Commercial Real Estate Update for the Baltimore Market

LAI Baltimore Chapter – February, 2019 meeting

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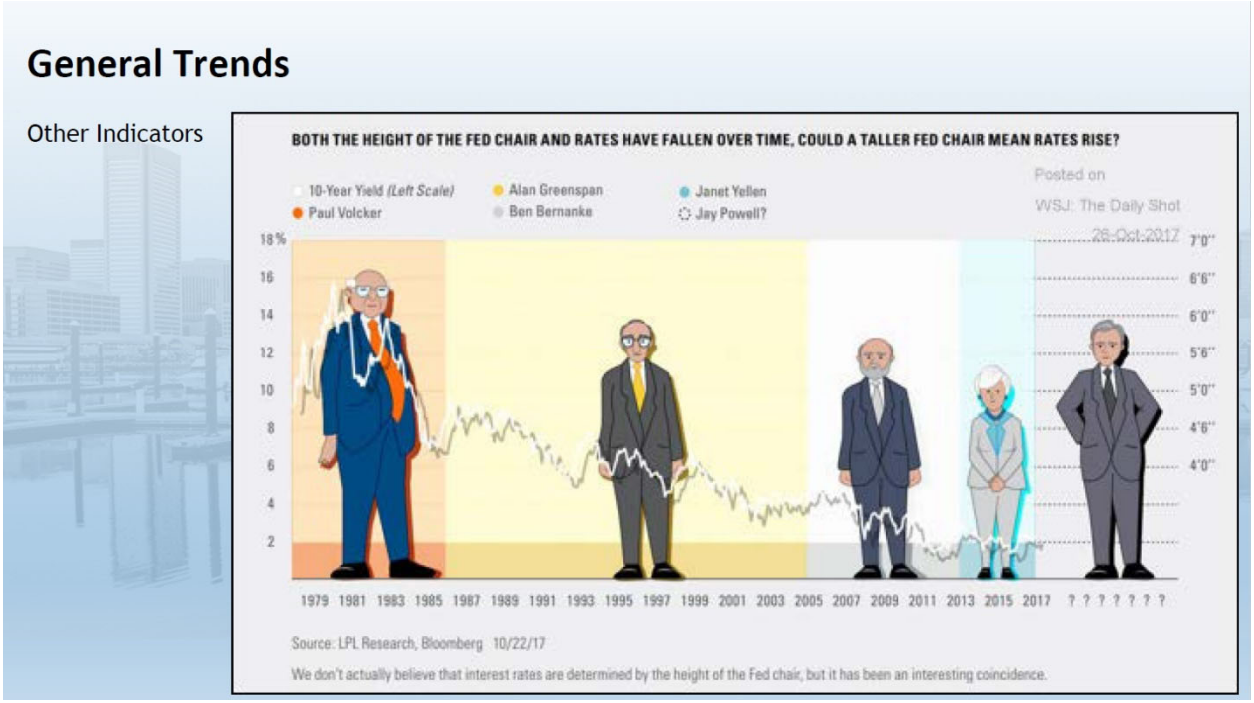
On February 27th, Michael Lester and Ed Steere provided the Baltimore Chapter of LAI with an overview of the commercial real estate markets, with emphasis on the Baltimore area market.

Michael Lester kicked things off with a high-level view of the national economic picture. Michael noted that most economists are currently trying to figure out whether the overall trend for the national economy is continuing to head up, or if we're now poised to see the economy begin contracting. He cited the positive trends including Consumer Confidence being at an 18-year high; the "sugar high" effect of the 2017 Tax Cut; and ongoing growth in employment numbers as pointing towards an economy headed up. Of concern however, are the CBO's projections of slowing employment growth, together with the slowdown in China's economic growth (down from around 10% annually in recent decades to now about 6%), and the prospect of additional increases in interest rates engineered by the Federal Reserve.

Michael pointed out that the flattening yield curve is also a potential indicator of slowing growth on the horizon, providing an interesting slide which compared the flat yield curve that preceded the Great Recession, with the fairly dramatic flattening that has evolved over the past several years. Does this portend a pending recession? Michael pointed out that a flattening, or indeed inverted, yield curve has preceded each of the past seven recessions experienced in the U.S.

Another even more reliable indicator Michael provided was highlighted by this slide:



As can be readily seen in the above slide, the height of the Federal Reserve Chairperson is highly correlated with the level of interest rates. Does Chairman Powell's stature mean rates will be on the rise? Let's hope that correlation ends with him.

Back on a serious note, Michael provided this snapshot of how the greater DC/Baltimore Metro area compares to the rest of the country:

Capital Markets - Nationwide

Metro Area Comparison

	Overall Investment		Office Investment		Industrial Investment	
	Metro	Volume ($m)	Metro	Volume ($m)	Metro	Volume ($m)
1	Greater New York	19,968	Greater New York	8,631	Greater Los Angeles	2,644
2	Greater Los Angeles	12,255	San Francisco Bay Area	4,015	Chicago	1,829
3	San Francisco Bay Area	10,023	Greater Washington, D.C.	3,350	Greater New York	1,481
4	Greater Washington, D.C.	7,854	Boston	3,113	San Francisco Bay Area	1,318
5	Chicago	6,994	Greater Los Angeles	2,884	Seattle	1,103
6	Boston	6,225	Chicago	1,546	South Florida	1,080
7	Dallas/Ft. Worth	5,605	Dallas/Ft. Worth	1,307	Dallas/Ft. Worth	1,049
8	Atlanta	4,231	Seattle	1,077	Atlanta	895
9	Seattle	4,010	Denver	1,070	Boston	757
10	South Florida	3,971	Phoenix	1,006	San Diego	753
11	Houston	3,851	Philadelphia	931	Memphis	582
12	Denver	3,789	San Diego	899	Houston	504
13	San Diego	3,478	Austin	705	Indianapolis	471
14	Phoenix	3,445	Charlotte	682	Minneapolis	446
15	Philadelphia	2,583	Atlanta	662	Phoenix	432
16	Orlando	2,248	Houston	606	Baltimore	431
17	Tampa	2,200	Minneapolis	503	Philadelphia	388
18	Charlotte	2,080	Raleigh/Durham	392	Jacksonville	377
19	Minneapolis	1,960	Portland	381	Denver	373
20	Raleigh/Durham	1,957	Nashville	348	Portland	372

	Multifamily Investment		Retail Investment	
	Metro	Volume ($m)	Metro	Volume ($m)
1	Greater New York	6,542	Greater Los Angeles	1,929
2	Greater Los Angeles	3,712	Greater New York	1,730
3	San Francisco Bay Area	2,317	San Francisco Bay Area	636
4	Dallas/Ft. Worth	2,309	Houston	706
5	Chicago	2,238	Chicago	636
6	Greater Washington, D.C.	2,165	South Florida	616
7	Houston	1,781	Boston	611
8	Denver	1,775	Greater Washington, D.C.	580
9	Atlanta	1,755	Atlanta	538
10	South Florida	1,508	Las Vegas	501
11	Phoenix	1,455	Dallas/Ft. Worth	424
12	Seattle	1,394	Phoenix	416
13	Raleigh/Durham	1,272	Richmond	371
14	Tampa	1,084	Detroit	310
15	Philadelphia	962	Seattle	290
16	Austin	898	San Diego	290
17	Charlotte	848	Tampa	236
18	Portland	793	Denver	221
19	Minneapolis	776	Charlotte	216
20	Boston	755	Raleigh/Durham	182

Source: CBRE Research, Real Capital Analytics, Q4 2018.

- Broken out, Washington is a top-ten market, with Baltimore in the top 20. Taken together DC/Balto is in top 5.
- Washington is more prominent in Office, Baltimore in Industrial. Together in MF at no. 6, and no. 8 in Retail.

With DC and Baltimore taken together, our Metro area is a top 5 commercial RE marketplace.

Michael provided graphic evidence that commercial RE sales activity has remained robust in recent years, despite an upward trend in cap rates, which can readily be seen in this revealing slide:

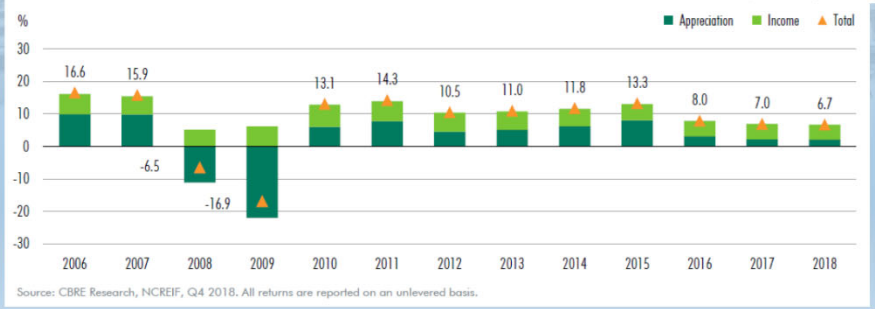
Capital Markets - Nationwide

Cap Rates/Returns

- Class B, Second- and Third-Tier locations are offering more attractive returns (esp. MF)

Property Sector & Segment	H2 2018	H1 2018	Change (bps)	Spread Over 10-Year Treasury (bps) H2 2018	H1 2018
Office - CBD	6.71	6.63	8	402	378
Office - Suburban	7.91	7.91	1	522	506
Industrial	6.34	6.41	-7	365	356
Retail - Neighborhood/Community*	7.50	7.40	10	481	455
Retail - Power	8.42	8.29	13	573	544
Retail - High Street	4.83	4.77	6	214	192
Multifamily - Infill	5.26	5.21	4	257	236
Multifamily - Suburban	5.56	5.53	3	287	268
Hotel - CBD	7.97	7.94	3	528	509
Hotel - Suburban	8.49	8.48	1	580	563

Source: CBRE Research, U.S. Department of the Treasury, Q4 2018. Spreads based on 10-year at end of period. *Grocery-anchored neighborhood and community centers.



Source: CBRE Research, NCREIF, Q4 2018. All returns are reported on an unlevered basis.

Ed Steere next addressed Opportunity Zones within the DC/Baltimore marketplace, opining that the OZ maps "are deceiving" in that they show large parcels such as Fort Meade as Opportunity Zones, when they are obviously not available for redevelopment. So, he cautioned the audience not to be swayed by current OZ maps.

Ed then provided and overview of the Industrial sector within the mid-Atlantic, advising that "vacancies are low" (at 7.2%) and absorption is robust (~6M SF in 2017). He opined that Tradepoint Atlantic is having a material impact on industrial absorption numbers given that our region typically absorbs about 2 – 3 million SF a year, but we're way above that with the large warehouses being rapidly leased within the old Sparrow Point site. Ed provided a succinct snapshot of the key metrics for industrial as follows:

Industrial – Baltimore Metro

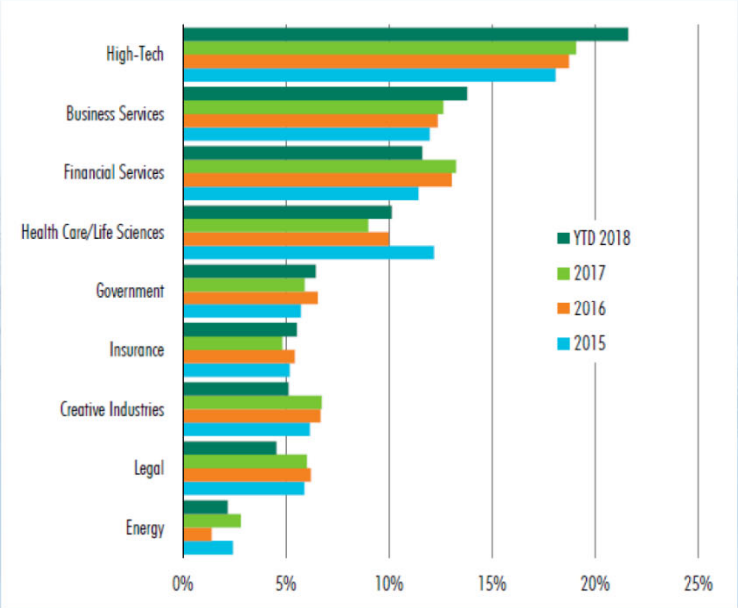
- Return to rent growth for Warehouse, spec development is finding tenants prior to completion.
- Developers are squeezing less space onto the same dirt than in the past, with tenants looking for larger truck courts and additional outside storage.
- Class A warehouse rents are reaching $7 and well into the sixes.
- 2017 was a record year for net absorption with 6.6 million SF; 3.9 million SF in 2018. 4.3 million SF are expected in 2019.
- Demand appears strong for larger spaces among users of over 500,000 SF in the Warehouse market driving vacancy to an all-time low 6.2%.
- Sales volume has skewed higher with acquisition of DCT Industrial by Prologis in the third quarter, the highest volume in a single year since 2005.
- Baltimore metro area cap rates have caught up to those in the DC metropolitan area.
- Rent growth surfaced for the first time in many years with Warehouse rental rates rising 3.7% to $5.55 per square foot triple net.

Michael Lester next addressed the "high level trends" in the office market. He advised that the office sector "suffered the worst" during the Great Recession, but has now recovered and is continuing to show improvement. Therefore he feels that there is "now an opportunity" within the office sector. Co-working spaces have had a positive impact on office occupancies. High Tech firms are now a significant segment of the office market as can be seen in this slide:

Office

National Trends

- Vacancy rates are down to the lowest level since 2007 (12.8%)
- Technology accounted for 21.6% of total office leasing followed by Business Services with nearly 15% (including co-working spaces)
- Overall asking rents are rising 1.9% year-over-year
- Tenant Improvement allowances are rising due to a rise in construction costs
- Spec development is still unusual (75% of delivered space is preleased)



Michael opined that "spec office is still too risky", so the great majority of new office construction is pre-leased. Baltimore's office market is "doing better than DC's", primarily because Baltimore's market is not overbuilt. "A lot of the cranes one sees on NY Avenue coming into DC are office projects – not all are multifamily projects". Overall, "there is real rent growth in the office sector"

Ed picked up the presentation from there, addressing both retail and multifamily. With respect to retail, Ed used Baltimore City's iconic Harborplace development as an example of the retail sector's woes. He opined that "rents are too expensive to maintain tenants" there, citing Five Guys and Noodles & Company as recent examples of retail operators who recently left because they couldn't justify the rent levels. Many retailers "have become showrooms for Amazon", opined Ed. Which is why most major retailers are pushing into on-line sales as aggressively as possible. Ed advised that "sticks & bricks" retail location rents are actually starting to decline as a result of the struggles by retailers to compete with Amazon and its ilk. The Big Question Ed opined is "What do we do with all the Big Box retailers?"

Shifting from the weakest RE sector to the most robust, Ed addressed the multifamily sector last. There is modest ongoing rent growth in multifamily (after quite a few years of strong rent growth). But that rent growth is being constrained by the propensity of Millennials to move frequently to take advantage of concessions. Ed put it bluntly, saying "Millennials are not loyal – they don't have the attachment to stay in place" that older generations do. For an overview of the Baltimore multifamily sector, Ed offered the following slide:

Multifamily- Are We Done Yet?

- 25,000 units delivered since 2010, 4,400 more on the way
- After completing more than 3,000 units in each of the past two years, developers will reduce delivery volume in 2019.
- Strong Renters' market -One third of properties offering some type of discount.
- People who once had to live in suburbs or rent an individual room can now afford downtown.
- Affordable/workforce housing is packed. Limited suburban construction
- Still able to achieve 1.5% rent growth during 2018. Most of this concentrated at older properties in Northeast, West, and Southeast Baltimore County. Class A buildings flat.
- MILENNIALS ARE NOT LOYAL! Take advantage of the free rent up front then move to the newest product across the street when it comes time to renew.

With respect to Baltimore, Ed advised that rent growth is slowing but occupancies are stable overall. Regarding DC, he advised that because of approx. 10,000 units in the pipeline, rents in the City would trend up very modestly. And in the DC suburbs, rents would be flat with increasing incentives offered. Ed opined that multifamily development "would slow down considerably in the coming two years", and offered this perspective on apartment units brought on line in recent years:

Multifamily

Historical and Projected Deliveries

HISTORICAL AND PROJECTED DELIVERIES IN THE DISTRICT (NUMBER OF UNITS)

2015	2016	2017	2018	2019	2020
2,249	4,071	5,878	5,488	5,916	3,155

HISTORICAL AND PROJECTED DELIVERIES IN NORTHERN VA (NUMBER OF UNITS)

2015	2016	2017	2018	2019	2020
5,106	6,110	3,703	5,203	3,597	3,872

HISTORICAL AND PROJECTED DELIVERIES IN SUBURBAN MD (NUMBER OF UNITS)

2015	2016	2017	2018	2019	2020
4,812	4,322	4,385	2,970	1,742	2,749

HISTORICAL AND PROJECTED DELIVERIES IN BALTIMORE (NUMBER OF UNITS)

2015	2016	2017	2018	2019	2020
1,575	3,534	3,919	2,979	2,069	2,805

Source: *CBRE Research, CoStar August 2018*

The members of LAI's Baltimore Chapter thank messrs. Lester and Steere for an excellent overview of the commercial RE industry.