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One-on-One With Lauren Gilchrist

In early January, Stradley Ronon Real Estate Chair, Chris Rosenbleeth, sat down to interview Lauren Gilchrist, Vice President and Director of Research for JLL's Philadelphia office. In a wide-ranging interview that covered all aspects of real estate in the Philadelphia market, Lauren gave us her review of 2017 and outlook for 2018.

Chris Rosenbleeth: So where are we in the cycle? It seems we've been saying for three or four years that we are in the "seventh inning," but it just keeps going.

Lauren Gilchrist: I think it depends on what part of the region you're looking at, quite frankly, because when I look around the region I see places that still have room to grow. I also see places that I think are maybe getting to be a little bit overheated at this point in time, either from a demand perspective or from a construction perspective responding to those supply-and-demand dynamics. One of the things that I think is really interesting about Philadelphia is the fact that we've never really experienced the high highs or the low lows like a lot of other places. We haven't seen the tech run-up like San Francisco. We've never seen a financial markets run-up like New York. So Philadelphia doesn't experience dramatic growth like those places from a real estate perspective, but we don't see the bottoming out either.

Everybody wants to put the baseball analogy to it, and everyone asks us and wants to say we're in the seventh or the eighth inning. It's sort of tough to categorize that way. Instead, we like to think of the cycle as a clock: from 6 to 12 are landlord-favorable conditions, and from 12 to 6 are tenant-favorable conditions, in terms of room to grow from a rental rate perspective. We put the central business district (CBD) roughly at the 10 to 11 o'clock position, which is the peak phase of rents.

CR: Is that for any particular asset class or across all asset classes?

LG: I would put office at 10 to 11 o'clock, suggesting we still have a little bit more room to grow from a rental rate perspective.

For multifamily, we're probably at that 12 o'clock position and getting close to going over the edge. There's a lot of data to suggest that product will eventually lease-up, no problem, but with a lot of concessions from the landlords to get there – we hear two to three months free rent.

Retail is already kind of on the decline. I would put it around, say, 2 o'clock; I don't think it will fall too much farther before it starts to kind of bottom out and then rebound again. On the other hand, there's a systemic structural change occurring in that industry as a function of e-commerce. No one really knows what the bottom looks like in retail in these conditions.

If we don't know where the bottom is for retail, we really don't know where the top is for industrial because of these sweeping changes. We hear of all kinds of new construction projects, incredible pricing in the capital market and very, very low cap rates. I think we'll be there for a while.

CR: Focusing now on multifamily, do you think there is an over-supply within the market? Overall, I think there's been a slowdown in this asset class; assuming you agree, what do you think are the factors?

LG: Multifamily is a very complex story, and there are a lot of parts to it.

First, this market cycle is the first time we really saw new construction. A lot of the past dynamics were a function of conversion of B and C Class office to apartment product – about 8 million square feet was converted over the last 25 years to apartments, condos, hotels and other uses. More recently, new construction started to make sense because we saw a rise in rental rates and obviously the 10-year tax abatement helped as well. So from 2012 to 2017, we saw about 7,500 new units come to the market, including new construction and adapted space. The vast majority of those units are targeting $3.50 a square foot for rental rates, making a 1,000-square-foot apartment around $3,500 a month. That is a really expensive apartment in Philadelphia, but to make the economics pencil out with the construction that's roughly what you need to get back. In 2018, we're expecting about 2,600 to 2,700 apartments to deliver. If you look at 2019 deliveries, it's about 200 or 300 units.

A second factor is the slowdown in the millennial population growth – certainly the [City of Philadelphia] is still growing, but we had the fastest rate of millennial growth in the country, and millennials were early sort of occupying a lot of that apartment product. There will be some empty-nesters and some trading up but, nonetheless, if [the millennials] are not coming into, or are leaving, the City, there's more supply.

Finally, the city's comprehensive reassessment of commercial property had a dramatic impact on the deal structures from a sales perspective. Unlike office product, where you've got a base year for your operating expenses that grows with inflation or according to some percentage, an increase in the assessment of a multifamily building will be passed on to the tenant in the form of higher rents. But we already had very high rents! So that product becomes even less attractive to the potential renters within a demographic whose growth has been slowing a little bit.

On top of all that, Philadelphia is still an affordable city in which to own. Someone can buy a single-family home, totally renovated, in an established neighborhood, within walking distance to the heart of the office district in Philadelphia. You couldn't do that in Manhattan or San Francisco, you know? So when you think about the economics of renting versus owning, a mortgage payment can be less than it costs to pay monthly rent in a newer apartment.

CR: Will the inclusionary zoning bill in Philly have any effect on all this?

LG: I feel like there are some challenges with this bill from the standpoint of how housing is priced in Philadelphia. Truly, the only way to ensure that housing remains affordable is to build as much as humanly possible – to make sure that there's a constant supply for anybody that might want to move in and potentially even an over-supply because in that environment you see prices decline. The inclusionary zoning bill is a problem from the perspective of requiring developers to incur additional costs in an already expensive construction environment without corresponding rents. We're already having trouble making the rents work, and now the public policy environment is saying you have to take even less rent for a project that costs the same to build. I think that will be a condition that slows down the construction of housing in the City overall. So for me it's very concerning because we're not addressing any of the costs that are baked into construction in Philadelphia that make us almost as expensive as New York to build.

CR: Do you think that Philadelphia has an "affordability" crisis or a "quality" crisis? With construction costs being what they are, can anything be done to fix the issue right now?

LG: When I think about affordability, there are tons of places in transit-accessible areas that are extremely affordable with great access to jobs in the CBD. It's not [necessarily] a bad thing that the CBD and the immediately adjacent neighborhoods are expensive. In fact, it's a positive from a real estate tax perspective because the city can collect more revenue from a very densely packed piece of land to support the services that we have. Having expensive real estate where expensive real estate should be, helps to support

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the infrastructure that we have everywhere else. If we are thinking about incentives to provide more housing in those areas [i.e., outside of Center City], we should think about incentives to attract more development in North Philadelphia or Kensington and attract people to live there, rather than imposing additional burdens on more expensive real estate in the CBD.

CR: Do you see a lot of out-of-town money coming in right now?

LG: We do, and we're starting to see more. Historically, we've never really had institutional investors like pension funds and insurance funds interested in Philadelphia office because the risk-adjusted return is just not there. But, we're starting to see more. Investors are getting pushed out of New York, D.C. and Boston so that definitely helps here. But if you're used to New York returns or doing business in San Francisco, sometimes Philadelphia is tough to wrap your brain around.

So, we spend a lot of time talking to [outside institutional investors] about how Philadelphia is different than it was even five years ago. A lot of the dynamic has been new capital coming to Philadelphia: a couple of years ago, Shorenstein bought 1700 and 1818 Market Street, and MRP acquired [the Bourse Building] as well as Three Parkway. Other, smaller private equity groups are circling the market at all times. I think when 1600 [Market Street] trades and when 2000 [Market Street] trades, we'll see a landlord or investor that has not been in the CBD historically.

CR: Why isn't retail doing well when all of the macroeconomic indicators are strong? Is it really the Amazon factor, or is it something else?

LG: I think that there's massive structural change underway in the retail industry. And it's partly Amazon but certainly it's the way that all of the different e-commerce players are acting in today's environment. So, in addition to consumer goods, we're also seeing people grocery shopping less in person because, now, grocery stores will deliver. Or they're doing Blue Apron, where you can order online and cook, not to mention you can have takeout from almost anywhere delivered right to your door. I think it's changing the way that we shop. Period. And as a function of that, we've seen a lot of major retail owners shift more to experiential concepts. Real estate's become about the experience across the board for retail, office and multifamily. It's all about the service aspect of it.

CR: The amenities?

LG: Yes, that's exactly where I'm going. People ask me all the time, "Well, King of Prussia Mall is thriving, but all these other malls are dying. What's going on?" King of Prussia has created an integrated regional destination experience. If I go to King of Prussia, especially coming from the city, I go in the morning, shop, have lunch, do more shopping in the afternoon. And I'll probably have a snack and maybe I'll stick around for dinner until the traffic dies down. Think about the food they even put in there recently. They're nice, sit-down, destination restaurants. So the retailers that are going to be successful, I think, are the ones that create a reason to stay for more than just a transaction. We've seen a little bit of this in the downtown market, where rents are falling a little bit. A lot of the kind of traditional retailers like goods and clothing providers, are struggling. Where we've seen success is in fast casual food and fitness.

CR: Is it true that suburban office is outpacing the CBD?

LG: It depends on which submarkets and which indicators you're seeing. Suburbs that are really successful right now from a rental rate prospective are Conshohocken, Radnor and King of Prussia. All of those are in environments that are close to public transit or diversifying their land use. What we've seen from an office prospective is that tenants are going where they can easily access talent. The talent has grown more significantly in Center City than it has in the suburbs. Therefore, proximity to transit is really important. The CBD is kind of the story of haves and have nots. Trophy office space averages $38 to $39 per square foot, [a] limited supply of large blocks. Creative office space averages, say, $31 to $34 per square foot depending on the location. It's the in-between, "vanilla" space that's not successful.

Downtown, we saw slight negative absorption this past year. On the other hand, the suburbs have finished the year with positive absorption. The CBD has been a little more "touch-and-go" as there is a little bit of a flight-to-quality aspect that we see going on here. I think it just proves that people will move their office to be in a beautiful new building, because we have so many '70s and '80s vintage buildings.

CR: What are your thoughts on 2018?

LG: I think the office market is going to be pretty robust. The first two quarters of last year were really slow from a leasing perspective. On average, downtown, we see about 715,000 square feet of leasing activity quarterly. Our first three quarters were significantly below that and we saw a bump in the fourth quarter to just about that level, largely due to Jefferson signing at 1101 Market Street. But there are a number of other large deals circling currently that are getting towards finalization of those leases. And so, I do think that the market will be robust within the next 3 to 6 months. New construction will also make it feel like there's ongoing momentum.

For multifamily, it's going to be a matter of plugging away at some of the occupancy numbers. Product that is renting below $3 per square foot is about 98 percent occupied. It's the very expensive product that is not as well-occupied. So, it's going to be a bit of a slog for those developers to chip away. As a result, we'll be hearing a lot less about multifamily in the coming year. From a success perspective, we will see new construction deliver again. That helps people feel like stuff is happening. But, from a lease-up perspective it's going to be a little slow, I think.

And I also am looking forward to hearing where Amazon lands. I think no matter where they land, it's going to be very splashy. My feeling is that they are going to land on the East Coast somewhere. So I think we will feel that in Philadelphia, even if they don't come to Philadelphia, which will be a good thing for everybody.

CR: Finally, how do you think 2018 will compare with 2017?

LG: I think 2018 is going to feel bigger than 2017 – there's a lot of new construction that will deliver. I think the opening of Comcast is going to be phenomenal and it will be a very big psychological boost for the market overall. We can't overestimate the impact of 4,000 people working in that building and what it does to the surrounding area. We'll just have to wait on the retail environment. But, in an environment that continues to grow residential and grow office occupants, retail will never really go away or starve. So all in all, 2018 will be a very big year.

About Lauren Gilchrist
Lauren Gilchrist is Vice President, Director of Research for JLL in Philadelphia, where she directs JLL's local market research platform for the region. Lauren's specialties include urban and regional economics and demography. Prior to joining JLL, Lauren served as the Manager of Research & Analysis at the Center City District in Philadelphia, a $25 million business improvement district, where she directed the organization's market and public policy research. Lauren received her Master of Science in Public Policy and Management with concentrations in Urban and Regional Economic Development and International Trade and Development from Carnegie Mellon University's Heinz College and a Bachelor of Science in Business Administration from Bucknell University. She serves on the local board of and frequently lectures on topics related to commercial real estate and economic development for institutions including the Appraisal Institute, CoreNet, International Council of Shopping Centers, International Downtown Association, Pennsylvania Bar Institute, Philadelphia City Planning Commission, Urban Land Institute, University of Pennsylvania, and U.S. Census Bureau.