April 25, 2016

Apartment Broker Says Apartment Vacancies Could Hit 10% This Year

Apartment broker Greg Johnson did the math and has come to the conclusion there is a good chance that the Denver-area apartment market vacancy rate could hit 10 percent this year. That would be a 47 percent increase from the 6.8 percent vacancy rate at the end of the fourth quarter, according to the Apartment Association of Metro Denver. If the vacancy rate does hit 10 percent, it would be the first time in 12 years. And the last time the vacancy rate stood at 10 percent, the market was actually recovering from the record-high 13.1 percent vacancy rate set in the second quarter of 2003, noted Johnson, who is a partner with Kyle Malnati at Madison Commercial Properties. What is driving the rising vacancy rate is the current building boom. One might even call it an overbuilding boom. "We are in the process of doing what Denver has always done. We overbuilt the market during the good times," Johnson said. Johnson is basing his projection on a variety of sources. "We look at all of the data from the Apartment Association, Cary Bruteig and Bill James, and they all seem to be in agreement that there are about 20,000 units under construction," Johnson said. "We anticipate that 12,000 of those will be completed this year, which I think is conservative," he said. Last year, the market had a net absorption of a mere 864 units, according to the Apartment Association. If the absorption doubles to 2,000 this year and 12,000 new units come on line, "and you do the math, that gives you exactly a 10 percent vacancy rate," Johnson said. However, Bruteig, owner of Apartment Appraisers & Consultants, at a recent multifamily conference he and the Colorado Real Estate Journal sponsored, reported markedly different absorption numbers last year. There were 7,901 units absorbed in the seven-county area in 2015, according to Bruteig. That was down from about 8,300 units in 2014. However, both years far outpaced the average yearly absorption of about 5,000 units, according to Bruteig. Bruteig also placed the overall vacancy rate at 4.87 percent at the end of 2015. Another way to look at it: The vacancy rate would have to more than double to hit 10 percent, based on Bruteig's numbers. Still, a number of speakers at the conference agreed that too much supply is being added to the Denver-area market. Also, the cranes constructing these new, luxury communities are mostly found in downtown Denver and nearby neighborhoods, from the Golden Triangle to West Highland. The concentration of the new supply is increasingly a cause of concern among apartment experts. One of them is Johnson. However, there is no denying the underlying economics, job growth and population increases are bullish signs for the economy and the apartment market, he said. "Rising vacancy rates are being caused by an oversupply, not by a lack of a demand," Johnson said. While construction is concentrated in downtown Denver, rising vacancy rates will be across the board, he said. "That is a slice of the story that a lot of people don't think about," Johnson said. A lot of apartment owners, he said, don't think overbuilding is going to hurt "their" property. "They think the only ones you have to be worried about are in the Ballpark area and other core, central Denver neighborhoods. But those people are wrong." He said he looked over 18 years of data from the late Gordon Von Stroh, a University of Denver professor, "and it clearly shows vacancy rates move across the metro area" at roughly the same pace, no matter the geographic area. However, from a macro-standpoint, rising vacancy rates from overbuilding always are preferable to the market softening from a slow economy, he said. "Our market recovers much faster from overbuilding than when it comes from a down economy and people are leaving the area," Johnson said. "A lot of apartment owners don't think overbuilding is going to hurt their property." The worst-case scenario, of course, is when there is both overbuilding and the economy is going south. That happened during the mid-1980s, during

the crash of energy and saving and loans, as well as during the early 2000s when the dot-com bubble burst, which was followed by the terrorist attacks on Sept. 11, 2001, he noted. Still, a 10 percent vacancy rate will have a dramatic impact on the market. "What that means is we will flip from a landlord's market to a renter's market," Johnson said. That doesn't necessarily mean that rental rates will go down, although it can, especially in the new Class A properties in and around downtown Denver, he said. What seems almost certain is that rents no longer will see double-digit increases, he said. "Rents will plateau and, in some markets, we will see modest declines," he said. Smaller mom-and-pop owners will lower monthly rents, while institutional owners will tend to provide concessions, such as months of free rent, he said. Cap rates will remain low, as long as interest rates remain low, he said. "Cap rates will continue to be driven by interest rates," Johnson said. Johnson and Malnati are advising owners to be realistic about their projection for their properties. "We tell them not to think they will be the one to buck this trend," he said. Buyers also should be conservative as far as taking on excessive debt, he said. However, he remains bullish on Denver for the intermediate and long term. "I want to stress that this is a short-term phenomenon," Johnson said. "Yes, it might take three years to absorb all of this inventory," he said, but the longer the time horizon, the better the outlook for rental properties. Also, investors who plan to own apartments for the long term shouldn't hesitate to buy today, even if the market faces a temporary softening, he said. Buying an apartment is not exactly like buying a blue-chip stock when the market is down, he said. "Blue-chip stocks are always available and are always liquid," Johnson said. "Blue-chip apartment properties in Denver are far more scarce. They are not always available. So if you spot a good asset this year and you want it, buy it." **(Colorado Real Estate Journal)**

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Unico Pays $63.75 Million for 1875 Lawrence, Plans Amenities

Unico Properties LLC continues to be an active buyer in downtown Denver, picking up 1875 Lawrence in an off-market transaction. Public records show Unico paid $63.75 million, or $327.69 per square foot, for the 194,541-sf building, which was approximately 80 percent occupied at the time of the sale. Unico plans to invest in tenant amenities and energy savings measures, similar to its investment strategies at 17th and Larimer and Writer Square. "We worked directly with the seller and its broker, HFF LP, to buy an asset in a location that is growing and evolving from good to really good and getting better," said Austin Kane, Unico Properties vice president and regional director for Denver and Boulder. "We will invest in 1875 Lawrence to further elevate the building's image, significantly improve our building amenities and create a premier work environment for a wide range of businesses." Sellers DPC Development Co. and Bridge Investment Group bought the property for $46.7 million just over two years ago. "This was a nice asset for us and a pleasure to own," said DPC President Chris King. "We purchased the building when it was less than 50 percent leased, made improvements and raised occupancy to just over 80 percent. After we did the heavy lifting, our partners at Bridge Investment Group and we decided to sell the asset to a group with long-term ownership plans," he said. "This is a great building with inherent long-term value, and I think this worked out well for all parties," he said. DPC Acquisitions Director Justin Lutgen, and HFF's John Jugl and Mary Sullivan orchestrated the sale. Unico Properties noted 1875 Lawrence is situated at the confluence of three of Denver's most dynamic areas: downtown, Lower Downtown and River

North. Built in 1982, the 15-story brick and concrete building has views due to its glass line as well as height restrictions in LoDo. Including a lobby renovation, more than $4 million has been invested in the building since 2011. Unico Properties plans to build upon prior renovations by adding a new fitness center with locker rooms and showers; bike storage; a conference room; restroom, common corridors and lobby modernization; new lighting and a 24-hour security system; and energy-efficient upgrades. It will pursue LEED certification. "With other properties we've purchased in downtown Denver, we have had to make massive improvements, both cosmetic and back of house. At 1875 Lawrence, we have a core asset with great bones. Our task now is to use our property management, leasing and sustainability expertise and skills to prepare 1875 Lawrence to serve tenants' needs well into the 21st century," Kane said. Some open ceilings and open office space will be created to appeal to technology and creative companies looking for collaborative work environments. The building houses a wide spectrum of tenants, including anchor tenant Ardent Mills, which has its headquarters in approximately 55,000 sf. Unico Properties' Denver portfolio consists of more than 2 million sf of Class A office and mixed-use properties. Within the last year, it acquired the Elephant Corral and Denver Club in downtown Denver, and Second and Josephine in Cherry Creek North. The company owns an additional 1.4 million sf in Boulder. Unico Properties will manage 1875 Lawrence. Unico is a Seattle-based real estate investor and full-service operator focused on office and multifamily assets in the western United States. **(Colorado Real Estate Journal)**

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New Train to DIA, Denver Rail Expansion are Turning Heads among Global Investors

Denver's profile among international real estate investors has risen significantly in the six years that RTD and Denver Transit Partners have been expanding Denver's rail network — including the rail line to Denver International Airport opening Friday. The line to the airport is important not only for itself, but as a symbol of the larger project and the metro area's ability to invest in large projects with big payoffs, according to one local real estate expert. "It's symbolically the most visible and most symbolically important line because it connects downtown Denver to every place in the world that Denver International Airport connects to," said Mark Falcone, CEO of Continuum Partners LLC, a real estate development company. It was six years ago that the Regional Transportation District signed a $2.2 billion contract with Denver Transit Partners to build three portions of the sprawling FasTracks project — including the A Line to DIA. Falcone's Continuum and East West Partners created the joint venture called Union Station Neighborhood Co., which was the master developer for the 19.5 acres surrounding the historic Denver train station. Real estate investors around the world have taken notice of Denver's growing transit network, Falcone said. "In real estate, we talk to people investing capital all over the world and it's amazing how high Denver's profile has become over the last five years. People look at the Denver region and see a lot of long-term growth and prosperity," he said. Real estate investors take a long, wide view before investing in projects. "They're investing in a region's economy and job growth — and Denver, five or six years ago, never would have been in the same sentence with Seattle, San Diego, or Boston from a real estate investment perspective. Now, we are," Falcone said. And it's not just American real estate investors, Falcone said. "Denver is a meaningful place and a place that foreign capital is interested in

investing, which is a great testament to some very sophisticated people's perception of our region's ability to be an ongoing center of vitality," he said. The mass transit side of Denver Union Station opened in 2012 when the light rail lines started operation a few blocks west of the historic train station. An underground bus garage opened two years ago, in the spring of 2014. Today, "we're extremely proud of what it is and what we were able to do," Falcone said of the project. "I walk through it back and forth to work every day and it's amazing, the shift that it's created in our neighborhood." RTD officials say about 24,000 people pass through Union Station every day. By the end of this year, more than 100,000 people are expected to pass through the state every day, according to RTD. And many people see the station's area of influence expanding throughout lower downtown, Falcone said. Continuum is planning a $150 million mixed-use development at the site of the old Market Street Station bus terminal on the 16th Street Mall. The terminal closed when the new underground bus terminal opened at Denver Union Station. Financial firms that Continuum talks to about the project don't talk about the old bus station as a part of LoDo, Falcone said. "They talk about it as Union Station — everything within three to five blocks is now in the sphere of Union Station," he said. During planning for Union Station, the train platform for the airport line was deliberately placed right next to the historic train station, Falcone said. "When you get off the train, if you are someone arriving from out of town we wanted the impression [of Denver] to be overwhelming when you arrived," he said. And he's a fan of the design of the train station at Denver International Airport. "I'm thrilled with what the airport did on their end," he said. "There's a lot of airport trains where you enter a parking garage and you walk through all the back tunnels and you finally get to some uninspired train platform somewhere. What DIA did [with its train station] is exactly what it ought to be. It feels grand," Falcone said. As for complaints that the commuter rail train platforms at Denver Union Station are too far from the light rail platforms — on the other side of the 1,100-foot long underground bus garage — Falcone said other train stations have a longer hike between different transit modes. At Washington, D.C., for example, the distance is greater between Amtrak platforms and the commuter rail platforms, and so is the distance between subway lines and some of the metro lines in New York City's Grand Central Station, he said."It's no different than walking four gates at the airport," he said. **(Denver Business Journal)**

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REITs Shift Strategies amid Market Uncertainty

Now is a good time to make sure your portfolio is well positioned, advises Gerard Sweeney, CEO of Brandywine Realty Trust. He spoke on the panel "Capital Markets: Where Are We Now and Where Are We Going?" during the 2016 Urban Land Institute Spring Meeting. "Every sector of real estate is under assault," he warned. Indeed, current market volatility and economic uncertainty are major concerns for all types of industries, and real estate is no exception. Sweeney was not alone in expressing such concerns, which have led them to reevaluate their strategies to ensure they're well prepared for any challenges that come their way. One of Brandywine's approaches is to shift its focus toward selling assets instead of pursuing new development. Sweeney noted that from 2014 to 2015, Brandywine sold about $2 billion worth of properties, with another $1.2 billion over the last 12 months. This strategy secures capital for the company, which is pre-funding the REIT's development pipeline, including $800 million currently under construction. Liberty Property Trust has a

similar model. "Selling assets has been the primary source of funding for our development," said Bill Hankowsky, chairman of the major public REIT and another session panelist. The REIT sold about $2.5 billion worth of properties over the last several years and plans to sell another $900 million to $1.2 billion in assets this year, providing funding for new projects without having to take out construction loans. This is especially useful since construction lending is so tight right now, noted Greta Guggenheim, CEO of TPG Real Estate Finance Trust, the mortgage investment arm of TPG Capital. "The beginning of this year was highly volatile. We saw major regulations come in that affected the regulated lenders," she said. "In the last three to four weeks, I've seen more requests for construction loans by developers who had accumulated land assemblages during this cycle but couldn't get the financing, and it looks like they're going to have to wait until the next cycle." This is a particular issue for condominium developers, as banks are reluctant to lend in markets with significant new supply, which is putting a lot of stress on that sector, she added. One market with such a situation is Manhattan, where 9,500 condo units out of about 14,000 to 15,000 units expected to be delivered are priced above $4 million. "Historically, the units priced at that level that were absorbed by the market was 1,200 units per year, so that's a nine-year supply." However, Guggenheim said the overall market is more rational in this cycle than it was in the last cycle and doesn't have the same amount of oversupply. Sweeney added that this is largely because "there's a lot more information out there today," adding that "there's been a real maturation of our business." Another strategy Brandywine is pursuing to ensure it's well positioned is changing its portfolio from suburban or near urban to primarily urban focused, and to cycle out of certain markets or products. "We started looking at the performance of certain properties and where we could justify long-term investments," Sweeney said. "Anything that didn't qualify under that guideline we started to sell, and the reality is that the majority of those properties were suburban." He added that the company also bought about $110 million worth of land in Washington, D.C., downtown Philadelphia, and Austin, its three main markets. In addition, 80 percent of the firm's portfolio is now urban or town center properties served by rail. Liberty Property Trust's change in product mix entailed shifting "from about 60 percent of revenues coming from office and 40 percent industrial to, by the end of this year, we should be 80 percent industrial and 20 percent office." He added that the 75 percent of the office component will be urban, as location is particularly important. "We're seeing a real movement among our customers where they recognize physical space helps define culture and culture defines brand," Sweeney added. "So if these companies want to focus on growing their images and attracting real talent, where they house themselves is important." The two REITs' changing strategies reflect where they believe we are in the real estate cycle. "I think we're in the later stages of the cycle," Sweeney said. "I think most of the markets that were going to move have moved; most of the rental rate increases will be the same; growth is decelerating. We have positioned ourselves so that if there's a downturn coming, we've got all our sales or repositioning done. If it's a false beep and things rebound, we're in great shape." Hankowsky mostly agreed with this sentiment, but believes that because the financial crisis was "unprecedented and extraordinary," the recovery really only started in 2011. Thus, we could have a longer cycle—perhaps until 2018. Either way, both agreed preparation is key in case of a downturn. **(Commercial Property Executive)**

	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED TARGET RATE	.50	.50	.25
3 MONTH LIBOR	.64	.62	.28
PRIME RATE	3.50	3.50	3.25
10 YEAR TREASURY	1.89	1.89	1.96
30 YEAR TREASURY	2.70	2.67	2.65