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Connecting Real Estate in Texas

RETAIL WILL LEAD IN 2017

TREB's forecast survey ranks retail, multifamily as top investment, development opportunities.

By Lynn Peisner

Retail and multifamily will be developed and traded more than other sectors in 2017, according to *Texas Real Estate Business'* 2017 forecast survey. TREB polled developers, owners, managers, lenders and brokers active across all sectors of commercial real estate in Texas to find out where the big plays will be in the year ahead. "Dallas-Fort Worth, Houston and Oklahoma will see, well, Texas-sized development numbers next year, and Austin will be the rising Lone Star market to watch," says Robert Kramp, director of research and analysis for CBRE's Texas and Oklahoma region.

Overall, the election results have polarized commercial real estate perspectives. There is a mixture of worry as well as positive anticipation over issues such as oversupply, rising interest rates and the changes accompanying Basel III, The Dodd-Frank Wall Street Reform and Consumer Protection Act and concerns over legislation involving carried interest. Still, valuations as well as commercial real estate transaction and development volume in general are expected to moderately increase.

More owners of commercial real estate say they plan to be net buyers rather than sellers in 2017. Forty-four percent of buyers responding to our survey say they will seek multifamily properties, followed by approximately 37 percent who want to acquire retail. A majority, 72 percent, of developers will break ground on new projects in 2017 (*see Figure 1*) that are either retail or multifamily (*see Figure 2*). However, many say that obtaining lending for new construction will become more challenging.

Lenders support this prediction, saying they will not finance as many construction loans this year. Instead, the lion's share of lending will fund refinancing activity, followed by financing for new acquisitions.

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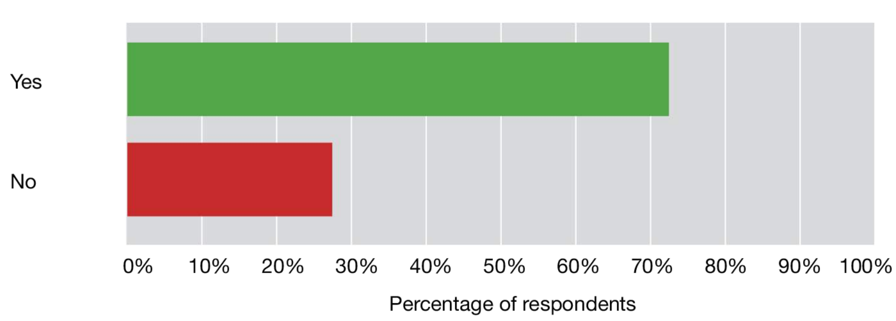
Fig. 1: Do you have any projects in the development pipeline that your firm will break ground on in 2017?



Source: TREB 2017 Developer/Owner/Manager Forecast Survey

An affiliate of Berkshire Hathaway is developing the $1.5 billion Grandscape mixed-use community in The Colony, Texas. Anchored by Nebraska Furniture Mart, the project will feature a host of entertainment and experiential retailers.

DEVELOPERS BET ON ENTERTAINMENT

More than ever, mixed-use projects tap non-conventional retail users to drive traffic.

By Joe Gose

Recognizing that today's retail environment stresses experience over shopping, developers of mixed-use communities in Texas are more frequently signing entertainment-oriented tenants to spaces that traditionally would have been reserved for department stores and inline soft goods retailers.

Developers pursue different types of entertainment tenants, depending on the projects, their locations and their audience. All of the projects leverage a growing number of new options in the food and beverage category, including food halls, artisan markets and re-imagined restaurants and bars. Boutique movie theaters and bowling lounges — concepts that also strive to give patrons a unique food-and-beverage experience — are in demand, and are in expansion mode.

Many landlords are adding specialty gyms or health-oriented services like yoga venues. And when it comes to pure retail, developers are enlisting operators that provide a differentiated customer experience across all categories, from beauty supply to sporting goods. For example, in 2015 beauty goods retailer Sephora launched in-store technology and education initiatives to enhance the customer experience, while newer Scheels sporting goods locations typically feature an

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TEXAS' TWO-STEP IN MULTIFAMILY DEVELOPMENT

The Lone Star State continues to show impressive apartment sector momentum, except in energy-based markets.

By Brian A. Lee

"Growing in power and worth," the multifamily sector seems to be singing right along with Texas' state song. The state boasts an abundance of jobs, population growth and developable land, but not all cities are alike. Developers still must keep a keen eye on apartment unit deliveries to time their moves with the Texas markets.

"It's a tale of two cities: Houston and everybody else — Dallas-Fort Worth, Austin and San Antonio," says James Eng, a senior director for Old Capital, about supply and demand balance in the Lone Star State.

PwC and the Urban Land Institute ranked Austin and Dallas as the top two markets to watch nationally in 2017 in their annual "Emerging Trends in Real Estate" report, but the sagging energy sector in Houston and the recent increased cost of capital [see sidebar, page 20] are causes for concern.

Too Much Space City

Brendel

The 2016-2017 period will finally see Texas apartment supply exceed demand before returning to a more balanced dynamic in 2018, according to Matt Brendel, senior vice president and development partner at JPI , an Irving, Texas-based firm that specializes in the development and investment management of Class A multifamily assets. He calls Houston "the obvious outlier market" going into 2017 due to the troubling combination of the energy sector slowdown with low job growth and an approaching large wave of multifamily supply.

In less than 18 months, Texas' energy sector experienced the percentage declines in oil drilling activity that it suffered through in five years during the tumultuous 1980s, according to a September report by the University of Houston's Institute for Regional Forecasting.

Eng

Eng reports that Houston will deliver more new multifamily units — approximately 30,000, according to RealPage Inc., a property management technology and data analytics firm — than new jobs this year. Typically, multifamily industry pros view one apartment unit for every three to five new jobs as a healthy ratio.

"Houston is going in the wrong direction, which is driving concessions of one to two months on new developments in lease-up," adds Eng. "There was a large gap between rents from Class A to Classes B and C, but with these concessions now prevalent the gap is becoming smaller every month."

Andy Trotter, chief investment officer at Centennial Holdings, did not mince words at the InterFace Multifamily Southeast conference in December when discussing his firm's holdings in Houston: "There are plenty of pockets in Houston that are doing really well… But if you're in the Inner Loop or in the Galleria area, you're getting mugged right now. We own there and it's brutal. We've been living in an upward trending market for a while, but we're budgeting for negative rent growth in Houston. That's how bad it is."

CBRE reports that year-to-date construction volume for third-quarter 2016 was down roughly 9,000 units over last year in the Space City. Class A apartment occupancy dropped from 82.8 percent to 78.4 percent from third-quarter 2015 to second-quarter 2016, but rebounded to 80.1 percent by the end of September. Despite the glut and gloom, David Wylie, vice chairman at ARA Newmark, forecasts a return to market equilibrium for Houston in late 2017 or early 2018.

"If you were to remove west, central and far north Houston, northwest San Antonio and uptown Dallas, Texas would be in great condition," says the Houston-based Wylie, who maintains that the three overbuilt submarkets in Houston are "dragging down the perception" of the rest of the market. "The Pearland, Clear Lake, Kingwood and East Houston submarkets are among the best in the state. It reminds me of the election: positive news doesn't get as much press as negative."

High-Demand Dallas

Calling it a "staggering figure," Brendel points out that nearly 6 million people moved to Texas from 2005 to 2013. According to site selection consultant Joseph Vranich, the state was on the receiving end of 219 corporate moves from California from 2008 through 2014, which amounted to more than 37,500 new jobs in the Lone Star State. The companies include Apple, eBay, Restoration Hardware and Toyota, which will relocate its North American headquarters to the Dallas-Fort Worth metro this year, generating approximately 4,000 jobs.

JPI has used the wrap-style design — residential wrapped around structured parking, like in the new 288-unit South Side Flats by Jefferson development — in about 70 percent of its apartment deliveries in the Dallas-Fort Worth metro area.

"Dallas-Fort Worth certainly is the star performer right now, hitting all-time highs on both occupancy and rent growth," says Greg Willett, chief economist at RealPage. "However, there's a stunning burst of new supply on the way that should bring performances back to earth. Performances should remain strong by long-term historical standards, but we're about to move past best-apartment-market-ever status."

On the strength of approximately 130,000 new jobs added in the year ending with third-quarter 2016, Dallas-Fort Worth apartment rents rose 6 percent to an average of $1,108 per month, according to CBRE. Multifamily occupancy in the country's fourth largest metro has remained near the all-time high of 95.65 percent since third-quarter 2015. Demand should be strong enough to handle the more than 37,000 units currently in the pipeline. Also, lenders are beginning to increase their equity and loan requirements, which will lead to a reduction in apartment starts during the next few years, CBRE reports.

"Dallas-Fort Worth and Austin are highly diverse economies that continue to have strong job and population growth," says Brendel, who forecasts about 100,000 and 30,000 new jobs over the next 12 months for those major markets, respectively. "Dallas-Fort Worth remains a leader for job creation as it lures large corporate relocations, including State Farm Insurance, Toyota, FedEx and JP Morgan Chase, and has pushed unemployment to very low levels."

Rent Growth for Largest Multifamily Markets

Rank	Metro	Y-o-Y Change (%)	Average Monthly Rent, Q3 2016
1	Seattle	6.6	$1,728
2	Tampa	6.1	$1,126
3	Phoenix	5.8	$956
4	Detroit	5.4	$989
5	San Diego	5.4	$1,943
6	Orange County	5.0	$2,049
7	Atlanta	5.0	$1,110
8	**Dallas**	**4.6**	**$1,123**
9	Chicago	4.3	$1,551
10	Boston	4.1	$2,282
11	Miami	4.0	$1,678
12	Los Angeles	3.8	$2,272
13	**Austin**	**3.8**	**$1,218**
14	Minneapolis	3.3	$1,339

Source: CBRE Research, CBRE Econometric Advisors, Axiometrics Inc., Q3 2016.

In July 2016, JPI completed South Side Flats by Jefferson, the first new market-rate apartment community delivered to Dallas' South Side neighborhood. Located on the DART rail line just across the interstate from downtown and benefitting from a 10-year tax abatement from the city and county, the 288-unit, mid-rise residential development wraps around a structured parking garage. JPI has used the wrap-style design in about 70 percent of its apartment deliveries in the Dallas-Fort Worth metro area.

In Frisco, Hillwood Multifamily will develop the 300-unit Station House, the first residential project to break ground in Frisco Station, a 242-acre multi-use property north of Dallas. Located adjacent to the new Dallas Cowboys world headquarters complex, the mixed-use development could ultimately provide as many as 2,400 urban-living units.

Alliance Residential's 301-unit Broadstone Lake Ridge was the company's fourth apartment community delivered in the Dallas-Fort Worth metro in 2016.

Completed in October, Alliance Residential's 301-unit Broadstone Lake Ridge was the company's fourth apartment community delivered in the Dallas-Fort Worth metro in 2016.

Many sources tell *Texas Real Estate Business* that foreign multifamily capital has been attracted to the strong market metrics in the Interstate 35 corridor, especially in Dallas.

Briner

"Dallas has joined 'the coastal club' of gateway cities that have caught the interest of foreign capital," says Clark Briner, founder and CEO of Dallas-based Revere Capital. "The underlying confidence in Dallas as a target market for foreign investors lies within the consistent population growth in Texas over the last decade, and the impact on the multifamily market has been extraordinary."

Hill Country Strength

The Austin-Round Rock MSA reached the 2 million population mark in 2015, according to the U.S. Census Bureau, and continues to see strong year-over-year population growth.

Wardlaw

Several of the nation's fastest-growing cities are located within the metro, including Georgetown (7.8 percent growth) and Pflugerville (4.5 percent growth), reports Michael Wardlaw, an Austin-based associate at CBRE.

"Austin has a large portion of new jobs coming in higher-paying industries such as technology, which is attractive to well-educated workers in the 20- to 34-year-old cohort," says Brendel. "This is a prime renter age and has contributed to Austin outperforming demand expectations over the past three years."

According to CBRE Research, Austin at 10,200 units and San Antonio with 6,600 units ranked fifth and 13th nationally, respectively, for multifamily completions for the year ending in third-quarter 2016. Wardlaw described Texas' capital city at equilibrium and the Alamo City with apartment supply slightly ahead of demand.

"Austin thought it had a supply problem in the last 18 months. However, as a result of job growth, it has absorbed the supply and the market is strong," says Wylie.

Busy in Austin, Transwestern Development is underway on the 139-unit Indie Apartments, a specialty micro-unit community situated in East Sixth, an entertainment district just east of downtown Austin. Across the street, Transwestern is also developing a two-building mixed-use project that will include 350 residential units called The Arnold apartments.

RealPage's Willett says that San Antonio remains the "solid, steady performer it usually is." Anticipated annual rent growth of 2.5 percent falls right in line with the metro's long-term norm, and San Antonio's urban core is spurring more apartment activity than seen in previous cycles.

Greystar's Agave development, located in San Antonio's hip South Town submarket, is attracting attention from both residents and investors. The

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Transwestern Development is underway on the 139-unit Indie Apartments, a micro-unit community in East Sixth, an entertainment district just east of downtown Austin.

capital to meet demand," he says. "Life insurance allocations for real estate debt will likely increase, and most of the CMBS players have figured out risk retention, so they will be in the market hungry for new loans."

Brokers are expecting transaction volume to be 5 to 10 percent higher in 2017 than it was in 2016. Nearly 60 percent of brokers say retail will experience the highest velocity of investment sales and the greatest increase in valuation with industrial and multifamily tied for second (*see Figure 4*).

The lack of new retail supply in the past few years has made the sector hot as performance increases while the number of available properties for purchase is smaller.

New hotels are the last priority among developers. Lenders concurred, saying it is the least attractive investment opportunity for their cohort. "Year over year sales volumes [of hotels] were down by almost 50 percent across the state," Kirkpatrick says. "However, sales volumes rebounded sharply in the third quarter, a trend that has continued into the fourth quarter. This trend is expected to continue into 2017. The perception is that with all the new construction, the market cycle for hotels has peaked and investors want to cash out."

Election Effects Still Unclear

A sweeping majority say the presidential election results will influence business, though exactly how remains to be seen. In fact, one respondent when asked to name one challenge to and one opportunity for commercial real estate in 2017 simply replied, "Trump."

Some are anticipating positive effects from a development-friendly president, saying the loosening of banking and environmental standards could encourage commercial property owners, borrowers and investors. "I believe this administration will be more favorable to small business owners and create tax breaks for investment property and commercial property owners," replied an anonymous respondent. "I also think the administration will do away with most, if not all, of the Dodd-Frank Act and lift heavy government restrictions on lenders."

Others are at the opposite end of the spectrum and commented that they are leery that the newly re-staffed executive branch could ignite political instability and global insecurity that would negatively sway the economy overall.

Some are simply unable to comment about what the future may bring. "Rising interest rates, lower corporate tax rates and a real estate-friendly president will have a mixed effect on real estate development and investment," said an anonymous owner. ■

About the Survey

In November 2016, *Texas Real Estate Business* e-mailed invitations to participate in an online survey to three separate groups: (1) brokers; (2) lenders and financial intermediaries; and (3) developers, owners and managers. The survey was held open through early December. An invitation to participate in the survey was also included in the *Texas Real Estate Business* newsletter, as well as REBusinessOnline.com.

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six-building, 349-unit mid-rise complex offers easy access to the HEB corporate campus and downtown San Antonio.

In November, Covenant Development broke ground on a 240-unit apartment community in San Marcos, located between Austin and San Antonio. The three-story multifamily development will deliver its luxury units this summer.

Texas-Sized Advantages

No other state does big and bold like Texas. That certainly goes for its business growth model. A pro-business stance means more jobs, which means population growth, and all of that is music to the ears of multifamily developers and investors.

"Texas is a primary example of a high-growth, low-tax, business-friendly state, which is conducive to a high-growth multifamily industry," says CBRE's Wardlaw.

The jobs-population growth-multifamily demand formula puts the Lone Star State high up on most statistical performance and investor target lists. Fort Worth-Arlington at 5.6 percent and Dallas-Plano-Irving at 4.6 percent were seventh and 15th, respectively, in Axiometrics' national ranking of top markets by annual effective rent growth for third-quarter 2016.

"Due to the favorable business climate and low cost of living, companies are relocating to Texas and bringing with them thousands of new jobs," says Eng. "It is forecast [using data from the U.S. Census Bureau and the University of Virginia] that the population in all four major Texas cities will increase by over 50 percent by 2040, with Austin increasing by 98.5 percent."

ARA Newmark's Wylie reports that Class A, Class B and value-add product are all hot in Texas, and Wardlaw says that affordable workforce housing is showing the strongest rent growth in the state's multifamily continuum.

Surprisingly, rent growth and the attractive business climate have not triggered an increasing flow of both domestic and foreign capital between the Red River and Rio Grande.

Despite the energy sector slowdown in Houston, the overall job growth rate in Texas is forecast to be 33 percent better than the national rate, according to JPI's Brendel.

"In fact in 2015 and 2016, Texas almost doubled the U.S. job growth rate," the Texas A&M alum adds. "This tremendous growth story has fueled a multifamily boom and should continue into the foreseeable future."

Texans like to talk up their home state, but perhaps nothing makes more of a statement than the strong influx of people wanting to make the Lone Star State their place of residence as well. Despite challenges in the capital and energy markets, the state's business and personal cost advantages combined with broad demographic and other factors, such as increasing home prices, should bolster Texas' relocation appeal and multifamily performance for a long time to come. ■

STRICT UNDERWRITING, RISING INTEREST RATES COMPLICATE APARTMENT DEVELOPMENT IN TEXAS

Texas boasts many advantages in the multifamily development sector, but one recent issue is working against the Lone Star State's apartment gains: increased headwinds in the capital markets.

Financing is an even bigger concern than usual for Texas multifamily developers, who have seen loan spreads increase about 50 to 75 basis points in the past 12 months. Not only did the Federal Reserve hike short-term interest rates by a quarter percentage point in mid-December — the first time it has raised rates in almost a year — but also 10-year Treasury rates have increased 60 basis points since November's presidential election, thus adding to the cost of borrowing.

"Rates have spiked because the markets believe President-elect Donald Trump is going to lower taxes and increase spending, allegedly on infrastructure projects," says Clark Briner, founder and CEO of Dallas-based Revere Capital. "If he spends $1 trillion on public works programs or anything else, that amount would add debt to a U.S. balance sheet that is already burdened with $19 trillion in debt. Would the Saudis and other sovereign states, including China, lend at the same rate to a country that increases its debt? No, rates will be higher."

Citing banking regulations, Michael Wardlaw, an Austin, Texas-based associate at CBRE, says construction lending has become arguably the biggest challenge for new apartment development projects nationwide. Calling construction debt "a hot topic in Texas," David Wylie, vice chairman at ARA Newmark in Houston, points to leverage levels and recourse as the real issues as to why borrowing costs are higher.

"Lenders are requiring much more equity and require most developers to provide personal recourse," says Wylie. "In the last two to three years, interest rates were in the LIBOR plus 175 to 225 basis points range for construction debt, and today they would be LIBOR plus 225 to 300. More importantly, leverage was in the 70 to 75 percent [loan-to-cost] range, and today it would be around 50 percent in Houston and 60 to 70 percent in most other Texas markets."

Due to the city's energy sector woes, financing for new multifamily development has essentially been shut down in Houston, according to James Eng, a senior director for Old Capital. He calls the increase in equity requirements significant in the other three major Texas cities, "even for very experienced developers in prime submarkets."

Matt Brendel, senior vice president and development partner at JPI, says construction loans have become increasingly more difficult to obtain due not only to the lenders' increasingly stringent underwriting standards, but also the shrinking number of independent banks.

"More lenders today are also requiring participant banks to syndicate a piece of the loan prior to closing to make larger loans work. The result is fewer construction loans available today, lower leverage and higher interest rates," adds the JPI executive, who maintains that a healthy increase in interest rates should bode well for the markets and help incentivize banks to lend a little more freely.

The election ramifications, interest rate bump and Texas-sized supply of apartment units currently in the pipeline — almost 60,000 units are scheduled to deliver in Houston and Dallas-Fort Worth this year, according to RealPage Inc. — will give multifamily developers, investors and lenders much to think about in 2017.

— Brian A. Lee