Commercial Real Estate Outlook for 2003

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The Greater Grand Rapids commercial real estate market faces a bumpy road mixed with opportunities and challenges for 2003. While the office and industrial markets met the challenges of more corporate downsizing and consolidation, which in turn led to increased vacancy, 2002 proved to be a year of growth and expansion for the retail market. The year 2003 looks to be another prosperous year for retail with continued development in what retailers perceive as an “under retailed market.” The office and industrial markets are expected to undergo a year of stagnation, rather than growth or decline, as available space is slowly absorbed.

To better understand how the major market types relate to the real estate market cycle, we utilize the Real Estate Market Cycle Graph (Figure A). Real estate markets are cyclical due to the lagging relationship between supply and demand for existing space. As illustrated, the cycle is divided into four phases: Recovery, Expansion, Hyper Supply, and Recession. Our research finds that each property type—retail, industrial, and office—falls into its own unique location due to the following circumstances.

The retail market is currently in Phase II of the market cycle called Expansion, showing such characteristics as declining vacancy and new construction. For retail, 2003 appears to be on track for another year of growth and expansion as more national retailers enter our market and existing companies expand to additional locations throughout Greater Grand Rapids. Confidence for growth was strengthened with reported retail sales during the Thanksgiving holiday shopping weekend up more than 10% over the same period last year.

Retail expansion will be realized in several areas throughout West Michigan. In Holland there are developments on the US-31 corridor including a new Meijer, as well as new construction for Target and Menards, all north of town. In Muskegon, across from the Lakes Mall, 400,000 square feet of retail space (Lakes Crossing) is slated for construction, with Kohl's rumored to be the anchor tenant. Lakes Crossing will also include two hotels, the AmericInn and Fairfield Inn.

On 28th Street SE in Grand Rapids near the I-96 interchange, new construction of some 500,000 square feet of retail space called Waterfall Shoppes is anticipated on the site where Showcase Cinema now stands. One anchor tenant, Home Depot’s Expo Design Center, an all-in-one home specialty store claiming to have every resource you could possibly need to complete your home projects, has been announced. On 28th Street SW, the Roger's Plaza renovation is well underway and includes a completely new façade and the addition of a Family Fare grocery store and A.J. Wright, a discount softgoods store. On Alpine Avenue, at the former K-mart site, approximately 166,000 square feet of new retail space called Alpine Summit is currently under construction and should be completed in the spring of 2003. Anchor tenants include Linens N Things, Marshall’s, Petco, and Schuler Books. On two lots in front of Alpine Summit, construction of a new Friday’s and Logan’s Steakhouse was recently completed.

Retail lease rates are expected to remain steady for 2003. See Figure B for a range of lease rates in Greater Grand Rapids.

The industrial market is in a completely different phase of the market cycle. It has witnessed increasing vacancy, almost no new speculative construction, and less demand, which places it in a unique area on the Real Estate Market Cycle: somewhere between Phase IV - Recession and Phase I - Recovery. The industrial market has been plagued with substantial corporate downsizing and consolidation leaving Grand Rapids with more than 6.2 million square feet of available space and 6% vacancy. With speculative construction at a virtual standstill, existing space will have an opportunity to be absorbed throughout 2003 and into 2004, thus decreasing supply. Rental rates should respond to this absorption.
of supply with a slight increase. Currently the weighted average asking rate is $3.25 per square foot per year for industrial space with a triple net lease.\textsuperscript{1} We expect to see that rate slowly climb from three to five percent in late 2003 and into 2004. Negative net absorption in 2002 peaked at a daunting 1.125 million square feet but is expected to drop into positive territory in the coming year. Another indication of industrial growth in 2003 is the great demand for investment grade industrial facilities at full or near-full occupancy, particularly from investors leery of a weakened stock market who have sought real estate as a safe haven and better investment alternative. See the graphs illustrating vacancy rates (Figure C) and net absorption (Figure D).

### The Office Market

The office market shares similar circumstances as the industrial market. The office market falls right next to the industrial market on the Real Estate Market Cycle Graph, lying between Phase IV - Recession and Phase I - Recovery. Corporate downsizing and consolidation, compounded with low interest rates, have forced the office market into another year of negative absorption and increased vacancy. Companies looking to survive the economic downswing have initiated employee layoffs, facility consolidation, and expansion freezes. This in turn has left the market with a glut of available space. In other words, the market has shown a considerable increase in supply with a significant decrease in demand. See Figure E (vacancy rates) and Figure F (net absorption).

Historically low interest rates have made real estate ownership an attractive alternative to leasing, luring many tenants away from their current spaces and into facilities that they can own. In many cases they purchase more square footage than they need and lease the remainder out for additional income. For those tenants determined not to purchase, or those wishing to move, expand, or simply renew an existing lease, the bargaining chips are in their corner. Over-supply has forced landlords to be very competitive as well as creative when it comes to luring new tenants and keeping existing ones. In addition to low lease rates, landlords are also offering very tempting build-out allowances and, in some cases, free rent.

The office market is expected to maintain its current trends throughout 2003, or until more of the existing space is absorbed. We project, however, that asking rates will decline slightly in 2003 as landlords continue to compete for a limited number of qualified tenants. See the Office Rental Rates graph (Figure G) for year-end office lease rates.

### The Investment Market

The investment market encompasses all of the markets including hospitality and multi housing. This year's outlook for commercial real estate investment in Greater Grand Rapids is marked by strong demand and limited supply, even though weak rental and occupancy rates, especially in the office and industrial markets, remain an issue.

The strong demand for investment property is driven by three primary forces: historically low interest rates, the reallocation of investment capital to real estate, and higher demand in West Michigan from outside investors. Despite softer rental rates and higher vacancies, potential sellers have a sense the market will strengthen and, with today's low interest rates, are able to take a wait-and-see approach. Overall, the climate for investment properties in West Michigan is expected to remain very strong for the foreseeable future.

Commercial real estate in general has an encouraging future filled with many more challenges, but even more opportunities. M-6, more commonly known as the South Beltline, will spark several new developments along its corridor as it reaches its anticipated completion in 2005. As Grand Rapids expands to the south, all the major types of commercial real estate will find opportunity here.

\textsuperscript{1}Source: Great Lakes 2003 Real Estate Forecast Book, Grand Rapids Industrial.