A development in development - by David Skinner

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There is a different tone in the industrial world, specifically in the development. You could say, there have been some developments in development. These developments include markets like Boston, but also formerly secondary and tertiary markets like Southern New Hampshire, Providence, R.I., Central and Western Mass., to name a few. I will tackle each of these. In addition, I will address my opinion of cap rates and the effect that interest rates have on the broader industrial market.

1. Development in Boston;
2. Development in secondary or tertiary areas;
3. Cap rates.

Development in Boston has taken a very interesting turn lately. The gubernatorial change over the last election and the mayoral installation have both changed the landscape of Boston development. Perhaps not better or worse, but it has changed. For example, whereas before 2020 there was a race to find sites in and around urban Boston and the inner suburbs to develop or redevelop industrial, lab, cGMP, or other similarly related industrial uses, the environment now has cooled off as both governor and mayor are much more motivated to change the prospects for 1) sustainability in the city, and 2) affordable housing situation in and around Boston. In addition with this change and the proposed legislation for a greater required percentage of affordable housing in new larger scale developments, it has become more difficult and less cost effective to both create a pro forma that works taking into consideration these costs and the reduced income for the project. Under normal market conditions, these trends in what we would call “market fundamentals” would typically result in lower sale prices. However, this is not necessarily the case because the last 10 years of pricing has shown a hockey stick trajectory—namely up and to the right. The prices have always gone up, so why would anyone take a haircut on the price? Of course no seller is forced to sell, and therefore something must give. If sale pricing will not give, and buyer demand will not give, market velocity will give. Buyers and sellers will cease to transact, which puts a real stall on the market. This is where we seem to find ourselves, especially in the urban Boston marketplace. In addition to this, financing has become far more onerous, even impossible where many banks are not interested in granting loans on speculative construction. This is even happening in premium areas for industrial and residential developments, arguably the most valued kinds of developments over the last few years.

Secondary and tertiary areas have also seen a change, namely that investors and developers are still looking here to find value. The spread in what one can develop to has shrunk so low that many larger developers are looking to places like I-93 and Rte. 3 as they extend into Southern New Hampshire, I-95 into Rhode Island, and I-90 in Worcester, Springfield, and I-84 into Hartford. We are still seeing value opportunities here as the spread is much larger than around I-495 much less Rte. 128. However, the risk here, as in any secondary or tertiary market is the vacancy risk. The difficulty to finance ground-up construction certainly also applies here, but construction costs in all markets, primary, secondary, and tertiary are what have most aggressively put the brakes on these deals. As in the markets like Boston, developers are waiting for construction costs to come back to earth before embarking on projects of any kind of real scale.

Lastly, a word on cap rates. I have heard many ask if cap rates are directly related to interest rates. The answer here must be qualified—yes, and no. It is true that if a deal made sense at a 5% cap rate because the debt was 2.5%, it would make sense that financing that same deal at 6.5% will not work out as well, or at all. But, reader, I leave you with this. Cap rate is simply a function of perceived risk. When interest rates rise, the effect is that the perceived risk in the market goes up. When the perceived risk increases across the board, it of course means that buyers will need to see a higher cap rate as a reward for the increased perceived risk. While this most clearly applies to stabilized assets, it certainly applies to development projects as the exit on these projects becomes harder and harder to attain.

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