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SIOR New England and NAIOP host mid-year market review on the 2017 commercial real estate market on June 8

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Boston, MA The New England Chapter of the Society of Industrial and Office Realtors and MA NAIOP held its mid-year market review on the 2017 commercial real estate market at the Boston Hyatt Regency on Thursday, June. Here is a summary from a panel of experts of the relevant points as it relates to 2017 and the economist Hans Nordby of CoStar Portfolio Strategy. The panel of experts included Andrea DeSimone, CBRE on retail; Evan Gallagher, Colliers International on Cambridge and suburbs; Sue Hawkes of The Collaborative Cos. on multi-family; Ben Heller of JLL on downtown office and Ed Maher of NGKF on the capital markets.

The Economy: Corporate growth margins are now durable and there is no foreseeable recession. Small businesses are excited and the unemployment is at a 17 year low. 45% of all jobs come from small business. The unemployment rate is real low. We need to slow down because there will be no one left to hire. We will have wage growth.

Another driver is that we need more housing. There is a shortage. The U.S. had 1.4 million units built per year and it's now half. We have worked off the excess but we don't have enough inventory. There is not enough for sale. Boston housing has a shortage but housing is expensive here so it drives the apartment demand.

Risks: First, the Trump administration policies. The executive arm doesn't have much power to enact changes. You need Congressional approvals. We are in the longest economic cycle. The average cycle lasts 5.4 years and we are over 8 years. We have a chance in 3 years to be in a recession but Nordby's model has failed twice on predicting recessions so who knows? However the next recession will be milder. Second, What will cause the next recession? Nordby thinks technology, cyclical, venture capital dollars are decreasing and there is less cash going into technology.

Capital Markets: Nordby thinks values are bobbling. Boston sales index is increasing but not as fast in the last years especially in multi-family which is not as great. The trading volume in Boston is about the same as last year and the same amount of square feet. It will lead to more stable values.

Apartments: The U.S. vacancy rates are predicted to be 30 basis points higher next year. Permitting activity has pulled back. Suburban Boston and Cambridge apartment inventory is very tight and expensive for consumers. The Boston vacancy is tighter than the U.S. average but is getting a little more inventory but permitting is dropping and vacancy is predicted to go down. We are close to the

U.S. average and it's easier to retain young workers. The rents of 35% of U.S. apartments required consumers to make $70,000 annual income and 57% of renters have to make over $100,000 a year to afford the rent. Most Millennials don't make $100,000 a year. Boston inventory was 17% growth versus U.S. at 11% so we built more in the U.S. Boston has little supply at the lower rent range.

Office: U.S. inventory is tight and has a rosy picture. Vacancy is below the average vacancy. Permitting is pulling back to be disciplined. The type of space being demanded is different. There is high demand for higher class space but there is slow construction activity because costs are high and land price is high. Rents aren't penciling due to high costs so there is low construction activity and therefore very old office stock.

Retail: Boston retail forecast suggest that rents are up 12% for high level locations but 10% of space is in very tight demand while 90% of retail space only has average demand.

After Nordby the panelists then gave a 10 minute summary of their sectors.

Multi-Family: "Place making" is the difference of this cycle vs. other cycles. We have price appreciation. Rents are only appreciating by 2% this year while last year it was 5%. There has been more construction and more micro-units that have curbed the rent increase. Smaller is better but now amenity wars are critical. It's all about services and not just about space. Sales are better with service supplied complexes than rentals with services. Services are including concierge, valet, etc. Co-habitating is going well. Fitness centers aren't has popular since people want specialized fitness such as cross-fit and kickboxing. So gyms are getting smaller in apartment buildings. Suburban housing residents are expecting condos to deliver more in services when they move back into the city. They don't need as much space since they aren't moving all their furniture back into the city. Boston rental rates are high as new construction costs will drive rents to $4,000-6,000 per month for high-rise units. It's a tough market for most people to afford. Studios at $2,000 per month are considered exceptional value. That is a tough rent to afford and the studios are going up in rent. New construction units will be at $5,000 per month or more.

Condos at $3,000 per s/f are not sustainable and is unbelievable but the cost of construction is the highest in Boston for the U.S. Even $1,500 per s/f sales can't be affordable here. There is also a neighborhood "buy" mentality that is impactful on decisions and drives what is being built and where. There is also a great deal of out-of-state consultants during this last growth cycle and an influx of out-of-state developers, designers, architects, consultants that have different ideas and have influenced the appearance of buildings.

Mid-Rise Luxury Condos: A mid-rise is considered 6-10 stories with full amenities but it isn't high rise. Mid-rise is hot from $1200-1500 per s/f sales price and it's affordable than hi-rise luxury. You still need parking especially for 2 bedroom owners. Parking is driving the unit sales. Complexes at mass transit locations is good but you still need parking. Somerville is a big demand market.

Conclusion: It is good have foreign capital here but the challenge is controlling it. East Boston is over $800 per s/f in sales price and is the new frontier. The BackBay is $1282 per s/f. You can sell a lot of $3,000 per s/f units. You need mid-rise at $1200 per s/f. We need more affordable units both for sale and rent.

The next panelist then proceeded with retail review.

Retail Market: Sears, Payless Shoes, JC Penny, Radio Shack, etc. have announced closing of stores and that number is growing. Leadership is changing as CEOs are being let go. Who is doing well? HomeGoods, Marshalls, TJ Maxx. They created a demand and you can't buy on-line. Walmart is doing well and they just bought Jet for home deliveries. On-line is not slowing down.

E-Commerce in 2016 comprised 25% of purchases versus 13.7% in 2010. E-Commerce is growing and can't be stopped. It's convenient. Amazon has a bookstore at Legacy Place.

How will Retail survive? Retailers will have to invest in technology and in-store experience has to be enhanced. Waiting for consumers to come to the store and buy is now a dead idea. You need a connection with the consumer and an emotional attachment to draw the consumer to a store. The restaurant scene is robust and are new anchors. They aren't hurt by the internet. You have to go to a restaurant to eat. The only threat is a shortage of good restaurant labor. Starbucks just opened a 43,000 s/f roastery in Chicago and it's the largest in the world. It serves beer and wine and has bicycles for sale. Centers today need new paint, new planters, etc. to update retail before a retailer shows up to lease. Boston will be "alright" in the retail world.

Cambridge and Rte. 128 BioTech: The next panelist focused on biolab and office space in Cambridge. The EpiCenter has 6.7 million s/f of space on 70 acres and tight demand. There are plans to add to a total of 11.6 million s/f and 145 acres. From 2010-15, there was a dramatic shift expanded to 130 acres with the addition of Binney St., expanding Volpy Center, Metropolitan Pipe site at 1 Kendall Sq., Northpoint and Intercontinental. 7 million s/f will be added of which 75% will be lab space and 25% office. 95% will be in East Cambridge. We are having a biotech renaissance. We have a lack of scientific lab workers. Class B space in West Cambridge has rents in the low $60s NNN while E. Cambridge is at $80 per s/f NNN. W. Cambridge is bridging E. Cambridge. Construction costs are going up especially with wet lab space.

Office space in Cambridge has historic rents at $85 per s/f gross and a low vacancy which is now slowing down. Some tenants are wondering if they should move to the suburbs to less expensive space. Some are also downsizing 25-30% and going to a more open space concept thus cutting back on office space demand.

Rte. 128 lab space has big benefits. It is 50% less in occupancy cost than 1 Kendall in E. Cambridge. Problem though is hiring young people to work on Rte. 128. Space is leasing at $38 NNN for lab class B space. Ground up new construction is leasing at $54 per s/f NNN. In 2015, 50% of IPOs were outside the Cambridge market so it can impact demand for lab space.

Evolution of Boston Commercial Real Estate: Ten years ago the iPhone was introduced and it was symbolic with real estate cycles. We went from low rise office demand to the Seaport but that didn't change real estate design. The iPhone did however. Hi-tech will have the singular #1 impact on real estate. The workforce is molded by Millennials. Private offices are now collaborative open space, cars are now driving without people, etc.

The core for space was about the timing of space delivery. Everyone wants to be in space real fast and it's not in a few months like years ago. Boston is now on the global map for headquarters demand. The human experience matters and a $10 per s/f swing in rent isn't so important anymore if the experience is better for employees. It's not a real estate play anymore but a people play on leasing decisions. Companies want to invest in the next big idea.

Boston is 11% above its historical highs for rent and above the U.S. average. There is 5 million s/f of new construction and tenants are willing to pay the high rents.

Capital Markets: The final panelist spoke about the capital markets. He started by asking Why is the market quiet? It isn't although Boston volume is down 18% YOY but still it is high compared to other years. Boston is the hot city in the U.S. to invest by foreign investors but nothing is really available. Thus the lower volume. It's quiet because we have had a lot of sales last year and less inventory with higher prices. Sales prices wouldn't be as high if it wasn't for foreigners. U.S. market is cooling however except for Seattle. Investment tours are down and offers are down so pricing is flat depending on the sector.

For multi-family, it's strong and resilient. Retail is misunderstood, industrial is hot and office investment is a head scratcher depending on the submarket location. There are 15 sales in the last 6 months in Cambridge and Boston with a lot of activity in downtown Boston. Cap rates are now 2.8 to 4.6% and no one wants to pay these numbers. The new action will be in the suburbs. There are 11 acquisition opportunities with 7 on Rte. 128. But it's a leap of faith because the sales have no benchmarks and very few comps at these level. Why would you pay a 4% cap when a couple of years ago, the same investor was buying at a 7% cap? You need more metrics and there's not any. It's all untested, speculative pricing.