WHAT DOES FUTURE HOLD FOR DEVELOPMENT?
SunTrust exec explores the roles that online shopping, ports, urbanization and nontraditional offices will play in the Southeast.

By Walt Mercer

The commercial real estate (CRE) industry welcomed 2014 with high expectations. With capital again more readily available and signs that demand is strengthening — especially in key Southeastern markets — there is reason to believe that the CRE sector is recovering along with the rest of the economy, albeit more slowly than many would prefer.

Making predictions about the current year is challenging enough in today's skittish business environment, but what about the next decade? While a longer time horizon is naturally more difficult to forecast accurately, it's vital to identify trends that are likely to play a key role in the health of the CRE sector over a longer term. There are already emerging factors that will impact the relative success or failure of CRE developments that are now just a set of draft blueprints.

A few of these factors — though not an exhaustive list — include declining per capita demand for office space.

Even though the Mid-Atlantic is home to some of the country's most favorable demographics, the lack of new development during recession years has led to tight vacancy rates and staggering high levels of retail leakage. Development companies are now eager to grab hold of the opportunity to meet this unmet demand by building projects in prime, infill locations.

There are currently 1.7 million square feet of retail under construction in Washington, D.C., according to the Washington D.C. Economic Partnership's 2013/2014 D.C. Development Report. Approximately 767,000 square feet of that is slated for a 2014 completion. Comparatively, more than 1 million square feet of new or rehabilitated retail space (representing $300 million in investments) will exist in metro Baltimore by the end of 2014, according to the Baltimore Development Corp.

The lack of availability has also established a very competitive market for prime infill locations to cater to an underserved retail market.

RETAIL RESURGENCE IN THE MID- ATLANTIC
Retailers, mainly grocers, have set their sights on prime infill locations to cater to an underserved retail market.

By Brittany Biddy

An uptick in net operating income (NOI) as a result of rental rate increases and improved absorption has driven real estate property values upward in major U.S. markets and across most all property types. Integra Realty Resources, in its Viewpoint 2014 report, projects that real estate values overall will rise each of the next three years. Integra contends that property fundamentals will boost values and will even offset potential increases in cap rates.

For 2014, total income returns for properties are expected to depend less on falling cap rates and high appraising for more

Lenders point to increased cash flow as boosting real estate property values in 2014.

By John Nelson

An uptick in net operating income (NOI) as a result of rental rate increases and improved absorption has driven real estate property values upward in major U.S. markets and across most all property types. Integra Realty Resources, in its Viewpoint 2014 report, projects that real estate values overall will rise each of the next three years. Integra contends that property fundamentals will boost values and will even offset potential increases in cap rates.

For 2014, total income returns for properties are expected to depend less on falling cap rates and high appraising for more

To see more information on this topic, visit www.REBusinessOnline.com.

INSIDE THIS ISSUE

Pike & Rose in Maryland offers diners, shoppers an upscale experience

Inn at Palmetto Bluff to Get $100M Upgrade

Nashville Market Highlight

Baltimore Multifamily Snapshot

page 8

pages 18-20

page 21
WHAT WILL THE FUTURE HOLD FOR DEVELOPMENT?

FUTURE from page 1

space, the growth of online retail sales, a large cohort of millennials seeking lifestyles with smaller urban living spaces and the East Coast’s new shipping prominence. Add the potential for a sustainable rebirth of domestic manufacturing, thanks to the natural gas boom and resulting lower energy costs, and you have the recipe for significant economic and cultural changes that CRE professionals would be wise to watch closely.

The impact of these factors will be particularly interesting to watch in the Southeast, which is already well-positioned for growth. Business friendly “right to work” laws, affordable housing options and lower taxes are making the region increasingly attractive to investors.

Following are key questions that investors, developers and others will be asking as they seek to translate trends into successful projects.

Will millennials continue to sacrifice square footage?

The millennial generation, which is now the largest population cohort the United States has ever seen, is emerging as an economic force equal to or greater than today’s baby boomers. Naturally, their housing and lifestyle decisions will impact CRE for decades to come. So far, they have demonstrated a strong preference for urban settings, which bodes well for multifamily and mixed-use developments in core downtown areas. If the trend continues, it could lead to accelerated gentrification of in-town neighborhoods as developers expand their search for land near urban cores.

However, it is hard to predict what this generation will do as they get older, marry and have children. Married millennials and their families may decide to purchase their first home in a mixed-use development in a close-in suburb where they can afford a larger condo, townhome or single-family home, while also maintaining some of the benefits of their former, urban lifestyle. This is a plausible scenario given the rapid urbanization of many suburbs.

Alternatively, millennials might decide to have fewer or no children so they can continue to afford their urban lifestyle — or delay children until they can buy a home in their desired neighborhood. It is also possible that millennials will return to traditional suburban communities in search of basements and better schools, putting the brakes on urban growth.

Regardless of which lifestyle selections millennials make, their decisions will have a profound impact on the CRE sector for decades to come.

Will declining office demand level off, slow or speed up?

The consolidated office and per-pervasive use of teleworking — not to mention the demise of the traditional office — has been predicted since the personal computer came along in the 1980s. The obituary was premature because companies and employees value the social interaction that happens most organically in a traditional office setting. However, that has not stopped per capita square footage in a typical office from declining to 100 from 150 as companies look for greater efficiency. The question is how low that number will sink before businesses find a new equilibrium.

According to the latest Metro Atlanta Regional Commuter Survey conducted in 2010, teleworking grew substantially over the preceding three years. The survey found that 7 percent of all commuters telework at least three times a week — up 75 percent from 2007. Recently, however, high-profile companies such as Yahoo! have scaled back their teleworking options, with management arguing that collaboration and teamwork were suffering. This incongruence seems to suggest that although technology improvements have made it easier to telework, there will always be advantages to collaborative work environments.

Speculative building has declined in popularity as developers and banks have become more risk averse following the recession. However, expect it to decline even more if teleworking continues its upward trend and companies see office space as an opportunity to cut costs. While the office sector will always have some level of imbalance between supply and demand such that new developments must be built to accommodate companies that need large blocks of space, it is possible that speculative building will become even more of a rarity. Teleworking could accelerate this trend.

How will shopping trends impact CRE development?

On Dec. 30, 2013, the Federal Aviation Administration went public with a list of six states where drone makers will test how to safely integrate the machines into commercial airspace. The announcement came shortly after Amazon’s CEO, Jeff Bezos, said that he wants to deliver the company’s goods via drone — even suggesting same-day delivery. While large-scale drone delivery may be far in the future, the consumer’s preference for online shopping is already here.

In order to draw even more business from brick-and-mortar stores, online retailers are trying to deliver goods faster and cheaper. In multifamily and mixed-use projects, developers have increased the size of storage closets at management offices to accommodate residents’ online purchases. They may ultimately have to adapt to new shipping methods and offer features to hold fresh grocery deliveries. In an industry where amenities rent apartments and sell condos, commercial refrigerators — or even a communal drone landing pad — are not out of the question.

From shopping centers to office buildings, most developments may
also need to accommodate new methods and scales for deliveries. Even industrial real estate could be affected as warehouses storing these goods may need to be replaced by larger buildings with higher clear heights. This could lead to new industrial developments and/or the retrofitting of existing buildings to meet these specifications.

Across all CRE sectors, developments competing with online retail will need to be smarter, more efficient and emphasize their unique value. Despite the competition, some retail developments will still thrive because people still like to touch what they are purchasing and take it home with them the same day. Grocery-anchored retail and high-end malls, for example, should continue to thrive.

What role will infrastructure projects play in Southeast?

The Panama Canal’s ability to handle larger ships — and the resulting port deepening projects planned in Savannah, Ga.; Jacksonville, Fla.; and other Southeastern ports — are bellwethers of the region’s economy. This could almost certainly move the CRE development needle in the Southeast over the next decade and beyond. The Port of Savannah, for example, is already the second-busiest container-exporting port in the United States and expects to process even more when the deepening is complete. The result is likely increased railroad traffic and the construction of inland warehouses and distribution centers to handle the increased volume.

Of course, this depends on the costly deepening projects actually getting completed. Those states that manage to get their projects approved and completed are likely to gain a competitive advantage over neighbors who either delay dredging or nix it altogether.

Another more localized example is Ponce City Market in Atlanta. This mixed-use project, combined with the Atlanta BeltLine (a network of public parks and trails under development along a historic 22-mile railroad corridor) and public transportation, is a prime example of looking forward to the current and future needs of the population versus looking back.

Broader national infrastructure projects will also impact the economy of the Southeast, such as our ability to become more energy self-sufficient and transport “capacity” to areas of the country that need it. Energy is still the largest single cost in the manufacturing process. If the United States continues to develop its own energy resources, manufacturing will likely continue to see a resurgence, especially in the Southeast.

The above factors create a unique landscape for the next wave of CRE developments. As planners look toward the future of the region, they will have to throw away traditional assumptions and focus on emerging fact patterns. Those in the industry who can maintain both a long-term and short-term vision of the region will create developments that stand out from the crowd and are economically viable. It is crucial that developers, bankers and other investors train a watchful eye on the lifestyle, technology and economic factors that will influence CRE over the longer-term, lest they make decisions based on traditional concepts that will be outdated before the ribbons on the new developments are ever cut.

Walt Mercer is executive vice president and head of commercial real estate for SunTrust Bank.