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Avison Young: Greater Philadelphia CRE Sectors on Track for Strong 2019

In an exclusive audio interview, Avison Young's Philadelphia market leader David Fahey looks at some of the trends driving CRE investment in the City of Brotherly Love in 2019.

FEBRUARY 7, 2019 | BY STEVE LUBETKIN

PHILADELPHIA, PA – Greater Philadelphia's commercial real estate market posted strong fundamentals in 2018, with rental rates up and vacancies down, and these are on track to continue in 2019.

Those are some of the key findings in **Avison Young's** *2019 North America, Europe and Asia Commercial Real Estate Forecast*.

The annual report covers the office, retail, industrial and investment sectors in 68 markets, including the Greater Philadelphia's tri-state area.

"Greater Philadelphia registered a very solid 2018, and we're positioned for another strong year in 2019," **David Fahey**, principal and managing director of **Avison Young's** Philadelphia region **tells GlobeSt.com exclusively.** "Unemployment is down, job growth is up. Philadelphia over the years has really become more of a knowledge-based economy, and with the universities and other education and healthcare and pharmaceuticals, there's a lot of vibrancy going on."

As the report notes, Greater Philadelphia is a broad market encompassing Southeast Pennsylvania, Southern New Jersey and Northern Delaware. With more than 1.5 million people, the tri-state region holds the title of third largest regional economy in the Northeast.

You can listen to the complete audio interview with David Fahey in the player below. If you don't see a player, click here to listen to the interview.

Here are some of the key trends detailed in the report for the Greater Philadelphia market:

Office

David Fahey, principal and managing director, Avison Young, Philadelphia, PA (Photo composite)

Despite a slow leasing environment, vacancy hit a 17-year low – at 9.7 percent as of the third quarter of 2018 – and was below that of other major US markets. Class A office space represented nearly half of total inventory (48.5 percent, or 117 million square feet) and achieved its highest average rental rate ($25.74 per square foot) in five years during the third quarter. Center City submarkets, as well as prominent suburban submarkets, also saw increases in rental rates year over year.

"Vacancy is down and there's not a tremendous amount of spec or new construction," says **Fahey**. "So rates are going up and vacancy is coming down, and I also believe that helps attract outside investors to Philadelphia. Philadelphia traditionally has not been what I would call an investment grade environment, but I think that's changing."

As of the end of the third quarter, there were slightly more than one million square feet of construction in the pipeline due to complete in 2019. Availability rates also remain low, suggesting the area's office market will tighten. Rental rates are projected to rise, with office vacancy rates expected to drop to 9.1 percent.

Industrial

Thanks to abundant land in northeast Philadelphia and excellent access to highways, Greater Philadelphia's industrial market remains active. Inventory

totaled 317 million square feet, with vacancy at 5.5 percent – down 20 basis points year over year.

"It's a combination of how people shop and that last mile distribution requirement," **Fahey** says. "I think another driver is that the typical warehouse distribution is along the New Jersey Turnpike at Exit 8A. As matter of fact, there's not a lot left there. There's approximately four million square feet of spec industrial warehouse space being built in southern New Jersey."

Retailers' need to optimize their supply chains, plus Philadelphia's convenient location, sets up the area's industrial market for a promising 2019. Nearly 5 million square feet remain under construction, as total industrial inventory is expected to grow to 324 million square feet in 2019. Industrial vacancy rates, meanwhile, are projected to tick a bit higher to 6.6 percent in 2019.

Retail

The closures of such well-known stores as **Kmart, Sears** and **Toys 'R' Us** throughout the Philadelphia area hampered shopping centers in 2018, but the market held on through the increasing emergency of grocers, fitness centers and more experiential retail stores. At the end of the third quarter, retail space totaled 327 million square feet, with another 1.15 million under construction.

Moving forward, the redevelopment of the 800,000-square-foot **Gallery Mall** into the new upscale **Fashion District of Philadelphia** is expected to complete by September. The project features such experience-oriented tenants as a **City Winery**, an **AMC Theater** and a wide range of traditional-mall tenants, including **Burlington Coat Factory**, **Polo Ralph Lauren** and **Guess**.

Investment

The first three quarters of 2018 saw $5.8 billion in transactions — about $9.6 million more than the same period a year earlier. Office sales made up the largest portion of market activity at $2.5 billion, or 43 percent of the area's total sales during the first three quarters of 2018.

Investors outside the market are expected to remain interested in Philadelphia's relatively high cap rates, indicating that the area's investment market should remain strong in 2019, pulling continued interest from New York and Washington, DC.

"With cap rates being low in those markets, I believe that investment is more about asset preservation," says **Fahey**. "And I think here in Philadelphia you can still get yield. So I believe that's a factor in money being drawn to Philadelphia."

The overall US market

"The US market continued to provide fairly predictable returns to investors in 2018 despite some turbulence, both economically and geopolitically. The strong correlation between job growth and real estate value was again demonstrated in 2018 as the US added more than 2 million jobs which, in turn, bolstered occupancy levels as well as consumer confidence," says **Earl Webb**, president of US Operations for **Avison Young**. "Vacancy rates across all property types remain low when compared with historically similar market cycles. Capital flows into commercial property in 2018 remained roughly equivalent to those of the prior year, and foreign investors continued to be significant investors across all US property types, especially office and industrial."

"The property markets continued to perform well in 2018, demonstrating resilience in the face of substantial development, and total sales were on track to outpace the 2017 total volume after declining for two years from a peak in 2015," Webb says.

Avison Young is tracking 46 US office markets totaling 5 billion square feet of inventory. As year-end 2018 approached, overall national vacancy was 12.1 percent. San Francisco (3.5 percent), Charleston (7.1 percent), Nashville (7.1 percent) and Columbus (7.7 percent) recorded the lowest vacancy rates.

"Co-working operators are dominating US office markets as tenants pay up for term flexibility, amenities and the ability to shift long-term lease obligations off their books," says **Margaret Donkerbrook**, principal and practice leader of research (US) for **Avison Young**. "Landlords are feeling pressure to renovate older properties to compete; as a result, plug-and-play speculative suites and tenant amenities, such as conference centers and lounge areas, are becoming ubiquitous. Ultimately, there will be some shake-out in the category; however, co-working will remain part of the real estate lexicon."

The report goes on to say that retail continues to be the asset type most affected by change even though consumer spending increased in 2018—and experiential and service retail outlets are blossoming. E-commerce sales grew by 14.5 percent year-over-year. Looking forward, online grocery sales and related home-delivery services represent a nascent opportunity for both e-commerce and industrial logistics.

The 10.7-billion-square-foot industrial market inven-

tory increased by two percent after almost 200 million square feet was delivered in 2018, but strong leasing demand held vacancy flat at five percent. Distribution-logistics and e-commerce demand led to upticks in construction and speculative development in many key US markets, including Atlanta, Chicago and Dallas—with each having more than 18 million square feet underway. Overall, the US construction pipeline near the end of 2018 was 19 percent larger than at year-end 2017, and projects underway were 32 percent preleased.

Beyond distribution, core data center markets are expanding to prepare for the arrival of 5G networks; increased cloud usage by consumers and Big Data suppliers; and higher blockchain and AI adoption levels in such markets as Northern Virginia, Phoenix, Chicago, Reno and Dallas. Construction starts are cooling in some metros that are critically land-constrained such as San Jose and West Palm Beach, but most markets feature burgeoning industrial-property-development pipelines. Industrial vacancy is expected to rise slightly by year-end 2019.

Investors remained steadfast in their support of the US commercial real estate market in 2018. Sales were led by the multifamily and office sectors and foreign capital continued to flow into the US. Canada was again the top source of foreign capital, accounting for more than $40 billion of transactions and doubling its investment in comparison with 2017. France ($8.7 billion), Singapore ($6.3 billion), China ($5.6 billion) and Germany ($4.9 billion) rounded out the top five sources of foreign investment in 2018. Foreign and private capital will continue to sustain the US investment market in 2019.

"Even though year-over-year volumes were fairly consistent in the US, activity was uncharacteristically weighted towards the early part of 2018," says **John Kevill**, managing director of US capital markets for **Avison Young**. "This situation was largely a product of the broader economic volatility, and we anticipate that early 2019 will bring an uptick in transactional activity, particularly with fresh lender allocations and the availability of transitional debt. Expect to see institutional investors buy smaller properties than they typically have been investing in, thereby putting pressure on the private investors who have been dominating the under-$30-million market segment."

"Our outlook for 2019 remains consistent with that for the prior year," says **Webb**. "Modest interest-rate increases by the Federal Reserve are expected, but at a much-decreased pace. The US economy is strong overall; and with continued job-growth-related occupancy levels healthy, that strength should be maintained. However, the supply of labor, especially skilled labor, will have an impact on operating costs as well as the cost of new construction. Technological innovation — in procurement, occupancy optimization, workplace strategy, supply-chain management and many other areas — will continue to keep our industry in an evolutionary mode."

Steve Lubetkin *is the New Jersey and Philadelphia editor for GlobeSt.com. He is currently filling in covering Chicago and Midwest markets until a new permanent editor is named. He previously filled in covering Atlanta. Steve's journalism background includes print and broadcast reporting for NJ news organizations. His audio and video work for GlobeSt.com has been honored by the Garden State Journalists Association, and he has also been recognized for video by the New Jersey Chapter of the Society of Professional Journalists. He has produced audio podcasts on CRE topics for the NAR Commercial Division and the CCIM Institute. Steve has also served (from August 2017 to March 2018) as national broadcast news correspondent for CEOReport.com, a news website focused on practical advice for senior executives in small- and medium-sized companies. Steve also reports on-camera and covers conferences for NJSpotlight.com, a public policy news coverage website focused on New Jersey government and industry; and for clients of StateBroadcastNews.com, a division of The Lubetkin Media Companies LLC. Steve has been the computer columnist for the Jewish Community Voice of Southern New Jersey, since 1996. Steve is co-author, with Toronto-based podcasting pioneer Donna Papacosta, of the book, The Business of Podcasting: How to Take Your Podcasting Passion from the Personal to the Professional. You can email Steve at steve@statebroadcastnews.com.*

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