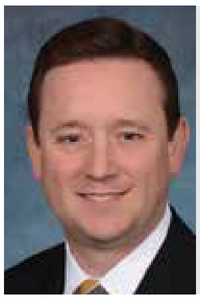
DETROIT'S DOWNTOWN REVIVAL, LED BY DAN GILBERT, GAINS MOMENTUM



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Detroit has become a five-sport town: The Pistons, Red Wings, Lions and Tigers have been joined by Dan Gilbert's Bedrock Real Estate Services LLC, the entity that has made a sport out of assembling a downtown Detroit portfolio of commercial buildings. In the process, Gilbert is becoming the city's biggest advocate.

Talking about Detroit's office market without including Gilbert's latest investment is akin to discussing Detroit's economy and excluding the automotive industry.

The Quicken Loans founder and principal shareholder of the Cleveland Cavaliers put himself on the region's real estate game board when the recession ended and he started buying up properties. To date, Gilbert and his team have amassed a portfolio of more than 85 properties in and around the downtown comprised of more than 13 million square feet and valued in excess of $2.2 billion.

The March 2015 acquisition of the 43-story One Detroit Center at 500 Woodward Ave. — which has since been renamed Ally Detroit Center — and attached 2,070-space parking deck for well over $100 million was his biggest deal during the acquisition spree.

Ally Financial is completing its relocation to the building this spring from the nearby Renaissance Center, as well as bringing employees from various buildings in Southeast Michigan into its new downtown headquarters. When complete, Ally Financial will employ some 1,300 workers on 13 floors and occupy 321,000 square feet of the 43-story, 1 million-square-foot skyscraper.

In addition to Ally Financial, Fifth Third Bank was lured from suburban Southfield into downtown last year for about 50,000 square feet at One Woodward Avenue, another property owned by Gilbert's Bedrock.

Gilbert has indicated that he is not done buying and stated he is poised to start building speculative office space.

In light of the data, one can understand Gilbert's temptation to build. The overall vacancy rate in Detroit's CBD has plummeted from 24 percent at the beginning of 2011 to under 15 percent by the end of 2015, according to CoStar Group.

First-quarter leasing activity indicates that vacancy could fall another point when the final numbers are tallied. Normally, speculative development is uncommon with vacancy hovering around 15 percent. However, a closer examination of the data helps explain why Gilbert or someone else may pull the trigger on a new office high-rise sooner than some might expect.

The total inventory in the CBD is slightly more than 26 million square feet. But Class A space had a vacancy rate of only 10.6 percent at the end of 2015 compared with 11.8 percent for Class B space and 30.5 percent for Class C space.

In most cities, a vacancy rate near 10 percent is considered a balanced market and is often the inflection point that spurs new construction. Developers tend to focus on the vital signs of Class A and B space rather than the overall market when considering moving forward with new projects.

Luxury living is catalyst

The city of Detroit's median home sale price in January 2008 was $75,500 and has fallen to about $34,000 currently, according to Zillow, yet demand for riverfront homes and condos in the downtown around Woodward Avenue has increased steadily since 2006. Woodward area homes were selling for an average price of $137,300 through September last year, up 95 percent from $70,400 in 2006. The east riverfront area's sale prices on average have increased from $76,900 to $126,000, or 64.5 percent, according to data compiled by Realcomp for the Federal Reserve Bank of Chicago.

The Detroit Events center, an arena currently under construction downtown, will be the new home of the Detroit Red Wings starting in fall 2017. District Detroit will be a 50-block, mixed-use area surrounding the arena that will include new office space.

As a result, new luxury developments are being built from the ground up for first time in decades. Residents can dock their boats in reserved slips at Water's Edge, an upscale apartment community on the Detroit River with a private marina and two private lakes that opened in January. Rental prices for its 134 apartments range from $1,285 to $2,324 a month. Triton Investment Co. is the developer of Water's Edge.

The Scott at Brush Park, a $64.5 million development with 199 apartments, will be completed in December. For $949 to $2,844 a month, renters will have access to a rooftop pool, outdoor kitchen and spa, as well as a pet-grooming station and on-site bike repair. Woodward and Erskine LLC, a real estate venture of Broder and Sachse Real Estate Services, is the developer and owner of The Scott project.

This year, Gilbert's Bedrock company will break ground on a new $70 million, 8.4-acre development in the historic Brush Park district with restored Victorian-era mansions, pedestrian greenways, shops and 400 new residences. More historic conversions are on the way, with downtown's appeal for high-end residences strongest among young professionals and empty nesters moving there for an urban lifestyle.

Gilbert isn't the only force behind Detroit's downtown revival. Mike Ilitch, the founder and owner of the international fast food franchise Little Caesars Pizza and owner of both the Detroit Red Wings and Detroit Tigers, is the man behind the downtown development and construction of the Detroit Events Center, where the city's iconic hockey team is set to begin play in the fall of 2017.

Ilitch's group, along with other private developers, has ambitious plans to build a downtown district adjacent to the new Red Wings arena. Planned in phases and partly funded by tax breaks and related public monies, the 50-block district known as The District Detroit calls for mixed-use facilities, retail, restaurants, multifamily and other commercial structures (*see related story on front cover*).

It will also include a $40 million Wayne State University business school named after Mike Ilitch. The Mike Ilitch School of Business will be built at the southwest corner of Woodward Avenue and Temple Street, with the land donated by the Ilitch family plus a $35 million pledge to build the school, and a $5 million endowment for added goodwill.

The downtown landscape has changed substantially in recent years, and more positive changes are on the way. For example, a new light rail system, partially funded by Gilbert, is coming on line soon. Named the QLINE (pronounced Q-Line) after one of its main benefactors, the light rail system will connect downtown with Midtown, where Wayne State University is located.

The PNC Center, a Class A office building in Troy, Mich., is currently 84 percent occupied.

Rising tide lifts all boats

For all the publicity downtown Detroit has garnered in recent years, the vast majority of the region's office space is solidly in the suburbs, with approximately 170 million square feet of space. Much of that inventory is occupied by the region's 315,000 companies, including 14 in the Fortune 500 (ninth most in the U.S.). Additionally, Detroit is one of the biggest U.S. trading partners with Canada.

Thanks to a resurgent automotive industry in recent years, a record 18 million cars, SUVs and light trucks sold in 2015 with a similar sales volume expected for 2016 and 2017, according to forecasters from the University of Michigan Research Seminar in Quantitative Economics.

In addition to the automotive industry, continued growth in healthcare, defense/aerospace, information technology and international logistics has boosted Michigan's economy in recent years.

The state has just completed its sixth year of economic recovery, averaging 74,200 (net) new jobs a year. Since the low point in the recession, the summer of 2009, Michigan companies have added 445,000 workers to their respective payrolls. The U-M forecast calls for the growth to extend at least through 2017 with 61,100 jobs forecast in 2016 and 64,800 the following year.

Michigan's seasonally adjusted state unemployment rate in February stood at 4.8 percent, down one-tenth of a percentage point from the prior month, according to the U.S. Bureau of Labor Statistics.

After five consecutive years of negative net office absorption from 2006 to 2010, net absorption of Detroit's overall office space has been positive for five consecutive years, beginning in 2011.

The overall office rate in metro Detroit has declined from slightly more than 19 percent at the beginning of 2011 to nearly 14 percent by late March 2016.

Net absorption in the suburban Detroit office market totaled 1.9 million square feet in 2015, with all four quarters in positive territory, according to CoStar Group.

While a drop of more than five percentage points in the suburban office vacancy rate is reason to cheer, particularly for office property owners, the vacancy rate remains stubbornly high. That's due in large part to some of our bigger submarkets. For example, Troy and Southfield have vacancy rates of 24 percent and 21.5 percent, respectively.

It is my opinion that the historically high vacancy rate in Southfield and Troy is due to a few main factors. First, these submarkets have historically been occupied by engineering, sales and service companies that in some respect have ties to the auto industry. Bankruptcies and restructurings by many businesses have led to more being done with less space.

Most of these businesses are wary of falling into the same trap of taking on too much overhead as the market improves. This coupled with the overall changes in the way space is utilized (technology allowing for hoteling, satellite office or working from the field) has also led to utilization of less space. This all has had an impact that has resulted in an improving market but not necessarily at the rate that we would normally be accustomed to coming out of recession several years ago.

Troy's gross rents are $18.64 per square foot and near the five-year average of $18.34 per square foot.

Bright spots in the suburbs

One exception in Troy is the landmark PNC Center. The building's occupancy rate of 84 percent is considered very good for a Class A suburban office center that is one of the largest office projects in all of the suburbs with over 500,000 square feet. The asking rates at PNC Center are at or near the top of the market at $19.50 to $22.50 per square foot. These are gross rents typically on a modified basis with the tenant paying for electricity and a pass-through of increases in operating expenses and real estate taxes over a base year.

In Southfield, which is a more service-oriented market that also has an older stock of Class B and C product, the asking rent average is $18.10 per square foot, a slight improvement from the five-year average of $17.31 per square foot.

In many cases, rents are about the same as when I got my broker's license in the 1990s. Indeed, 10 years ago quoted rental rates for the overall Detroit office market averaged $20.28 per square foot (at the close of 2006). Asking rents dipped as low as $17.57 per square foot by 2013 and have since climbed back to $18.60 per square foot at the end of the fourth quarter last year.

Auburn Hills, where Fiat Chrysler is headquartered, has the lowest vacancy rate for Class A space among the major submarkets, at 4.1 percent. The Class A vacancy rate in Dearborn, the headquarters city for Ford Motor Co., stood at 7.8 percent at the end of 2015, according to CoStar. Quoted rental rates for Class A office space in Auburn Hills averaged $22.02 per square foot at the close of 2015 compared with $18.33 per square foot in Dearborn, reports CoStar.

Capitalization rates have ranged between 8 and 10 percent and are likely to stay in the same vicinity for the balance of this year. Detroit's cap rates have been comparable to other Midwestern cities. CORFAC affiliates told me that cap rates are about the same in Minneapolis and St. Louis for non-institutional grade office properties, while in Pittsburgh, first-year yields on office properties have averaged 7-9 percent recently. And Cleveland's office cap rates edged up in 2015 to 8.87 percent on average, compared with an average of 8.34 percent in 2014. That said, I have clients in areas of the country such as California who view Detroit as an excellent investment given the cap rates and the upside potential on most deals.

Even with pockets of high office vacancy in suburban Detroit, there is room for rental growth and good opportunities for investors to make money — if they are selective and patient.