BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

MARKET REPORT *Detroit Metro Area*

2H/20

Economy Begins to Regain Footing After Big Hit as Businesses Reopen and Unemployment Returns to Single Digits; Rising Confidence Has More Investors Reentering Buyer Pool

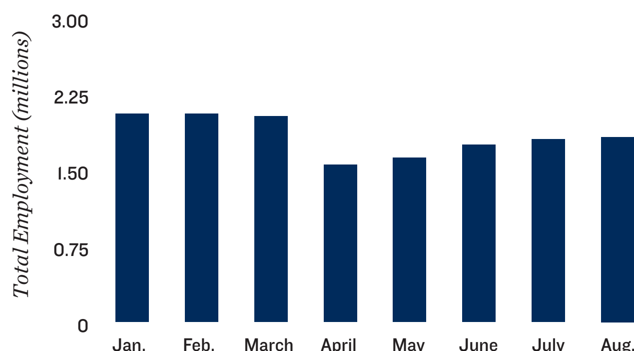
Employment rebounding after significant fall. After enduring one of the nation's stricter lockdowns, which included automakers, hotels, retailers and many restaurants, unemployment soared to 23.2 percent in May, one of the highest rates in the U.S. Job losses rose to 477,300 in April alone and a surge in coronavirus cases caused a prolonged closing, but as firms reopened, the economy has rapidly improved. Roughly 272,700 people were brought back to work in the May through August period, dropping the unemployment rate to 9.6 percent in August, 120 basis points above the national rate. Total employment remains down 225,900 people from the end of 2019, however, and a number of these positions are unlikely to return as many small firms have permanently closed.

Uneven job losses among employment sectors. Segments of the economy that were required to close suffered the greatest drop in workers. Roughly 118,000 leisure and hospitality staff lost their jobs in March and April, compared with less than 8,200 in each of the information, government and financial services segments. Since reopening began in April, most sectors have brought back workers. The largest gain of 66 percent was in leisure and hospitality as roughly 54,700 jobs returned. The segment is still 63,000 workers below the February level, however. The manufacturing sector has also made great strides. After employment dropped by nearly 83,000 workers during the shutdown, staffing was down by 25,300 people in August from the pre-coronavirus level. Hiring should continue to improve as vehicle sales rebound and auto companies and their suppliers ramp up production.

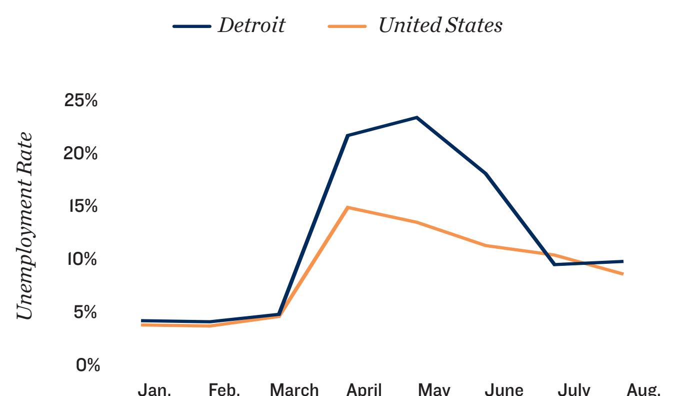
Changes ahead will impact commercial real estate. The pandemic has altered traditional patterns as people and businesses adjust to the new reality. Once stay-at-home orders were lifted many households sought more suitable living quarters. The apartment sector will be affected by changes to commuting patterns and a desire for larger living quarters with space for a home office and online schooling. With less emphasis on commuting to an office in a home search, the suburbs are gaining favor. Demand for apartments surged in the Southfield submarket during the second quarter, dropping vacancy 100 basis points to 2.9 percent. Companies may also relocate or open satellite space to be near staff, which could benefit suburban office buildings in areas including Royal Oak and Troy as leases come up for renewal. Office demand may also change as companies with employees working remotely at least part time consider consolidating office space, while others expand to accommodate social distancing. Retailers have been significantly impacted by changing consumer preferences, especially online ordering, which is benefiting industrial demand.

Investors moving from sidelines as economy improves. After pausing due to uncertainty as the pandemic spread, the metro's quick employment turnaround is providing confidence that is drawing more people back into the buying pool. The surge in online ordering has been a boon to the metro's industrial sector amid the increased need for last-mile delivery space. Smaller suburban industrial buildings, in particular, are receiving attention. Many of these properties are located near residential density and may be suitable for e-commerce deliveries.

2020 Employment Trends

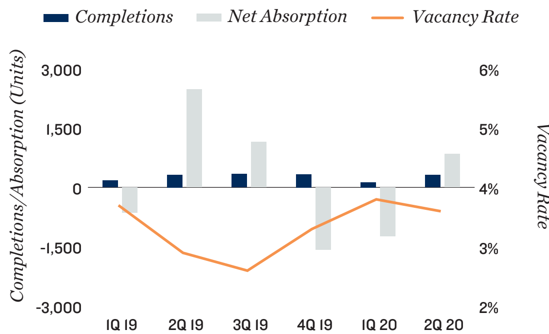


2020 Unemployment Rate Trends

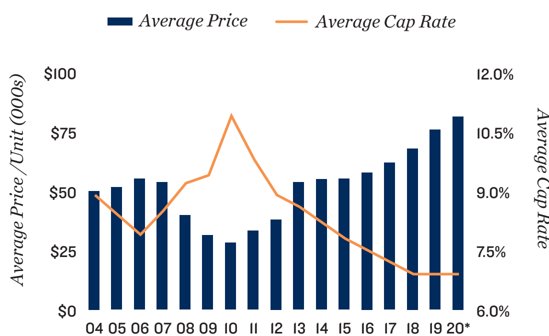


Source: BLS

Apartment Completions and Absorption



Apartment Price and Cap Rate Trends



** Through second quarter*

Sources: Real Page Inc.; CoStar Group, Inc.; Real Capital Analytics

APARTMENT

Rental Market Well Positioned at Midyear; Full Brunt of Coronavirus Could Be Yet to Come

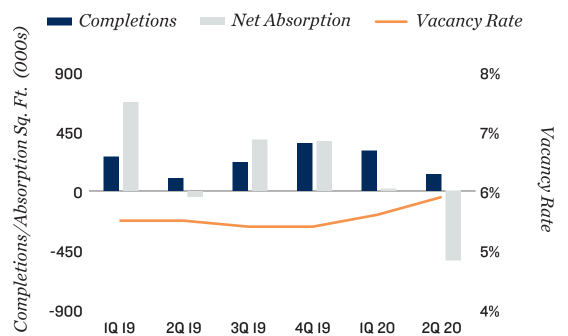
- The multifamily sector was healthy heading into the pandemic with a restrained delivery pace, vacancy resting below the replacement level, and steady rent gains. A preference for larger units and an increase in homeownership, however, dampen the outlook.
- Developers completed 440 units in the first six months of 2020, down from the prior period's 674 rentals. Another 600 units could come online this year.
- Marketwide, vacancy rested at 3.6 percent in June, down 20 basis points from the first quarter and just 70 basis points above last year's cyclical low. In the second quarter, the largest vacancy improvement was registered in Class A. Renters seeking larger units in desired locations dropped the rate 60 basis points to 4.7 percent.
- The average effective rent climbed 1.3 percent to $1,020 per month in the second quarter. The rent in Class A buildings posted the largest quarterly gain of 4.7 percent to $1,440 per month.
- After a strong first quarter, investment activity plummeted as uncertainty due to the pandemic sent many investors to the sidelines. Over the past four quarters, the average price soared 13.3 percent to $81,400 per rental, while the average cap rate held in the high-6 percent range.

RETAIL

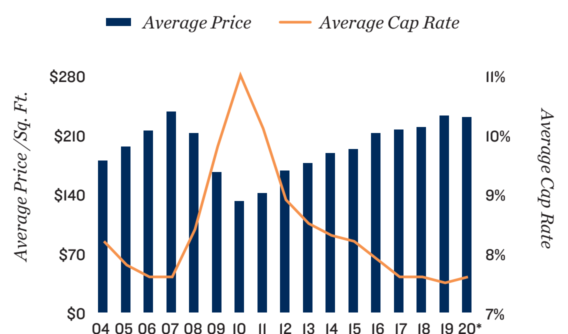
Metro's Retail Landscape Began the Year on Solid Footing; Pandemic Especially Hard on Nonessential Retailers

- Not all segments of the metro's retail sector fared equally during sequestration. Stores deemed essential remained open, benefiting necessity-based retailers. As a result, grocery-anchored centers and buildings with a drive-thru capability outperformed the many closed restaurants, clothing stores and experiential retailers.
- A slowdown in construction contributed to deliveries shrinking to 432,000 square feet so far in 2020, down from 581,000 square feet in the second half of last year. Builders have another 100,000 square feet potentially due in 2020, which is 84 percent leased so far.
- Stores permanently shutting doors contributed to multi-tenant vacancy climbing 20 basis points in the second quarter to 5.8 percent, while the rate in single-tenant buildings rose 30 basis points to 5.9 percent.
- So far, the uptick in vacancy has not had a major effect on rent. The average asking rent rose 2.0 percent in the second quarter to a decade-plus high of $14.97 per square foot. The increase was buoyed by a 2.3 percent gain in single-tenant rent as expanding retailers leased the more desirable locations.
- Trading velocity plummeted in April as a lack of clarity kept many potential buyers waiting. The average sales price increased 2.3 percent year over year to $231 per square foot, while the average cap rate remained in the mid-7 percent span.

Retail Completions and Absorption



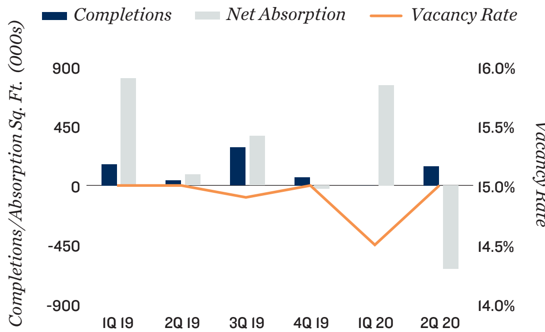
Retail Price and Cap Rate Trends



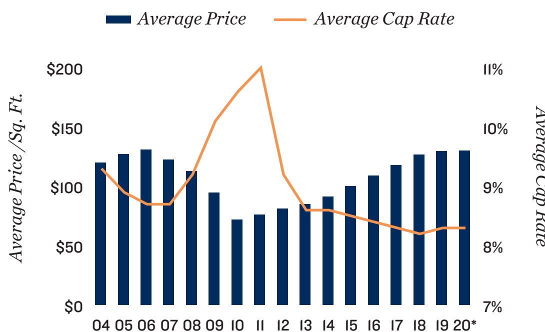
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

Office Completions and Absorption



Office Price and Cap Rate Trends



** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

OFFICE

Vacancy Rises From the Cyclical Trough as Rents Begin to Soften and Inventory Additions Loom

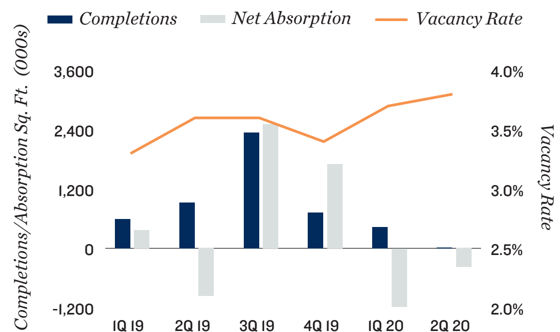
- Developers finalized 145,000 square feet of office space so far in 2020, raising the year-over-year sum to 500,000 square feet. Looking forward, the largest project expected this year is a 310,000-square-foot addition to One Campus Martius in downtown Detroit. Due in the third quarter, the building is fully leased.
- Builders also have roughly 2.7 million square feet under construction with completion dates extending into 2023. Some notable projects include Ford's redevelopment of Michigan Central Station and the former Hudson's site.
- During the first quarter of 2020, the metro's office sector peaked, recording the tightest vacancy and highest asking rent in 13 years. Business closures and space requirement uncertainties brought upon by the pandemic contributed to fundamentals waning in the second quarter. Vacancy posted a 50-basis-point hike to 15.0 percent at the end of June, while asking rent registered the first quarterly dip since 2018, declining 0.6 percent to an average of $20.41 per square foot.
- Investors took a cautious stance as the pandemic surged in the second quarter, cutting sales to less than half of those in the prior quarter. Over the past 12 months the average price rose 1.4 percent to $130 per square foot, while the average cap rate is holding in the low-8 percent range.

INDUSTRIAL

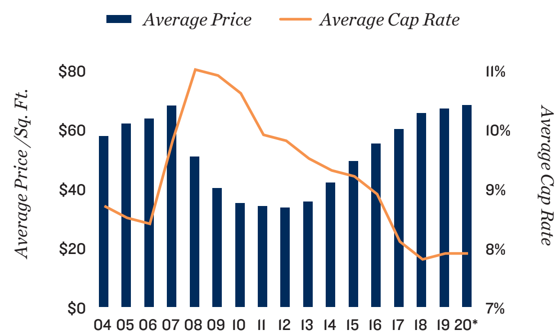
A Sharp Drop in Deliveries Amid Strong E-commerce Demand Buoys Industrial Sector; Headwinds Brewing

- Industrial properties benefited from a surge in e-commerce activity during the pandemic while deliveries plunged. Less than 15,000 square feet of new inventory was finalized in the second quarter, raising completions in the first half to 442,100 square feet. This compares with 3.1 million square feet over the prior two quarters.
- Developers also have 4.7 million feet under construction, of which 1.5 million square feet is possibly due for delivery in 2020. Large speculative distribution buildings underway could put further upward pressure on vacancy next year.
- The vacancy rate moved up 10 basis points in the second quarter to 3.8 percent, just 50 basis points above the 20-year low registered in early 2019. Asking rent is sitting just below last year's peak, inching up 1.2 percent in the past quarter to an average of $5.99 per square foot at midyear.
- Although sales activity dropped substantially in the April to June period due in part to a lack of inventory and uncertainty in the market, investors remained interested in Detroit's industrial assets. In the second quarter of 2020, older warehouses with less than 45,000 square feet near the urban core were most often sought. The average price rose 2.8 percent year over year to $68 per square foot, while the average cap rate rested in the high-7 percent span.

Industrial Completions and Absorption



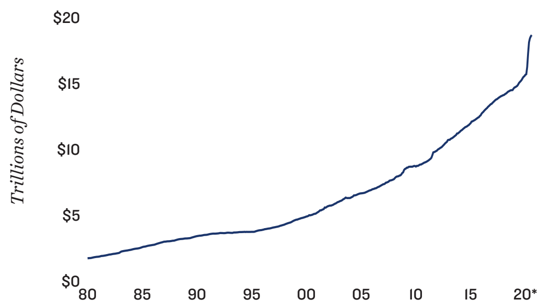
Industrial Price and Cap Rate Trends



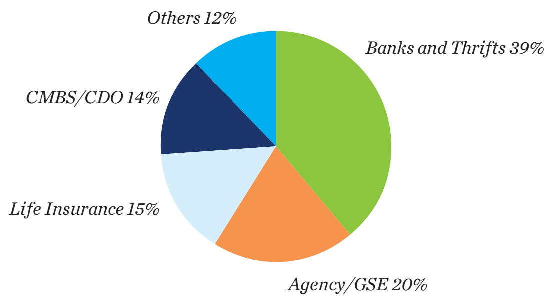
** Through second quarter*

Sources: CoStar Group, Inc.; Real Capital Analytics

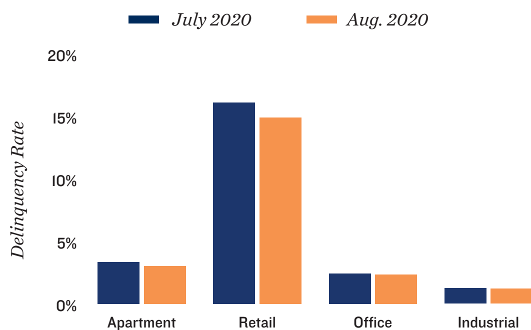
Fed Sharply Increases Money Supply During Health Crisis



Total Outstanding Mortgage Debt**



30+ Day CMBS Delinquency Rate



** Through August*

*** As of second quarter*

Sources: Federal Reserve; Mortgage Bankers Association; Trepp

CAPITAL MARKETS

By TONY SOLOMON, Senior Vice President, Marcus & Millichap Capital Corporation

- **The capital markets are thawing relative to the height of the crisis.** Most lenders have adapted to dispersed working, and more information on the economic damage of the pandemic is affording buyers, sellers, and lenders risk and price clarity for large swaths of the commercial real estate sector. Both property performance and location can impact financing as some areas of the country outperform and the pace of recovery remains in doubt for others. Capital is readily available for assets that perform on or near par with pre-crisis levels, especially industrial assets, which buyers and lenders see as a safe part of their portfolios. Single-tenant retail with national credit tenants are also heavily favored by lenders, followed by grocery-anchored multi-tenant properties. Apartment rent rolls are more heavily examined, though financing remains available from the agencies and banks. Loans are more readily accessible for suburban office, while core buildings are more difficult to leverage. Some lenders continue to operate in the hospitality space, but obtaining financing is challenging.
- **Loan-to-value ratios were already declining prior to the pandemic and average 60 percent.** Freddie Mac is offering rates in the high-2 percent to high-3 percent range for seven-year terms. Debt service coverage is approximately 1.35 times. Life insurance companies will finance below 3 percent for apartments in some cases, and peak at 4 percent for retail. CMBS loans are available, though strict criteria makes deals more difficult to find. Rates bottom in the low-3 percent range for apartment and industrial and rise to 4 percent for office.

Prepared and edited by

Nancy Olmsted

Senior Market Analyst | Research Services

For information on national commercial real estate trends, contact:

John Chang

Senior Vice President, National Director | Research Services Division

Tel: (602) 707-9700 | john.chang@marcusmillichap.com

National Multi Housing Group

John Sebree

Senior Vice President, National Director | National Multi Housing Group

Tel: (312) 327-5417 | john.sebree@marcusmillichap.com

National Retail Division

Scott Holmes

Senior Vice President, National Director | Retail Division

Tel: (602) 687-6700 | scott.holmes@marcusmillichap.com

Office and Industrial Properties Division

Alan L. Pontius

Senior Vice President, National Director | Office and Industrial Properties Division

Tel: (415) 963-3000 | al.pontius@marcusmillichap.com

Detroit Office:

Steven Chaben

Senior Vice President, Regional Manager

Tel: (248) 415-2600 | steven.chaben@marcusmillichap.com

2 Towne Square

Suite 450

Southfield, MI 48076

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Mortgage Bankers Association; Real Capital Analytics; RealPage, Inc.; Trepp

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