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West Michigan - Grand Rapids Economic and Commercial Real Estate Forecast

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Industrial

With an industrial market near capacity, building new seems to be the logical next step. However, high new construction costs and more efficient operations are resulting in many companies making do with what they have or paying a premium for additional space.

Historically, West Michigan has not been a market where developers build large amounts of speculative space. It has been one, however, where companies move around the market, nestle into pockets that fit their needs, and expand on existing buildings when necessary. Generally, growth is fairly conservative. But now that market vacancy is down near five percent, moving around in existing inventory has become difficult. This has fueled more creativity in non-listed properties as well as new build-to-suit projects.

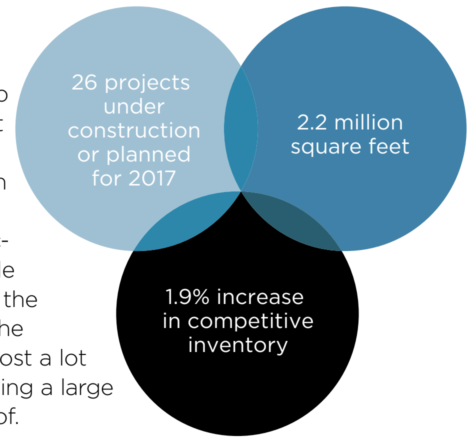
At the beginning of 2016, as many industries continued showing strength, we predicted land sales to increase in anticipation of an expanding market. The 140-acre Jamestown Commerce Center, the 92-acre Site 36, and the 250-acre Walker Ridge development were sites we were eager to keep an eye on for industrial activity due to their accessibility and infrastructure. However, many tenants have been hesitant to be first in, and developers have waited for tenants to sign pre-construction leases rather than building speculatively. In 2017, we look for all three sites to gain momentum.

Some hesitation has come from high construction costs and long lead times for completion due to building company constraints. Those looking for new space are usually in need of it immediately, and waiting 12-18 months for a new building is often less than ideal.

Those who have planned, started or finished new construction in 2016 include Lacks Industries, Gourmet International, Laminin, Kent Quality Foods, RT Baldwin, Tesa Tape, FedEx, Viking Products, Laserone and ETO Magnetic to name just a few. At year-end, we were tracking 26 construction projects totaling more than two million square feet. However, this represents less than two percent of the current market inventory.

The Grand Rapids economy has largely rebounded from the recession, with annual Gross Metropolitan Product now nearly 30 percent higher than it was in 2010. Industrial rental rates are consequently 23 percent higher as well. In addition, approximately 100,000 jobs have been added to the workforce over that period of time, back to a level greater than what we saw before the downturn. Much of that employment and production has come from the manufacturing sector. Twenty years ago, manufacturing employment made up more than 25 percent of the Grand Rapids economy, however, an economy that relies so heavily on one sector is more susceptible to feel fluctuations in the economy, so during the recession the region lost a lot of its strength – creating a large hole to dig itself out of.

Industrial Construction Kent & Ottawa Counties



This is precisely what we have been doing for the past six years. Manufacturing job growth has been positive at a rate of roughly 34 percent annually, and as industrial production has built back up, more than half a million square feet of industrial space has been absorbed. Over that time, transaction velocity has also remained strong. However, heading into 2017 we are largely out of room for companies to grow into. As mentioned, construction is occurring, but is expensive and only done out of complete necessity; transaction activity has slowed two years in a row; rental rates are strong, but for the most part plateauing; and the Purchasing Managers Index shows the industry is still growing, but at a slowing pace. So what does this mean going forward? Does this mean we are at the end of an expansion phase, that we are done recovering? Or are we so pent-up that something will inevitably have to give?

Well, the answer isn't so simple. Industrial users have adapted and the way they utilize space has changed. It is possible that we can both continue to see positive production and industry growth without an equal increase in space demand. Automation is creating efficiencies that allow companies to produce in less space with better quality and fewer people.

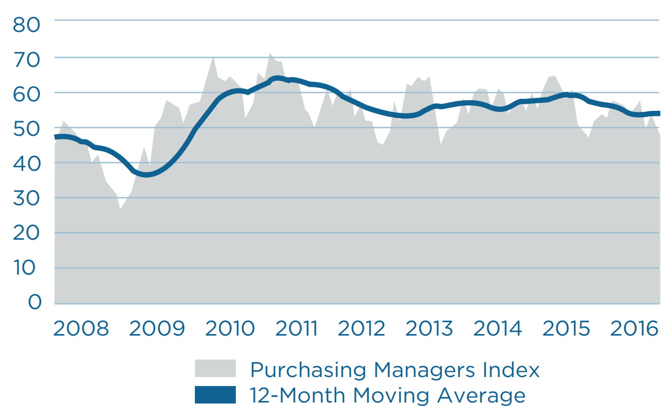
The small amount of spec construction that is taking place is designed based on flexibility and efficiency. Both 5300 Broadmoor Avenue SE and 3833 Soundtech Court SE were built with this in mind and saw leasing activity in 2016, despite above market rental rates. Companies are coming to grips with the fact that in order to position themselves in space for the future, it will cost them more than it does currently.

Local economic development organization, The Right Place, is reporting record amounts of capital investment, but the investment is largely in equipment, not personnel. This is causing management and technical positions to gain value, yet entry level jobs are seeing wage stagnation, making it much harder to attract the new wave of workforce. Many industrial businesses who are hiring are complaining about a drained talent pool as a result.

To fill the talent pipeline, new education programs are being developed to teach youth about the benefits of a career in manufacturing. Schools are also making professionals available to answer questions and share successful career stories of the past. West Michigan is a community in which much pride is taken from the products we produce, so in order to allow companies who are wanting to expand the ability to do so, this issue will need to be continually addressed in 2017.

Many questions remain for 2017 across the entire regional and national economy, but balancing a new paradigm of how companies operate with an aging workforce and depleted employee pipeline will be key to sustaining the growth we have seen over the past half-decade.

Figure 1: Purchasing Managers Index (PMI)



The PMI is an indicator of the economic health of the manufacturing sector. It is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. An index reading above 50 indicates positive growth.

Investment

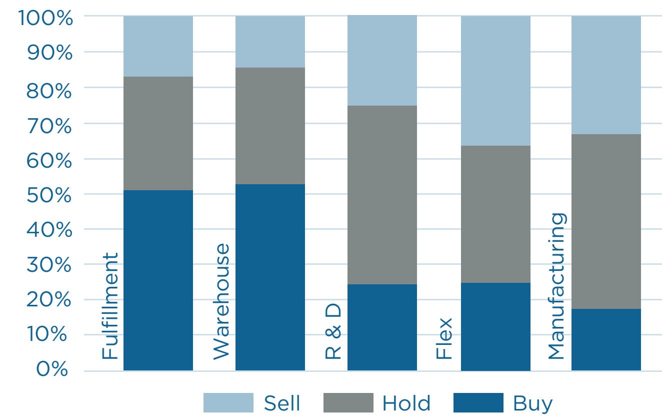
Industrial property has been a favored sector for investors and developers in West Michigan and, according to The Urban Land Institute's 2017 Emerging Trends in Real Estate survey, it is again the favored sector heading into 2017. This is largely due to being lower risk relative to the other property sectors.

In 2016, West Michigan saw a large industrial portfolio change hands when the 1.1-million-square-foot Crosslake Portfolio was sold to an out-of-state investor. Previous owners had purchased the six-building portfolio in 2013 with various short term and rolling leases resulting in about 70 percent occupancy. This created an opportunity to add value. Sellers spent time and money to stabilize the asset, bringing it to 95 percent occupancy, and sold it this past September. This was the largest transaction of the year in the region and represented a 9.46 percent cap rate.

This year we saw a 10.7 percent difference between average listed for-sale price and final transaction price in our market, 190 basis points less than in 2015.

Going forward, we see investment opportunities still available in the industrial market. Smaller R&D/Flex space recovered slower from the downturn, so cap rates still remain inflated. Additionally, some opportunities exist to repurpose functionally obsolete buildings, as submarket vacancies rates across the region are at historical lows and users are hungry for space and are willing to be creative.

Figure 2: Sell/Hold/Buy Industrial Investment Recommendations



Source: Emerging Trends in Real Estate 2017 Survey (based on U.S. respondents only)

Office

Office buildings offering amenities, quality design elements, and parking are having little trouble attracting tenants at premium rates. Outdated and neglected buildings, however, are struggling to keep up.

Downtown

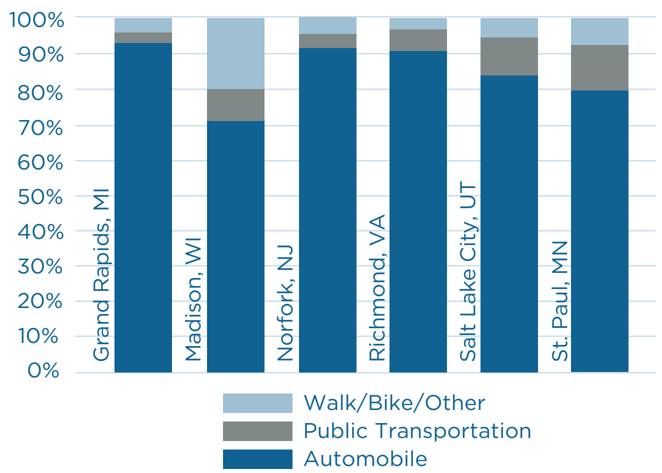
At the beginning of last year, one of the biggest questions we posed looking forward was how the region would start to measure up against major markets given the trajectory we were on. Was our weathering of the recession and subsequent growth a nice local story, or was Grand Rapids really on its way to the national conversation? After years of being one of the stronger performers in the low-to-middle market categories, we wondered how we would compare when stacked up next to the likes of Chicago, Detroit, and Atlanta.

To find the answer, we had to look past the differences in physical size. Throughout the past year we tracked and reported on a number of indicators such as new construction starts, transaction velocity, vacancy, list/sale price differential, and investment cap rates – and compared them to trends we saw in major cities. By most accounts, the office sector has shown us that despite our smaller population, we are beginning to act like a major market. However, we are not at the adult table yet.

A basic, yet meaningful indicator that helps show we are on our way is rental rates. Rental rates are the product of a supply and demand equilibrium, and show where the market's ceiling and floor are. Increasing top-end and submarket averages reflect growing space quality and tenant appetite. A year ago, we saw the downtown Class-A average listed rental rate finally cross the $20.00 per square foot (modified gross) mark for the first time and wondered if leases would be executed at that level in 2016 or if it would serve as a mental barrier. We opined that tenants would have to justify crossing this threshold by comparing our market to larger markets. If talent and client attraction was really paramount, we predicted this mark would be breachable and sustainable. By the end of 2016, after four more positive quarters of growth, the Class-A downtown average asking rate stood at a record $22.44 per square foot, showing that our market continues to exhibit strength at resistance points and desire to break through the middle-market classification.

Much of the reason rental rates and occupancy continue to climb downtown is the realization of the need to reposition. After years of relative stagnation downtown, we continue to see the city's skyline significantly change. Franklin Partners' acquisition and reposition of 99 Monroe Avenue NW really started the ball rolling in 2013. Since then we have seen TWENTY 5 at 25 Ottawa Avenue SW undergo considerable redevelopment and subsequent lease-up, improvements to 200 and 300 Ottawa Avenue NW and 250 Monroe Avenue NW, new construction such as Arena Place at 45 Ottawa Avenue SW, and a transition of ownership in 111 Lyon Street NW. Some of those buildings have had to endure temporary vacancies in order to accomplish this, however, we expect the downtown Class-A vacancy rate to drop under 10 percent in 2017 (currently approximately 15 percent), with a total downtown vacancy below 7 percent (currently approximately 9 percent).

Figure 3: Transportation Mode Split Between Workers In the CBD



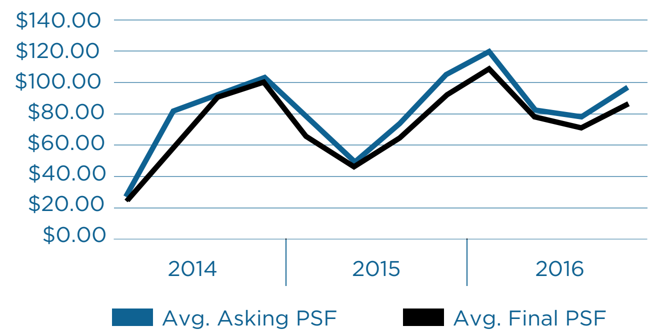
Relative to peer cities, Grand Rapids has room to grow its alternative transportation usage.
Source: GR Forward Parking Study

Repositioning a building is not cheap, however, and is part of the reason rental rates have climbed. Exterior changes are what is visible, but within those buildings, physical layout of office space has changed as well. A newer generation of workforce is disrupting the status quo and traditional work environments are being transformed into culture and collaboration facilitators. This is key in the battle for talent. Companies are investing significant capital into finishes and amenities, and landlords who do the same are finding significant success compared to those who are not.

Tenants who renewed low rates during the downturn are now forced to face realities of a much higher market, and many are doing whatever they can to extend longer. This is part of the cause for a decrease in overall completed new transactions in 2016.

Furthermore, parking downtown continues to be a concern for many. However, as previously mentioned, part of acting like a major market is finding solutions to this problem. We are far below our peer cities (Madison, WI; Norfolk, NJ; Richmond, VA; Salt Lake City, UT; and St. Paul, MN) in terms of public transportation usage by residents and workers downtown. So emphasizing alternatives to driving will be key going forward. Almost all new office development contains a parking component, however, for rehabilitations like TWENTY 5 in which no new parking could be added, a creative parking stipend program was implemented for Spectrum Health's nearly 400 staff members who now occupy the building. Further programs like this will also be instrumental in absorbing continued demand to locate businesses downtown.

Figure 4: Office Sale v. List Price Kent & Ottawa Counties 2014-2016



10.7% difference between list and final sale price in 2016

Figure 5: Top Industries Job Openings, Grand Rapids - Wyoming MSA

Health Care & Social Assistance	11,000
Manufacturing	10,000
Retail Trade	9,000
Prof., Scientific & Tech.	5,600
Finance & Insurance	5,100
Transportation & Warehousing	4,800
Accommodation & Food Services	3,900
Administrative & Support	3,800
Educational Services	2,400
Other Services	1,700

Source: Burning Glass International Inc. (2016)

Suburbs

In West Michigan, 2016 will be remembered as the year data server-provider Switch started its multi-billion dollar investment in the West Michigan region. Leasing the former Pyramid-shaped Steelcase headquarters building in Gaines Township, the company committed to contributing more than 1,000 new jobs to the region over the next decade. More than half of those jobs are expected to be with companies other than Switch. This means that Switch and economic development organization The Right Place, who helped bring Switch to the area, are planning on more than 500 jobs to come from companies Switch provides its services to.

We expect this to have a massive impact on the suburban office market. While 2017 might be too early to see many of these jobs come to fruition, we expect a number of companies to locate workers in West Michigan on a co-location basis initially, with eventual permanent locations established in the future. Ancillary benefits of more office workers being in the area will be more retail, hoteling, and residential rooftops. As mentioned, the downtown office market has seen a renaissance over the past decade, however, the suburban market has seen far less capital investment in updating and building new space. Heading into 2017 we see significant opportunity in peripheral office submarkets for developers and owner-users to create high-quality office spaces. Access to parking gives suburban buildings an advantage over their downtown counterparts, so those who build great space to couple with ample parking should see significant interest. We have seen suburban development such as Heritage Pointe on East Paris Avenue fill up quickly, and we expect future development to have similar success.

A number of smaller office users who have been patiently waiting and searching for a new home purchased land south of Grand Rapids and began construction knowing the area is primed for expansion. Medical practices are especially active, and in 2017 we forecast further movement of medical users from tenancy in neglected buildings to owning or being a tenant in a new medical development. However, construction costs will continue to be prohibitively high in some instances.

In 2016 we saw a 9 percent difference between average listed for-sale price and average final transaction price, compared to 12.9 percent in 2015.

Investment

Currently, much of the Grand Rapids office investment inventory is owned by smaller local investors. However, as we progress into the national picture as an overall market, it is important to be aware of investment trends on a national level.

Office product is often a popular category for larger institutional investors for a number of reasons. Central Business District office product has generally been an easy way to scale up a portfolio and is often favored by foreign investors who prefer high value transactions. Because of this, office product weathered the recession relatively well considering the hurt they feel with lost occupancy. In 2016 office portfolio sales were down according to Real Capital Analytics and according to the 2017 Emerging Trends Report by the Urban Land Institute, many investors feel that 2017 could be the peak of the office investment market. Because the office market historically reacts harshly to a downturn, many investors are taking their returns now and de-risking their portfolios.

Suburban office investment has fallen distinctly out of favor due to deferred maintenance and other operational issues in many cases. High capital outlays to attract tenants are scaring away investors. In addition, maturing debt is expected to bring a number of underwater assets to market in 2017. Because of this, opportunistic investors might find opportunity.

Retail

West Michigan has become a melting pot of retailers, attracting companies of all shapes and sizes to the market. As room to accommodate demand dwindles, creativity has become key.

By almost all accounts, 2016 was a great year for retail real estate in West Michigan. Unemployment for the Grand Rapids-Wyoming Metropolitan Statistical Area (MSA) has hovered around 3 percent, which most economists consider full employment. A year ago we predicted the retail market would show strength while other sectors started to slow, and that rental rates in marquee locations would continue to push higher. Although deal velocity across all property types slowed, retail performed the best with just a 1.3 percent year-over-year decline (compared to a 17.8 percent decline in industrial, for example). Rental rates in power corridors like 28th Street SE and Alpine Avenue are seeing asking rates as high as $38.00 per square foot triple-net, which reflects high demand and low well-located supply – yet prices some tenants out of those markets.

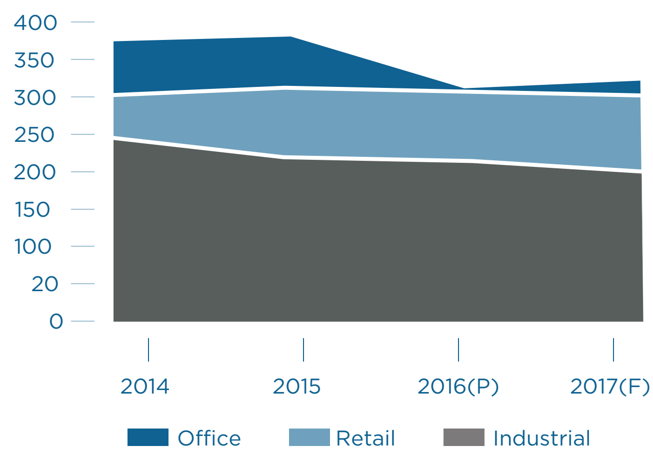
In most cases, creativity is key to finding great locations for tenants who demand them. In 2016 we saw a number of key deals happen in the marketplace at sites that were not previously considered available. In order to find locations for Chick-fil-A in West Michigan, this is precisely what needed to be done. Brokers and tenants continue to work with landlords to utilize out-lots and parking areas to build standalone retail buildings. Spots like downtown Ada and Gaines Township have seen creative re-use of sites as well as new ground up retail construction.

Downtown continues to see activity, as mixed-use development has created new opportunities for retailers. As the city's core expands in all directions and more residents live closer to downtown, we anticipate companies previously hesitant to enter or expand downtown will consider doing so.

Centers

Last year we saw the relatively new retail center Village at Knapp's Crossing add three out-lot buildings, creating 10 new retail suites. By the end of the year we saw 9 of those 10 filled. In 2017, we expect the next phase of this development to break ground and for the center to see a high level of interest from well-known national retail brands.

Figure 6: Transaction Counts Kent & Ottawa Counties 2014-2017



(P) projected (F) forecast

Retail centers outside of key corridors and ones that have been neglected are having trouble capitalizing on the high demand for space in the region. Prime locations are all but full, yet tenants are so eager to locate there that they are finding ways to squeeze in – thus driving rates up. In order to stay relevant, retail centers like the Cascade Center at 6250 28th Street SE, which was purchased by investment firm Great Lakes Capital earlier in the year, invested significant money into renovating the exterior façade, parking lot, and landscaping. Since then, a number of leases have been signed including The Blue Moose Sports Pub, which will fill the anchor space vacated by Cascade Sports Bar & Grill.

We expect to see other centers with growing vacancies address similar issues with similar capital improvements. As these centers gain strength, landlords will become more selective with tenant mix. Credit-worthy tenants who complement each other are preferred, and with a retail market that is growing competitive for space, landlords will look to assemble the right roster of tenants for their centers.

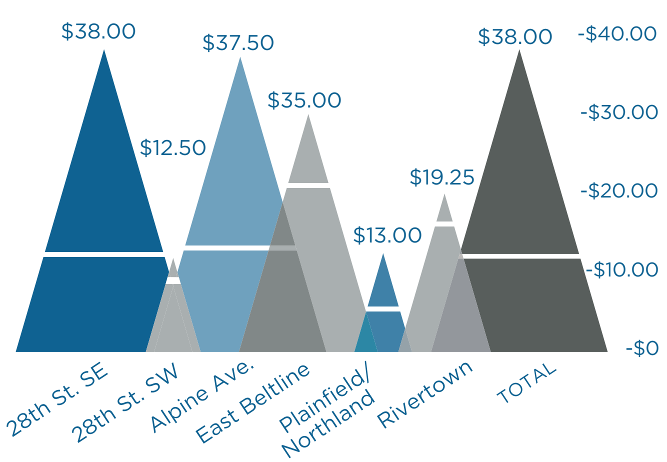
Malls
Traditional shopping malls and their big box anchors have been seemingly under siege over the past few years. However, despite mass-closure announcements made by companies like Macy's and K-Mart, in general we are seeing landlords who are willing to be flexible survive this shift in retail paradigm. Some malls have pivoted away from interior space, and in some instances creative repurposing of big boxes have saved the center they're in.

Recently, we saw Centerpoint Mall undergo a "de-malling" which resulted in an increased occupancy of approximately 35 percent, as well as the addition of numerous new out-buildings.

Westshore Mall followed suit and has subsequently signed more than a dozen new tenants. Now, Breton Village Mall is undergoing the same type of reconfiguration. The upper story and roof will be removed and storefronts will be added for all tenants. Additionally, out-buildings are being built to provide more street presence. This work is in response to the overwhelming success of Centerpoint and Westshore, and the reaction to changing consumer preferences and tendencies. Across the street, Breton Village South has been designed and partially built with the same plaza-style site design.

In 2017, we very well could see other malls like Woodland and RiverTown Crossings undergo changes as well, as some of the big box tenants consider their future at the sites. While this could potentially represent change, it also could represent opportunity.

Figure 7: Asking Rental Rates



Maximum and average asking rates for 6 main corridors, with the average asking rate represented by each shape's white line.

E-commerce
One phenomenon that has been cutting into physical store sales is the proliferation of e-commerce. Cost effectiveness of selling products online make it hard to justify overhead costs like utilities, staffing, and rent that are associated with bricks-and-mortar locations. According to Forrester Research, online sales in the United States are expected to grow 56 percent between 2015 and 2020 to more than $523 billion. We are currently in the middle of that acceleration. However, it is possible that a physical presence has become even more important since the dawn of the internet shopping era. More than ever, retailers desire to approach consumers from a number of angles. While online shopping offers efficiency, physical stores offer the brand experience, which is an important differentiator considering the amount of competition in the marketplace. In our estimation, this is a large reason why shopping malls will remain relevant.

In 2017, we anticipate getting closer to a resolution on a tax reform bill requiring online retailers to pay state sales tax. Currently, a loophole exists that allows online shops to avoid this collection cost, making it hard for physical stores to compete and causing states to miss out on the additional tax revenue. It is estimated that this loss in revenue is costing states more than $23 billion annually. The new White House administration campaigned for e-fairness, so it will remain to be seen if any changes are enacted.

Investment
Nationally, the retail sector of the investment market was relatively sluggish in 2016. Investment sale transactions were down 23 percent across the country through the first three quarters, largely due to slow consumer recovery and negative headlines regarding shopping malls and big box tenants. New retail development was also slow in 2016 for many of the same reasons, and some retail-focused developers have even been seeking alternative project categories. According to the Emerging Trends 2017 report by The Urban Land Institute, retail came in last for overall investor sentiment heading into 2017.

Feelings about retail remain diverse, however. Retail properties have historically been appreciated by public REITs and foreign investors, but in a market our size, we do not see much activity from those groups. One positive to retail investments is the ability to pass through costs to tenants, relative to other property types. This makes owning retail property less capital-intensive.

As mentioned previously, de-malling has been a strategy deployed that has added value to three different malls in the region. Creative repurposing of mall space will be an opportunity for investors to add value and re-stabilize failing assets.

Multi-family

Favorable conditions have led to recent growth in the multi-family market and we expect this to continue into 2017, with numerous projects underway or planned. Yet many feel they are in a race to be built and filled before we reach a saturation point.

Apartments
The multi-family investment sector has been a steady performer due to its relatively inelastic demand and consistent cash flow. Management of these properties can be consolidated and streamlined as assets are accumulated, and value can be added easily. Today, the sector is as popular as ever as the large millennial generation changes the way home-owning was previously viewed.

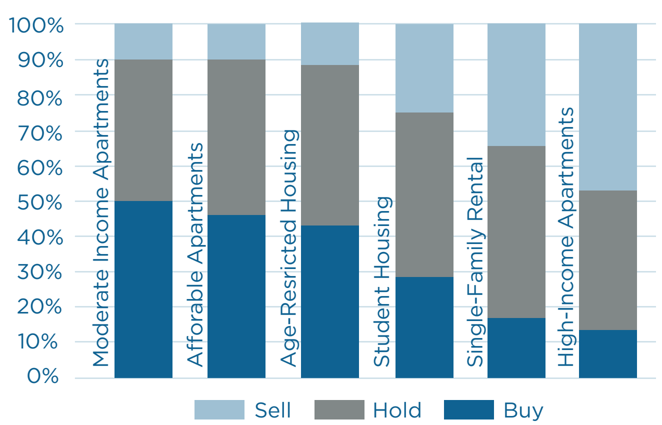
Since the recession, the share of 18- to- 34 year olds who own a home has fallen to a 30-year low. Millennials have less desire to be anchored to a particular asset or location and are far more likely to change their work and living environments than prior generations. Credit issues caused or compounded by student debt are keeping many in this generation from even having the choice to buy a house. Additionally, lessons seemingly learned by their parents through the housing crisis have soured the notion that purchasing a house will always result in positive return on investment. As a result, renting a residence has become popular and investors in the multi-family market have consequently reaped the benefits.

In addition to millennials, empty nest baby boomers have been increasingly interested in luxury urban apartments.

Debt and equity have become more readily available, so although construction costs are currently high, strong demand is allowing developers to build in occupancy projections that satisfy lenders and allow a high percentage of projects to be green-lit.

New residential projects in West Michigan are aplenty. Seemingly every week we hear the announcement of a new project. While many are ground-up, the redevelopment of functionally obsolete buildings is popular as well. Currently there are nearly 1,000 market-rate units under construction and an additional 1,545 units proposed or approved within the Grand Rapids area. There are also 658 units of income-restricted housing in the pipeline.

Figure 8: Apartment Sell/Hold/Buy Recommendations



Source: Emerging Trends in Real Estate 2017 Survey Based on U.S. respondents only.

The current residential occupancy rate remains above 97 percent in the area, gradually coming down off its peak of 98.6 percent at the end of 2013. Annualized apartment rent growth in Grand Rapids has been between 7 and 8 percent over the past two years, but this is forecast to slow as more units come online and as inflation remains tempered. Since rates are at such high levels, many are having to sacrifice size for location because they can't afford both. To maintain affordability for the largest portion of the population, we anticipate rates to plateau and for some developments to aim at capturing parts of the market that rates have passed by.

In 2017 we will look to see if planned unit rate continues at the levels we saw in 2015 and 2016, or if it starts to slow or even drop off significantly. Delivered units will likely be strong in the upcoming year, however, new projects are anticipated to slow as developers watch the wave of new units hit the market and measure the effect on occupancy and rent.

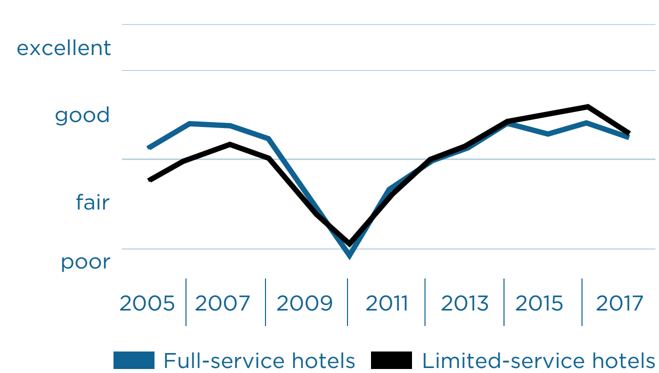
Hotels

West Michigan experienced a healthy level of hotel activity in 2016, mainly in well-trafficked retail corridors such as 28th Street SE, East Beltline Avenue, and Rivertown Parkway. Also, the addition of Switch to the market has spurred future hotel plans south of Grand Rapids in Gaines Township – as evidenced by two parcels of land sold for that purpose.

Additionally, Grand Rapids-based Grand Action, a business-based nonprofit, recently released findings from a local asset study and revealed in their findings a need for expanded hoteling downtown to accommodate a proposed increase in convention space. In 2017, we expect some decisions to be made in response to the study and for more rooms to potentially be planned in the city's core.

Despite strong demand locally, national investment experts are growing bearish on the hotel market and are concerned that the sector has hit its peak. This is noteworthy because the hotel market is often looked to as a leading indicator for the rest of the commercial real estate market, as room demand essentially refreshes daily. Room-sharing concepts like Airbnb have cut into hotel demand (as much as 10 percent in New York City), and as businesses have become more technologically interconnected, corporate travel has dropped. In West Michigan's case, with strong tourism and economic growth, we seem to still be in good shape and growing, however, it will be a key indicator to keep an eye on in 2017. ■

Figure 9: Hotel Market Sentiment



Source: Emerging Trends in Real Estate 2017 Survey.