Education’s Driving Force in Boston CRE

Boston’s highly educated talent pool is increasingly attracting businesses to the city, contributing to significant rental growth, rising occupancy rates and demand for suburban housing. But will affordability, infrastructure and a concentration in technology dampen the growth prospects?

*Boston real estate is hot.*

Fueled by its high concentration of research universities and colleges and a highly educated, technically inclined workforce, Boston real estate has drawn growing institutional interest that has resulted in significant absorption across property types. In fact, in some sub-markets, vacancy rates are essentially zero.

For GreenOak Real Estate, such talent concentration means Boston has continued to outperform other U.S. major markets post-crisis. Human capital, recruitment and retention needs have become critical components of corporate growth strategies.

Mark Van Zandt, Head of East Coast for GreenOak, says Boston has been one of the firm’s most profitable markets in the current cycle, and the near-term outlook remains strong.

*“There is no better city in the world to access highly educated, highly motivated young people, than Boston.”*  
—Mark Van Zandt, GreenOak Real Estate

“Education and the city’s educational institutions have always been a driver for Boston’s commercial real estate market,” says Van Zandt. “But particularly this cycle, with technology and creative industries helping drive the U.S. economy, companies want to be where the talent is. There is no better city in the world to access highly educated, highly motivated young people than Boston.”

Dan Cummings, Head of Bain Capital Real Estate, concurs. “[Talent] is a huge strategic advantage for Boston. That advantage is evident in Greater Boston’s unemployment rate, which stands at 3.3 percent compared to 4.1 percent nationally. That trend that has helped office vacancy rates fall more than 100 basis points below the historical average.

**Constrained Supply**

And it’s not just talent and education that’s driving Boston’s commercial real estate fundamentals. Boston is a supply-constrained market, with limited new inventory coming online and long-term holders controlling an ever-increasing share of the commercial real estate market.

“There’s probably two more years until meaningful new supply comes to the Boston market,” says Van Zandt, whose firm has acquired 11, predominantly Class B office, assets in Boston since 2012. In 2017,
the firm bought the 741,200-square-foot, three-building Center Plaza, along Boston’s Cambridge Street.

The $365M deal highlights Boston’s supply dynamic at work. “There were only 15 large blocks of office space with over 50,000-square-foot available in Boston’s CBD at that time,” says Van Zandt. “Those 15 blocks of space totaled 1.6m square feet, but there were more than 20 tenants looking for around 2.2m square feet of space. It was a pretty powerful statistic for us.”

Those same supply constraints are being seen in submarkets such as Cambridge, which attract professional services, technology and biotechnology firms looking to hire from Harvard University and MIT. In the first quarter of 2018, office vacancy in Cambridge was 2.1 percent, while lab space vacancy was 0.9 percent. The submarket also experienced the second largest increase in rent growth among U.S. tech submarkets, according to CBRE, increasing more than 25 percent between 2015 and 2017.

The lack of new supply, coupled with heightened demand, means rental growth has been strong in Boston, with central Boston office rates increasing from around $48-square-foot in 2009 to more than $56-square-foot today.

The commercial real estate industry is carefully watching the uptick in interest rates, not least amid concerns about the potential impact on cap rates, NOI and property valuations.

However, RSM partner Troy Merkel says real estate investment managers should also pay attention to rising rates for one other reason—the potential need to refinance 2015 and 2016-originated debt earlier than the maturity dates of 2020 to 2023.

“Many investors refinanced properties when cap rates and interest rates were at their lowest in 2015 and 2016,” says Merkel. “When a lot of that five- and seven-year debt comes due there could be some real challenges for investors, particularly in the office space, with valuations lower than when they originally refinanced and interest rates much higher.”

CBD office values in the U.S. posted a 0.3 percent year-over-year decline in value to May 2018, according to the Real Capital Analytics CPPI valuation indices.

The decline stands in contrast to the performance of almost every property type which saw increases in valuations, CBD office values in the U.S. posted a 0.3 percent year-over-year decline in value to May 2018, according to the Real Capital Analytics CPPI valuation indices.

The Suburban Shift

The trends extend well beyond the central business district.

“Boston is getting more and more expensive for everybody and it’s driving people to higher-end suburban markets with direct access into the city,” says Taurus Investment Holdings’ CEO Peter Merrigan. “It’s where people want to be and need to be.”

Taurus, which over the past two years has acquired more than 2,000 apartments in the Boston suburbs of Everett, Malden, Beverly, Lowell, Chelmsford and Fall River, recently disposed of a land parcel in Wakefield and saw “extraordinary” demand.

“The lack of new supply, coupled with heightened demand, means rental growth has been strong in Boston, with central Boston office rates increasing from around $48-square-foot in 2009 to more than $56-square-foot today.

“Boston [is recognized] around the world as being one of the top locations globally to find talent in industries with meaningful growth potential and demand. That’s a huge strategic advantage.”

—Peter Merrigan, Taurus Investment Holdings

“Lack of affordable housing options is something already high on the agenda of state and city politicians,” says RSM partner Robert Langley.
some by more than 11 percent year-over-year. Even retail, significantly impacted by eCommerce, remained away from negative territory posting zero growth in May 2018.

“The key is returns,” says Merkel. “Investors need to carefully understand what their returns from a potential refinancing or exit could be at that future date. They may need to evaluate their projections and their future valuations given the maturity of the real estate cycle and give serious thought to what their debt situation could be in five-to-seven years.”

Another macro trend that real estate investment managers need to be mindful of is the war on talent—and the impact that weak growth in the working-age adult population could have on economic and job growth.

Robert Langley, audit partner at RSM, says clients are exceptionally focused on the issues of recruiting and retaining talent, whether internally in their own organizations or in providing highly-amenityed space for tenants to support HR strategies. However, Langley asks, with the large Baby Boomer generation heading into retirement and immigration policies in transition, “will the U.S. have enough workers to sustain the recent economic growth we’ve had?”

The U.S. total working-age adult population is expected to increase just 0.3 percent a year in the decades between 2015 and 2035, according to Pew Research Center compared to peak growth of 2 percent between 1975 and 1985 when the Baby Boomers came of age. Without future immigrants, the total U.S. workforce is projected to decline by more than 17 million people by 2035 to 165.6 million.

“It will be telling in the years to come how manpower and immigration not only impacts the growth of the economy, but also how it shapes demand for commercial real estate space on a going-forward basis. It’s something we all need to be thinking about.”

““There are significant demand drivers at play in Boston... and it’s creating some compelling opportunities to invest in transit-orientated suburban and inner-suburban markets.””

—Peter Merrigan, Taurus Investment Holdings

"Boston needs to retain its highly-educated workforce and to do that they need affordable housing options, including workforce housing,” Langley says.

The suburban spread means infrastructure needs are paramount.

"Boston is well-positioned to grow,” says Cummings. “The challenge for Boston is to be able to respond with infrastructure that respects the heritage of the market, makes it easier to move around and that is responsive to the opportunities in the market.”

For Merrigan, infrastructure is all about transit and connectivity. “I think transit is critically important to Boston. Traffic is difficult but we need to ensure we connect people with the job centers, with the urban core.”

“Transportation is one issue that could truly choke growth in Boston,” says RSM partner Troy Merkel. “If Boston wants to grow from a small, older city to a larger international market it needs to unlock infrastructure around the Seaport area and it needs to connect with the suburban communities with public transportation.”

Cycle Risk and Resilience

Despite the challenges presented by affordability and infrastructure, Cummings, Merrigan and Van Zandt all see room for growth in Boston’s commercial real estate market. “We are believers in Boston, we are actively looking for opportunities for investment and we are excited about the near-term,” says Van Zandt.

He cautions that Boston’s concentration on high-tech jobs this cycle could pose issues during the next economic downturn—even given the U.S. economy’s shift from financial services to technology-based industries. “That may provide some additional resilience to Boston [in the short-term], but the technology sector also feels very heated...,” he says.

“Also, Boston has historically been a volatile market. You can make a lot of money on the way up, but the opposite is true on the way down, which means you have to be more conservative on a going-forward basis,” says Van Zandt.

Merrigan, though, feels that Boston’s enduring edge in higher education and intellectual capital gives the market greater resiliency.

“I’m from Boston, I grew up here, I was educated here and I’ve been through a number of different cycles at this point,” says Merrigan. “What’s always quite compelling is how strongly Boston bounces back and how it usually enjoys a V-shaped recovery. That’s heavily driven entirely by the universities, which create huge demand drivers for a large number of corporations and industries.”
Creating Opportunities from Disruption

Technology continues to impact every facet of commercial real estate, according to LaSalle Investment Management’s David Schreiber—requiring LPs and GPs to stay aware of technological advances to make more informed investment decisions.

David Schreiber
Managing Director, Acquisitions, LaSalle Investment Management

Commercial real estate (CRE) has been undergoing a significant transformation in the past decade. What demand drivers will have the greatest impact on CRE in the next decade?

David Schreiber, LaSalle: Demographics, technology and urbanization are shaping everything that we’re looking at [within commercial real estate]. One way we’re seeing that within the office and multi-family space is through the greater need for building amenities. Prior to the last 5-7 years most office buildings didn’t offer or require conference facilities, fitness centers, cafes, tenant lounges and/or roof decks. But this has become a strong demand driver for today’s tenants. And that’s now a common investment strategy within the office space—finding opportunities to activate buildings by introducing full-scale amenities and making them more relevant to today’s users, thereby driving tenant demand, rental rates and, ultimately, building value.

CRE has been notoriously slow to adopt new technologies. Is the industry finally changing?

Schreiber: You’re seeing [technology being adopted] in a very pervasive way across all property types, and I think you’re going to continue to see adoption impact the way the built environment is used. For today’s tenants and users, technology is a daily part of their lives, and real estate will have to change to meet their needs.

That means, as an investor, it’s critical to stay ahead of new technology. I spend more time than ever before focused on disruptive technologies that are impacting real estate to evaluate how we can potentially integrate them in the properties we own and pursue.

But technology is also hurting some CRE property types, not least in retail. What property types are out of favor with investors today—and does that create opportunities?

Schreiber: Investor demand for commodity suburban office and big box retail has never been at more of a low—and that creates compelling opportunities for contrarian investors. If you look at the cap rate spread between high-quality urban and suburban office, or high-quality grocery anchored retail and generic big box retail, there’s a lot of opportunity for higher risk strategy investors to capitalize on that real estate being out of favor.

Not all real estate is created equal, of course. But there are a lot of very sophisticated investors taking advantage of price disinflation in the current market by buying well-located suburban office and high-quality big box retail centers at a very attractive cost basis.

The suburbs aren’t dead, people still live there and there certainly are a lot of companies that prefer suburban locations and will continue to prefer suburban locations in the future. But many of those tenants still want all the same amenities that users in a downtown office want. By activating higher quality buildings with locational advantages, that are close to transit, and by putting amenities in the building, significant value is being created.

What is happening in the urban core, the CBD, not least in Boston?

Schreiber: Urban migration has been an important trend nationally and that’s been a particularly huge driver in Boston. Companies such as GE, Amazon and Reebok are a few of many examples of companies migrating from suburban locations or other markets to Boston’s urban core for their employee recruitment and retention strategies.

Boston CBD office fundamentals have rarely been stronger than they are today. Urban demand is outpacing supply and it’s put significant upward pressure on office rental rates, particularly Class B office rents [as tenants search for greater rent value]. The market has demonstrated robust rent growth in recent years, and it’s now very difficult to find office space of any quality in downtown Boston for less than $50 per square foot gross.

Where are the greatest challenges given the U.S. CRE industry is so mature in the cycle?

Schreiber: The biggest headwind is rising interest rates. That will, at some point, put upward pressure on required returns and cap rates, and in turn could put downward pressure on real estate valuations. The counterbalance is that rising interest rates should eventually put upward pressure on rents and net operating income.

It means that current investing requires us to be increasingly thoughtful about where we are in the cycle and potential recessionary events. We address the potential risk of a softening economy in our pro-forma underwriting assumptions as well as by approaching certain opportunities with more caution, such as investments with binary outcomes like office buildings with outsized near-term lease expiration exposure.
What’s The Real Fallout of Rising Construction Costs on CRE?

“Higher construction costs have increased construction replacement rents to levels that are above most market-clearing prices. Both labor and materials have been inflating well above the level of the Consumer Price Index since 2013. While many markets demand [and need] the construction of new buildings, most cannot afford it or if they can, for a relatively few number of buildings. This has put a damper on significant supply in most markets around the country, maintaining favorable supply and demand levels.”

—David Lynn, Chief Executive Officer, Everest Healthcare Properties, a core and core-plus medical office platform investing primarily in net-lease assets

“While many people are talking about tariffs on steel, aluminum and lumber, challenges with construction labor are driving up the cost of build-outs and new developments more dramatically. Whether it’s finding their own people or finding enough labor for projects, the rising cost of labor is actually slowing projects down.”

—Troy Merkel, Partner, RSM

“Rising construction costs means that developers in most major markets can only make a 5.5-to-6.25 percent return on cost and to generate even this initial yield developers are forced to build upper-end rental product. The U.S. is congenitally unable to build affordable middle-income housing. Rising land and construction costs are one reason, but lack of political will power and financing are also causalities. Without land or financing subsidies the market simply cannot build affordable rental units.”

—Ken Munkacy, Senior Managing Director, Kingbird Properties, the U.S. real estate arm of a Puerto Rican family office focused on multifamily investments.

“Construction costs have been a big challenge and I don’t see any relief on the horizon. It impacts your ability to budget properly and make sure you have available labor when you go to complete a meaningful renovation project.”

—Mark Van Zandt, Head of East Coast, GreenOak Real Estate, a value-add platform focused on major gateway markets globally.

Construction Unemployment

Experiencing a 2.5 percent drop in 2017, construction unemployment started out the year at 8.4 percent and closed it at 5.9 percent.

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2017</td>
<td>8.4%</td>
</tr>
<tr>
<td>Q2 2017</td>
<td>4.5%</td>
</tr>
<tr>
<td>Q3 2017</td>
<td>4.7%</td>
</tr>
<tr>
<td>Q4 2017</td>
<td>5.9%</td>
</tr>
</tbody>
</table>

Average cost per square foot of gross floor space to build commercial real estate properties in the U.S. in the first quarter of 2018—up from $149.19 in 2013.

Prime office in Boston cost up to $475 per square foot of gross floor area to build in the first quarter of 2018, the third highest cost behind New York and Honolulu.

Source: Rider Levett Bucknall