MARKET FORECAST

IPA INSTITUTIONAL PROPERTY ADVISORS

OFFICE

Central Coastal Region, California

Q2/19

Tight Conditions Unable to Motivate Development; Investors Examine Medical Office

Vacancy remains cyclically tight. In the past two years, employment growth in the Central Coast region exceeded or met the national rate of increase. Much of this job creation stemmed from expansions by traditional office-users in the government, healthcare and professional and tech services sectors. Payroll enlargements by these firms supported increased demand for available office space, translating to the absorption of more than 800,000 square feet over the 24-month period. While consistent leasing velocity placed regional vacancy at a cyclically low level entering this year, a lack of available labor will make it difficult for businesses to expand operations in 2019. Companies' inability to lease additional or larger floor plans this year will place slight upward pressure on absorption, equating to a nominal rise in vacancy. Longer term, barriers to housing development have the potential to hinder job growth and office use, resulting in more sizable upticks in vacancy.

Dearth of office construction persists. Annual office deliveries are slated to comprise less than 300,000 square feet during 2019, continuing a cyclelong trend of subdued development activity in the Central Coast. Santa Barbara and San Luis Obispo counties represent the only locales to witness an increase in office inventory this year. Together the two markets welcome four properties, highlighted by the completion of 100,000 square feet in Santa Maria. Outside this city, finalizations are restricted to Arroyo Grande and south San Luis Obispo. The lack of deliveries in the region's largest submarkets coupled with relatively limited availability will prevent many large move-ins this year, maintaining stable office fundamentals in the near term.

Local Office Yield Trends

**Cap rates trailing 12 months through 1Q19*

Sources: CoStar Group, Inc.; Real Capital Analytics

Central Coastal Valley Region consists of the following counties: Monterey, San Luis Obispo, Santa Barbara and Ventura.

Office 2019 Forecast

Metro	Vacancy	Y-O-Y Basis Point Change	Average Asking Rent	Y-O-Y Change
Monterey County	6.5%	-100	$22.14	-0.9%
San Luis Obispo County	3.3%	40	$22.97	0.7%
Santa Barbara County	5.3%	20	$20.63	1.1%
Ventura County	14.8%	20	$25.39	0.8%
Coastal Counties	**11.6%**	**20**	**$23.93**	**1.0%**

Investment Trends

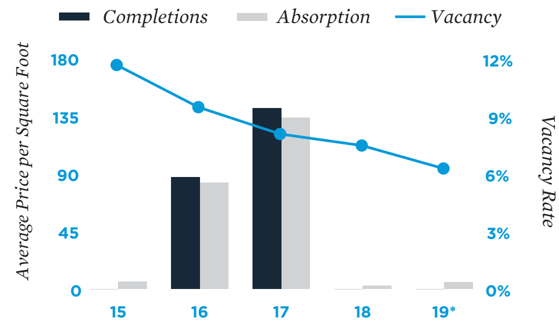
- Comprising two-thirds of the region's office inventory, Ventura County accounted for half the transaction activity over the past 12 months ending in March. Here, properties rarely trade for more than $200 per square foot, attracting a collection of Los Angeles-based investors seeking discounted pricing. These buyers are also lured by the county's low-7 percent average cap rate, which is roughly 200 basis points higher than their home market. Assets in cities off Highway 101, in the eastern portion of the county, are coveted due to their proximity to the San Fernando Valley, a market that is experiencing a notable increase in apartment development.
- The Central Coast's southern counties are witnessing an uptick in medical office trades. In Santa Barbara County, sales involving these assets drove overall deal flow during the past year, with most properties providing buyers with low-6 to 7 percent cap rates. Westlake Village and Thousand Oaks represent popular spots for these acquisitions in Ventura County. Unlike in Santa Barbara, where medical office buildings are available at below-average pricing, properties in these locales are the highest valued assets.
- Throughout the region, most sales continue to involve sub-$5 million properties. Buyers seeking opportunities for larger capital deployments target downtown Santa Barbara, where most assets change hands for more than $8 million and pricing rarely dips below $400 per square foot.

CONSTRUCTION

0 square feet completed Y-O-Y

- Following the first quarter of 2017, when 141,000 square feet was finalized, the county's office stock has remained unchanged.
- While no office space is slated for completion during the remainder of this year, construction is underway on a 30,000-square-foot speculative building. Located in Ryan Ranch Office Park, off Highway 68, the Class B property is on pace for 2020 finalization.

Supply and Demand



VACANCY AND RENT

130 basis point decrease in vacancy Y-O-Y

- Office space availability dropped by triple-digit basis points over the past year, reducing vacancy to 6.3 percent, the lowest rate since early 2009.

1.9% decrease in asking rents Y-O-Y

- The county's average marketed rent continues to moderately decline, having fallen 6.9 percent over the past three years. At the end of March, the average rate sat at $21.60 per square foot.

Investment Highlights:

- Transaction activity was limited over the past year ending in March, with an average of one property trading every two months. Sales that did occur were in Salinas and Monterey, where local buyers, including some owner-users, obtained first-year returns in the 6 percent to 8 percent range.
- Assets that sold during the past 12 months traded for an average of $214 per square foot, with select medical office properties fetching higher values. Historically, most deals fall in the $2 million to $6 million range.

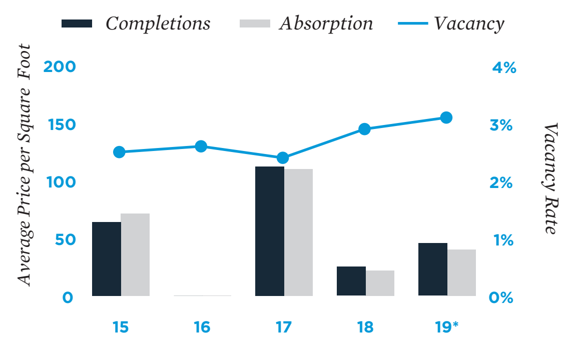
SAN LUIS OBISPO COUNTY

CONSTRUCTION

45,500 square feet completed Y-O-Y

- A medical office building in Arroyo Grande, dubbed the Matthew Will Memorial Medical Center, was the only property completed during the past four quarters. In the previous 12-month period, the county's office stock increased by 137,000 square feet.
- One property is underway and slated for completion later this year, a 21,000-square-foot speculative building adjacent to the San Luis Obispo County Regional Airport.

Supply and Demand



VACANCY AND RENT

70 basis point increase in vacancy Y-O-Y

- The volume of available office space rose slightly over the past 12 months, yet vacancy remained tight at 3.1 percent entering the second quarter.

16.5% increase in asking rents Y-O-Y

- A small inventory of office space allows for notable year-over-year swings in marketed rent. Over the past 12 months, the average rate rose by double digits, reaching $20.31 per square foot.

Investment Highlights:

- Sub-$3 million transactions that provide in-county, private buyers with 6 percent to 8 percent yields account for the bulk of deal flow in the county, yet several atypical sales closed in downtown San Luis Obispo over the past 12 months.
- A newly built office-residential building recently sold for $7.4 million, or more than $600 per square foot, while a traditional office property was acquired by a private buyer for nearly $6 million. The latter asset traded at a low-7 percent cap rate.

* Forecast
Sources: CoStar Group, Inc.; Real Capital Analytics

CONSTRUCTION

22,000 square feet completed Y-O-Y

- Driven by two completions in Santa Maria, the volume of office space added in the county over the past 12 months was just below the 26,000 square feet finalized during the prior yearlong period.
- A three-story, 90,000-square-foot building leased by Coast Hills Credit Union is underway in Santa Maria and slated for delivery this year. The office property is part of Enos Ranch, a mixed-use development largely composed of retail space.

VACANCY AND RENT

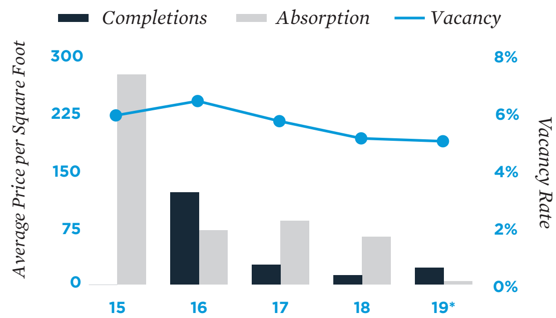
20 basis point increase in vacancy Y-O-Y

- The county's vacancy rate rose nominally over the past year, reaching 5.0 percent. During the prior 12-month window, a compression of 140 basis points was recorded.

8.4% decrease in asking rents Y-O-Y

- Since reaching a cyclical peak in late 2016, the average asking rent has fallen by nearly 21 percent. Entering the second quarter, the average marketed rate sat at $20.32 per square foot.

Supply and Demand



Investment Highlights:

- The first three months of this year represented a historically strong quarter for office transactions, supported by an uptick in Class B sales in Santa Barbara and neighboring Goleta.
- Over the past 12 months ending in March, three property trades accounted for approximately a third of the county's total sales volume. The largest transaction involved a medical office building in Santa Barbara that was purchased by its tenant for more than $30 million.

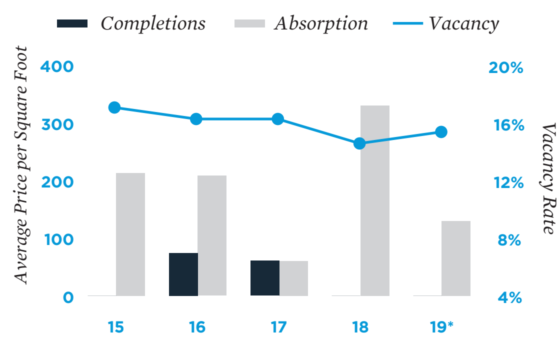
VENTURA COUNTY

CONSTRUCTION

0 square feet completed Y-O-Y

- The county's office stock did not adjust during the past 12 months, as the most recent delivery occurred during the third quarter of 2017.
- No office projects are slated for finalization during 2019; however, construction is underway on a 27,000-square-foot medical office building in Oxnard that will reach completion during 2020.

Supply and Demand



VACANCY AND RENT

60 basis point decrease in vacancy Y-O-Y

- The absorption of 129,000 square feet over the past year lowered vacancy to 12.8 percent during the first quarter. Spanning the prior yearlong period, a dip of 40 basis points was recorded.

1.0% increase in asking rents Y-O-Y

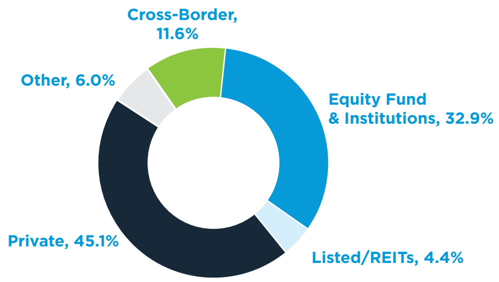
- Marketed rent rose slightly over the past 12 months to $25.28 per square foot in March. The region's average rate has held in the $25 per square foot range for 11 consecutive quarters.

Investment Highlights:

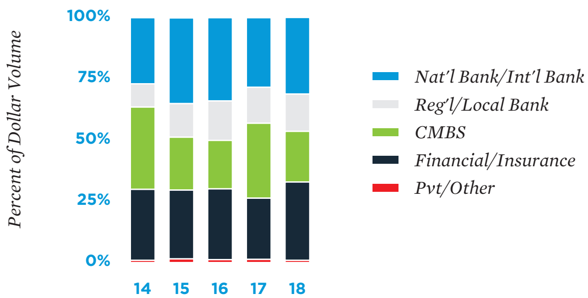
- Sales activity was steady over the past four quarters, yet sales volume dipped by 12 percent. A high number of sub-$5 million transactions coupled with sparse $10 million-plus trades accounted for the drop. Overall, initial first-year returns in the mid-6 to high-7 percent range are readily available, with higher cap rates obtainable for properties with vacancy issues.
- Anti-growth initiatives have motivated more investors to acquire office properties with plans to redevelop the buildings.

** Forecast*
Sources: CoStar Group, Inc.; Real Capital Analytics

1Q19* Office Acquisitions By Buyer Type



Office Mortgage Originations By Lender



** Trailing 12 months through 1Q19*

Include sales $2.5 million and greater

Sources: CoStar Group, Inc.; Real Capital Analytics

Capital Markets

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation

- **Ongoing trade concerns weigh on growth outlook; Fed plots next steps.** Amid rising trade tensions between the U.S. and China and slowing global growth, the outlook has turned more cautious. Market volatility, along with a flight to safety trade, has flattened the yield curve dramatically, with the 10-Year Treasury trading below 2.2 percent. This has pushed the broader yield curve into inversion, a closely watched precursor to a potential recession. Meanwhile, many measures of the domestic economy remain buoyant, including continued job and wage growth, historically low unemployment and muted inflationary pressure. These conditions have prompted a dichotomy, with Federal Reserve officials signaling more accommodative policies. The impending end of quantitative tightening in September, coupled with potential cuts to the Fed funds rate in the second half of the year, highlight the shift in Fed policy. As a result, long-term interest rates are likely to remain subdued, with Fed policy leaning toward accommodation.

- **Conservative underwriting balances abundant marketplace liquidity.** While debt availability for office assets remains widely available from a wide range of sources including local, regional and national banks and insurance companies, sentiment surrounding the health of the economy has fallen somewhat in recent months. Lenders remain broadly cautious in underwriting, with loan-to-value (LTV) ratios typically in the 55 to 70 percent range, depending on the borrower, asset and location. The conservative approach has filtered into a focus on proven property results, with much less willingness to lend against pro forma rents. This has prompted investors to turn toward short-term mezzanine debt and bridge loans to cover capital improvements, while seeking long-term solutions once returns have been solidified. Construction origination remains muted, with lenders focusing on core locations with proven demand.

National Office and Industrial Group

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Price: $250

Sources: IPA Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; TWR/Dodge Pipeline; U.S. Census Bureau