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SIOR and NAIOP host end of the year market review and forecast

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Boston, MA The New England Chapter of the Society of Industrial and Office Realtors (SIOR) and MA NAIOP held its end of the year market review and forecast for the 2020 commercial real estate market at the Westin Hotel, on Wednesday November 20th. Approximately 380 professionals were in attendance. Here is a quick summary from a panel of experts of the relevant points as it relates to 2019 and 2020. The program commenced with an economic overview by Kelly Whitman, vice president, investment research, PGIM Real Estate. The panel of experts included Kristin Blount, Colliers on the Downtown Boston Market; Rob Byrne, Cushman & Wakefield on the Suburban Market; Ben Coffin, JLL on the Cambridge Market; Rick Schuhwerk, Newmark Knight Frank on the Industrial Market; and Chris Skeffington, CBRE on the Capital Markets. Rob Nahigian, SIOR was the facilitator for this program and addressed the audience.

The Economy: Whitman started her presentation with an overview and looking at 2020. She stated that we are 10 years into this up cycle and it has been a long time running. She says that we are in the “goldilocks zone,” not too hot and not too cold. We are experiencing a range of 6-7% for investment returns. The commercial real estate industry however will have to work a little difficult in 2020 to lease up space but leasing and absorption will still occur. She sees cap rate compression as completed and done. Cap rates have stopped compressing but still positive.

U.S. Real Estate Forecast and Overview: Whitman stated that investors still love real estate investing and there is a great deal of capital and “dry powder” (cash on hand). There has been a sustained interest in real estate for the last 5 years across all sectors of real estate and all markets geographically. Real estate pricing a year ago was looking expensive. Interest rates have declined so now real estate values are looking better. She feels comfortable with real estate pricing especially if compared to U.S. Treasuries and Bonds. She does not see any real red flags. Supply has been disciplined. There is no new demand for retail space. Overall it’s a landlord’s market. Developers and lenders have been disciplined. However the key word for 2020 is uncertainty since 2008-09. There has been steady growth over the last 10 years and the U.S. GDP is now at 2% which is good.

Outlook: Whitman’s outlook for 2020 is more of the same but at a slower pace with some issues. Expect 2% growth and she does not consider 2% growth a recession.

Indicators: Whitman reviewed some economic indicators for any insight to 2020. She stated that the job growth is healthy. There is a softness in manufacturing. Housing starts are flatter. But there is an overall balanced view of risk. Her base line is more of the same.

Policies: The Tax Act cut impact had a boost but the Act is now phasing out. Vacancies are tighter on the west coast. Boston has a slowdown in job growth but that is due to the fact that everyone is employed. The U.S. unemployment is 3.5% and Boston is 2.9%.

2020 Growth: Whitman felt that the strongest growth will be labor force growth. She likes the industrial sector over all other sectors. The hottest rent growth will be the coastal industrial markets and markets near large population centers that are currently underserved.

Downtown Boston: Kristin Blount of Colliers International

Blount stated that the downtown market vacancy rate is down and rents are up. Class A rents are up 78% since the last downturn in 2007-08. Class B rents are up 44% since the last downturn.

Structural Economic Changes: Blount stated that it's a landlord's market and many rents are now converting from a modified gross basis to a triple net basis for office space. BackBay rent is $88 per s/f, triple net which translates to over $100 per s/f, gross. This is an historical rental rate. The Seaport rents are now at $50 per s/f, triple net. Annual rent escalators have moved away from $1 per s/f per year to 2-3% compounded annual increases. Tenant improvement allowance is limited to $5 per s/f.

Tenant Demand: Downtown tenant demand is soaring. The average tenant actively seeking space is 25,000 s/f. The median size is 10,000 s/f. The total tenant demand currently is 5,000,000 s/f and there is not adequate space to satisfy that demand. The driving force for tenants right now is recruiting and retaining talent.

Flex Space: The total flex space market comprises of 2.5 million s/f or 3.5% of the entire market. That demand is here to stay. WeWork is the currently the elephant in the room and there are questions if it can survive. It leases 1.6 million s/f in Boston. They either consolidate, file for bankruptcy or drive more demand but it is definitely a flat market for them.

New Frontiers: Blount then identified other submarkets outside of downtown Boston that are become new hot beds for office and lab space. She identified: Watertown, Alewife, Allston/Brighton, Seaport, Dorchester and Somerville. She noted major office/lab developments in each of these select markets. It was clear that lab space was dominating the need of today's commercial tenant and the supply of tomorrow. Lab space is taking away from the office supply thus driving up rents for office tenants.

Office Supply: There is 7 million s/f of office space in the pipeline being designed and permitted for development. Space is being leased 2 or 3 years in advance of construction and quickly leasing up the future. This process is leaving little for other tenants.

Blount's 2020 forecast is that class A rental rates will rise. We will break $100 per s/f in the Financial

District. She thinks that WeWork will consolidate and more life science ventures will demand space in Boston.

Suburban Market: Rob Byrn of Cushman & Wakefield

Byrn started with some office market statistics on 3Q 2019 vacancies and rental rates compared to 2Q 2019. The total suburban office market comprises of 95 million s/f with an overall vacancy of 12.4%. More specifically the 495 North market (22.3 million s/f) has a 17.2% vacancy down from 20.4%. Rents are up at $20.54 per s/f from $19.62 per s/f. Rt. 495 West (30.1 million s/f) has 16.8% vacancy, up from 15.9%. Asking rents are up from $19.52 per s/f to $20.83 per s/f. Metro West has 2.9 million s/f with 17.7% vacancy, unchanged from the 2Q. Asking rents are slightly up at $24.97 per s/f from $24.77 per s/f. Rte. 128 North has 12 million s/f, a vacancy of 7.8%, down from 10.5% in 2Q and asking rents are down to $22.33 per s/f from $23.00 per s/f. The 128 Central market has 30.1 million s/f, a decreased vacancy to 9.1% from 12% and an increase in rent of $33.65 per s/f from $33.48 per s/f. Rte. 128 South comprises 10.8 million s/f. Vacancy is now at 14.1%, up from 13%. Asking rents are up to $26.71 per s/f from $23.10 per s/f.

The office market is becoming a difficult place to find affordable quality space. Rental rates are now over $40-45 per s/f. Some buildings are reaching $50 per s/f. Job growth is a problem for many companies as its difficult to find new hires in all subsectors.

Old vs. New: Byrn summarized that we lack state of the art quality office space. The buildings constructed in the 1980s and 1990s are old functional space but out of date. Millennials are moving back to the suburbs after growing up.

There is a push on demand by companies for suburban office space to satisfy the Millennial movement to suburban housing. There is a demand for office building amenities to meet the needs of these millennials as again new hires are difficult to find.

There is a total of 2.5 million s/f for sublet in the market which is 2.7% of the office suburban market.

Life Sciences: The lab effect has been extremely impactful in the suburbs. The drive for life science space has driven up the rental rates to high numbers. There is a large drive of current space absorption and large demand for more space that is triggering 1 million s/f of speculative development.

Conclusions

Byrn had 4 conclusions:

1. Access to labor talent is 100% the suburban office demand driver. Millennials are living downtown, getting older and moving to the suburbs whether they thought they would or not. It’s happening. They are moving to the suburbs and there is large demand for suburban office space.

2. There is limited large blocks of space. This demand is driving rental rates.

3. The demand for lab space is effecting office supply as many buildings are converting to lab space and the lab space tenant. This conversion leaves little for suburban office demand. 4. Headwinds of the economy will play a role.

Cambridge Market: Ben Coffin of JLL

Coffin started with a summary of the market statistics. The office market in the total Cambridge market has an average rental rate of $90.34 psf, triple net, a total inventory of 11.1 million s/f and a vacancy of 3.2%. The total lab market is comprised of 10 million s/f, an average asking rent of $97.30 per s/f, triple net with a vacancy of 1.6%. These rents convert to over $100 per s/f on a gross basis.

Tenant Demand

There are 49 active tenants looking for space in Cambridge. The total demand of those 49 tenants is 2.47 million s/f. The average tenant demand is 50,272 s/f. Coffin stated that the lease velocity to date for lab space is 1.6 million s/f and for office 906,000 s/f.

E. Cambridge

Coffin said that E. Cambridge is on fire. Rents are well over $100 per s/f, triple net. The lab space vacancy rate is 0.8% and the office space vacancy is 1.4%. Basically there is no space available. Tenants are pre-leasing new developments under construction and projects that have not broken ground. After all this preleasing, the first year that any space will now be available will be 2022.

W. Cambridge

Rental rates are on the rise here as well. From 1Q 2019 to 3Q 2019, rent growth on a quoted rental basis is up 20.3%.

Conclusion

Coffin is bullish about the Somerville market as well. Right now as a developer, you have to build speculatively for lab tenants if you want to attract the tenant demand. Waiting for a build-to-suit is not timely. There is currently not adequate space supply.

Industrial Market: Rick Schuhwerk of Newmark Knight Frank

Schuhwerk started with a statement that 2007 was a dead end for the industrial market. There were a lot of industrial vacancies with a 20% vacancy rate in 2007.

Now, ecommerce is the driver going back 18 months from today. For every $1 billion in sales, there is a 1.25 million s/f of new warehouse demand.

Today online sales equals 11.6% of total retail sales and it’s expected to rise to 16.2% by 2023.

Tenant Demand

Today there are 91 active tenant requirements seeking 11.5 million s/f of demand. The demand is big and will be satisfied in the next few months. Therefore the current industrial vacancy in the Boston market could be below the U.S. average of 4% in the next 45-60 days. We are running out of industrial space. U.S. online sales are growing by $70 billion per year. There is a western migration. Since 2002, over 100 buildings in the Boston area have been demolished equaling 6 million s/f. These sites are being used for other higher and best uses that are not industrial.

The Rte. 495 beltway, since 4Q 2018, has 2.5 million s/f of speculative development. The Worcester Connector is attractive as it can accommodate 11 million s/f in multiple sites combined. The Rte. 128 corridor is saturated with urban infill. Everything is being pushed out of Boston. Rte. 2 out by Rte. 495 will become popular. Rte. 146, Lancaster and Fitchburg are becoming popular due to the lack of space.

Capital Market: Chris Skeffington of CBRE

Skeffington started with a macroeconomics observation. In the first half of 2019, foreign capital was attracted to the U.S. The U.S. cities that attracted foreign capital based on the square footage of supply purchased were in this order:

1. Seattle

2. Boston

3. Los Angeles

4. Manhattan

5. Chicago

Skeffington then reviewed Boston capitalization rates for office and life science buildings. For office he cited 100 Summer St. sale at 4.5% cap rate; 99 Chauncy at 5.01% and 75 State St. at 4.8% cap rate.

For Life Science buildings, the Osborne Triangle sold at 4.68% cap rate, 1030 Mass Ave. sold at 4.53% cap and the Linx in Watertown sold at 5.96% cap rate.

For industrial product cap rates, the Boston Metro area experienced an average cap rate of 5.71%; 150 Charles Colton, Taunton sold at a 3.6% cap rate and 1 Tech Dr. in Peabody sold at a 5.9% cap rate. Skeffington stated that these cap rates convert to a price per square foot range of $150-175 psf. He cited some examples of tenant demand and said the demand would continue.