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The Streets of Philadelphia

Institutional appetite for the City of Brotherly Love is rising 'exponentially' as LPs and GPs target the city not just for its education and medical industries, but also for its appeal to millennials, culture, and affordability.

In Philly, they call them "eds and meds."

Modern-day Philadelphia is a city built on education and health services. Today these two industries represent a third of all jobs in Philadelphia, with nine out of 10 of the largest private employers either universities or medical institutions.[1]

Indeed, 80 percent of U.S. pharmaceutical and biotechnology companies have a presence in the Greater Philadelphia region.[2]

The rising prominence of education, health, and life science as major growth industries has spurred increased appetite for Philadelphia commercial real estate transactions as institutional investors and fund managers look for greater value in secondary markets across the U.S. and away from gateway cities.

"Over the past five to eight years, institutional capital coming into Philadelphia from outside the region has grown exponentially," says Daniel Killinger, managing director of development at National Real Estate Development.

"Traditionally, a small pool of institutional capital traded almost all the Philadelphia assets. Now there is a world of investors eager to invest."

The May 2018 acquisition of GlaxoSmithKline's U.S. headquarters by the South Korean sovereign wealth fund Korea Investment Corporation is one example of the heightened cross-border appeal of Philadelphia. The deal marks KIC's second deal in the city and set a record per square foot (psf) price of $628.

But while eds and meds continue to be at the heart of Philadelphia's growth story, the City of Brotherly Love's renaissance in the wake of the 2008 financial crisis is not just about job growth in two industries.

Private real estate LPs and GPs have increasingly turned to Philadelphia thanks also to its demographics, culture, and affordability—factors that have helped the Greater Philadelphia region retain young, highly educated talent and help it rank top for growth of millennials.[3]

"People don't give the city the credit it is due," says Christian Dalzell, managing partner of Dalzell Capital Partners, which targets Class A boutique multifamily assets located in urban centers along the East Coast.

"Philadelphia is one of the most livable cities in the U.S. Anyone who spends time in Philadelphia will notice how enjoyable it is to walk around and/or to live here," Dalzell says.

While Philadelphia's economy has traditionally been, and continues to be, driven by the eds and meds industries, Killinger says growth in the technology sector is also contributing to the city's rising status. For example, Comcast Corporation is building a $1.5B technology hub in Center City alongside its global headquarters.

The growth of the technology, education, and health service industries is "encouraging a population of educated, young students to stay in Philadelphia rather than move elsewhere after school," says Killinger. "Philadelphia today is a dynamic urban environment."

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Indeed, the retention of higher-education students has been dramatic, with 67 percent of students in 2017 saying they would be very or somewhat likely to stay in Philadelphia—up from 58 percent in 2010.[4] It's part of the reason why Philadelphia today boasts a young population, with 51 percent of residents aged 34 years or younger and the median age of a Philadelphian just 34 years, compared to the U.S. average of 37.8 years.[5]

It's a significant change from the gritty Philadelphia depicted in the 1993 Tom Hanks movie of the same name. The city was on the brink of insolvency after years of poor fiscal management, and was so plagued by the heroin and crack epidemics that parts of the city were nicknamed "the badlands." The city suffered some of the highest rates of poverty in the country.

Philadelphia still experiences chronic levels of deep poverty, with the poverty rate in the city increasing more than 10 percent between 1970 and 2016—compared to a 0.1 percent increase nationally.[6] It's an issue that will take decades to solve, says Alex Dembitzer, CEO of Sky Management Services, but Philadelphia is continuing to change rapidly.

"I don't see Philadelphia as a secondary city anymore. It's a small primary market that feels good. It's where people want to be and which is going to succeed," says Dembitzer, who invested in Philadelphia more than 30 years ago in his company's first transaction outside of New York. Today, Sky Management is redeveloping a 1-million-square-foot public safety campus, The Quartermaster, on South 20th Street.

"There are significant challenges ahead… [but] we continue to see a lot of value and upside to Philadelphia," says Dembitzer, who also installs renewable energy projects, such as solar roof panels, at his assets.

Killinger also sees continued upside to Philadelphia, with National having grown its presence in the city from a 100-unit multifamily construction loan eight years ago to today leading a $780 million redevelopment of a full-block site at the heart of Center City.

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—Christian Dalzell, Dalzell Capital Partners

The multi-phase East Market redevelopment, which National is investing in through its $4 billion open-ended fund Indure, will ultimately deliver 800,000sf of Class A commercial space and 800 apartments.

"National slowly worked its way up the capital stack as they got to understand Philadelphia's fundamentals. We truly believe in the long-term growth of the city and the opportunities it presents," says Killinger. "We focus on neighborhood-making, transformational projects that have a huge impact on growing urban areas and that's happening here in Philadelphia."

The affordability of Philadelphia's downtown, for residents and businesses, has been a key factor in the city's growth over the past decade. "In cities such as New York, you need to make a significant amount of money in order to live there, but in Philadelphia someone could afford an apartment, have a decent job, and save money," says Dembitzer. "It has many positive quality-of-life attributes."

Changing Spaces

Tenant demands for greater flexibility are changing the nature of traditional working spaces.

The traditional 10-year office lease may be set for change as the very nature of work transforms. Technology and employee needs are paving the way for increased open spaces, co-working, and even shifts in working locations.

RSM partner John Rilling sees tenants requiring more open spaces and less space in general, for shorter lease durations.

At RSM, key offices have employed hoteling concepts whereby the majority of staff do not have assigned desks and where only partners have offices. Employees instead work at clients' offices or sit at shared spaces.

"You will still need space, but you don't need as much," says Rilling. "Instead of having six floors in a building, you may need two floors."

Two potential impacts of tenants' changing use of space could be lower tenant improvement (TI) allowances—and greater lease-term flexibility.

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Regional Highlights

$628psf Paid by Korea Investment Corporation for GlaxoSmithKline's North America headquarters in Philadelphia's Navy Yard. KIC acquired the 208,000sf office for $130.5M from Liberty Property Trust.
Source: The Philadelphia Inquirer (May 2018)

30% Increase in the number of Philadelphia residents educated to degree level or more, more than any of the 10 largest U.S. cities. Today, 36% of Philadelphia residents are educated to degree level or higher.
Source: JLL U.S. Life Sciences Outlook 2017 and CBRE Tech 30 2017

14,100 New jobs added in the education and health sectors in the Philadelphia MSA in the year to Q2 2018.
Source: Cushman & Wakefield Philadelphia Market-Beat Office Q2 2018

67th Rank out of 193 cities globally for its international retailer presence—ahead of Seattle; San Diego; São Paulo, Brazil; and Sydney, Australia. Philadelphia was ranked alongside Miami as the U.S. city luxury and mid-range retailers most targeted for expansion.
Source: CBRE, How Global is the Business of Retail (March 2018)

500 Tech companies call Philadelphia home. The University City submarket was the most in-demand area for high-tech companies and experienced 10% rent growth between 2015 and 2017, compared to 4.3% for the Philadelphia market generally.
Source: CBRE Tech 30 2017

1.9% Vacancy rate for life science lab space in Philadelphia's CBD, significantly tighter than Boston's East Cambridge market where vacancy is 6.8 percent.
Source: JLL U.S. Life Sciences Outlook 2017

Dalzell agrees, saying Dalzell Capital, which has purchased three multifamily and mixed-used properties in Core Center City, has been spending the bulk of its time in Philadelphia "because you have the opportunity to buy good, solid cash-flowing assets that are in unbelievable locations. The first thing that drew us to Philadelphia was its affordability."

In Philadelphia, average asking rents for CBD offices are around $30psfup from just over $25psf in 2013 but below Boston's $36psf and Chicago's $39psf, and significantly below New York and San Francisco's $72psf.[7] Killinger says average office rents surrounding the firm's East Market development prior to construction were in the mid-$20s. Today, the firm is leasing in the low-to-mid-$30s.

"Philadelphia is in the middle of transitioning from its manufacturing-based "old economy" to a new economy that is based on bio-med, life sciences, education, media, and technology. The resulting diversification of the local economy is pulling many firms and people back to the Center City," says Dalzell.

"It's an exciting time to be in Philadelphia," adds Killinger. "You watch the demographics, the millennials, and the empty-nester baby boomers, and you see the city's growth in technology as well as in education and health. You watch that together with Philadelphia's amazing museums, food, and cultural scenes, and this is a city that is growing. It's exciting to be a part of that." ■

Sources

➜ **1, 5, 6:** *Pew Charitable Trust, Philadelphia State of the City, 2017*

➜ **2, 3:** Select Greater Philadelphia Council. *SGPC classifies the Greater Philadelphia region as the Northern Delaware, Southern New Jersey and South Eastern Pennsylvania corridor*

➜ **4:** *Campus Philly, Ready to Launch 2017 report*

7: *Cushman and Wakefield Philadelphia Office MarketBeat Q2 2018*

Rilling says offices spaces are becoming more functional with only basic necessities provided, such as a clean, well-lit space, technology, and communal areas for dining and other activities, which could help lower final TI allowances provided by landlords. Another impact could be on the traditional 10-year office lease.

"Tenants are becoming much more efficient in terms of how they utilize their space, and that applies to the use of shorter-term leases," says Rilling. "I believe you will see a lot of space consolidation within the office sector."

Rilling also highlights the demographic shift back to the urban core. In the 1950s and 1960s, demographics led employers out to the suburbs, but today Philadelphia's central business district has almost 30 large-scale construction projects being built or due to deliver in 2018.

"Philadelphia is a vastly different place today than it was 30 or 40 years ago," says Rilling. "The neighborhoods around Center City have gentrified and developed, and many people want to live there. They want to live where they work."

Philadelphia's status as an education and medicine hub is helping attract highly skilled workers to the city at a rate faster than Boston, Seattle, or San Jose, according to JLL.

Although Philadelphia's suburbs still hold an appeal for some large employers, the demographics are dictating the movement. RSM's own main office in Philadelphia is in the suburbs, but "80 percent of new hires want to be in our Center City location," says Rilling. "We're constantly taking more space downtown to satisfy that need."

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Going Large in the Suburbs

Best-in-class office properties right outside the urban core can have a lot of asymmetrical upside, according to Philadelphia-based Rubenstein Partners' Steve Card and Brandon Huffman.

Historically, your portfolio has been evenly distributed between suburban and urban assets. Why have you been buying more suburban properties recently?

Steve Card, Rubenstein Partners: We have been buying large blocks of quality vacancy in suburban office buildings because that's where we're currently finding the largest pricing inefficiencies. It's not a function of us liking suburban more than urban assets—it's a function of us liking the pricing and the underlying fundamentals that are attractive relative to the financing and pricing. Quality vacancy in the suburbs can be priced as a high-risk asset, while the reality often is that this perceived risk is mitigated once we apply our strategy to update and amenitize them. Frequently our assets are in high demand post-renovation simply because there's nothing else as good in the local market.

How do you define large blocks? What are you doing with them?

Brandon Huffman, Rubenstein Partners: It depends which market you're in, but generally we would consider 50,000 square feet or more to be a large block. We're not buying commodity assets that we can't make truly unique. We're buying best-in-class assets at scale, which allows us to invest significant capital to take the amenities to a whole new level and further differentiate the assets from the competition. Buying at scale allows us to justify the cost, since it's amortized over a large investment—conversely, in most cases, our competition cannot replicate our strategy, because they cannot justify the cost on a smaller deal. In terms of our approach to amenity improvements, it's the urban/suburban concept. We reposition the properties we buy into great blocks of large contiguous vacancy in markets where those blocks are fewer and farther between. We're often the only large-block player that's trophy or Class A quality in our markets.

It gives us a very real opportunity to transform vacancy into large, long-term stabilized-lease assets that price like bonds even in the traditional suburbs. There's considerable investor demand for the product we aim to create – modernized, stabilized properties with credit tenancy. That's where we've been tremendously successful, buying vacancy that's priced like it's risk but which has a lot of asymmetrical upside because, with the right execution, you can secure large or full-building-credit tenants and add tremendous value.

What kind of amenities are tenants asking for?

Huffman: It's having the state-of-the-art fitness center, concierge service, conference centers, and all-day healthy dining options. It's bringing in food trucks certain days of the week, having after-hours events and pop-up beer gardens on some of our campuses. These amenities are very different from what you would historically see in a standard suburban office campus.

Is demand for offices in suburban nodes increasing relative to the urban core?

Card: The [rent growth] gap [between the suburbs and CBD offices] has been closing. It mirrors demographic changes. If you look at the data, more millennials have moved out of the cities to the suburbs over the last three years than vice versa by a meaningful margin. We're also seeing that pickup on the office side, so office vacancies have decreased. They're still higher in the suburbs than they are in the cities throughout the country, but they've come down a lot more. And it's often the best-in-class properties around these nodes, often the first stop outside of the urban core, that are absorbing all that space.

We're starting to see pressure on rents in a lot of those markets. Construction costs are up across the board, which has made replacement cost very, very high in these markets. Before you see any meaningful new supply as competition, rents are going to have to run a long, long way. We can see the fundamentals strengthening; we don't see any new supply coming online, yet the suburban markets are still very out of favor. That's a trend we really like when it comes to supply and demand. ■

Steve Card
Principal & Regional Director, Mid-Atlantic, Rubenstein Partners

Brandon Huffman
Managing Principal & Portfolio Manager, Equity Investments, Rubenstein Partners

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CRE's Biggest Technological Disruptors

Which technology will cause the greatest disruption in commercial real estate, and why should the private real estate business pay attention? We asked experts from across the U.S.

"**The rise of shared spaces.** The untethering of place and user due to the interconnectivity allowed through new communication technology. This paradigm shift has decreased our expectation of private ownership or private use of space, a shift that will be felt at different paces for different types of CRE [as demand for shared spaces rises]. Historically, the risk attributed to functional obsolescence [in CRE] from technological disruption was small and incremental. Our challenge now is to design and build assets that can adapt and remain useful."

—David Castilla, President, GenCap Partners

"**Blockchain technology.** It has the ability to eliminate the title insurance business."

—Stephen DeNardo, CEO, RiverOak Investment

"**Renewable energy.** The energy market in the U.S. [and globally] will move over time to greater independence from fossil fuels [with] geothermal, solar, and wind energy production—combined with significant improvements in insulation and air circulation technologies—will become the market and regulatory norm over the coming years. This change will have far-reaching impacts on planning, design, construction, and financing of all new real estate projects and projects, not built to these standards will become obsolete and decline in value."

—Peter Merrigan, CEO, Taurus Investment Holdings

"**Blockchain technology.** What are the long-term applications in real estate? Fast and accurate deed recordings, leading to accurate title reports. In development, full transparency over plans and sign-offs. And in leasing, record-keeping, which is currently in the hands of multiple teams of owners, brokers, users, architects, and attorneys, will be streamlined. It will take time, but blockchain appears to be the answer."

—Alice DiMarzio, BSD Realty Worldwide

"The biggest technological disruption to CRE, and what keeps me up at night, is the potential devaluation of assets, not from market fluctuations, but from **technology-enabled platforms.**"

—Daniel Farber, Principal, HLC Equity

"**3D printing.** When labor costs as a part of construction shrink, the supply-side dynamic should shiftdramatically."

—Ezra Dweck, CIO, The Oved Group

"**Digital manufacturing** will fundamentally transform the world as we know it over the next 20 to 30 years, enabling items to be produced in a variety of ways never before known and without the need for mass production. In the U.S., this will mean a move away from large factories to smaller assembly shops and, combined with 3D printing, allow small businesses to effectively compete with larger corporations. As a result, low labor/production-cost countries like China and India will need to reinvent themselves to live through this major disruption of their economic model."

—Malte Stoeckhert, Managing Director, Cambridge Wilkinson

"**Blockchain.**"

—Eric Distenfeld, Director of Business Development, Treetop Development

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