PRINCETON OFFICE MARKET REPORT

CLASS M THE MILLENIAL IMPACT

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INSIDE:

- State of the Market
- US Demographic Groups
- Where will they go?
- Economic Outlook
- Investment in US Real Estate

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THE PRINCETON AREA OFFICE MARKET WAS RELATIVELY ROBUST IN 2017 WITH CONTINUED STRONG LEASING ACTIVITY, POSITIVE ABSORPTION AND STEADY RENTAL RATES. THE MARKET WAS DOMINATED BY THE LIFE SCIENCES INDUSTRY YET AGAIN WHICH IS NOT A SURPRISE DUE TO THE FACT THAT OVER 40% OF THE 30 MILLION SF IN THE PRINCETON MARKET IS OCCUPIED BY LIFE SCIENCE COMPANIES.

Bristol-Myers Squibb (BMS) is the largest pharma company in Princeton (and the largest corporate office user in the Region). BMS relocated 650,000 sf of space from a 1990's vintage office park in Forrestal Center to approximately the same amount of space in Lawrenceville in a new mega-building that BMS recently constructed. This move caused an increase in total space in the market, but also caused vacancy in the northern part of the market to spike. No alternative tenant has been secured for BMS' old space as yet. More Build-to-Suit construction is expected in 2018, however, the number of approved sites are dwindling. During the last boom (2005-2008), many developers obtained approvals for new office construction. Since then, many of the permits have expired and few developers have engaged in the expensive and time consuming process of obtaining new approvals. New Build-to-Suits will take longer and real estate advisors will need to have a sophisticated understanding of the legal and political process in order to negotiate the best deals for their clients.

The lone build-to-suit lease negotiated in 2017 was for GS1's new US headquarters. GS1's new 42,000 sf building is under construction at 300 PrincetonSouth Corporate Center and will be completed by December, 2018.

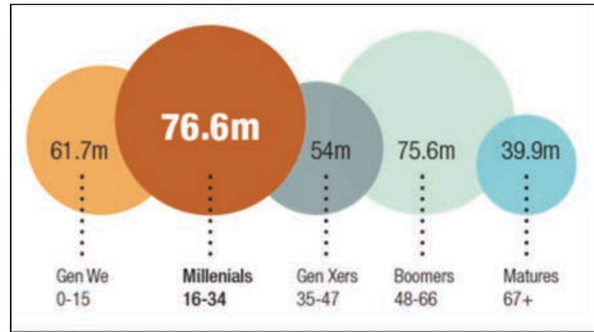
GS1's New US Headquarters, Ewing, NJ

(Mercer Oak Realty negotiated this lease transaction on behalf of the owner of this property).

For 2018, we see a number of tenants in the market that will impact availability and rental rates. Several law firms are looking to relocate to "downsized" space. The old model of dozens of closed offices surrounded by dark wood paneling is being replaced by a more modern, open and bright environment. Law libraries are out. Large, glass-lined amenity spaces are in. High-tech companies are looking to expand and upgrade their facilities. Many of these companies expect to rely on millennial employees for future growth and need to have modern spaces to attract that demographic. Like the law firms, many tenants are looking to tighten up their use of space and offer more amenity-rich spaces within their office environment. The trend towards home-officing seems to have peaked as more companies have determined that working at home may not be productive for many employees. Working in a wide-open office environment (the other big trend of the past 10 years) also seems to have peaked. Many firms realize that openness can be achieved by utilizing glass walls which bring natural light into the space and provide a visual connection between the work force, while at the same time enabling sound-privacy for employees in private offices.

US DEMOGRAPHIC GROUPS

Many demographers are predicting that Millennials will be headed back to places like Princeton in large numbers. There are about 76.6 million Millennials in the US now, making them larger than the next largest demographic, Baby Boomers (75.6 million). The Millennial generation, aged 20-36, has previously been characterized as shunning the suburbs. However, as they form families and have children, they are coming back to the neighborhoods where they grew up. 60% of Millennials with a 4-year college degree live in the suburbs. If you parse out the Millennials with a college degree and 1 child, the percentage increases to 75%. When you look at that demographic and limit the search to families with a child over 6 years old, the percentage increases to 85%.



The impact of the millennial generation can't be overstated. If 85% percent of this demographic has/ will move to the suburbs as their children enter school-age, that will have a significant impact on places like the Princeton Region. Companies want to be located where their future potential star-quality employees want to live. The Princeton Region boomed in the 1980's and 1990's, but growth has been much less robust since 2000. The exodus of Millennials back to Princeton will be a game-changer for the commercial and residential real estate business in Central NJ over the next decade.

WHERE WILL THOSE MILLENIALS GO?

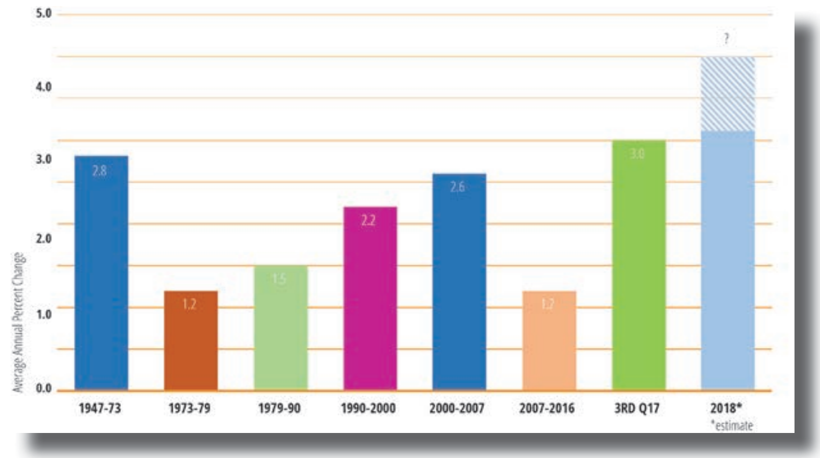
Howard Hughes' Proposed New Town Center, West Windsor, NJ

Development approvals are currently being sought for large tracts of land, however, many Towns in the Princeton area have been resistant to the idea of approving residential development that will increase the burden on their schools. Meanwhile, legal action is forcing every municipality in the Region to accept affordable housing quotas. When developers build affordable units, they typically mix them with market-rate residential space. Many Towns have an obligation ranging from 1,000 to over 2,000 affordable units. If these are mixed with market units at typical ratios, this will amount to tens of thousands of housing units. Many of the developments are being designed to accommodate a town-center and multiple uses, which appeal to Millennials (and others). This kind of development represents the next generation of live/ work/ play spaces that has become predominant in the rest of the United States.

ECONOMIC OUTLOOK

Productivity growth dipped to a cycle low of 1.2% in 2007-16. This trend was reversed in 2017, when productivity growth hit 3%. Productivity is the basis of wealth creation. Capital investment by companies will spur productivity. The Federal Tax Legislation provides for 100% deductibility of capital expenses, encourages repatriation of trillions of dollars in offshore profits and a lower tax rate for corporations. Despite threats by the new administration in Trenton to increase taxes on high-earning individuals in New Jersey, the impact of the Federal Tax changes will more than offset any headwinds coming out of the State.

US Productivity Change, 1947-2017



In 2017, the US economy achieved steady GDP growth of over 3%. We expect that the US economy will grow even faster in 2018 than it did in 2017. A significant number of people dropped out of the labor force after the Great Recession. The Labor Participation Rate dropped from 66% in 2007 to around 63% now. There are currently 160.3 million people in the labor force, so a 3% drop represents 4.8 million people. This leads many economists to conclude that the low labor wage inflation is due to underemployment.

If the economy starts growing more rapidly and companies are making major capital investments, many of the underemployed folks will be drawn back into the work force and have more disposable income. A boom in capital investment would also result in an increase in productivity which will have a virtuous-cycle impact on economic growth.

INVESTMENT IN US REAL ESTATE

In its latest Emerging Trends report, the Urban Land Institute describes shifts in investment patterns. Many investors are reallocating assets to non-core (suburban) markets in order to achieve higher returns. Capitalization rates (cap rates) in urban core investments are now at 6-6.5%. For suburban investments, buyers are requiring returns of 7-8% (or higher). Certain suburban markets are considered elite. In New Jersey, Princeton is considered an elite market. For the past few years, property values have moved up, mostly due to decreasing interest (and cap) rates. Many owners have increased the value of their properties by completing significant capital improvements resulting in increased rent and occupancy.

Class A rental rates have not moved up over the past 15 years, while construction costs and operating expenses and taxes have increased significantly. Therefore, as the economy moves forward and market tighten, rental rates will necessarily have to increase. Class A rental rates in Princeton are in the low $30's per square foot, while rental rates in NYC are in excess of $100/ sf. As Millennials are increasingly interested in a suburban lifestyle, the rent differential between Princeton and Manhattan could be determinative. New high performing buildings, built to be green and healthy, located in a mixed-use amenity-rich environment, delivered for a rent in the mid- $30's per square foot, will compete effectively with their urban counterparts that are 3 times as expensive.

The Pharma industry continues to drive demand in the Princeton market, absorbing both office and laboratory space. A few major office parks are suffering recent vacancies that will need to be filled in the coming years. This will provide opportunistic tenants and investors with the potential to add value. Companies continue to "downsize" their operations to create efficiencies, however wide open offices and home-officing appear to have peaked. Millennials are coming back to the suburbs, especially places like Princeton, where the educational opportunities for young parents are far superior to competing urban locations. Superior economic growth and the potential for a surge in corporate capital investment create a new dynamic for the Princeton Office Market in 2018 where demand and rental rates could achieve new post-2008 highs.