Why Weathering Boston CRE's 'Perfect Storm' Takes Teamwork, Capital And Creativity

Boston

Economy

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As the biggest commercial real estate market in New England, the success of Boston CRE has largely hinged on the city's growing population, robust job market and lively life sciences, financial and healthcare sectors.

However, because of the pandemic-related challenges of inflation, workforce shortages and rising interest rates, Boston, much like the rest of the country, is starting to feel the effects of an uncertain real estate market.

Interest rates have reached 5.5%, making access to capital tighter than the CRE market has seen in the past 20 years. Office vacancies in Boston have hit record highs of nearly 17.5%, and construction costs are up almost 40% from pre-pandemic levels — making for a "perfect storm" that has created uncertainty across the industry.

As the uncertain U.S. economy continues to challenge the city's CRE sector, developers must now adapt to the evolving landscape or risk falling behind, said Michael Scott, co-managing partner at Nutter, McClennen & Fish, a Boston-based law firm with expertise in real estate law.

"There has been a confluence of events implicating CRE deals and the larger market," he said. "To get through these uncertain times, it takes a team effort. At Nutter, we have one of the largest real estate groups in the region. Our attorneys leverage the depth and breadth of our team's experience, contacts and insights to advise our clients with perspectives informed by timely practical experience navigating everything from permitting to financial markets."

Bisnow spoke with Scott, alongside Mark Development founding principal and CEO Robert Korff and principal Damien Chaviano. Mark Development is one of Nutter's developer clients. The discussion focused on how the economic climate has altered how CRE deals are made, how business at Nutter has been impacted and what advice the firm has for Boston CRE professionals moving forward.

Bisnow: How has the economic climate impacted the way CRE deals are getting done in Boston?

Scott: Some of the same pressures facing the broader economy create a particularly difficult environment for CRE.

We’ve seen interest rates continue to rise, impacting the likelihood for additional investments as financial structuring becomes challenging given the cost of capital. Scarcity and cost of capital are real at every stage of a project.

Construction costs are also up, and supply chain issues continue to affect lead times, which yields challenges moving projects forward from budget and timing perspectives. The impacts are being felt across the real estate life cycle, from investor to end user.

Bisnow: From a developer perspective, business is slowing down. How has this impacted the scope of work Nutter has been experiencing?

Scott: Our development clients are talented, forward-looking and pragmatic. While cost increases have slowed the pace of immediate investment, many of our clients are looking ahead to the next trend and future needs. This includes maximizing opportunities in Boston and, more recently, outside the metro market on housing, light industrial/biomanufacturing, warehouse, fulfillment, last-mile distribution and more.

Bisnow: What is Nutter doing to ease client tensions/fears during this time of economic uncertainty?

Scott: We advise clients with both a realistic assessment of the risks and challenges in an evolving market and creative problem-solving that maximizes both short- and long-term opportunities. As our clients re-evaluate projects in the face of significant obstacles, we work with them on creative options — whether it’s finding alternative sources of financing such as private equity, grants, government-sponsored direct loans or various state resources for economic assistance from within the existing state and federal programs or through special legislation.

Working with our clients to access capital remains critical at every inflection point. Ultimately, we work hand in hand to develop and implement strategies to maximize the value our clients bring to the market.

Bisnow: What's trending in the Boston CRE market and beyond? What is the firm's outlook on the Boston market and nationally in the near term and long term?

Scott: Boston and beyond are trending toward the convergence of lifestyle and office, creating projects with options and amenities to live, work and play. We're seeing more highly amenitized offices to accommodate employee needs with the intent to drive people back to the office. Today's tenants are looking for amenities such as community space to socialize with co-workers, fitness centers, outdoor space and smart technology, among others.

We're also seeing an increased interest in the construction of projects that provide a mix of affordable — both low- and moderate-income — and workforce housing. It's estimated that Massachusetts needs 175,000 low-income multifamily units, and 26% of all Boston-area renters are rent-burdened. The city's current administration is focusing on this area to ease housing affordability for residents.

We're seeing clients double down on public-private partnerships to rethink how to get a shovel in the ground. The Healey-Driscoll administration has made a strong push for housing, and our developer clients that are exceeding baseline inclusionary housing policies are having success with the new administration in identifying deeper pools of public subsidy and financing that are making the market-rate housing more feasible in this challenging environment.

Finally, the emergence of proptech continues to radiate throughout the sector in Boston and beyond. This includes configuring mobile access points, incorporating building management and monitoring systems, KPIs and equipment monitoring/failure points. Naturally, proptech and its inevitable expansion into propsci will have a great impact on all sectors across Boston, especially the life sciences sector.

Korff: On the local level, municipalities that are willing to lean into housing are seeing housing units increase in their towns, whether through hands-on rezoning — arguably as a byproduct of MBTA Communities acts — or through more meaningful balance sheet investments, such as long term TIFs, housing trusts and CPA funds.

Bisnow: What advice does the team have for developers dealing with financing difficulties, supply chain troubles, and rising construction and land costs?

Scott: To navigate the current market, developers should be open-minded and not be wed to the original project design and programming. In some cases, significant changes need to be made to reduce costs and maximize timely returns to attract capital to allow these projects to be constructed. Weathering these complex and intersecting factors takes a team effort from developers, attorneys, financial institutions and local/state administrators and officials.

Our clients are exploring a much wider swath of capital sources in order to execute deals. The "traditional" capital stack has been turned upside down, as both large-scale and regional banks have been hampered by underwriting standards and investors have taken flight for safer yields.

Chaviano: To capitalize multifamily housing right now, we are seeing a much more chopped-up capital stack, akin to how affordable housing projects have been financed. To attract alternative sources of capital, we are finding you need to take one step back on the pro forma to move two steps forward on the project. Whether it be increasing the affordable mix above baseline zoning or deep commitments to sustainable pursuits, these measures are opening up alternative sources of capital that can plug the gaps of where conventional lending and equity are falling short.

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