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2018 OUTLOOK

By Steve Lewis,
Sponsored by SIOR Foundation

How long will real estate's "hot streak" continue? At least through 2018, according to the experts. The Urban Land Institute (ULI), in its "Real Estate Consensus Forecast," predicts a number of areas of continued strength, both in those that create a fertile atmosphere for commercial real estate growth, and in specific key sectors. For example, ULI predicts:

• Transaction volume of $450 billion in 2017 and 2018, and $430 billion in transaction volume in 2019;

• GDP of 2.3 percent in 2017 and 2.6 percent in 2018, with a decline to 2 percent in 2019;

• A total of 920,000 single-family housing starts in 2019, up from 781,500 in 2016;

• Commercial financing (through commercial mortgage-backed securities) will remain at $76 billion in 2017, then grow to $80 billion in 2018 and $85 billion in 2019;

• Commercial real estate price growth will ease to 5 percent in 2017, 3.5 percent in 2018 and 3 percent in 2019;

• Commercial real estate rent growth will be between 2 percent for apartments and 4.6 percent for industrial assets in 2017, then around 2 percent for apartments, office assets and retail assets and 3 percent for industrial assets in 2019.

SIOR's are also bullish for prospects in the coming year. In fact, when it comes to industrial real estate, "I am bullish for the next three years," asserts John Culbertson, SIOR, Senior Vice President for Brennan Investments Group in Charlotte NC.

Danny Zelonker, SIOR, Broker-Partner with Real Miami Commercial RE, LLC, agrees. "I think it looks great," he says.

And Gabriel Silverstein, SIOR, Managing Director, Director of Capital Markets at SVN | Angelic in New York City, sees a strong office market as well in 2018. "The general office market is in good shape," he observes.

Strong Prospects for Industrial Market

Nationally, industrial occupancy is over 95 percent, Culbertson reports, and rent growth has been exceeding 5 percent for the past two years. "There's a positive absorption streak where more space has been leased than built for 27 consecutive quarters, according to CBRE," he says.

Industrial developers have always tended to be a little conservative, Culbertson continues, which has helped contribute to this absorption streak. Still, he notes, they have a lot of reasons to believe the market will continue to be strong. "One is housing; there's a strong outlook for single family housing for the next three years," he says, echoing the ULI prediction. This, he points out, is key for distribution.

"It's not only the trusses and sinks and plumbing fixtures, and all the [building] materials, but when they're out of the house what happens? They go to the mall and buy furniture and get beds and go online to buy new picture frames, and so on," Culbertson explains. "There are huge acquisitions that result in a great boom for many industries."

The lowering cost of energy, he adds, results in more manufacturing being done in the U.S. In addition, things like fracking allow for energy producers to invest in equipment that is very heavily industrial, requiring a lot of manufacturing and warehousing.

E-commerce is another strong factor, notes Culbertson. "Compounded online growth is 16 percent versus 2 percent bricks and mortar, and that will result in a lot more distribution," he predicts. Finally, he says, banks are very strong, which results in more lending for manufacturers who are moving jobs back to the U.S. from abroad and investing in robots and high-end manufacturing.

Beyond that, says Culbertson, this growth will be broad-based -- across all industrial products and nearly all of the industrial markets. "The only ones I've seen lagging are in northern Michigan and parts of Wisconsin – otherwise it's a strong story no matter where you go and what product you build," he summarizes.

What does that mean to him as an investor? "We are value-oriented, so we are looking harder at our development pipeline," Culbertson shares. "We have done very well this year with developments in Florida and elsewhere in spec distribution," he says. Such a strong industrial market, however, can be a challenge for a broker, he says. "It's tough; there's no inventory with a 31/2 percent-4 percent vacancy; prices are rising a lot," says Zelonker. Demand is so strong, he adds, that "even bad neighborhoods are hot."

Zelonker cites a steady influx of population as one of the key sources of this strength. The political problems in South America, and even in Europe, are contributing to the demand for U.S. real estate, he notes. "I'm even selling land," Zelonker says. "Near Homestead it's very hot – but few people can build affordable units when it's up to $25,000 a door."

While he naturally wishes for continued market strength, he predicts a "big correction" somewhere between the end of 2018 and 2019 — not in industrial, but

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in housing and condos, and “everything will affect industrial real estate.” Still, he maintains, the market will still be relatively strong because there’s not that much building.

For Culbertson, the only contingencies that could change how 2018 unfolds would be a spike in inflation, or “If Trump is not able to push his agenda, and [the economy] ends up in a quagmire.”

How can an SIOR prepare for such contingencies? “The way to protect yourself is to know what you do really well, and to be disciplined,” he advises.

‘Some Leveling Off’ in Office Market

While he still envisions continued strength in the office market, Silverstein notes that certain factors typically emerge at this point in a cycle. That includes, for example, an increase in rental concessions as absorption begins to level off.

“We will continue to see rental rates move up, at least in the CBD and some suburban markets,” he says, “But I also think we will see concessions moving up because when you get a leveling of absorption, logically that’s a flattening of the demand curve. Typically later in an expansion and cycle you see people willing to give bigger allowances, and we will continue to see that.”

Still, he observes, we continue to have good employment levels – historically low, in fact. “Still, there’s a problem when you go from the U3 (the official number) to the U6 number (which includes workers who are part-time for economic reasons). There’s a major shift in workforce participation; many aren’t even trying anymore and we’ve got to get them back into work or at least into the market.” The office market can only continue to expand, he notes if people “fill the seats.” Otherwise, you can run out of people to take office jobs and fill the square feet built. There has already been some leveling off of absorption in New York and other markets, says Silverstein.

He also predicts a long-term jobs shift. There is more and more office job creation relating to technology, and over a long period of time places like Seattle, Denver, San Francisco, San Jose, Boston, New York, Raleigh-Durham and Austin will continue to benefit, he predicts.

So, for example, as Amazon searches for a home for its “HQ2,” while there is a lot of hubbub over many potential locations, Silverstein believes that after New York, Chicago, Dallas, and perhaps Denver it drops off precipitously. “I think these will be stronger cities on absorption and getting things like the Amazon deals,” he predicts. “Other than that I see reasonably flat absorption numbers.”

CBD Over the Suburbs

Silverstein says he is generally not very bullish on the suburbs around the country. “It’s not so much about Millennials,” he says. “The bigger issue to me is more fundamental; it’s harder in the suburbs. They are generally much smaller than CBD buildings. You don’t create that scale, which gets to some things that are very critical.”

Those “things,” he continues, include being transit-oriented and quality of life. “CBDs have lots of restaurants in walking distance, and car-share,” Silverstein notes. “Those suburban projects that can check those boxes will be much better than stand-alones. But the biggest problem is that with an average size of 60,000-100,000 square feet, the cost of technology and infrastructure for office space users today — and the increase going forward — requires the constant and very expensive re-investment of building structure. You need bigger square footages to do that.”

Build-out costs, he continues, have doubled or even tripled with technology. Beyond just electrical capacity, there is now open architecture and far denser office space. Heating loads and cooling requirements can’t be met in the suburbs with a redo without huge expenses.

Silverstein tells the story of a recent contact in Chicago with a very well known suburban office developer who “has one of the nicest developments, and was about to sign a contract to sell two truly Class-A buildings." The price, he shares, was about $80 a square foot, or less than half the replacement cost. "Here we are towards the end of one of the longest expansions in history and he's selling at a price less than half the replacement cost; that's an unbelievable statement about the suburban office market," Silverstein asserts.

While some markets, like Raleigh-Durham, are suburban in nature, Silverstein believes suburban office markets in general will continue to struggle. There are a lot of obsolete buildings, he states, and he clearly "sees a shift over, say, the next 10 years."

However, he adds, there is an interesting angle when it comes to smaller investors; after all, they can't buy 1.5 million square foot buildings. "If you want to buy something much smaller you will always be somewhat relegated to a suburban product and you will do your best to maintain it as a value play," says Silverstein. "What I do think you will see is a declining stock of suburban office product; the square footage that exists will either drop over time in most cities or if it expands it will do so at a slower rate than the CBD will."

Global Issues a 'Wild Card'

The single biggest factor that could change everything is the geopolitical sphere, says Silverstein. "We haven't had, ironically, a geopolitical upset in awhile," he observes. "And despite the fact that there's a lot of rhetoric and concerns I do not necessarily expect that, although at some point we've become overdue for it." However, he adds that "you can't plan for that."

The other "wild card," he continues, is the global economy, which he currently believes has more potential to the upside than to the downside.

"It has really not kept up with the U.S. economy over the past seven years," he notes. "The downturn is as acute and jarring as it was here, but at least we've started on an uptrend and in some ways are ahead of past records – like the length of expansion."

Europe, he observes, is only finally "kind of back," and just now emerging as a potentially positive influencer on our market. "I expect some level of rebalancing of focus of global portfolios, and likely some of that overseas money may cycle out of the U.S.," Silverstein predicts. "That said, a lot of international money comes to the U.S., and some is even focused on second- and third-tier markets."

The Germans, for example, have been one of the more consistent cycle after cycle investors in the U.S., but the viewpoint has been that German money historically would not be anywhere you couldn't get to on a direct flight, says Silverstein. But he says he now sees a little more willingness to move into very good second-tier markets (i.e., Columbus, Ohio) as the Germans have become more sophisticated in the U.S. and know these markets have some quality as well.

A Different Future?

How should SIORs adapt to the future market shifts such as the ones Silverstein has cited? For instance, should they concentrate more on CBDs and less on the suburbs? "As a broker there's always a clearing price for something – people are always buying and selling," says Silverstein. "I don't think you necessarily throw [the suburbs] away, but you need to be completely aware there will be a continued shift — and a sustained one — unless we see something else significantly change."

So, if the number of brokers active in the suburbs holds steady "There will be fewer things to eat for the same number of people," Silverstein predicts. "Now, if you are a tenant rep broker you will have fewer tenants to go for, but you will be able to make them great deals. But as product [desirability] shifts from the user and investor standpoint, you will probably see a shift in broker focus."

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