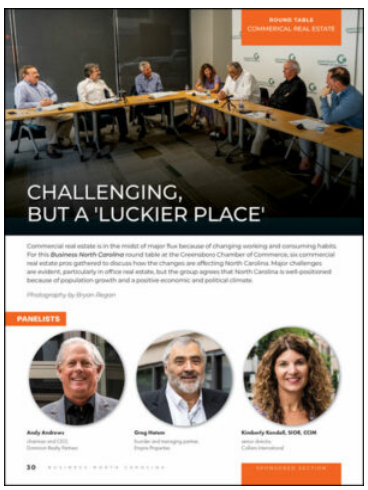
JULY 2023

Round table: Commercial real estate, challenging, but a 'luckier place'

By **BusinessNC** 06/30/2023



Click image above to view full PDF.

••• SPONSORED SECTION •••

Commercial real estate is in the midst of major flux because of changing working and consuming habits. For this *Business North Carolina* round table at the Greensboro Chamber of Commerce, six commercial real estate pros gathered to discuss how the changes are affecting North Carolina. Major challenges are evident, particularly in office real estate, but the group agrees that North Carolina is well-positioned because of population growth and a positive economic and political climate.

Adcock Real Estate Services, Dominion Realty Partners and Smith Anderson law firm sponsored the discussion. It was moderated by David Mildenberg, editor of *Business North Carolina*. It was edited for brevity and clarity.

WHAT'S GOING ON WITH OFFICE SPACE IN THE RALEIGH AND CHARLOTTE MARKETS?

KENDALL: It's a big question mark, for a lot of different companies. They're trying to figure out this whole outlook in the future, and nobody knows what it's going to look like. Hybrid work is here to stay for a while. For certain sectors of business, it's seamless to work from home. So call centers, those types of uses, they have completely gone remote. I don't think they're coming back, because they haven't found a decline in productivity.

I think with other types of tech firms, and even law offices, they're back in the office every single day. A report recently said that for the first time since the pandemic happened, we are at 50% occupancy across the country. That's a good sign, especially since you're never at 100%. Before COVID, it was typically around 75% to 80%, at any given time.

I would also share that for the first time, there have been five consecutive quarters of declining productivity. That's the first time that's happened since post World War II.

Companies are realizing: "We thought we were productive, but it's starting to go downhill." Employees are starting to watch more Netflix instead of working or they're doing laundry or walking their goldendoodle.

It's still an employee-based world, and the employees want to work from home. In Charlotte, when you drive in on Tuesday, Wednesday or Thursday, it's locked down traffic. Everyone, of course, picks to have Monday and Friday off. It's going to flip, though. It's going to go back to an employer-dictated environment. Then the employees will either have to find a new job, or go back five days a week if their companies are dictating they go back.

HATEM: We had a lot of unrest in 2020. People have found a way not to come to work. I don't know how they do that. But I guess it's a nice gig. So we're trying to recruit people back into downtown. We're jumping back in and learning how to do all those things we did at the beginning to revitalize downtown again today.

In many ways, I'm not as excited about 50% occupancy, but you're the optimist at the table, Kim. A 50% number popped up in a report on cell phone usage. In Raleigh, we're at about 50% of what we were pre-pandemic. Some cities like Salt Lake City are at 70% to 80%. We're at about 52%. We know there are fewer folks in our downtown, because everybody has a cellphone and they're just tracking less usage. So that's a little concerning.

As for employees choosing to work in person on Tuesday, Wednesday, Thursday, restaurants are pretty dead on Mondays. Folks come in on Friday evening. I think we're going to continue to grow in this state and that will heal a lot of what's happening. We just have to be a little more cautious about how we grow. With interest rates the way they are, we don't have to be too cautious about growing, It's dictated.

THORNTON: There's a lot of talk about what the effect of hybrid working is going to be. I don't think we've come to the point yet that employers are leasing smaller spaces because people are working from home. I haven't heard of that yet because then what are they going to do on the days everybody comes in? It could happen soon. But I think the shrinkage in occupancy is more dictated by companies looking for more efficient space and cost savings.

There's talk about hoteling, (employees scheduling days or hours to use a workstation instead of permanent desks for each employee.) There's talk about what you can do to bring people back into the office five days a week. Adding common workspaces, lounges, coffee bars and other amenities make being at the office more attractive. My primary clients are on the developer side, so that's more challenging today, given the interest rates. But in a market like Raleigh and North Carolina we're in a much luckier place. The economy in other parts of the country has bigger dips, the dips here are smaller because we have a more talented workforce and lower cost of living that continually attracts new business.

MALLOY: Being in the counties (surrounding Raleigh), we've never seen much office leasing. But a recent *Wall Street Journal* article said many privately held developments are financed by small and medium sized banks. It quoted someone who speculated when it comes time to refinance, as many as 80% of those buildings may not refinance. And that could really put a lot of pressure on those small and medium banks. Is anyone seeing this in North Carolina?

KENDALL: Not as much with the small– and medium–sized banks, but we have seen some groups that have given back their notes or the banks have called the note. That's already happening in Charlotte.

ANDREWS: We have a large office park called The Wade, it's 600,000 square feet. During the pandemic, we'd count the cars to get an idea of how many people were physically there. We were down to 18%. Right now we're at 60% physically occupied. We leased 75,000 square feet at The Wade last year. Every tenant we leased to cut their space by 50%. Tenants are saying: "Half of our folks want to stay at home or need to stay at home,"and they want to keep their employees.

We might have $1 billion (worth of projects under development) right now — not one of them is an office building. In Charlotte and Raleigh combined, there are 4 million square feet of sublease space that's vacant, but tenants are still paying. It's going to quit being paid on when the leases run out. Then you're going to have the lender problems that we've read about lately, and developers giving back the office buildings.

STONE: I'm having some tough conversations with some legislators about the shortage of housing and multifamily. The legislature is debating adaptive reuse for office space into condos and apartments. It's interesting to balance that. Do we worry about getting too far out in front of our skis? You may need the office space later, and now it's been converted to condos.

ANDY, YOU PUT APARTMENTS IN SOME CENTER-CITY OFFICE BUILDINGS, WHICH LOOKS SMART NOW.

ANDREWS: We delivered those buildings in July 2021. We were trying to limit our exposure. Instead of doing 450 apartments, we did 200 apartments, and 160,000 feet of office. We didn't think we were overexposed on either one, which was how we could get a high-rise and then get the tenants' name on the top of the building. So we could win that battle.

We have dissected what it costs to convert brand-new office space into apartments. It can be done. It is very expensive. But if you're in uptown Charlotte or downtown Raleigh, the rents do justify the means. It's going to be done, because you're not going to fill those empty offices. You're going to need to morph those buildings into something.

HATEM: I'm getting back to feeling like I'm back to the beginning (of revitalizing downtown Raleigh). Adaptive reuse is where we started. We took a 100-year-old building that was empty for 20 years and brought it back with retail, residential and office for the first time in decades. And, legislatively, we were able to adopt the North Carolina rehab code, which was the New Jersey code. It allowed you to change existing buildings from one use to another without bringing it to all new code. That's what allowed us to do what we've done.

WHAT IS THE CREDIT SITUATION FOR REAL ESTATE BORROWERS RIGHT NOW?

THORNTON: Lenders are more cautious and underwriting is very hard to get for a new office building financed without pre-leasing that's pretty substantial, at least 40%. Interest rates aren't the only issue. A lot of projects I work on get financed by private-equity companies. That's really where we made up for the higher equity requirements back during the 2008 financial crisis. I'm starting to see the private-equity companies getting more conservative as well. I think that has as much to do with future development as the interest rate increases.

HATEM: When your cost of borrowing is almost nothing, the amount of money you can get from investing in normal things, everybody's going to go into real estate. Now there are other alternatives in the marketplace to get a return and people are going for less risk. Banks, to your point, have other constraints.

EVAN, IS INDUSTRIAL PROPERTY STILL THE BELLE OF THE BALL?

STONE: The starts have slowed down, but it's still rolling. We're in a market here that's a little bit different nationally because of the economic development success. The last five or 10 years, what the legislature has done to bring down corporate tax rates has made a very business-friendly environment for industry to come into the area. So that's kept industrial stoked. Even when people are kind of taking their foot off the gas, they haven't hit the brakes, but just slowed the process. They're either waiting until they get a better rate or they're going to 50 banks rather than five. Maybe they've got all their sight work done or civil work done. They're just waiting on the money.

STEVE, YOU HAVE AN INTERESTING PERSPECTIVE AS A PART OF THE CAROLINA CORE REGION THAT HAS ATTRACTED KEY MANUFACTURERS.

MALLOY: Obviously, you've all heard about Wolfspeed, VinFast and Toyota. Our area has also picked up a lot of life science businesses. Pfizer has grown like crazy. What we haven't seen quite yet is some of those new businesses start to hire. We haven't yet seen people come in, or the suppliers come in. We did a little research, and the life sciences sector apparently doesn't have the same coattails that other industries do. So we're just waiting.

Prices on the residential side for a subdivision have gone down a little bit, but it's still very active. We have a lot of situations, with a subdivision or industrial development, where if the first (buyer) backs out, there are two more in line to take it over. So we've been very fortunate. We were at an event in Johnson County about economic development and most of what was talked about was Lee County because of the regionalism. From Fuquay-Varina and Holly Springs to Asheboro, and from Greensboro down to Sanford, people and the governments are working together. It's really exciting.

WITH SO MUCH ORDERING PRODUCTS ONLINE, IS THERE STILL SOME LIFE IN RETAIL?

STONE: We all went through this the time when we thought brick and mortar was going away and we're going to Amazon with everybody shopping online. Now I think the event of going shopping or going somewhere is still refreshing for people. This has kind of slowed the death of brick and mortar. You still see some of your retail centers, North Hills in Raleigh, Ballantyne in Charlotte, Friendly in Greensboro, that are still busy. Maybe parking lots aren't quite as full, but these shopping centers are still pretty robust. I think there's a dichotomy there. From a growth standpoint, whether it's brick and mortar or online, we all know that rooftops follow jobs and jobs follow economic growth. Retail follows growth and rooftops. So the growth is going to continue for North Carolina.

KENDALL: I do not specialize in retail, but what we are seeing relates to the adaptive reuse we talked about earlier. In Charlotte, there are several pockets of adaptive reuse projects. They are marketing space as office and retail. It's going more to retail users and it's all experiential retail. It's the breweries, indoor pickleball courts and ax throwing, rather than the big box stores.

MALLOY: With all our growth, even if the stores-per-person (ratio) reduces, retail is still going to grow in this area. I've got a quick side story. A couple of years ago, the first time I saw ax throwing was in Charlotte. I came back to Sanford and called the planning department and said, "Can I do that?"They said, "No, you can't." I said, "Show me where it is in the ordinances?" And they said, "Well, it's not there. You just can't do alcohol and axes."

THORNTON: The thing about retail is, we've moved away from your typical grocery-anchored strip center. In a lot of ways, what you're seeing now are mixed-use developments that are creating a sense of place with restaurants, coffee shops and entertainment. I don't know if we'll ever get back to your typical strip-center economy because you have to compete with the convenience of ordering online. It may be a little early to tell how brick and mortar retail is going to do. But you see products coming out of the ground like Fenton (open air shopping district) in Cary and continuing retail development in North Hills in Raleigh. They're very successful. We see all kinds of parking issues there because so many people are coming.

HATEM: To add to the point about experiential retail. If it's a commodity, I'll order online in a heartbeat. But if there's something special, I'm looking for a kid's book, or some special gift for somebody, I want to touch it. We were out getting our son a suit for his eighth grade dance. He's got to try it on. So at some level, (in person) retail is always going to be there.

HOW SERIOUS OF A MARKET CORRECTION DO YOU EXPECT IN THE NEXT YEAR OR TWO?

THORNTON: If you've chosen a real estate career, then by definition you're an optimist. We all believe it's going to come back. We're all playing for the long run. As for what's going to happen in the next six months? Are we done with interest rate hikes? We've got to be pretty close, right? Inflation seems to be coming back under control. You have to adjust to how you're financing projects. But I think that's probably a short-term problem on a relative basis.

STONE: People are concerned. I don't think you're seeing the pain at your neighbor's house or what maybe you saw in '08 and '09. Though there are definitely some market similarities. But I do think it's going to come back.

HATEM: If you're in (commercial real estate) for the long haul, it's the place to be. If you're doing this, because you're transactional, you're going to get shaken out if you haven't already. If you're trying to get bridge financing to keep that building and get it financed, again, you're a dead man walking. So you have to take that long view. And, we're just fortunate we are in North Carolina.

FOR YOUNGER PEOPLE, IS REAL ESTATE AN EXCITING CAREER LOOKING OUT 10 TO 20 YEARS? WILL AI CHANGE EVERYTHING?

STONE: To Greg's point, if they're a long-view person, it's good. If you want to make a bunch of money tomorrow, it's not the right career. There's a lot of teeth-cutting that goes on when you get into this business. I still learn stuff every day by talking to people in the industry, about putting different deals together and all the different factors.

ANDREWS: I think if you get into business in a down cycle, you're much better off. You learn twice as much as getting in during an up cycle. I think if you're with a good firm that's got long-term vision, you're going to reap the rewards for living through the down cycle. So you appreciate the uptick. And again, we're in North Carolina, so it's a better market.

MALLOY: I think AI will affect the agents, the brokerage side of things very much. Even now, people are doing video tours so you don't need an agent right there. Eventually there'll be digital closings, and you won't even have to go. We want to be on the forefront of this kind of thing. We're looking for different ways to get more involved with AI.

KENDALL: With the type of commercial estate that I'm involved with, it's a relationship business. People like to do business with someone they like. So if you have good integrity, you know what you're doing and you're educated on your product, they're going to enjoy doing business with you. This is not a cutthroat business. It can't be a win-lose for both sides. It has to be meeting in the middle. Now one side may feel better in the end than the other. But at the end of the day, it can't be a win-lose, because then you're not going to have that repeat business in the future. And so, yeah, I think it's a great opportunity for those who enjoy working with others. ■