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The Culture of "Better"

A DIVERSIFIED GROWTH PLAN AND VISIONARY BUSINESS TENETS HAS KEPT MARCUS & MILLICHAP ON TRACK FOR OVER FOUR DECADES

From left: Gene A. Berman, John J. Kerin, William E Hughes, George M. Marcus, Hessam Nadji and William A. Millichap

2013's DEALS OF THE YEAR

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Property Sectors in Focus

A NATIONAL UPDATE ON THE MAIN ASSET CLASSES AND WHAT TO EXPECT GOING FORWARD

By Carrie Rossenfeld

All commercial real estate asset classes appear to be healthy and thriving. But each property sector has its own strengths and weaknesses, so examining each of the main categories gives us a more nuanced perspective on each and a better understanding of where we are and what's to come. Here, Real Estate Forum takes a separate look at the four main property sectors—office, industrial, multifamily and retail—to reveal the current and emerging national trends in each.

OFFICE: SNAIL'S-PACE IMPROVEMENT

US office-sector recovery remains slow, but the market is tightening, according to Cassidy Turley. Recovery is uneven, although overall, 2013 was a positive year for absorption. On average, US office vacancy tightened by 50 bps from the previous year to 15.3%, the firm reports. Regionally, the South and the West led the way, absorbing 62% of total office space absorbed nationally. Fitch Ratings classifies the national office market as moving from negative to stabilizing, with moderate improvement expected in overall fundamentals.

Jerry Holdner, VP of market research for Voit Real Estate Services, tells Forum that national office vacancy rates have been trending downward since the beginning of 2010, with class-B space dropping at a faster rate than class-A space. "Lease rates have begun to increase and demand remains high for the purchase of trophy class-A buildings. Also, construction levels remain well below average for office buildings."

The tech and energy sectors continue to capture outsized revenues, according to Studley, and Silicon Valley, San Francisco and Houston are unique, with availability rates creeping ever lower; the first two regions' availability rates are below New York City's for the first time in more than a decade. Coldwell Banker Commercial cites Reis and Real Capital Analytics in listing the five top-ranked office markets in terms of changes in vacancy, rental rates, population and unemployment: Orange County, CA; San Jose; Denver; Charleston, SC; and New York.

Hans Mumper, executive managing director for Colliers International, tells Forum, "We have turned the corner in most submarkets in terms of vacancies and leasing activity, and there is

growing interest from investors, both domestic and foreign, in all categories of office space, which is a positive sign that should strengthen the office markets unless something unforeseen and unpredicted takes place."

The most notable development trend in the office sector is creative office, which is growing as users seek a more collaborative, less structured workspace that promotes efficiencies on many levels. While this trend can be found across the country, it has not necessarily been embraced by all markets. One problem—or opportunity, depending on how one views it—that creative office has engendered is a need for parking, especially since this type of space allows for greater density in the same footprint. This is one reason why creative-office space is thriving in urban and transit-oriented markets where public transportation is widely available and many people walk or bike to work.

Creative office is also creating construction work in a development cycle slowed by excess inventory, allowing developers to rehab older buildings and make them sustainable in addition to providing an environment for greater densities. Jim Proehl, EVP and managing director for the western division of NAIOP SoCal, recently told Forum's sister news website GlobeSt.com, "The way tenants utilize space in office buildings is continuing to change and evolve as companies reduce the number of private offices and increase the amount of collaborative areas. Major capital investment in tenant improvements and technology will require longer-term leases to amortize these greater capital expenditures."

On the investment side, office investors are the most cautious of the lot, according to Craig Tomlinson, senior director of Stan Johnson Co. He tells Forum that the single-tenant office market is somewhat insulated from macroeconomics and the long-term trends affecting multi-tenant markets. "Most single-tenant office space is 'mission critical' and driven by the labor shed or customer mandate. For 2013, single-tenant office sales totaled $14.9 billion, exceeding 2012 volume by a whopping 35%. The positive trend continues into Q1 '14, with Real Capital Analytics projecting $5.2 billion in sales of this asset class."

INDUSTRIAL: CLIMBING UP THE RANKS

The industrial sector continues to gather strength. Some experts view industrial as the next industry darling, but it still has a way to go before competing on the world stage, according to Cushman & Wakefield's 2014 global manufacturing index, which ranks the top 30 manufacturing locations worldwide by assessing costs, risks and operating conditions. The index places the US ninth among all regions as the most suitable to expand or relocate.

Data centers and large big-box distribution centers that cater to e-commerce, logistics and retail continue to be the primary demand drivers for industrial space, which could reach 250 million square feet in 2014, according to a recent study from NAIOP Research Foundation, surpassing the near-record level of 233 million square feet in 2013. The organization attributes this significant level of absorption to the expected return of housing construction, which requires warehouse space for building materials, appliances and furniture; the continued expansion of e-commerce, which shifts goods from retail stock rooms to fulfillment and distribution centers, and the improving economy, which is expected to grow by more than 3%.

Thomas J. Bisacquino, president and CEO of NAIOP, remarks that demand for all types of industrial space—warehouse, fulfillment/distribution centers, manufacturing and flex space—is robust thanks to e-commerce, and study authors Dr. Hany Guirguis and Dr. Joshua Harris predict growth will most likely result from the construction and retail trade sectors. The report also predicts that 2014 quarterly net absorption will range between 60 million and 65 million square feet; 2015 quarterly net absorption figures will range between 61.5 million and 75.2 million square feet, with a mean forecast of 68.8 million square feet; and as consumers purchase items online vs. in person at traditional stores, demand for distribution and fulfillment centers will increase.

"While we are encouraged by this positive growth in industrial, it is important to recognize that the same demand isn't being experienced across the industry," says Bisacquino. "The commercial real estate industry as a whole has yet to reach its full potential due to uncertainties about fiscal policy and an unsteady economy."

Nevertheless, industrial vacancy rates, which average 8.4% nationwide, according to Cassidy Turley, continue to tighten in most markets, particularly those near ports such as Southern California. One issue, particularly on the West Coast, is finding developable land on which to build industrial facilities. Some coastal markets are creating industrial centers further away from ports, such as the Inland Empire, which is booming with large-box industrial.

David Boyd, principal of Boyd Commercial/CORFAC, tells Forum that industrial activity, development and absorption is stronger than pre-recession levels nationwide, and Cassidy Turley reports that absorption in this asset class is the strongest it's been since 1998. "The hottest markets are Houston and California's Inland Empire," says Boyd. "Yet, Kansas City is seeing large-format industrial built speculatively by outside investors, which until a couple of years ago was unheard of, and Houston has become a 'gateway city' in the eyes of the investment community, in part because of population—Houston is one of the five largest cities by population in America now."

Boyd adds that he recently counted 15 speculative developments occurring in various stages in the Houston market. "However, the other 'big three' industrial markets in the US—Atlanta, Chicago and New Jersey/Eastern Pennsylvania—are still build-to-suit markets. New industrial is being delivered in those markets, but they are not quite ready for spec."

Industrial rental rates began to grow in 2013, but still remain low at just under $5 per square foot, according to CBRE Research. The firm reports that rents have been rising since 2010 and are expected to exceed 4% this year—a rate above inflation—and available rates have either reached or are nearing full recovery in many markets.

With rental rates rising, industrial development, which took a clear hit during the recession, may soon rebound. CBRE reports that more than 200 million square feet of new space was completed in the first year of the recession, but as rents plummeted beginning in 2009—in some cases by more than 40%, peak to trough—many projects were put on hold or canceled entirely. Absorption represented the nation's strongest year since 2005, but only 66 million square feet of space was added from construction. With availability rates falling and rental rates rising, speculative building may become more attractive to developers.

Also fueling potential development is the fact that demand for industrial space continues to soar, reports Cassidy Turley. Net absorption has been consistently 10% over the pre-crisis average

for three straight years, and the sector has now absorbed 178 million square feet more space in the recovery than was shed during the recession. Kurt Strasmann, senior managing director for CBRE, tells FORUM that because of e-commerce, "2013 was the best year for the US industrial market since 2007. The national industrial availability rate dropped 40 bps during the fourth quarter of 2013, ending the year at 11.3% for the year. During that time, the US absorbed 77.7 million square feet of space, representing the 14th consecutive quarter of positive net absorption." Strasmann sees the 66 million square feet delivered last year as a positive, with 2013 representing the strongest year since 2009 on the development front.

One issue holding back industrial construction is the fact that in many cases land is going to higher use, experts say. "There's no question large-scale industrial projects have been very popular in coastal areas where land is available," Salvatore Provenza, SVP with Colliers International, tells FORUM. "However, many municipalities and their residents have rejected this type of mega development in favor of alternative land uses. Land owners with desirable infill parcels are economically compelled to consider more housing. Projects originally slated for industrial buildings in Southern California are being redesigned for mixed-use communities with 'for-sale' housing, apartments and retail. Homebuilders and apartment developers are eager to secure these sites and are paying a premium for the right infill site."

On the investment side, Cassidy Turley reports that industrial sales activity, warehouse and flex, was slow in the first half of the year and strong in the second, with 2013 going down as another year of growing momentum for the capital markets. From January through November 2013, sales volume of significant industrial properties totaled $40.5 billion, up 28% compared to the same period a year ago. The warehouse sector is driving most of the increase in activity, with sales volume up 36% during that time period, and flex sales were up 11% over the same period. The warehouse sector is also experiencing a strong acceleration in price appreciation, with average cap rates moving downward 20 bps from the beginning of the year to 7.3% in November.

"Office lease rates have begun to increase and demand remains high for the purchase of trophy buildings. Construction levels also remain well below average."

JERRY HOLDNER
Voit Real Estate Services

RETAIL: E-COMMERCE POUNDING STORES

E-commerce is still taking its toll on brick-and-mortar stores nationwide. In fact, GlobeSt.com recently reported that, according to Green Street Advisors' 2013 Mall Outlook, online shopping is stealing more than 100 basis points per year of sales growth from brick-and-mortar stores. The report also shows that roughly 15% of currently operating malls in the US will either be fully or partially repurposed into something other than retail or closed in the next 10 years—this is up from a 10% estimate several years ago. The nation's strongest malls will continue to gain market share, while weaker malls are at risk.

Fitch Ratings reports that, while retail is continuing its bumpy recovery, it is stabilizing. Vacancy rates are continuing to decline, hitting their lowest levels since the recession, and sales growth is moderately improving, with the organization estimating annual growth in the 4% range for 2014. The Northeast and West regions showed the lowest vacancy rates, while several distressed Florida malls liquidated at greater than 100% severity.

Fitch also reports that holiday sales were up, but similar to the previous quarter's back-to-school sales, they were heavily discounted. Online sales were up 10% in November and December, likely taking away from brick-and-mortar stores. Also on the downside, JC Penney announced store closings post-holiday, and sales remained weak but up in the 4th quarter. Same-store sales were up for Costco by 5%, Target by 2%, JC Penney by 1% and Gap by 1%, but down for Sears by 9%.

Store footprints are shrinking for many retailers. Michael Weiner, president and CEO of Excess Space Retail Services, tells FORUM that this trend, which started slowly a few years ago, will continue to build momentum and likely continue well into the next decade. "Omni-channeling, in which retailers track their customers across both virtual and brick-and-mortar sales channels, is creating an environment where consumer traffic—and ultimately the point of sale—is often driven to the retailers' websites or mobile apps. Retailers' sales will be increasingly derived through the Internet as consumers continue to become technologically savvy, Internet access becomes increasingly available to more consumers and security on the Internet improves. As a result, over time, fewer shoppers will visit brick-and-mortar locations."

"Major capital investment in tenant improvements and technology will require longer-term leases to amortize these greater capital expenditures."

JIM PROEHL
NAIOP Southern California

Although this trend presents some challenges to the retail real estate sector, it isn't necessarily bad for retailers. With less consumer traffic, and consequently a decreased need to maintain large inventories within stores, many retailers will require significantly less space, says Weiner. "In addition, retailers have made great strides regarding their technological sophistication. This has allowed them to connect with their consumer base like never before. By learning their consumers' interests and needs and carrying more popular queues, retailers need less inventory and, accordingly, less square footage. Moreover, distribution efficiencies allow retailers to replenish the

inventory in stores at a much faster pace."

Weiner also points out that economic factors will ultimately play a role in decreasing store footprints. "There has been a compression of the middle class, and if this trend continues, many retailers will be adversely impacted, creating additional pressure to close stores and reduce store footprints. "

Gwen MacKenzie, president, brokerage services, for the Woodmont Co., tells Forum that national retailers are also adapting by considering and committing to sites in previously overlooked secondary markets, including areas like Bismarck, ND, and Great Falls, MT. "Although the density in these areas is somewhat sparse in the immediate vicinity, retailers have proven they can pull from a much larger radius than they originally projected. There is a lack of competition in many of these areas, which provides a great opportunity for high sales volumes. In addition, those retailers entering these markets in the first waves can achieve customer loyalty and market share, which will provide a competitive advantage in the future as these areas continue to grow."

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CRAIG TOMLINSON
Stan Johnson Co.

One of the most significant changes that has occurred in the retail sector is the transition of big-box space, Matt Hammond, director of retail brokerage for Coreland Cos., tells Forum. "While traditionally big-box retailers have served as key anchors, today's owners are now looking to fitness centers and specialty grocers to bring in a healthy stream of customers."

With e-commerce continuing to impact the health of a variety of retailers, the focus has shifted to finding shopping-center tenants who fill a need that you can't fill from your laptop at home, Hammond adds. "Entertainment components continue to be the key for healthy shopping centers. Whether it is a marquee restaurant, a variety of QSRs or a theater, these tenants give people reason to shop. They have become the main driver at retail destinations, from regional malls to neighborhood shopping centers."

MULTIFAMILY: ENTERING A COOL-DOWN

Multifamily, which has been hailed as the hottest sector for several years, is now beginning to cool, experts say. GlobeSt.com recently reported that annual effective rent growth for multifamily has continued flattening out, especially in the urban core of many markets, according to Dallas-based Axiometrics. Nationally, effective rent growth for apartments in January remained essentially flat at 2.8%, compared with 2.7% in December 2013. The annual growth rate peaked at 5.3% in June 2011, and has slowed in eight of the past 12 months. "As we get further into 2014, concern remains about which MSAs will become oversupplied as new supply outpaces demand," says Jay Denton, VP of research with Axiometrics, which has projected that 240,000 new units will be delivered nationwide by year's end.

"The industry as a whole has yet to reach its full potential, due to uncertainties about fiscal policy and an unsteady economy."

THOMAS J. BISACQUINO
NAIOP

Freddie Mac reports that it expects multifamily rent growth and vacancy in the coming year to be consistent with long-run average performance at the national level, slowing a bit from 2013. In the past few years, metro-level rent growth and vacancies have consistently improved with national averages. The organization expects more dispersion as some metros will continue to improve while others will slow due to varying supply-and-demand conditions.

The 25- to 34-year-old age cohort is seen as a key driver of demand for rental housing, according to Freddie Mac. Assuming employment conditions return to previous norms, this could add 1.6 million new workers from this cohort. The GSE also reports that favorable investment conditions persist, but have moderated slightly because of increased interest rates.

According to Marcus & Millichap, ties to technology, energy and trade characterize the top-ranked apartment markets. Expensive housing and tight vacancy rank New York, San Francisco and San Jose highly, despite price fatigue from residents. Tight vacancy in Oakland-East Bay and Miami and robust job growth in Denver created a strong run-up, displacing Orange County and Los Angeles.

New supply thus far has been well-matched by rising renter demand, but it does add risk to space fundamentals balanced at 4.9% vacant, M&M also reports. The number of new units delivered in 2013 increased 84% over the prior year to 168,000. Another 215,000 units in 2014 will surpass demand for 176,000 units, increasing vacancy by 20 bps to 5.1%.

Sales volumes for the multifamily sector reached more than $100 billion in 2013, Faron Thompson, managing director for JLL, tells Forum. "We expect this trend to continue due to an improving economy and continued housing-market recovery. Sunbelt cities such as Atlanta and Phoenix are acting as later-inning markets and will pick up momentum in 2014 as the 24-hour gateway markets moderate."

High-tech markets are also experiencing a demand for multifamily properties, Thompson adds, with Fannie Mae and Freddie Mac continuing to play a pivotal role in multifamily lending. "However, we are also seeing capital from many different players, and we anticipate increased activity from national banks, financial institutions, CMBS and life companies." ◆