE	$1.10
INDUSTRIAL	$1.97	INDUSTRIAL	$1.03	INDUSTRIAL	$1.15

SANTA MARIA (per/SF)		PASO ROBLES (per/SF)	
RETAIL	$1.79	RETAIL	$1.16
OFFICE	$1.50	OFFICE	$1.27
INDUSTRIAL	$0.78	INDUSTRIAL	$0.99

All information furnished regarding financing is from sources deemed reliable, but no warranty or representation is made to the accuracy thereof and same is submitted to errors, omissions, change of price, rental or other conditions prior to sale, lease or financing or withdrawal without notice.

THE LEE & ASSOCIATES CENTRAL COAST TEAM

PRINCIPAL TEAM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STEVE LEIDER


MARTY INDVIK

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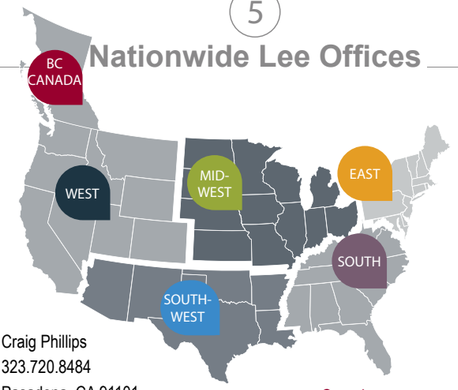
Nationwide Lee Offices



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