BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *Boston Metro Area*

2H/20

Health Crisis Derails Employment Growth and Clouds Real Estate Outlook; Need for Biomedical and Industrial Space Underscored

Boston's job recovery lagging that of U.S. Boston employment in August rested 350,000 workers below the February total, with an above-national unemployment rate of 12.1 percent, nearly five times its pre-pandemic level. The greatest share of staff losses were in the leisure and hospitality sector as sheltering and physical distancing orders curbed consumer spending at hotels, bars, restaurants and entertainment venues. Even with recent additions, employment at these establishments remains 42 percent below the pre-pandemic levels. The total number of construction workers in Boston is also down about 15 percent, possibly signaling upcoming delays to the current real estate development pipeline.

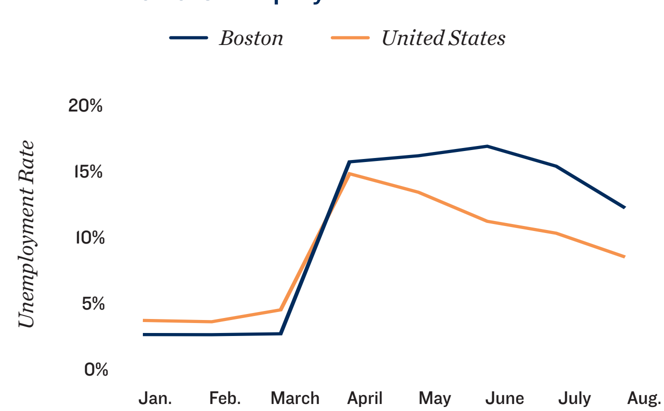
New supply paired with health crisis reverses apartment rent growth. Before the onset of the health crisis Boston's multifamily sector had already recorded rising vacancy because of inventory additions. The delivery of over 6,000 units from July 2019 to March 2020 pushed the vacancy rate up 100 basis points from a cycle-low 2.8 percent. Another 1,800 apartment openings in the second quarter lifted availability a further 60 basis points. Fewer people willing or able to relocate diminished rents, especially in the urban core where living costs are higher and floor plans are smaller. The closure of some offices and retailers, as well as the suspension of in-person classes at many of the metro's prominent universities, only weighed more on renter demand in the central business district. This behavior may extend into the fall as many office employers and colleges, including Harvard and MIT, limit physical attendance to some degree.

Rising health needs may push biomedical companies to the suburbs. The global spread of COVID-19 and the race for a vaccine has notably increased the demand for life science and pharmaceutical services. Cambridge has long been at the center of Boston's medical research industry, allowing companies to work closely with nearby universities. Space is limited, however, pushing asking rents to multiple times the market average. These restrictions may drive some firms planning to expand their footprints to suburban space. A shift in residential preferences toward larger accommodations adds further motivation to organizations seeking to be near their staff. Investors of properties that could support lab research and pharmaceutical production may benefit from securing these tenants as well. While suburban life science rents are below those found in Cambridge, they generally exceed local asking rates for other space uses.

Retail, industrial trading leads sales activity in second quarter. As with the country overall, commercial property investment in Boston paused at the onset of the health crisis. Substantial federal aid, greater clarity regarding the economy, and more available financing have helped partially restore trading activity. Transaction volume moderated less among industrial and retail properties, reflecting heightened consumer spending online and at essential stores. Numerous apartment and office buildings also changed hands, driven by activity in the sub-$10 million price tranche. The largest share of trades were in suburban Middlesex County, reflecting greater inventory and possibly added concerns regarding urban assets.

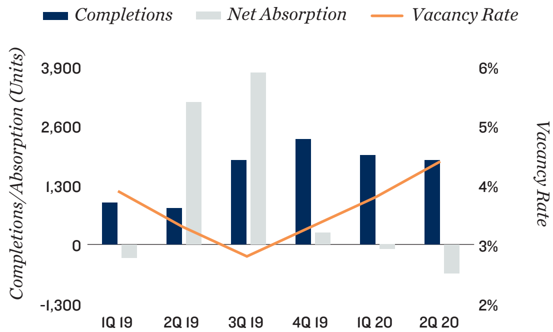
2020 Employment Trends

2020 Unemployment Rate Trends

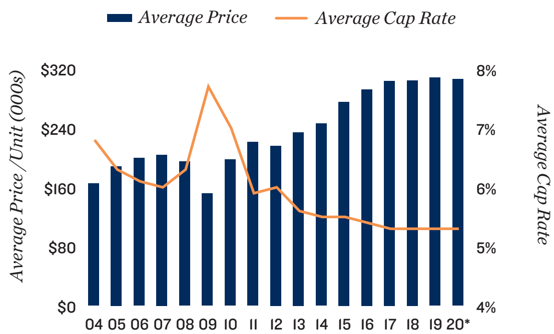


Source: BLS

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



** Through second quarter*

Sources: Real Page Inc.; CoStar Group, Inc.; Real Capital Analytics

APARTMENT

Ongoing Construction Activity Pushes Up Vacancy as Investors Target Class C Suburban Properties

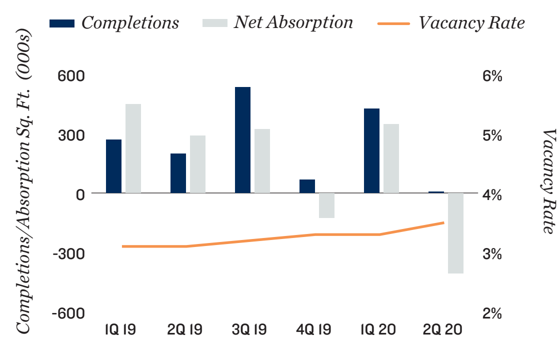
- Between April and June approximately 1,850 apartments were delivered, exceeding the trailing five-year quarterly average by 100 units. Most completions were in the InTown area and East Middlesex County.
- Elevated construction activity has pushed the vacancy rate up 110 basis points over the past 12 months to 4.4 percent in June. Difficulty showing new units lifted Class A vacancy to 5.1 percent, 170 basis points above Class C properties.
- Boston's average effective rent fell 1.8 percent between April and June, the largest drop of any major Northeast metro, to $2,360 per unit. Rates declined the most, nearly 4 percent, across the heavily urbanized Intown submarket.
- Sales velocity receded by about half between the first and second quarters as investors became more considerate of rent rolls. Strong underlying renter demand for affordable units prompted investors, predominantly local, to pursue Class C assets.
- Buyers targeted suburban properties along the North Shore and in Middlesex County, with less activity in the urban core. For the 12-month period ended in June, assets changed hands at an average sale price of $306,000 per unit, comparable to the prior period, while the average cap rate stayed flat at 5.3 percent.

RETAIL

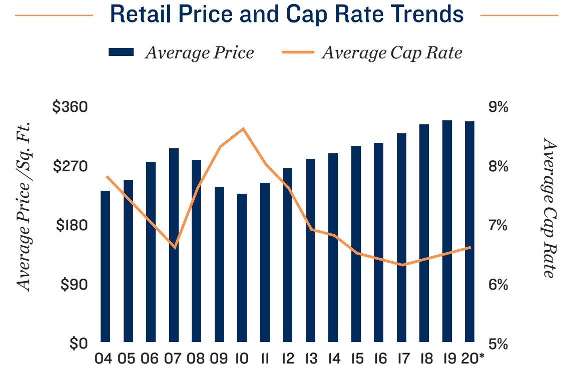
Multi-Tenant Properties Endured Health Crisis Hurdles More Than Single-Tenant Space in the Second Quarter

- Approximately 434,000 square feet of retail space opened in the first half of 2020, although the pace of completions slowed substantially in the second quarter. Another 350,000 square feet may be completed before year end.
- Vacancy rose 20 basis points to 3.5 percent despite few second quarter supply additions as store closures increased vacant stock by 406,000 square feet. Availability rose 30 basis points for single-tenant space while multi-tenant stayed flat.
- Both single- and multi-tenant average asking rents fell by more than 3.0 percent quarter over quarter in June to $21.22 per square foot and $18.00 per square foot respectively. Combined, the metrowide average lies at $20.58 per square foot.
- Trading volume in the second quarter was broadly comparable to the same period in 2019. Demand for multi-tenant space pushed the trailing-12 month average sale price up 3.0 percent year over year to $316 per square foot while the single-tenant average dropped 2.4 percent to $353 per square foot. Metrowide the average cap rate was in the mid-6 percent zone.
- The highest concentration of second quarter trades were in the Middlesex County suburbs, including storefronts in Somerville, Everett, Concord and Maynard.

Retail Completions and Absorption



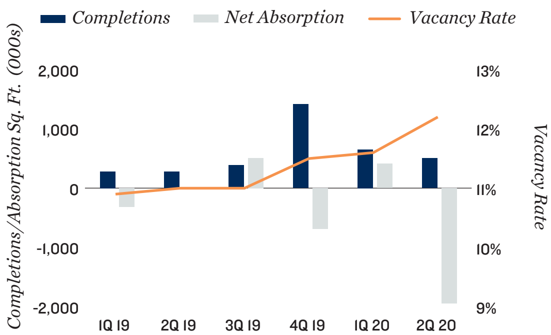
Retail Price and Cap Rate Trends



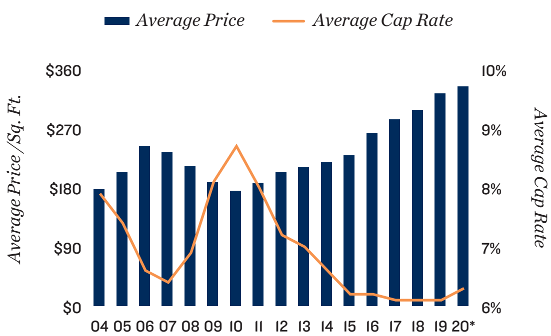
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

Office Completions and Absorption



Office Price and Cap Rate Trends



** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

Offices in Urban Core Face Downward Pressure on Rents; Suburban Offices Attract Investors in Second Quarter

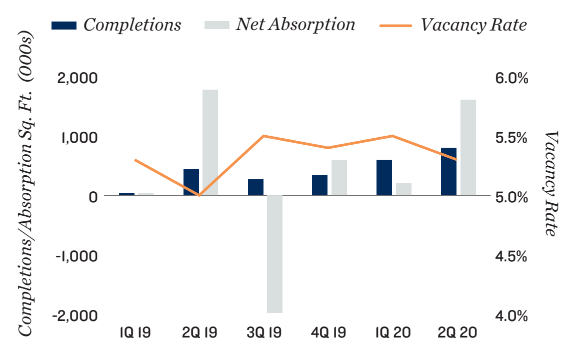
- After 1.4 million square feet of office space was delivered in the last quarter of 2019, less than 1.2 million square feet has been completed in the first half of this year. Major second quarter arrivals were in Waltham and Wakefield.
- Amid uncertainty over long-term tenant space needs, about 2.5 million more square feet of office space was vacant in June than in March, lifting the vacancy rate 60 basis points to 12.2 percent in the second quarter. Availability was highest among certain outer-loop submarkets.
- More space being marketed helped push the average asking rent down 4.7 percent quarter over quarter to $32.37 per square foot in June. The drop was driven by a 6.7 percent decrease in the average rate for offices in the central business district.
- The added appeal of low-rise suburban offices during physical distancing may have lent momentum to a series of transactions across suburban Middlesex County as metrowide trading velocity fell by about half quarter over quarter in June.
- The average sale price over the 12-month period ended in June rose 7.5 percent to $333 per square foot while the average cap rate remained in the low-6 percent range. Suburban Class B offices continue to make up the highest concentration of trades as Class A and C exchanges have fallen sharply since March.

INDUSTRIAL

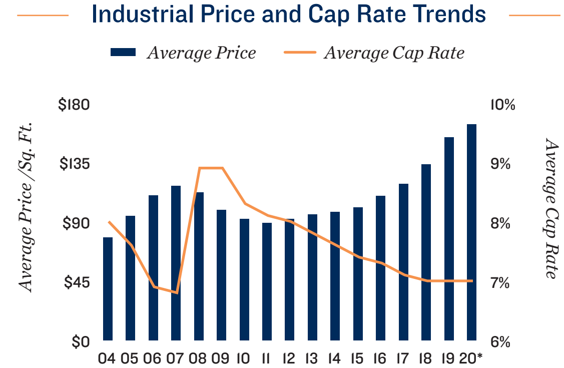
Development Extends West as Both Tenant and Investor Competition for Space Supports Rent; Sale Price Increases

- Industrial development in Boston surpassed the 2019 total within the first six months of this year with the arrival of roughly 1.4 million square feet of space. Nearly 60 percent of those deliveries were west of the I-495 in Worchester.
- The net absorption of industrial space surged between the first and second quarters amid rising distribution needs, dropping the metrowide vacancy rate 20 basis points to 5.3 percent, its third lowest level in over 10 years.
- Tenant demand aided in accelerating growth in the average asking rent during the second quarter to $8.45 per square foot, up 0.6 percent since March and 6.0 percent from a year prior. Rates exceed $10 in the urban core and northern submarkets.
- Industrial investors did not pause during the pandemic as surging e-commerce sales and supply-chain disruptions underscored the need for distribution and manufacturing space. In the second quarter several such assets changed hands in metros along the I-495 outer loop, including Lowell and Hopkinton.
- Consumer needs helped drive the average sale price for the 12-month period ended in June of $164 per square foot up 13.9 percent from a prior year and nearly 50 percent since 2016. The average cap rate has remained flat at 7 percent in that span.

Industrial Completions and Absorption



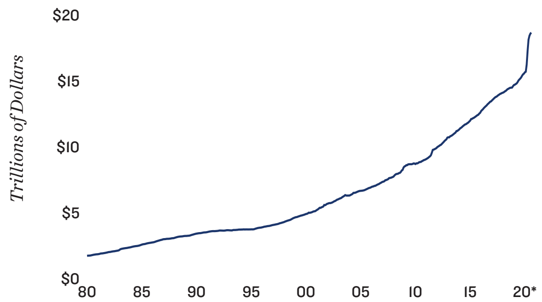
Industrial Price and Cap Rate Trends



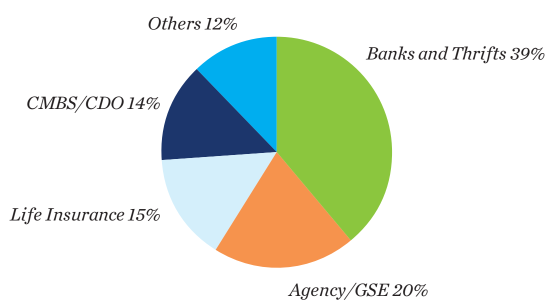
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

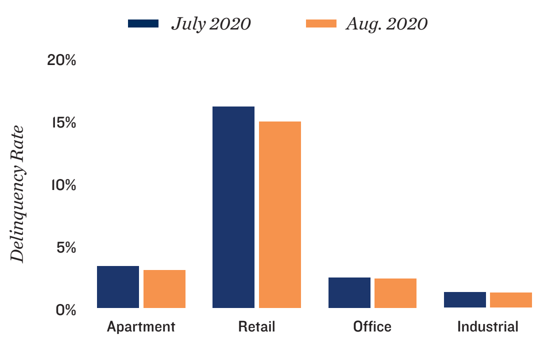
Fed Sharply Increases Money Supply During Health Crisis



Total Outstanding Mortgage Debt**



30+ Day CMBS Delinquency Rate



* Through August

** As of second quarter

Sources: Federal Reserve; Mortgage Bankers Association; Trepp

CAPITAL MARKETS

By TONY SOLOMON, Senior Vice President, Marcus & Millichap Capital Corporation

- **The capital markets are thawing relative to the height of the crisis.** Most lenders have adapted to dispersed working, and more information on the economic damage of the pandemic is affording buyers, sellers, and lenders risk and price clarity for large swaths of the commercial real estate sector. Both property performance and location can impact financing as some areas of the country outperform and the pace of recovery remains in doubt for others. Capital is readily available for assets that perform on or near par with pre-crisis levels, especially industrial assets, which buyers and lenders see as a safe part of their portfolios. Single-tenant retail with national credit tenants are also heavily favored by lenders, followed by grocery-anchored multi-tenant properties. Apartment rent rolls are more heavily examined, though financing remains available from the agencies and banks. Loans are more readily accessible for suburban office, while core buildings are more difficult to leverage. Some lenders continue to operate in the hospitality space, but obtaining financing is challenging.
- **Loan-to-value ratios were already declining prior to the pandemic and average 60 percent.** Freddie Mac is offering rates in the high-2 percent to high-3 percent range for seven-year terms. Debt service coverage is approximately 1.35 times. Life insurance companies will finance below 3 percent for apartments in some cases, and peak at 4 percent for retail. CMBS loans are available, though strict criteria makes deals more difficult to find. Rates bottom in the low-3 percent range for apartment and industrial and rise to 4 percent for office.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Mortgage Bankers Association; Real Capital Analytics; RealPage, Inc.; Trepp

Price: $250