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SIOR/NAIOP holds annual end of the year forecast

January 13, 2011 - Spotlights

The New England Chapter of SIOR and Mass. Chapter of NAIOP on Thursday, Dec. 2 held its annual end of the year commercial real estate market review and forecast for 2011. Approximately 300 commercial real estate practitioners attended the event at the Seaport Hotel. Tom Farrelly, the new SIOR 2011 Chapter president made the introductions to the audience and thanked the sponsors for this event and then introduced NAIOP Chapter president Sarah Abrams. Abrams introduced the Economic Forecaster and the expert panelists.

Following is a summary of their presentations.

Bill Wheaton, professor, MIT Center for Real Estate

Global Market

Wheaton stated that the last two decades have become more complex to describe due to the global capital market and how it has affected Boston real estate. The national and international capital markets in the last two decades have really impacted what happens in Boston. It is more macro and not micro in terms of the international impact on local capitalization rates. In 1990, the office cap rates in 30 U.S. markets have a spread in the cap rate range (low to high range) of 400-600 bps. But in 2000 the cap rate spreads narrowed to 400 bps and in the last couple of years the cap rate difference is 250 bps; it has narrowed. Cap rates are lower now (6-8.5%) compared to the broader range in 1991 of 4-14%.

What is in a cap rate?

There are four factors that influence cap rates. 1. U.S .Treasury rates have gone from 7.5% to 3% based on global factors and not Boston influences. 2. The risk premium is 2-4%. 3. Illiquidity or availability of debt is 1-3%. 4. Availability of debt has added 100-300 bps over the last 20 years. Expected income growth (the Boston component) is based on the local economy. So 3 of the 4 factors are due to international trends.

Savings

The savings rate internationally has been in the 20-40% range in such regions as India, Asia, etc., but not in the U.S. The international saver is a potential investor of capital and that savings account wants to be invested somewhere. The amount of saving dollars is a large pool of capital internationally. It wants safe investments like a bank or U.S. Treasuries. The global savings rate is increasing dramatically, but the interest rates on bonds are falling and will continue to decrease.

Risk Premium

The risk premium has been increasing since 1970. The last 20 years, it has increased because there is a flight to safe assets. Therefore "risk" demands a higher return. With 4% Treasuries, cap rates will continue to drop because there is too much capital and a ton of debt. The supply of debt is greater than the demand for debt. With a ton of debt, the market needs equity partners. Capital is flowing due to Asia savers, the Feds and other factors. Pricing is indiscriminate and cap rates are bouncing up 200 bps. Wheaton predicts that cap rates will come down more over the next five years as there will be a continued flood of capital. This capital will find its way to Boston.

Fundamentals of Industrial RE

Fundamentals have two types of markets; a local market and an international path of goods distribution market. Shipping, containers and huge growth, however, have not happened in Boston because it is not on the path of goods. Markets like Riverside, Calif. and Indianapolis are on that path and have experienced big growth with state of the art construction. The export/import ratio of U.S. home grown products increased from 8% of GDP to 28% in the last 20 years. But Boston doesn't show up on this path. Boston is at the end of the path and is a little local market. Boston is more of an R&D market but not distribution.

Fundamentals of Office RE

Big office users historically have come from the financial services industry and now that will be a tempered growth market moving forward. Financial service jobs in primary cities like Boston are losing to secondary cities in the U.S. Boston has already peaked with financial service growth and it will never come back. The financial industry is losing jobs in Boston so the office market is now dominated by smaller tenants that are more nimble.

U.S. Industrial Jobs

U.S. distribution workers are up 31%, but Boston has declined and growth has stopped. Manufacturing has stabilized. But there is no growth in distribution. R&D has growth. The U.S. has 14% record vacancy today with industrial because people are building industrial along the path of goods like in Harrisburg. It will be a slow recovery.

R&D/Flex Market

This market is the area for growth in Boston and it has less vacancy issues and less absorption issues. It can only improve but mostly will be active with BTS. From 2001-08, Boston had no growth in the financial services and the recovery will be weak. So in 2015, there will be less in financial jobs than in 2000 for Boston.

U.S. Office Market

The vacancy with office is not as high as it was in 1988. But from 2000-03, there had been more construction. Boston is in a healthier condition as compared to the U.S. Boston had little construction, not due to the lack of demand, but due to a muted supply.

Conclusion

The need to understand the global market and the ability to obtain financing is important. Boston is a little entity that has to figure out its future; it is an R&D market and not industrial. The Feds don't want to raise interest rates once inflation starts increasing. Feds want short-term rates to continue into negative rates. They want 3% T-bills to balance a 3% inflation rate and influence people to spend money. Cap rates will fall in the next two years as will two year T-Bills.

Cathy Minnerly of NAI Hunneman: The Boston Industrial Market

Minnerly started her overview with the statement that it's a real estate war for industrial to find any tenant. The last six months have been much better, however, and some deals are getting executed. She sees the growing industrial markets as liquor/beverages, recycling industry, auto industry, food, building supplies, transit, medical and robotics. Most of the movement has been with downsizing and consolidation. The industrial leasing market rental rates for 100,000 s/f and up has been in the \$3.25-\$4.75 per s/ f range with \$5-\$10 per s/f of TI. Flex deals are in the \$8 to \$9.50 per s/f NNN with \$10-\$20 per s/f for TI. These rates are down approximately 25-40% from 2007.

She then targeted each geographical area around Boston. The North Shore Industrial Park has 22.7% vacancy but Ward Hill has 3-4%. The South Shore has 17.6% vacancy (Myles Standish has 13.6%, Forge Park at 12.6%). Consolidating is leading to efficiency; absorption is starting to occur and large transactions are starting to get signed which will lead to rent increases. Minnerly concluded by encouraging everyone to feel positive about 2011.

John Boyle of FHO Partners, Suburban Boston Market

Boyle concluded that 2011 will be a very tough year for the suburban office and R&D markets. There is an overall 127.4 million s/f in the market with 32.6 million s/f available space in the suburbs or 17.3% vacancy and a 25.6% availability rate. The office market has a 16.4% vacancy with 23.3% available and the R&D market is 18.6% vacancy with a 18.6% availability rate. There is a transition by tenants to move away from 2-story buildings to nicer buildings. But in the end, there is too much space in the market. Many of the tenants today are recruiting knowledge-based workers that want an urban location. Sales prices decreased in the market. Today 38 buildings totaling 2.7 million s/f of distressed properties traded hands in the North Market at an average cost of approximately $43 per s/f and some as low at $18 per s/f.

The "supply side" is "an under-demolished market" as 78% of suburban buildings are over 20 years old. In the Waltham market alone, a 10-20,000 s/f tenant has 93 options in 47 buildings, but Riverside in Auburndale is experiencing rent increases and is almost all leased. The location is the critical difference. From the "demand side" there has been the same number of office jobs since 1997 totaling 536,800 and today 536,800 jobs. But in 2007, there was only 20 million s/f delivered in the suburbs. The 20 year average office suburban absorption is 800,000 s/f per year and now we are at 580,000 s/f for the year. Everyone is consolidating and a great deal of shadow space exists. The rents in Burlington at NEEP and Waltham reflect the lack of job creation demand.

Future

Tenants are globally focused but scaling down here. There is a "push" to work from home but India is scaling up. Work here is about using office for conferencing and classrooms but not for workspace. It will be super competitive. Space today has to be unique and not treated as a commodity with high TI packages. Rents will stay flat and large deals will be far and few between. Sustainability will also matter moving forward as well as a building's professional competence but 2011 will be tricky.

Chuck Kavoogian of CBRE, Cambridge Market

There is limited vacancy today when it used to be "no vacancy". The 2010 year was very active for Cambridge. It started as a landlord's market but has ended as a tenant's market. In the 3Q of 2010, the office vacancy was 11.2% and lab space 12.1%. Asking office rents are averaging $35.12 per s/f; asking lab $50.17 per s/f, triple net. The demand for life science companies is growing. The office demand has 900,000 s/f, net 450,000 s/f. Lab demand has gross 2.2 million s/f, net 1.1 million s/f. There is very few large blocks of space for the demand right now. There are a great deal of big block demand users looking and having limited choices. New development has a great deal of permitted sites in E. Cambridge that might help the demand.

Forecast for 2011

Tech Titans will put pressure on top tier office rents. BTS will be fueled and some office space will be converted to lab space. Kendall Square will continue to be in big demand.

Ron Perry of Colliers Meredith & Grew, Downtown Market

The financial district is a tenant market while the Back Bay space is tight; it is a segmented market.

There is a 16% vacancy, negative absorption of one million s/f and Class A rents in the $40-$60 per s/f range; Class B in the $25-$35 per s/f, range. The real picture is the demand side. Back Bay is one-third the size of the financial district and very tight with space. Key players are from the financials and law firms.

Vacancy

From 2010-2013, Perry sees the vacancy rate coming down from the current 16.3% to 13.5%. The Financial District tower space (from the 20th floor and higher) has less than a 7% vacancy while lower rise space has over 10% and that's the real issue. Back Bay has a vacancy for 20th floor and higher at 3.9% and below the 20th floor at 7.5%. There are more options available in the Financial District as compared to the Back Bay for all office users. Tenants in the market today total 2.3 million s/f of demand or 105 total tenants or an average of 21,900 s/f per tenant. Signed leases in 2010 totaled 4.3 million s/f with an average size of 24,000 s/f. Two-thirds of the tenants renewed and one-third relocated. The market is soft and is a tenant's market.

Ed Maher of Cushman & Wakefield, The Capital Market

Maher started by stating that the best thing about 2010 was that it wasn't 2009. The total U.S. Sales Investments totaling: 3Q 2010: $67 billion; 2009: $5 billion; 2008: $145 billion; 2007: $502 billion; 2006: $352 billion; 2005: $303 billion; 2004: $204 billion; 2003: $123 billion; 2002: $101 billion; 2001: $78 billion.

The U.S activity is up 86% and the 4Q of 2010 should be good. Boston is in the top 3 cities in the U.S. markets for investments with Washington D.C. as #1 and N.Y.C. as #2. There has been an employment base shrinkage in the U.S. but not as bad in Boston. The Boston investment volume in the 3Q of 2010 is $1.6 billion while it was $1.5 billion for the entire 2009 year. It is a bifurcated market; a price per s/f market. The grey zone buildings that are the toughest to sell right now are buildings that are 70% vacancy or with single tenanted buildings with less than 10 years remaining on leases. The stronger buildings are those with 90% vacancy. Mid-year 2010 everything seemed to stop but by Dec. 2010 Maher expects to see more activity with cap rates closer to 9% for downtown Boston buildings.

2011 Forecast

Next year will be a great year to Maher's surprise as was 2010. But 2011, Maher feels will be an epic year for investment activity for four reasons: 1. Cheap debt 2. Recap opportunities 3. Distressed sales and; 4. Pent-up core pipeline.

The SIOR Chapter would like to thank the following sponsors: Brookwood Financial Partners, CBRE, Colliers, Cushman & Wakefield, FHO Partners, NAI Hunneman and Banker & Tradesman.