The Commercial Real Estate Climate in Western New York is Undergoing Fundamental Change

September 2018
Summary

It is the belief of the Commercial Real Estate Development Association (NAIOP), supported by hard data, that our region is at that juncture where it needs to advance beyond the traditional approach to economic development, proactively recognize emerging economic trends and development, and implement a series of new policies to position our economy to maximize the benefits of those new trends.

In order to promote a regional discussion about the economic development priorities of various levels of government, the Association recommends the following policy changes be adopted by the Industrial Development Agencies representing the cities, towns and counties of Western New York. We believe these policies will encourage a regional dialog which will facilitate further development and growth in the key areas of population, employment and wages.

POLICY RECOMMENDATION ONE: Develop and execute a single regional comprehensive plan for retention, attraction and support for millennial residents.

POLICY RECOMMENDATION TWO: Allow PILOT agreements and tax abatements for multifamily housing developments within high density zoning.

POLICY RECOMMENDATION THREE: End single use zoning and allow buildings which formerly had single use to be adapted to mixed use that includes housing styles attractive to millennials.

POLICY RECOMMENDATION FOUR: Industrial Development Agencies and other government entities should immediately complete the infrastructure and entitlements for industrial properties which they own and commence RFPs to encourage the private sector to begin construction on industrial property.

POLICY RECOMMENDATION FIVE: Immediately allow PILOT and other tax incentives for speculative industrial developments without tenants.

POLICY RECOMMENDATION SIX: Take steps to correct the inverted housing market including removing housing stock, expanding the boundaries of thriving neighborhoods and encouraging investment in single family houses.
After generations of languishing in the economic doldrums, the last several years have seen a noticeable uptick in economic activity in Buffalo and Western New York (WNY), positive economic indicators and high-profile projects that have put construction cranes on the skyline and people to work on the ground.

This activity fed a growing feeling of optimism and a belief that the Western New York economy has finally turned the corner and a long-term renaissance was possible.

Although this “conventional wisdom” and upbeat attitude is an important contributor to revitalization and necessary for economic stability, the willingness of the development community to invest in job producing projects essential to is economic progress. It requires an evolving strategy that recognizes the conditions in the market and the relative position of WNY among other cities with whom we compete for residents, employers and investment.

Just as we saw an emotional uplift from the dark days of the past to a new optimism we are currently experiencing, an attitude of complacency or the presumption that ENOUGH has been done to restore the economic fortunes of the region is a grave misconception that can usher in the return those difficult years. Any region that rests too long on its current accomplishments and presumes that current economic forces will continue indefinitely, is likely to find itself extinguishing the flame on economic development that the region worked so hard to ignite. Missing the new trends means consequently playing “catch-up” when these new trends are recognized and implemented by other regions.

It is the belief of the Commercial Real Estate Development Association (NAIOP), supported by hard data, that our region is at that juncture where it needs to advance beyond the traditional approach to economic development, proactively recognize emerging economic trends and development, and implement a series of new policies to position our economy to maximize the benefits of those new trends. (See Part 2)

It is the purpose of the “white paper” to examine those emerging trends, place them in the context of our regional needs and goals, and recommend a series of economic development policies for public officials and economic development agencies to that will continue the economic resurgence of recent years to increase wealth and job-producing activities for all WNY communities.
Part 1: The Western New York Commercial Real Estate Economy today – Where we are versus where we think we are

In order to understand the current condition and evolving trends within our economy, it is necessary to first examine the forces that drive these trends – Supply Side forces and Demand Side forces.

We recognize that growth opportunities can be derived from replacing an aging supply or from meeting a growing demand. However, these opportunities are limited until the demand for real estate in our region is greater than supply. This is an existential challenge as our region was built to accommodate more residents and employers the we can realistically hope to attract. Thoroughly understanding ways to reconcile these forces is essential to the next comprehensive economic development strategy.

Beginning on the supply side, one must understand that the nature of commercial real estate is one of change - new buildings typically come on line as “class A” space with the feature amenities that are expected from tenants paying the highest rent in the market. New Class A space causes buildings that were formerly considered A space to now become B space (think One Fountain Plaza and Seneca Tower) and so on down the line. If developers are able to maintain a good balance of supply in the market, when product ages out of its class and demand remains relatively steady, rents can remain stable or rise. In fact, considering all of the development in Western New York since 2012 when the Buffalo Billion was announced, most of what has occurred can be attributed to a restoring the mix of products on the supply side of the ledger. i.

What remains to be accomplished in the Western New York market is growth driven by demand. The demand side of this equation is triggered by population growth, employment growth and/or income growth. It is with these indicators that the we have clear signs that future economic growth will require a different economic development approach than what has been done thus far. Consider the drivers of demand since the announcement of the Buffalo Billion in 2012:

- Population Growth – 15,000 people have LEFT Western New York ii.
- Employment Growth – 4,000 FEWER people are employed in Erie and Niagara Counties iii.
- Income Growth – income growth is 4.5% BELOW the inflation rate

While supply-driven growth opportunities can come from within the region, demand-driven opportunities generally require our region to compete effectively against other regions in the country or world seeking the same population, employers or investment. The Western New York region has a number of “organic assets” that can serve as the catalyst to attract these numbers to the region such as Buffalo Niagara Medical Campus, SUNY at Buffalo (UB), Niagara Falls, and our proximity to the Canadian market. However, without the right policies in place, these assets will not be able to perform to capacity. However, other regions are not waiting for us to catch up but rather continue to evolve and leverage their strengths. Consequently, Western New York must compete under new realities.
Part 2: Three New Realities of Economic Development Policy

While Western New York has been enjoying a resurgence, other communities are also making strides to improve the attractiveness of their regions for residents, employers and investment. The collective pursuit of growth exposes new ways in which regions compete and achieve success.

In order to reverse the indicators of decline we see in Western New York and maximize the job creating potential of our organic assets, economic planners need to recognize some new realities in the marketplace and adopt the correct policies accordingly:

1. **Housing leads to economic development**: cities, which we will show in a later section of this report, that have developed policies that incentivize affordable, attractive housing options in highly dense, amenity rich, walkable neighborhoods have been successful in attracting well-educated millennials. This in turn has attracted new business and industry in need of a highly educated workforce.

2. **The old policies of “Shovel Ready Sites” and “Build to Suit” are dead and no longer a tool to attract industry**: In today’s economic climate, many companies are not looking for a shovel ready site that will take 18 months to fully build out. Rather, they are looking for “Finish to Suit” space that can be ready to occupy within 90 to 120 days.

3. **Preference for renting vs. home ownership**: In response to market forces such as millennial preferences, aging populations and higher density housing options, the importance of a healthy rental market is essential to growth. Thus, apartment rental rates are the baseline indicator of the health of a region’s real estate market.

**SUMMARY: Where Are We Now?**

- Western New York has a much-improved economic picture
- Western New York has more economic momentum than in the past
- Western New York has a real opportunity to attract millennials
- Western New York has a healthy real estate stock with pockets of strength and value appreciation
- Western New York is experiencing a very modest increase in rents due to supply forces (not increased demand)
- Western New York currently does not possess a significant base of organic demand
Part 3: Benchmarking the Multi-family Housing Market—Fact vs. Fiction

For the last 18 months, the City of Buffalo has been engaged in a debate as to whether to institute a policy of “Inclusionary Zoning” (IZ) to address the issue of rent affordability. A proposal written by The Buffalo Inclusionary Housing Coalition recommended a mandate that all new housing developments of ten or more units set aside 30 percent of those units as affordable (as opposed to market rate).

That policy recommendation was fundamentally flawed in a number of critical respects.

First, and most importantly, the study used the real estate markets of Boston and Chicago to justify the recommendation of a 30 percent IZ set aside. The financial realities of these two markets that allow IZ at this level and still enable developers to realize a fair profit do NOT exist in Buffalo. A pro-forma analysis of a real estate development in Buffalo, prepared by the Buffalo Niagara Partnership, accounted for the cost of land, labor and taxes conclusively showed that ANY percentage of IZ set aside would economically prevent any new development from taking place. It would kill construction jobs and, in all likelihood, produce fewer housing units.

Secondly, the proposal used rental and housing economic data that was out of date and did not accurately reflect the current nature of housing costs in Buffalo.

A subsequent study commissioned by the City of Buffalo by CZB Consulting concluded that the problem in Buffalo is not the cost of housing, but rather the level of poverty. A look at the data bears this out.

Buffalo apartment rental rate growth since 2011 has amounted to a 0.355% Compound Annual Growth Rate (CAGR) or a $10 in rents per year for a seven-year period. In Erie County, the housing cost growth since 2011 has been 2.36 percent CAGR or a $179 increase over a seven-year period. During this time, inflation has been compounding at 1.57% per year.

This is an extremely low rate of rent increases, especially relative to other healthy communities during the same period and has discouraged even “value-added” redevelopment of rental units to improve quality (without substantial government assistance) and virtually prohibited all new building.
Part 3: Benchmarking the Multi-family Housing Market—Fact vs. Fiction

As anemic as the rental market has been, the residential housing market has been worse. The contrast has produced a very interesting dynamic in the local real estate market—an inverted market in which even a person earning minimum wage can now PURCHASE a home for less than that of renting a comparable unit.

Example:

- In 2017, the median City of Buffalo home price was $80,600.

- The median monthly mortgage payment for a home at this value was $566 (including $81/month in property taxes), for a total annual cost of $6792.

- Using the accepted figure of housing affordability being equal to 30 percent of household income translates to a yearly household income of $22,640 (6,792/30%).

- A single person earning minimum wage ($11.75/hour) earns $24,440/year.
Part 4: The Buffalo Billion: What happens when it’s gone?

Governor Andrew M. Cuomo’s commitment to revitalizing the Western New York economy is indisputable. The governor has backed up words with a solid list of actions and accomplishments since taking office. Getting state government to recognize the seriousness of the economic weakness, the history of government neglect, the positive impacts a recovery would produce for the region and the entire state and then backing it up with real and significant financial resources has given our region and economy a huge economic boost.

But what happens when the “Buffalo Billion” is over?

It was never the governor’s intention to get Western New York perpetually reliant on state funds, but rather to jump start and stimulate the economy so that it could begin producing jobs and wealth through the private sector.

The governor’s vision and jumpstart goals have been met on both fronts. In addition to the infusion of more than $1.5 billion from New York State, the private sector has invested additional private capital during the same period on a wide range of highly visible and “game changing” projects, i.e. Delaware North headquarters, HarborCenter, Conventus and many others.

The revitalization of Western New York itself is an economic driver, creating direct job and spin-off related jobs. The development industry has been the leader in bringing our economy out of recession. For every 1,000 construction jobs, another 800 jobs are needed in other industries.

What does that hold for Buffalo and Western New York once the jobs associated with public funding from the Buffalo Billion and the Medical Campus expansion no longer exists?

Now is the time for region - government and private sector leaders - to begin mapping out a “Post Buffalo Billion” strategy. Area leaders need to assess the economic and demographic trends that offer the best opportunities for economic and job growth, design the best public policies for maximizing those trends and implement the right policies to continue the momentum started under the “Buffalo Billion”

The remainder of this paper will focus on the demographic and economic trends and policies to accomplish those goals.
Part 5: Existing approaches to a swiftly evolving marketplace

Millennials

We hear much today about the need and wisdom of “attracting millennials” to the community. Millennials are the trendy demographic group economic development professionals across the nation spend time developing strategies to attract and maintain, and for good reason. Convincing millennials to live and work in a community creates a growing population segment which is highly desirable for employers. Do millennials matter? From the standpoint of economic results and case studies of the communities where millennials matter? From the standpoint of economic results and case studies of the communities where millennials choose to live and work, the answer is a resounding “YES”.

But are new strategies, different from what has been used to attract baby boomers and subsequent generations, needed?

“Build it and they will come” has been the operative principle in attracting people to a community. The “it” in this principle was aimed at attracting business and industry jobs first and using it as a lure to attract workers. Based on survey research and the actual experience of numerous communities, the millennial generation has turned the old axiom on its head.

Communities that have been successful in attracting millennials develop strong housing strategies centered on affordability, convenience and urban amenities. **It is the attraction and concentration of a millennial workforce that then attracts business and industry to that community.** “Build it and they will come” now refers to building a strong, “millennial-friendly” housing stock, a vibrant city core, access to public transportation and availability of cultural and recreational amenities.

In the areas of a revitalized downtown core, public transportation and availability of a wide range of cultural and recreational pastimes, Buffalo has made great strides and is now recognized as an attractive place for millennials to call home. But when it comes to designing new housing strategies, our area seems to be out of step with the new market forces.

The economic policy implication of this new reality will require a break from old policies and the design of a totally new approach.
Part 5: Existing approaches to a swiftly evolving marketplace

Many Industrial Development Agencies (IDA’s) have policies specifically tied to “job creation” (which housing doesn’t do) and some specifically prohibit the use of public incentives for housing projects. In light of the data and track records of numerous municipalities, this prohibition needs to be lifted and housing developments that will attract the kind of workforce that business and industry will follow should become an integral piece of the strategy of IDA’s. In addition to freeing IDA’s to incentivize housing developments, other concepts and policies need to be designed and implemented including:

• Purpose-built housing

• Innovative ownership models

• Increased density

• Policies to modernize existing housing stock
**Industrial Space**

For the past two decades, the predominant strategy in attracting industrial operations to a community revolved around “shovel ready” properties. Under this model, the preferred policy for industrial development agencies and governments is to have parcels of land under ownership, with all zoning, permitting, infrastructure and environmental issues resolved.

Today, the strongest demand is for move-in-ready or finish-to-suit industrial space.

Given the new economy and the speed now necessary to meet the demands of the marketplace, a strategy that requires a company to secure land and then begin a construction process that could last from 12-18 months before operations commence is not viable.

**Industrial Space – Shovel ready vs. Move-in Ready**

“Rising values in the industrial real-estate sector have outpaced all other real-estate sectors this year (2017) as the growth in e-commerce has fueled demand for sites that are close to densely populated areas and well-connected transportation networks” (The Wall Street Journal Dec. 26, 2017)
Industrial Space – Shovel ready vs. Move-in Ready

Buffalo N.Y. currently has one of the LOWEST vacancy rates in the nation for industrial buildings, less than half the vacancy of the cities in the list below. However, in contrast to these cities with hundreds of thousands of square feet of industrial space in construction, Buffalo has virtually NO industrial space in development:

- Minneapolis – 1.50% in development
- Phoenix – 1.66% in development
- Atlanta – 2.89% in development
- Dallas – 2.96% in development
- Chicago - 0.70% in development
- **Buffalo – 0.00% in development**

In a market exhibiting strong demand for new industrial space and with no new space under development, Buffalo and Western New York is stuck in a policy time warp. “We don’t build unless there’s an employer ready to move in,” however, that luxury is no longer an option, when a more assertive policy that is attuned to the market conditions would likely jumpstart an entire economic sector.

In Western New York, much of the desirable industrial land is controlled by government and what land isn’t requires at least a PILOT agreement in order to make a speculative development viable. Thus, government action is required to address the market conditions.

The speed of market forces today has rendered obsolete our policy of relying on “shovel-ready” sites as an economic development tool. IDA’s need to recognize the demand for move-in-ready industrial space, the shortage of such space in Western New York, and the need to fill the gap with policies that will incentivize this type of development.

To ignore the current supply and demand environment will result in other cities filling that need and Western New York missing an obvious economic growth opportunity.
Housing Policy

Housing policy, in most communities, has often been considered a separate, standalone issue from economic development. When it was considered, it was usually as a “lagging” indicator, one that was dealt with AFTER business and jobs came to a community. More and more this approach is being questioned when applied to a new marketplace, demanding responsiveness and one made up of a new generation with views, values and lifestyles much different from their predecessors.

Housing policies should be developed that provides modern, affordable housing units with access to public transportation and civic amenities, innovative ownership models along with a focus on increasing density. This should be a tool in the economic development strategy of each community.

**POLICY RECOMMENDATION FOUR:**
Industrial Development Agencies and other government entities should immediately complete the infrastructure and entitlements for industrial properties which they own and commence RFPs to encourage the private sector to begin construction on industrial property.

**POLICY RECOMMENDATION FIVE:**
Immediately allow PILOT and other tax incentives for speculative industrial developments without tenants.

**POLICY RECOMMENDATION SIX:**
Take steps to correct the inverted housing market including removing housing stock, expanding the boundaries of thriving neighborhoods and encouraging investment in single family houses.
Appendix

Tables:

- Population Growth 2010-2016
- Job Growth
- Real GDP
- Real GDP Growth
- Millennial Population
- Percentage of Millennials
- Millennial Population Growth
- Educational Attainment
- STEM Workers
- Growth of STEM Workers

i. A majority of the projects completed since 2012 were not in response to new demand or growth. For example, the new Children’s Hospital replaced an existing hospital. In another example, the only new Class A office space, 250 Delaware was filled with local tenants moving in from buildings which were previously Class A but are no longer.

ii. US Census Bureau Change in WNY residents from April 2010 to July 2017

iii. Bureau of Labor Statistics Comparison of December of 2011, the last full month before the Buffalo Billion was announced compared to December of 2017 shows the size of the work force shrunk from 563,243 to 542,111 and the number of people employed shrunk from 516,609 to 512,388.

iv. Source: Zillow Research, All Rental Classes, July 2011 – July 2018

v. InflationData.com July 2011 – July 2018