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Commercial Real Estate Outlook for 2005

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West Michigan-Grand Rapids Commercial Real Estate Review and Forecast

The West Michigan economy has weathered stormy economic times in the past several years. This article will discuss the impact of the commercial real estate market following this period of instability. The majority of market sectors indicate moderate improvement on the horizon, but a few areas continue to show mixed results. The following summaries of past performance and changes anticipated in each market sector are based on data compiled for the West Michigan region.

Industrial Market

The outsourcing of lower volume and lower profit product lines by major manufacturers will have a two-fold effect on the West Michigan economy. To begin with, the market will need to absorb some very large manufacturing facilities that are no longer effectively utilized in today’s environment.

The second issue facing the market is one that draws upon West Michigan’s historic strength — the smaller independent entrepreneurial manufacturer — now poised to pick up business. This will create stepped-up demand for small-to-medium sized manufacturing facilities necessary to accommodate their growth. The challenge for 2005 and beyond is to examine these two issues within context and formulate a solution accommodating the need to redevelop these facilities with the desire to meet the needs of the smaller users.

In 2004 the demand for small facilities ready for acquisition outstripped supply. As the demand levels for smaller manufacturing facilities grow in 2005, factors allowing for the successful redevelopment of larger single facilities in single tenant or multi-facility manufacturing operations will become attractive to these users.

Positive absorption of industrial space from the fourth quarter of 2004 will carry forward into 2005. The near stoppage of speculative construction will continue into early 2005 with potential for some very specific spec construction (based on a product and geographic need) to occur in the latter part of the year. Rental rates are not expected to increase; however, we foresee a reduction in landlord-tenant incentives in 2005.

Office Market

Vacancy in the Grand Rapids area office market peaked in the second quarter of 2004 paving the way for a sense of growing optimism. The fourth quarter showed improvement in both office occupancy and absorption. Rent incentives are decreasing, renewals are adjusting down to market rates, and rental rates are expected to hold without significant increase. A number of new and exciting projects will continue to gain momentum in 2005. While not all of the projects are office space, they should have a positive effect in the area. Some of these projects include the proposed mid-rise on the former Jacobson’s site, the Art Museum, Mercantile Bank’s new headquarters, and numerous new medical projects throughout Grand Rapids.

Large warehouse distribution facilities have taken the biggest hit over the last few years resulting from the manufacturing slowdown. Occupancy for this product type has improved by five percentage points over the previous year. Looking ahead, we expect that it will require up to 24 to 36 months for this inventory level to be brought back into a stable supply-and-demand ratio.

Land prices will start to rise and are expected to do so at a rate greater than inflation. This is due to a shortage of developed zoned industrial land.

The impact of the opening of the new M-6 South Beltline along the south corridor of the Grand Rapids market will be closely monitored. The new roadway will have a major impact on the development of new industrial facilities along the exits of these corridors. This corridor is expected to breathe new life into currently congested industrial areas by displacing the automobile traffic and allowing easier truck access into outlying areas such as Roger B. Chaffee Blvd.

Commercial Real Estate Outlook for 2005

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In 2005 there is much anticipation for further downtown development in Grand Rapids and throughout West Michigan. Downtown office occupancy has the potential to improve faster than suburban markets due to the massive investment in downtown for the medical, educational, residential, and institutional sectors. The conversion of obsolete office space to alternative uses will reduce office vacancies and improve the overall lifestyle of the downtown market.

Renaissance Zones continue to attract tenants. Some observers argue that without these tax-free zones, the City may not have been as ripe for development as anticipated. Low interest rates have also spurred the office sector’s growth while allowing for additional residential condo projects to take over obsolete buildings and create an increase in retail/condo development.

Medical education continues to be the buzz in Grand Rapids. While Michigan Avenue undergoes a major advancement in medical office and mixed-use projects with more universities sparking interest in joining the progression, city planners may find a change in employment demographics. Manufacturing, for instance, may no longer be the leading employer as Bioscience and Health projects become more prominent.

As 2005 begins, office occupancy is improving. Absorption is positive for the first time in several years, and asking rates are down 7 percent. In 2004, the Grand Rapids Central Business District (CBD) improved its occupancy by over two percent, and the suburban market, lowered mostly by the Centennial Park and East Beltline submarkets, decreased by nearly 3 percent. Large-scale tenants may find the decrease in rental rates in the suburban areas, specifically Centennial Park, as an attractive alternative to a busy downtown.

With the economy on the rebound in 2005 both nationally and locally, the office real estate market will improve steadily. Tenants will not see increased incentives or discounted rates as they did in preceding years. Landlords will benefit from increased occupancy and at-market renewal rates.

Retail Market
Large national retailers continue to be attracted to the Grand Rapids area because of its strong demographic profile — 1.3 million people in four surrounding counties comprising the CSA (Combined Statistical Area). Local retail giant Meijer continues its turf battle with Wal-Mart, with Meijer stores opening (or under construction) in Standale, Gaines Township, and Muskegon. Wal-Mart continues to expand its presence here with new stores in Ionia, Grand Haven, Greenville, and Muskegon. Other national retailers such as Costco Stores (2), Staples (3), Home Depot, and Lowe’s continue to penetrate West Michigan.

Retail statistics for 2004 indicate rising market rental rates with occupancy maintained even while new development occurs. Rental rates over $28 per square foot have been paid on 28th Street in Cascade and near Knapp’s Corner, one of the largest new mixed use office-retail centers in West Michigan since RiverTown Crossings opened in Grandville in 1999. New projects in the M-6 corridor are under construction, while RiverTown, 28th Street SE, and East Beltline corridor development steadily increases at a slightly slower pace. Over one million square feet of retail space is planned or under construction in the Grand Rapids area. This new development will be concentrated in key corridors and is expected to continue through 2005. Asking rents will proceed at a current or slightly quicker pace.

The impact of new big box construction will be especially pronounced at the M-6, Kalamazoo Avenue interchange and at the 28th Street, Interstate 96 interchange. Both of these areas offer an ideal combination of mature rooftops as well as new growth along with highway access. Kalamazoo Avenue has been a development hotspot through much of last year, with major projects spawning peripheral development. A more mature market is situated along 28th Street, with redevelopment underway that capitalizes on an advantage of traffic generated by surrounding retailers and desirable trade area demographics. Additional projects are in the planning stage along the East Beltline, but they face zoning challenges.

The redevelopment trend is not exclusive to 28th Street. Savvy owners of well-located retail centers throughout the market are capitalizing on attractive construction costs while face-lifting older projects. New restaurants have strengthened
retail presence in the CBD, but retail expansion will occur very slowly (waiting on significant downtown population increases).

Nevertheless, a close watch will be maintained on the downtown retail market and its anticipated 2005 growth, with regard to the impact of a new burgeoning residential mix and how it is likely to contribute positive results to Grand Rapids in the next few years. City planners look forward to the CBD's continued evolution into an entertainment and residential district.

**Investment Market**

As interest rates nudge upward in 2005, investors will be closely monitoring marketplace reaction. After two years of chasing West Michigan's limited supply of investment-grade property, investors continue a trend of formulating creative solutions, partnerships, and new development to make their own supply. The effects of historically-low interest rates, strong demand, and post-election market impact will continue to reshape the investment landscape in 2005. Market fundamentals continue on a slow moderating trend, but all signs point to continued improvement. Despite lackluster fundamentals, investors show an ever-steady appetite for new growth opportunities. This speaks highly of the continued faith and anticipated growth in the West Michigan market.

Despite mediocre market fundamentals, cap rates on all property types have remained at historically low levels (making for historically high sales prices); this is especially true in retail and multi-housing properties. This trend is likely to continue into 2005, and, of course, moderating as the interest rate landscape changes. As interest rates increase, property cap rates are expected to increase as well; investors should expect a slow increase on both these fronts.

With properties commanding record rates, owners looking to sell will experience difficulty finding 1031 exchange properties and will be hesitant to do so unless an adequate replacement property can be found. This trend further limits the supply of investment property, contributing to a new wave of creative deal-making. Market dynamics are fueling a variety of bold new options for investors looking to create their own supply. The trend of “condominiumizing” existing properties, and redeveloping properties utilizing both local and state tax credits, ranging from historic tax renovation credits to Brownfield redevelopment options, will continue.

Urban renewal, growth, and expansion of the downtown Grand Rapids area will continue to trigger investor interest and opportunities. Old, historic properties once dismissed as impractical and costly are now highly coveted for their significant upside potential.

Residential development continues, as area housing developers maintain a trend that has fueled the largest home ownership percentages in the United States. The multi-housing sector expects to see increased occupancy, and that is expected to continue well into 2008 as the next generation enters the housing market.

It is expected that 2005 will be another strong year for investment properties in West Michigan. Improving market fundamentals have moved the confidence level from hopeful expectations to certainty in the renewed growth of market fundamentals.