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RealEstateMatters

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C&I Council: *2023 Real Estate Outlook*

Following are selected highlights of remarks by Mark Fitzgerald and the High Real Estate Group leadership team to the Lancaster Commercial & Industrial Real Estate Council at their annual meeting in February 2023 – the first in-person meeting in three years. Download the slide presentation: http://bit.ly/3ZSrNp0.

Employment Trends – There were strong employment gains across all sectors in 2022; only leisure and hospitality, mining

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The Benefits of RACP Grants

By: Tony Seitz – Vice President of Development, High Associates Ltd.

On November 18, 2022, Governor Tom Wolf announced that Greenfield North, which consists of two industrial buildings and a 628-unit multifamily apartment community, would receive $11 million in Redevelopment Assistance Capital Program (RACP) funds for eligible site work activities. It was the largest award granted in the fall 2022 round of RACP funding.

The magnitude of the state grant speaks volumes about how High Real Estate Group, and our economic development initiatives in Greenfield, are viewed by those in Harrisburg. In many ways, this is a continuation of the partnership that funded and has been executing the $22 million Walnut Street Extension (WSE) project, which will directly connect Route 30 to Greenfield. While the sources and uses of funding are different, both the RACP-funded site work and the WSE will serve the same planned Greenfield North development and, in that sense, are fully complementary.

By way of background, RACP is perhaps the most impactful economic development stimulus program available

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President's Message

At the recent Lancaster Commercial and Industrial Real Estate (C&I) Council's annual meeting, it was energizing to return to an in-person format, bringing together approximately 150 industry professionals to discuss the market forecast and share expertise. Thank you to everyone who attended. For those who were unable to make it or are interested in learning more, please visit **http://bit.ly/3ZSrNp0** to download the slides. This issue of Real Estate Matters includes highlights of my remarks and those of our asset class leaders on the issues impacting the economy and implications for each asset class.

The industrial and multi-family residential sectors remain strong and still have some runway left for positive returns. The hotels sector has fully recovered to pre-pandemic levels driven by continued strong leisure demand. With the return of the business traveler and larger group business, we expect select service hotels to outperform pre-pandemic highs.

The shift to "Work from Home" has proven to be sticky and continues to impede the recovery of the office sector in larger urban areas.

While there are some headwinds for new construction due to increased construction cost and higher interest rates, the overalll real estate markets continue to have a bright future ahead.

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to Pennsylvania's governor. The program is a Commonwealth grant program administered directly by the Governor's Office of the Budget (OB), making it somewhat unique since most other economic development programs are run through the Department of Community and Economic Development (DCED). The program allows the governor, with advice and input from a wide array of state and local officials, to help fund projects that may otherwise never get off the ground.

RACP is intended to fund the construction of critical community and economic development projects across the state. The program has a number of "guideposts" intended to ensure that projects both satisfy RACP guidelines and have widespread support from community leaders. First, the project must be included in an itemization bill approved by the General Assembly and signed by the governor. The itemization bill process ensures candidate projects receive initial scrutiny from state elected officials. Second, applications may only be submitted after the governor opens the program up for a round of funding. Inviting RACP applications is at the discretion of the governor. Only those projects that were included in an itemization bill may apply for funding. Finally, OB will review and score the applications and recommend approval of impactful projects. Final approval of awards and amounts is granted by the governor.

Only impactful projects that have significant support from local and state officials will be funded. RACP is designed to reward collaboration, and shared vision, and be a catalyst for transformational projects. If any of these elements are not present, a project will have a hard time making it through the program review process. In many ways, the High Philosophy, especially its commitment to "Building Trustworthy Relationships," is tailor-made for the RACP process. Our approach of building collaborative partnerships to execute a shared vision helped ensure a deep reservoir of support when it came time to demonstrate this for the funding application.

The housing and industrial development that RACP will support is very much needed in Lancaster County, and policymakers have come to know and support the quality of High's projects. All the elements were present with Greenfield North to facilitate a strong RACP outcome, which was achieved.

Now, we turn our focus to executing the vision. Plans are out to bid, and the intent is to commence the Greenfield North site work in mid-2023, with an expected construction duration of about 6-8 months.

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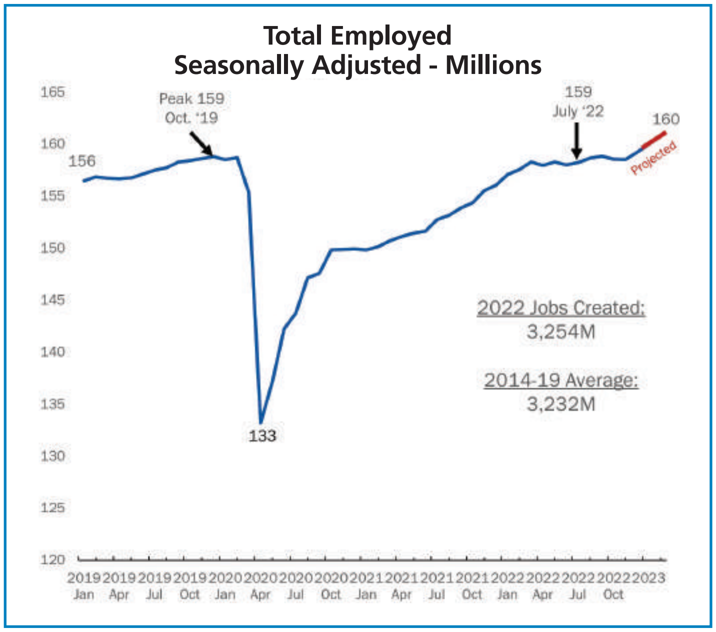
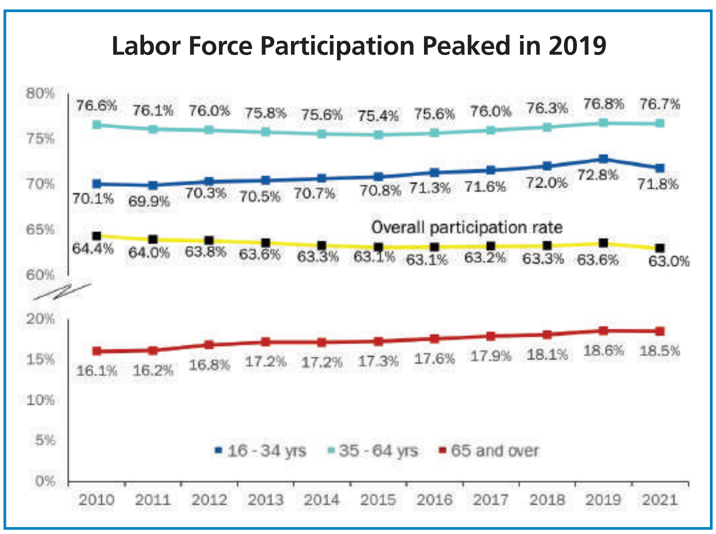
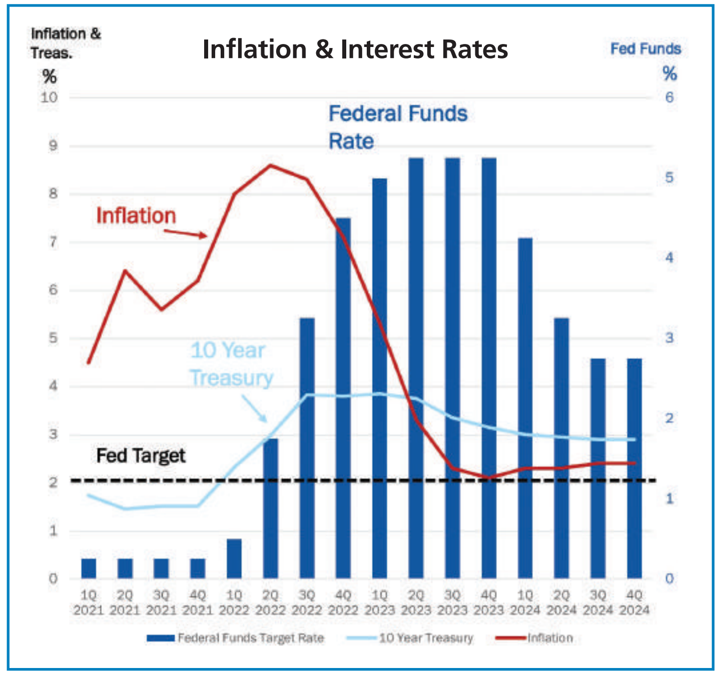
and logging, government, and other services have yet to recover to pre-pandemic levels. During the calendar year, there were 3.254 million jobs created, which was roughly equivalent to the 3.232 million average annual number of jobs created between 2014 – 2019. In July 2022, the U.S. reached pre-pandemic employment levels of 159 million.

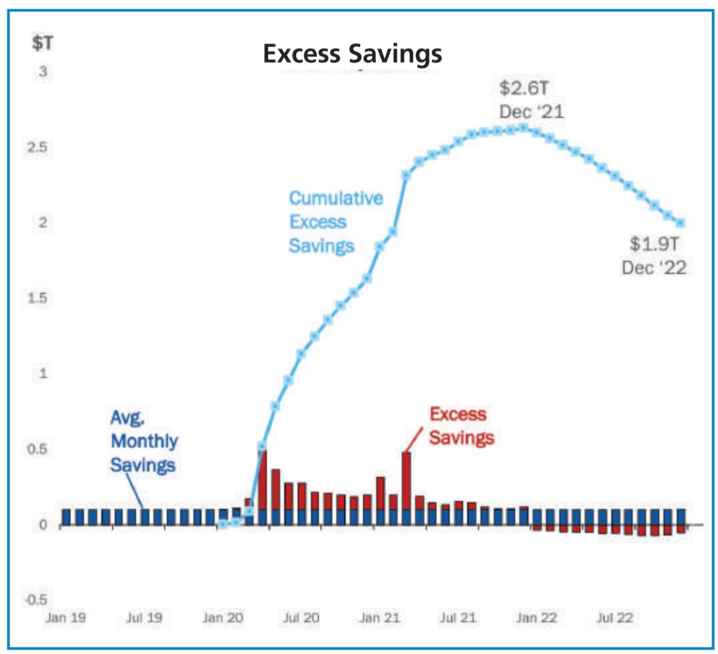




Workforce Participation – The total workforce population grew by 20 million between 2010 – 2019; however, the shift in demographics associated with an aging population lowered the overall participation rate from 2010 – 2021. While the participation rate for each age cohort stayed flat or increased slightly, the total participation rate dropped as the percentage of workers over the age of 65 (the cohort that has the lowest participation rate) increased from 16.6% in 2010 to 20.5% in 2019.



Inflation – The federal funds rate grew from 0.5% at the beginning of 2022 to 4.5% by year-end. Inflation hit its peak at 8.6% in Q2 2022, falling to 7.1% by year-end. It is expected to continue declining throughout 2023 but is not expected to hit the Fed's 2% target rate.



Excess Savings – Consumers continue to drive gross domestic product (GDP). 2022 GDP grew at 2.1%, compared to the Federal Open Market Committee (FOMC) 2022 projection of 4%. Cumulative excess savings grew during the pandemic driven by

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massive public stimulus, reaching $2.6 trillion in December of 2021. As the stimulus subsided and inflation accelerated, the cumulative excess savings fell to $1.9 trillion while credit card debt balances increased to record levels.

Real Estate Investment Sentiment – National sentiment for acquisition and development remains largely unchanged. Industrial and multifamily continue to lead investor demand for acquisitions with buyers focused on interest rates, capitalization rates, and available debt/ equity. Development prospects are also positive in the industrial and multi-family space; however, challenges with labor cost/availability, material costs, interest rates, and capitalization rates make projects more difficult to pencil.

US: Cap Rates Are Rising

	Range	2022 Average	Change from 2021	BPS
Apartments	3.3 – 8.0%	4.9%	↑	47 bps
Warehouse	2.0 – 6.3%	4.4%	↑	12 bps
Suburban Office	4.3 – 7.8%	6.0%	↓	(-19) bps
CBD Office	4.2 – 7.5%	5.8%	↔	(-5) bps
Neighborhood/ Strip Centers	5.0 – 10.0%	7.3%	↑	16 bps
Limited-Service Hotels	8.0 – 11.5%	9.8%	↑	77 bps

- Cap rates decreased for CBD/Suburban Office
- Ranges tightened for Apartments and Industrial
- Debt & Equity underwriting is becoming more restrictive

Cap Rate Trends – Cap rates are rising in most areas. However, they did decrease for CBD and suburban offices, and ranges tightened for multi-family and industrial. Additionally, debt and equity underwriting is becoming more restrictive.

Lancaster Market – *Key Observations by Asset Class*

Office and Industrial

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Office – Three new office projects, totaling 102,562 square feet, have been proposed. Class A occupancy is relatively stable at 92.5% with existing space renting between $23 to $26 per square foot and new space between $32 to $35. A modest rent increase is expected in 2023. Net absorption for Class A space was 35,200 square feet, and vacancy rates increased slightly from 7.1 to 7.5%. Class B & C office space had negative absorption of 37,000 square feet due to tenant contractions and the migration to Class A. Business centers also had negative absorption of 44,500 square feet and ended the year with a vacancy rate of 20.2%.

Industrial – Three new projects were completed, adding 559,500 square feet to the market, bringing current available space to 600,000 square feet. Three projects are under construction, totaling 648,578 square feet, and five projects have been proposed, which could potentially add another 1.5 million square feet to the market. For industrial space, 371,700 square feet was absorbed in 2022. Vacancy decreased from 2.7% to 2.4% and rents saw a 4% average increase. New product is being marketed from $7.25 to $7.95 a square foot. Flex space is leasing at $9.95 a square foot, a 4-5% increase. Flex absorption was 138,600 square feet.

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Multi-Family

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Over the last year, rental growth has been slowing both nationally and in our local market. Lancaster's growth was 5.8% last year and is forecasted to increase by 2.6% this year. Currently, there are 796K units under construction in the U.S., with 450K expected to deliver in 2023. This will add a total of 2.6% to the total inventory. Locally, there are 20 projects, with a total of 3,700 units proposed and being planned. Meanwhile, affordability continues to be a concern with one-third of renter households earning less than $36,000 per year. National rental rates went up 3.7% in 2022 and are forecasted to increase by 1.7% in 2023.

Hospitality

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The hospitality recovery continued throughout 2022. In April 2022, the hospitality industry reached peak pre-COVID Revenue per Available Room (RevPAR). By the end of 2022, US RevPAR achieved 108% of year-end 2019 RevPAR results. Locally, those numbers for Lancaster and York were 120% and 113%, respectively, according to data from Kalibri Labs. Hotel type, location, and availability of leisure activities all played a positive role in the speed of recovery. Markets that had robust leisure offerings and that were drivable exploded in popularity. The return of corporate travel along with "bleisure" (combining business and leisure travel) growth also helped aid in a quicker recovery than predicted. Meanwhile, staffing and compensation pressures remain a leading challenge to a sustained recovery.

Development

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While construction costs are not yet declining to a meaningful extent, we are seeing a decrease in the significant increases we experienced in 2021 and 2022. Additionally, loose lumber prices have come down significantly over the past 18 months, after a peak of $1,686 per thousand board feet vs. $400 today. Remaining challenges include labor availability in smaller markets coupled with high interest rates which will make securing financing for new development projects harder to obtain and will require owner-developers to come up with additional equity. Some things to keep an eye on include potential environmental, social, and corporate governance (ESG) regulations from lenders and lawmakers, which will drive up costs, as well as long-term water availability.

Strong Fundamentals Propel Warehousing Forward

By: Mike Lorelli – Sr. Vice President of Commercial Asset Management, High Associates Ltd.

Warehousing and distributing have had more than a decade of positive net absorption on a national level. To understand the success of this real estate asset class, it is important to identify the drivers behind the demand. Three segments drive the majority of the growth in this area – retail/wholesale, logistic/distribution, and third-party logistics (3PL) companies.

Growth in the retail/wholesale segment has been driven by the changing expectations of the American consumer – primarily influenced by Amazon. The convenience of online shopping for virtually everything, combined with the need to deliver within days or hours, has caused a dramatic increase for warehousing close to transportation hubs and well-placed infill locations close to consumers. According to Deloitte's 2023 Commercial Real Estate Outlook, e-commerce accounts for approximately 20% of all retail sales and is expected to grow to 33% by 2031. Based on this projection, the need for warehousing will continue to be strong.

Traditional logistic/distribution companies' demand for square footage has grown due to their need to maintain higher inventory levels to compensate for supply chain interruptions. When sourcing inventory, many companies have gone to a 'China Plus One' strategy, which involves diversifying business with countries outside of China to mitigate the risk of shipping port and regional shutdowns that have occurred in recent years. Different 'plus one' options include other Asian countries, "nearshoring" such as Mexico or Canada, or "onshoring" (i.e., domestic production). All have had an impact on space absorption. Onshoring has created an increased demand for warehouses by manufacturers looking to invest in new manufacturing facilities here in America.

The third segment is 3PLs – companies that help merchants manage their e-commerce supply chain. This segment accounts for 40% of warehousing absorption nationally over the last two years. This explosive growth is driven by the need for smaller

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Strong Fundamentals Propel Warehousing Forward continued from page 6

retailers and companies to compete when it comes to delivery speed to their customers, without having to make investments in transportation and warehousing. 3PLs are able to aggregate customers to offer services competitively. Additionally, with the scarcity of labor for warehouse operations and transportation, as well as increased fuel costs, most small retailers and companies would struggle to compete with larger companies.

At the national level, 2022 had a very strong performance with positive absorption at 477 million square feet of space, second only to 561 million square feet in 2021. Vacancy remains well below historical levels at 3.3%. Even with more than 650 million square feet under construction, vacancy is only expected to increase by 10 basis points. With strong demand and a constrained supply, market rents are expected to increase between 4.0% and 5.5% in 2023. This is down from 2021 and 2022 which experienced rate increases of 11% - 15% annually.

In central/eastern Pennsylvania, there are 30.75 million square feet of projects in planning or under construction, including two new buildings here in Greenfield. While a sizeable number, this volume is down 33% over the past 12 months. Vacancy at the regional level is expected to remain at 2.4%. Locally, rents have increased 8% - 12% annually during 2021-2022. Local rent growth for 2023 is expected to be approximately 5%- 8%. This softening in market rate escalation for 2023 is due to the current economic uncertainty causing some occupiers to revise their growth strategies or take a "wait and see" approach on expansions.

Adding to the tightness of the market, construction has remained in balance with demand. What has kept construction in check has been the sharp increases in construction costs during this same period. On a national level, warehouse construction costs have increased by 25%. Within central Pennsylvania, construction cost

> **"At the national level, 2022 had a very strong performance with positive absorption at 477 million square feet of space, second only to 561 million square feet in 2021."**

increases have been closer to 35%. Most markets have seen a leveling of costs for materials and construction margins. However, all agree that labor expenses will continue to increase. Also hampering construction are supply chain issues on key materials. Two years ago, roofing and bar joists were 12-14 months out. Today, electrical switch gear and HVAC rooftop equipment are the critical path at 10-14 months out for delivery.

Here in central Pennsylvania, in addition to cost escalation, we have added challenges of zoned land availability and other regulatory issues. With all these obstacles, central and eastern Pennsylvania continues to be one of the top five strongest warehousing submarkets in the country. Its close proximity to eastern ports, highway infrastructure, and the U.S. population will continue to fuel demand within the region.

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