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NAIOP/SIOR commercial market mid-year review 2018

July 13, 2018 - Front Section

Boston, MA The New England Chapter of the Society of Industrial and Office Realtors (SIOR) and MA NAIOP held its mid-year market review on the 2018 commercial real estate market at the Boston Seaport Hotel on Wednesday, May 30. Here is a quick summary from a panel of experts of the relevant points as it relates to 2018 and the economist Ryan Serverino, chief economist of JLL. The panel of experts included Travis D'Amato, Walker & Dunlop on multi-family; Jonathan Freni, CBRE on the downtown market; Bill Lynch, Colliers on the suburbs; and Lauren O'Neil, HFF on the capital markets; and Juliette Reiter, Newmark Knight Franks on Cambridge.

The Economy: Serverino started his presentation with a title, Mastering the Economic Cycle, Boom or Bust? From a macro standpoint, Serverino stated that it is all still good news. We are in the second largest expansion in history. Although the economy is good, he concluded that it was not great. We have had the 107th month of uninterrupted expansion. The Dot.com era was the longest expansion. He is feeling more optimistic about 2018, deleveraging of tax cuts and spending packages passed by Congress in the last 12-18 months that will be good for the economy. Serverino recognizes that 2015 was indeed the high water mark of the economy and we will continue to see a similar robust economy today.

Business Sentiment: People are feeling good but sentiment can get carried away. In the past, we have not remained at a high sentiment level for a long time. Sentiment can disappear quickly. Serverino wonders if business sentiment statistics are really an appropriate factor to gauge the economy. He feels that there is a good chance that we see the economy continue to expand into 2020.

What to Look Out For: Serverino says that the pace of job gains is unsustainable with all the job growth. Wage growth is slowly accelerating and we are running out of workers. There are 6.6 unfilled jobs per person because we don't have qualified workers. Therefore there is an inflation concern. He doesn't think hyper-inflation but slow sustained upward pressure. Inflation impacts interest rates and the trajectory will be inflationary long-term. We will see increases from the Feds this year and next year.

Interest rates matter because high interest rates impact economic growth. There have been 9 periods since 1954 of high interest rates and then followed with down economies at some time thereafter or slow economies thereafter.

The Future Projections: The economy will run well into 2020. 2018-19 will be good but then we have a high risk of a recession in 2020 and 2021. He can guarantee that the recession will happen but he feels a relative high probability for 2020. There is a 32% probability for a recession in 2020 before the probability tails off. He feels that we will have interest rate increases of 150 basis points over what the rates are now and it will slow down the economy. He advised that we have to watch the warning signs to see what will happen but he makes no promises of any recession since he has been wrong before.

Boston Relative Performance: Serverino said that Boston is narrowing the gap. In 2001-08, the Boston economy underperformed in comparison to the U.S. economy. From 2008-17, the Boston economy grew as did the U.S. economy. From 2017-2022, he feels that the Boston economy and U.S. growth gap will narrow.

Top 15 Metro Economies in the U.S.: In 1978, Boston was number 8 top metro U.S. economy which was its lowest rating. Since 1978, Boston has ranked from # 1 to #8 while other cities have jumped to #1 and then tanked. Other cities have had more volatility than Boston. Boston has sustained its economy. NYC has maintained a #1 rating since 1978, then Los Angeles as #2 and Chicago as #3.

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

Cambridge Markets: Juliette Reiter, NKF

The Cambridge market has two major factors:

1) Continued space scarcity

2) Confident building

Continued Scarcity: Reiter concluded that the Cambridge market is tight. Lab versus office space keeps growing in demand and rental rates. The Cambridge lab market consists of 11 million s/f and the Cambridge office market inventory is 10 million s/f. The lab inventory has now exceeded the office market. The lab market only has a 4% space availability. The office market has a 7.7% space availability. Lab space rent averages $85 per s/f, triple net while office rents average $90 per s/f, gross. Over the last 5 years, Cambridge has averaged 5% space availability overall.

Reiter then gave specific building examples of rents.

200 Tech Building: Five years ago, rents in this building were $51 per s/f, triple net. Today rents are $85 per s/f, triple net. It is a 67% increase from rents 5 years ago.

• 2005 office rents averaged $26 per s/f, gross and in 2018, $93 per s/f, gross.

• 2006 v. 2018: 2006 Lab = $26 per s/f; Office $28 per s/f; 2018, Lab = $104 per s/f; Office, $93 per s/f.

Space Demand: There are 51 total companies looking for Cambridge lab space and 53 companies looking for Cambridge office space. The average lab tenant is seeking 40,000 s/f. Space banking is becoming more popular in which a company leases more space than it needs and sublets the space until its actually needed.

35 Cambridge Park Drive: This building was recently constructed. Prior to construction, there were only two showings. Today there have been 17 showings and 67% of the building is committed.

DivcoWest has leased 337,000 s/f to Phillips as well in East Cambridge. 90% of leasing has been on spec space or renovated development.

Intelligent Future

There are a great deal of AI companies looking for space with 4 major industries supporting AI or robotics and academia. The need for space has spread to inner suburbs such as Watertown, Allston, Somerville and Fenway. Comfy is a new technology with light and temperature individual control that is now being incorporated into buildings.

The Boston Suburbs: Bill Lynch, Colliers

Lynch stated that there is 256 million s/f of total inventory in the suburban market. The suburbs are alive and well with over 100 million s/f of occupied space. There is a reverse migration out of Cambridge to the suburbs in order to save 50% on rents. There is also an abundancy of tenant activity. There is still a flight to quality and amenities in and out of buildings. There has been abundant tenant activity due to organic growth or through acquiring companies. These lease signings have occurred in Waltham, Billerica and Westboro. These companies want game rooms, genius bars, surrounding support systems, fitness centers, etc. Health care requirements are driving the need for space from hospitals. The hospitals are pushing its own needs to the suburban space and competing with the non-medical tenants causing a rental rate increase and lack of inventory.

Class A Office Space

The average rent on Rt. 128 is now in the mid-$40 per s/f. Rt. 128 is in the $40-50 per s/f, with limited supply causing tenants to push out to Rt. 495. Rt. 495 low end rent is now low $20 per s/f with an average of $25 per s/f. When and how rents will peak is not clear.

Rents should stay plateau through 2018 but the next few months after you will see an increase in rents again.

Outlook for 2018-19

There will be more housing development in the suburbs. The lab market will be more relevant than the office market. Health care requirements will be steady. 57% of Peak Millennials are most likely to purchase homes in the suburbs according to NAR. Millennials will push out to suburban housing that will drive suburban office demand.

Downtown Boston: Jon Freni, CBRE

Freni sees 5 impact factors on commercial real estate.

• Co-working

• Development

• Consolidating

• Labs (where the Seaport is the focus)

• Deal structure evolution

• Growth Disruption: Co-working

There is 80 million s/f in the market with 2 million s/f of co-working space. Development continues to grow: Two Drydock Avenue; 321 Harrison Ave., Parkside on A and the Beat. As an additional note: JC Cannistraro has its grand opening in June for a multi-million dollar renovated 160,000 square foot facility in the Seaport area. A deal that the Mayor of Boston was quite instrumental to bring to Boston and a deal transacted by SIOR brokers, Bob Cleary and Rob Nahigian. There are tons of co-working competitors such as WeWork who is number 1. WeWork is looking for 100,000 to 200,000 s/f of space when they actually lease space and then, by default, become one of the largest landlords in Boston.

How does co-working affect building?

Landlord considers the risk of weak tenant financials with co-work companies. But co-work companies want 15 year lease terms so the landlord has to be careful in its leasing decision.

Co-working space brings happiness to a building that then attracts other companies.

Co-work companies need space now but Boston only has 2 options today and will only have 1 option in 2019. Therefore there is a lack of space for co-working companies and few options for large blocks of space. It is a tight market.

Consolidation. You will see expiring leases with consolidating companies in need of different locations. The consolidating companies may have 5 locations in a city. There is now a need to be efficient and to consolidate that will impact commercial real estate.

Lab Space: Landlords today who have a better grasp of lab space and a better idea of converting office space to lab space will be the winners. The office market industry does not understand the lab space industry. Lab space requires a big investment of dollars to transform office space into lab space. The office landlords don't understand the dynamics and need to be educated of the costs and tenant demand. Many of the landlords are scared off.

Deal Structuring: applies to lab space as does office space. But deals are changing as tenants are reluctant to make moves with tenant improvements now reaching costs of $65-100 per s/f. Today the landlord needs to bridge the gap by supplying high tenant improvement packages but charge a higher rent.

In the future, 2018-19, new space today will experience a percent escalator in the rent rather than a money per square foot increase.

Outlook for 2018

Co-working demand will grow by another 200,000 square feet. Speculative development will benefit large users needing space immediately. With consolidation, a great deal of homework is needed to decide to consolidate locations or keep 5 offices in Boston. Landlords who have experience, like Related Beal, with lab space and lab space experience will benefit and have an advantage over other landlords. Deal structures will have percent annual increases in the rent as escalators and not $ per square foot increases.

Multi-Family Market: Travis D'Amato, Walker & Dunlop

Fundamentals are good. The vacancy rate is 1% increase from last year. Vacancy rose from 5% to 6%. Rents are still increasing even with vacancy increases and that is due to job increases. Rent increased by approximately 0.5%. Boston has the highest percent of young professionals at 37.8% of population. The U.S. average of young professional population is 20.8%.

Where are we building multi-family?

In 2014, the suburban market was the biggest area for building. Now it is even between suburban urban and outer suburban. Now Boston is included with institutional housing development. In 2004, multi-family was not recognized as a separate asset class and now it's different. From 2013-16, the outer suburban market was the largest area. Fourteen percent (14%) of the housing stock is Class A housing today and it's the lowest percent in the U.S. As costs increased in the city, the suburban market became more affordable to develop. Not everyone works downtown nor wants to be downtown.

Downtown Boston Rents

In 2018, we have built 1324 units. In 2015, we peaked and built 2400 units. The average is now 1,000-1,300 units being built in downtown Boston.

Capital Attraction

Multi-family is still #1 for investors and Boston is the top 3 in the U.S. We don’t have adequate supply to buy units and we don’t have enough sellers. As an example, there were 17 bidders on one project. There were over $1 billion in total offers. There is not an adequate supply for the capital demand. Prices are at 3.5% cap rates and now it is flat because of the wall of capital. Investors are pushing for lower returns and have longer holding periods. For example, Girard sold at 3.9% cap rate; Harborview at the Navy Yark at 3.8% cap; and Watermark Seaport at 3.9%.

Price per Unit

Right now, multi-family units are selling in the $690-750,000 per unit. Are prices dropping? Maybe but look at the price per square foot as a metric rather than dollar amount per unit. Travis is seeing price per square foot increasing to $847 per s/f to $1074 per s/f. Unit sizes are becoming smaller so the price per square foot is rising. The price per unit seems to be decreasing but it’s a myth. We will experience some compression in the suburbs in the future. 2015 seemed to be the peak year at $2,411 per square foot.

The Capital Market: Lauren O’Neil, HFF

O'Neil closed out the program with the capital market review.

U.S. Macro

O'Neil stated that the U.S. is the top investment target. Domestic allocations are under allocated in real estate. Individual retail investors are new and becoming a growing source of capital. Plus there is a growing investment into REITS.

Foreign Investors

There is strong demand in the U.S. to diversify and use the U.S. has a safe haven as it’s a better risk tolerance. 2017 foreign investments were down from past years due to China and Scandinavia investors shying away. The market is down 5% from 2017.

Off-Shore Cash Flow

In the last 10 years, there have big winners in the U.S. Those cities included Houston, NYC, San Francisco, Austin and San Jose. Boston was a loser in 2017.

Liquidity

Liquidity is at an all time high with a lot of dry powder (unused cash). The amount of dry power has increased from $83 billion to $177 billion over the last 10 years. The pace of fund raising is now slowing significantly. Commercial real estate becomes an AUM (assets under management) game. No one wants to sell because no one knows what to do with the capital. Open versus closed funds are up approximately 114% since the prior peak. A scarcity premium exists for all saleable investments. The platform deals continues to grow.

Industrial real estate is still #1 to buy

Apartments continue to be a favorite

Office has some interest

The 2017 investment volume is down from 2016 but 2018 is up. The first quarter of 2017 = $109 billion versus 1Q of 2018 = $114 billion

Cap Rates

The cap rate spread is 140 basis points. The average cap rate for office investments is now flat while multi-family is in big demand. The hotel market has seen an uptick after being down a few years ago. But with the lack of new construction, multi-family is now experiencing record breaking prices.

Industrial sales are over $100 per s/f in Boston

Retail is now seeing investors jump back in. The recent Las Vegas ICSC saw uptick sentiment.

Loan Originations

There has been an 8% increase in 2017. Most of the increase has come from the CMBS market. Banks are in excellent health. Banks continue to show discipline in 2018 and are issuing more construction loans. Rate spreads have compressed.

Bridge loans have become the deepest portion of the market. Spreads continue to compress here as well. Debt funds are the most liquid.

The CMBS market is the best option for long-term. CMBS is beating life insurance company rates. There is an “all in” borrowing that is very competitive. CMBS is likely to see an uptick in 2018. Life insurance loans are a $60 billion player and will continue to be aggressive.

Boston

Boston is still very healthy. The supply/demand factor remains in balance for all major property types with the last mile, in-fill industrial leading the charge. In-fill industrial has a lower yield commitment which translates to value-add plays that is producing core-plus returns. In-fill development is happening in Quincy, Everett and Malden which are locations big in demand.

It will be difficult to find any office towers for sale. The 1 or 2 towers that are for sale right now are attracting a great deal of bidders. The Boston office market has sales in the $751-850 per s/f. The Suburban Office sales are in the $210-300 per s/f range. Construction costs are surpassing sales per square foot. Apartments are selling in the $300,000 to $800,000 price range per unit.

Hotels are selling at $170,000 to $700,000 per key. Development is being pushed to Dorchester, S. Boston, Malden, and Somerville with mixed use. Watertown recently had a 147 hotel room development. There is another 326,000 square feet of retail development at the Arsenal in Watertown as well.