2024 Emerging Trends in Real Estate

Cleveland

ULI Cleveland

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2024

Content

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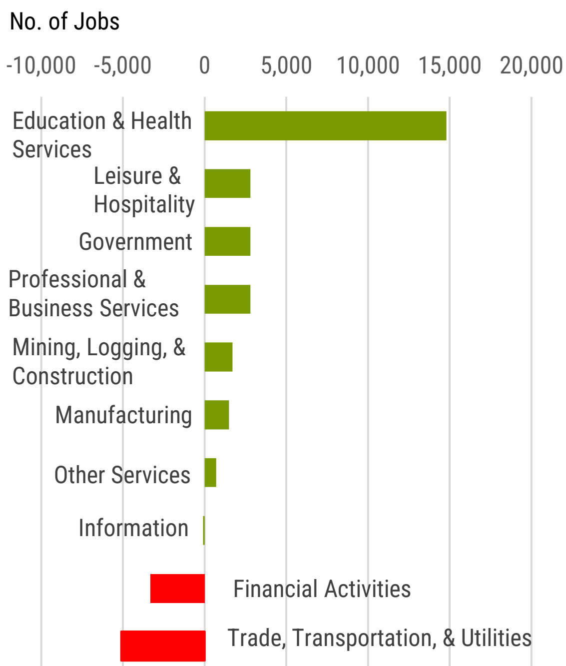
Regional Economy

Jack Newton

Though Cleveland's economy has recovered from the depths of Covid, it continues to underperform when compared to the United States as a whole. Weak fundamentals—an over-reliance on traditional manufacturing as well as an aging and declining population–will continue to challenge the region. As seen below, Education and Health Services remain a major economic driver, adding nearly 15,000 jobs year-over-year. One just has to look at the number of cranes in University Circle on any given day. These numbers offset losses in traditional office-using sectors like Financial Activities which shed 3,300 jobs.

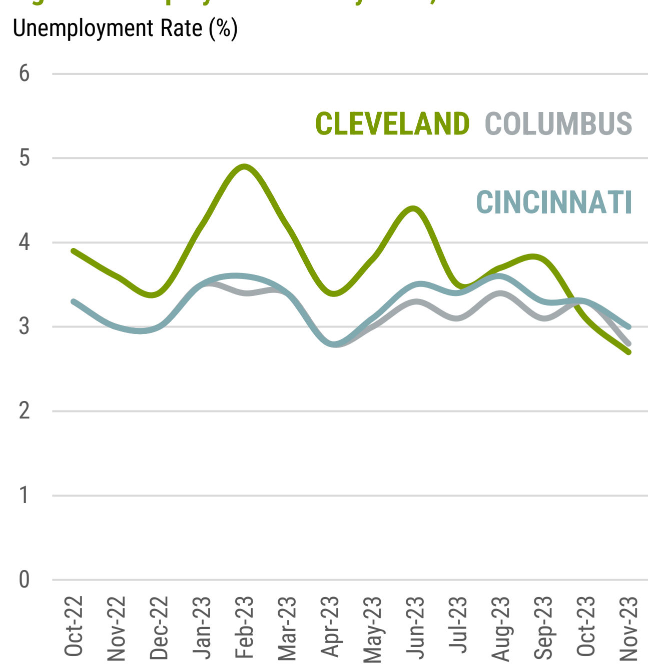
Compared to Ohio's other C's—Columbus and Cincinnati–Cleveland's unemployment rate appears to be much more volatile. According to Oxford Economics, manufacturing jobs will continue to decline through at least 2027. However, the 'Eds and Meds' sector should continue to provide stable job growth at least until next year. It is also worth noting

Figure: Change in No. of Jobs, Nov '22 thru Nov '23



Source: OH Bureau of Labor Market Information, Q1 2024

Figure: Unemployment Rate by MSA, Oct '22 thru Nov '23



Source: OH Bureau of Labor Market Information, Q1 2024 the continued progress of Sherwin-Williams' new downtown headquarters. Retaining large corporations should never be overlooked. Though overall, Cleveland's economic growth will be tepid, there are nuanced stories of challenges and successes.

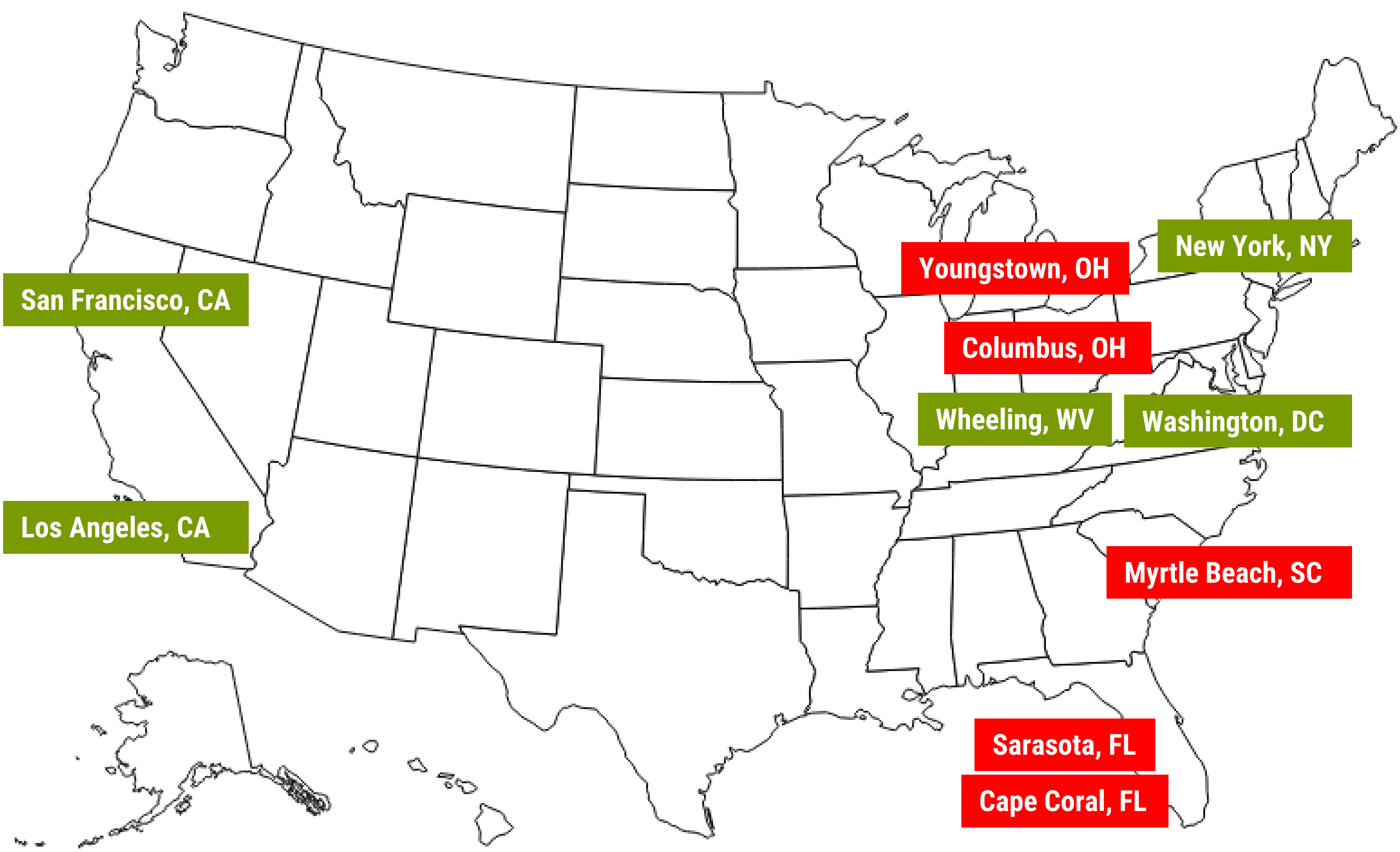
A bright spot remains affordability, but even this has its nuances. Cleveland's housing stock can be described as bifurcated with many new construction units being luxury. For those that can afford to buy, Cleveland remains a favorable destination for people fleeing high prices of coastal markets. According to Redfin (see below), four of the top five metros for migration to Cleveland are outside of the Midwest. In terms of outbound migration, many Clevelanders are leaving for Sunbelt markets in Florida and the Carolinas. This is not unlike its peer cities throughout the Great Lakes region. The average home in Cleveland, according to Zillow Research, is $97,000. This is significantly cheaper than even other Ohio metros like Cincinnati ($223,000) and Columbus ($232,000).

Inbound Migration

1. Wheeling, WV
2. Los Angeles, CA
3. New York, NY
4. San Francisco, CA
5. Washington, DC

Outbound Migration

1. Columbus, OH
2. Youngstown, OH
3. Cape Coral, FL
4. Sarasota, FL
5. Myrtle Beach, SC



Source: Redfin, Q1 2024

Office Market

Charles Thompson

The office market had a shift in dynamics marked by positive absorption of 12,427 SF in Q3 2023, a trend not seen since Q1 2022. Class A spaces specifically have experienced positive absorption, totaling 4,894 SF. This positive absorption happened despite buyers struggling to secure acquisition financing amidst higher appraised vacancy rates and risk that are driving valuations down.

Among 40 major markets, Cleveland has the highest share of office space slated for new uses. Cleveland stands out as a leader in repurposing office spaces, with 10.8% (3.5 million square feet) of its office space slated for conversion. The city leverages historic structures, state/federal tax credits, and property tax breaks to drive transformations into apartments, hotels, restaurants, and event spaces. While conversions offer a solution, they might be slowing Downtown because of a softening demand for housing, high interest rates, and high construction costs.

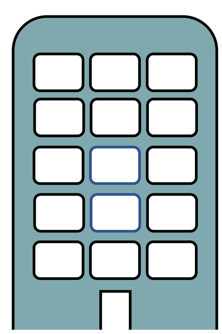
Since Q3 2023, 64% of leasing activities have been focused on Class A properties, indicating a continued flight to quality trend. The average gross lease rate has seen a $0.13 increase, reaching $19.19, reflecting a preference for higher-quality office spaces. Industry leaders like Doug Price, CEO of K&D Group, note a shift in demand dynamics, with larger tenants returning space and mid-sized tenants seeking refreshed or alternative spaces. This leaves owners with uncertainties when office leases come up for renewal. Will the tenants leave? Will they downsize?

There is a disconnect between media portrayals and market realities, as Class A suburban office markets retain higher occupancy and rental rates, even amid

There is a disconnect between media portrayals and market realities, as Class A suburban office markets retain higher occupancy and rental rates, even amid rising interest rates and lender caution. The traditional correlation between office market growth and headcount is evolving to take more consideration on how business operators see their needs. Space needs reflect what is important to tenants who are increasingly focused on talent attraction, employee retention, and flexibility on going to the office.

The movement in the downtown market is a result of companies re-evaluating their needs and moving to higher quality and efficient spaces. Tenants such as Benesch, Friedlander, Coplan and Aronoff LLP and The Riverside Co. have moved into the newly renovated Key Tower. Stewart Kohl, CEO of The Riverside Co. described the strategy to create a destination office. The refreshed office has spectacular views and an environment for the future which includes fewer

Figure: Return-to-Work Update, Dec 2023



54%

Share of Downtown Cleveland Workforce Back in the Office

Source: Downtown Cleveland, Inc

private workstations and more collaboration space to facilitate employees and visiting partners to meet and work together to build relationships.

Tenant dynamics are changing, exemplified by MRI, a real estate technology company located in Solon. MRI renewed its 100,000 SF lease despite a new landlord and considering downsizing. The technology company doubled down on investing in the already impressive space as a tool for the business as well as a hub for employee collaboration and development. Riverside Co.'s move to the top floor of Key Tower exemplifies the downsizing trend, emphasizing flexibility and a preference for collaboration spaces over offices. Despite the corporate real estate pruning trend, certain firms, like Nicola, Gudbranson & Cooper LLC, are taking advantage of the soft market to move to higher-quality spaces.

The downtown office market is a mosaic of challenges and opportunities, with various properties facing foreclosure, change of ownership, and strategic moves by tenants. These activities underscore the nuanced nature of the market and the importance of adaptability in navigating the current real estate landscape.

The 200 Public Square building, listed for sale in September with no asking price, presents an opportunity to gauge current office values when it sells. The 1.26-million square foot tower and attached 757-space parking garage was last sold in 2018 for $187M, but unofficial reports say a purchase agreement deal for only the tower has been reached with a New York based investor for almost a third of the 2018 sale price at approximately $65M, or $52 per square foot. If this report is true, the difficult office market really hurt the skyscraper’s value. The tower’s occupancy was listed at 72% following tenants reconsidering spaces such as Huntington downsizing its footprint and a large tenant, Benesch, Friedlander, Coplan and Aronoff LLP, moving across the way into an upgraded space in Key Tower.

950 Main Ave., the former EY Tower, navigates a looming foreclosure auction and the departure of anchor tenant Ernst & Young (EY) who previously occupied 150,000 square feet in the building. 1215 Superior Avenue on the Eastern edge of Downtown is also the subject of foreclosure proceedings. A less publicized yet noteworthy transition is occurring at 600 Superior Ave. While not likely to be recorded in public records, there is a change in ownership.

Much of the excitement in the market is centered around Public Square due to the Sherwin-Williams Tower project and the development plans for the river front led by Rocket Mortgage. In 2024, The Sherwin-Williams Tower will have around 900 employees moving into the brand-new iconic Tower. Following the announcement of the original tower, a reported sales increase at the company of 15% has increased growth in the company faster than expected. Word on the street is that there may be an announced second tower and parking garage on the site to the west which is already owned by the coatings giant. A similarly optimistic prediction is that a decrease in interest rates from the FED will activate Rocket Mortgage’s river front development due to an increase in their lending business as well as better financing conditions for construction projects. One of which includes a new office tower for the company along the river.

The Cleveland office market in 2023 exhibits a nuanced landscape, balancing many factors including positive absorption trends and challenges with financing. The flight to quality trend, coupled with Cleveland's leadership in office space conversions, reflects the industry's adaptability and resilience. Downtown sales activities and shifting tenant dynamics underscore the need for flexibility and strategic approaches amid a changing market. As the office market continues to evolve, local insights and adaptability will remain key to navigating challenges and seizing opportunities created by these challenges.

Industrial Market

Jack Newton

Like other major markets around the country, Cleveland's industrial sector continues to see strong demand driven by onshoring initiatives and ecommerce. However, according to Team NEO, the region continues to struggle with presenting shovel-ready sites that are attractive to national site selectors.

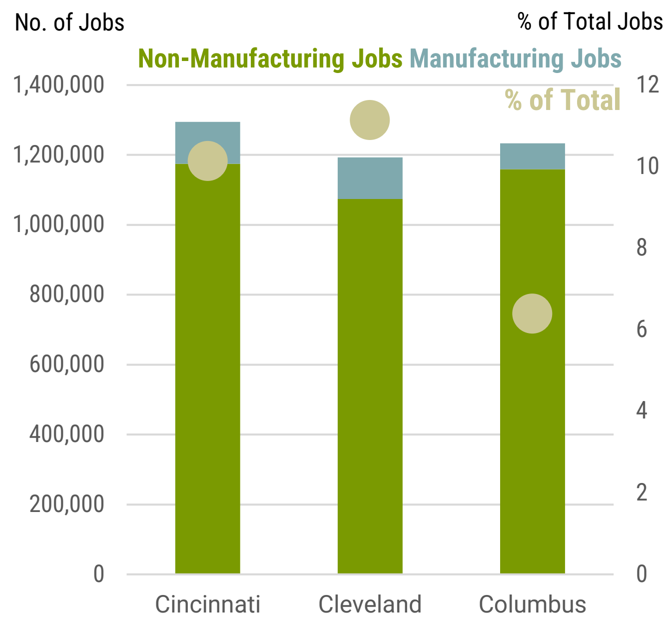
Industrial inventory in the region is low. This goes for leasable space, properties for sale, and sites to build new structures. In 2023, TeamNEO, which is focused on advancing regional competitiveness, pored over site selection data. Their findings revealed that though there is land to build on, many potential development sites are lacking due diligence that firms look for when deciding where to build.

The leasing environment remains active although space is hard to come by. According to CBRE's Q3 2023 Industrial Figures, vacancy sits at 2.5%. The Southeast submarket—which contains the I-271/I480 interchange and is the area's largest by square-feet—has a 3.5% vacancy rate, but it has also seen more construction activity than the other submarkets. Most of this space is warehouse with roughly 1 million square-feet of speculative space under construction.

In terms of jobs, Cleveland's manufacturing sector does the heaviest lifting. Manufacturing jobs account for over 11% of total jobs in the Cleveland MSA. This is roughly in line with Cincinnati (10.1%) and almost double Columbus' proportion (6.4%)—see chart below.

Construction starts have slowed, according to JLL's Q3 2023 Industrial Insights. Despite consistent leasing activity and a tight vacancy rate, interest rates and other market factors continue to impact groundbreakings. Unlike the office sector, the industrial sector will most likely remain a "landlord's market" in 2024 as tenants compete for space.

Figure: Manufacturing Jobs by MSA, Nov '23



Source: OH Dept of Jobs and Family Services, Q1 2024

Retail Market

Jack Newton

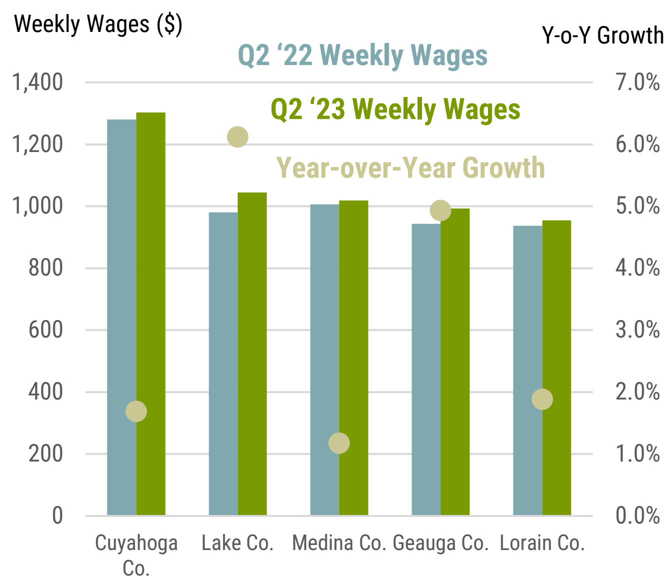
Cleveland retail performed well throughout 2023 as a dearth in new supply keeps available space at historic lows. Nationally, researchers at CBRE note that the shift to ecommerce and increased construction costs have dulled new builds, which should lead to rent growth across the sector. Cleveland is no exception to this trend.

Defying predictions, the US economy continues to chug along despite interest rate rises in July 2023. Because incomes are a major driver of retail consumption, it's worth highlighting that all five counties in the Cleveland Metropolitan Statistical Area experienced wage growth (see chart). Although wages rose in each county, only Lake and Geauga Counties experienced growth that kept up with inflation at the end of 2023 (3.4%). Please note that newly adopted Ashtabula County, for which data will be integrated next year.

According to Marcus & Millichap, 75% of new product in the Cleveland area is build-to-suit, single-tenant properties. Existing spaces, especially in the urban core, will benefit from this lack of new development. Complementing this trend is Downtown Cleveland, Inc's new retail strategy, which recommends street-level retail activation. This sector of retail in the Central Business District has low vacancy and can benefit from focusing recruitment efforts in high-density areas. The large shopping centers (i.e. Tower City and the Galleria) continue to lag in performance.

Contrary to the strong economy, national consumer sentiment remains well below pre-2020 levels. Although it rebounded following the 2023 holiday season, consumers will face headwinds in 2024 from the resuming of student loan payments and high housing costs. Thankfully, Cleveland remains a relatively affordable place to live compared to other markets. However, stubbornly high levels of poverty and slow wage growth will continue to weigh on the retail sector.

Figure: Weekly Wages and Y-o-Y Growth by County, Q2 '22–Q2 '23



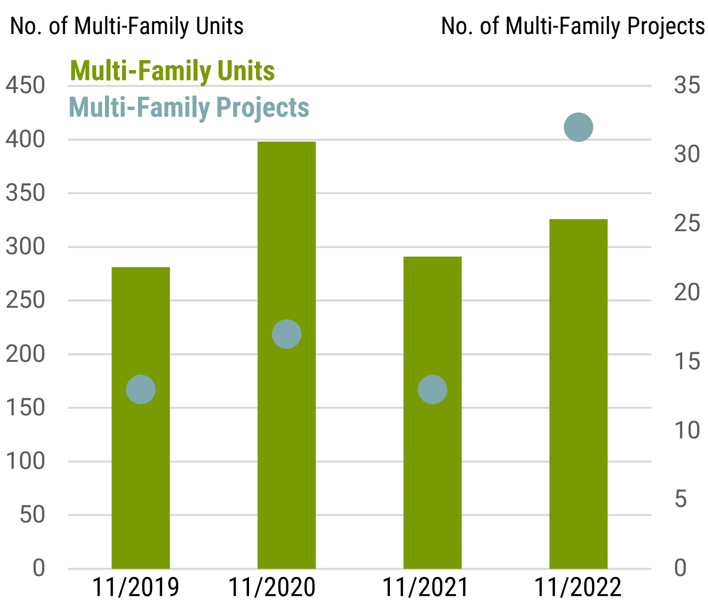
Source: Bureau of Labor Statistics, Q1 2024

Multi-Family Residential Market

Sean Dittoe

As we have seen over the past several years, Cleveland has been a national leader in repurposing distressed properties into multifamily properties. As of Q4 2023 there were over 1,300 units under construction (12.1% of the total existing inventory). Since 2017 the Cleveland market has seen a steady growth of multifamily inventory. Most projects were adaptive reuse, but over the next few years there will be several new construction projects that will either break ground be completed. This upward trend is projected to continue into the future with thousands of new units coming online over the next several years. Overall, Cleveland multifamily market fundamentals in are encouraging and exciting with the most growth still on the horizon.

Figure: Multi-Family Units and Projects by Annual Total, 2019-2022



Source: US Census Bureau, Q1 2023

As far as occupancy goes, the Cleveland market has stabilized since the peak of the pandemic. Vacancies have declined over 100 basis points since 2022 due to an influx of deliveries in the market and an increase in leases signed. The region is still experiencing higher vacancies in the downtown submarket (10.8%) when compared to other surrounding submarkets (7.1% on average). From the Bedrock projects to the new Downtown Cleveland retail strategy recently put in action to fill the many vacant retail spaces, only good things are on the horizon for the market.

Rents in Cleveland come in at $1,590/month which is below the national average of $1,702/month making Cleveland one of the nation's most affordable metropolitan areas. The hope is that new inventory can keep up with absorption and keep these rents lower than the national average and spur even more residents to downtown Clevland and the surrounding areas. The downtown Cleveland submarket saw its rent growth peak at 4.5% in Q2 of 2022 and it has fallen only 0.8% in the time since this boom was due to an influx of demand for apartments in the market, a revival of downtown living, as well as build up from the pandemic.

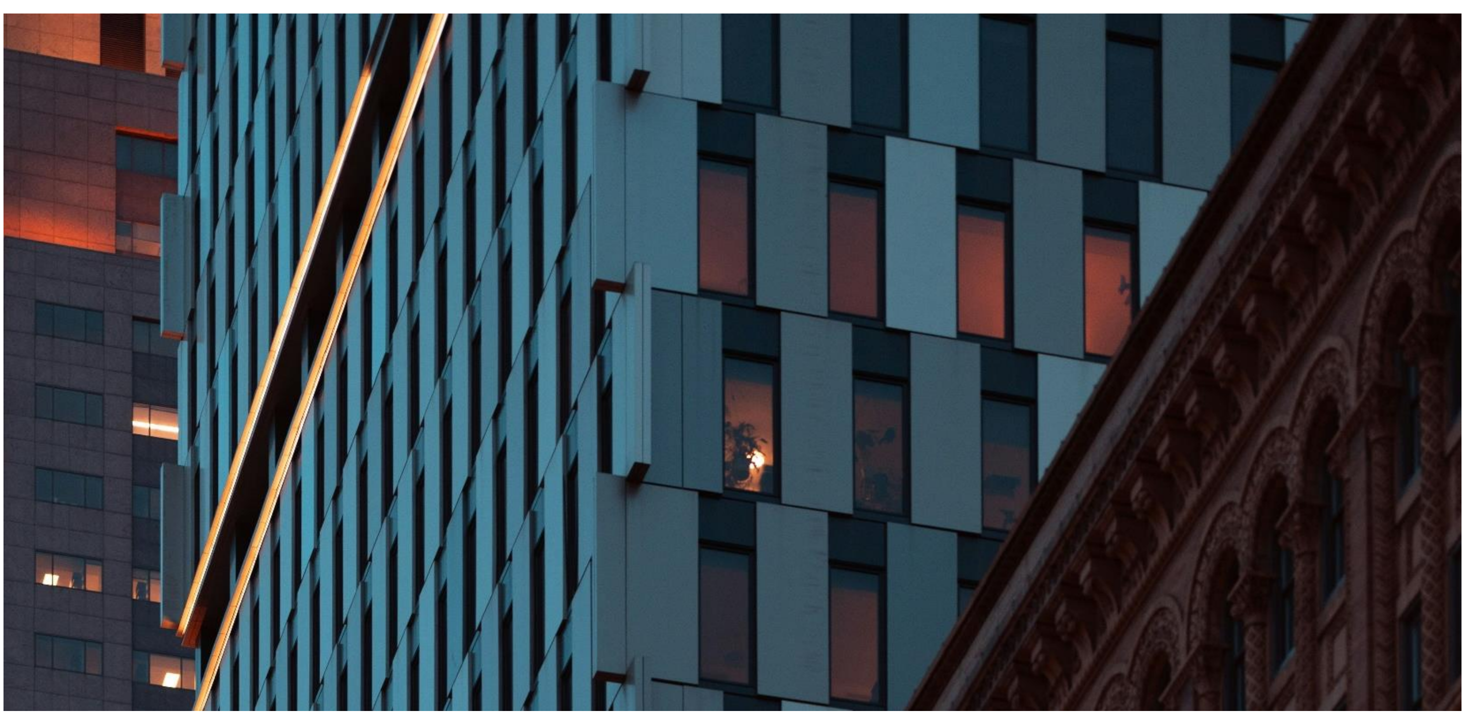
While record numbers of new units continue to come online, there is some reason for caution. With all these new units, who is going to fill them? Can it be expected that thousands of new residents move into the Cleveland MSA over the next year to fill these units? While the market occupancy rate has hovered about the national average, it fell below the Midwest average in the later parts of 2023. Even if there is a large enough population surge to fill the units, it seems that new multifamily development in Cleveland may slow. This is attributed in part to the current state of the residential tax abatement system in the Cleveland area. Several changes to the development standards were made, making it harder for market rate projects to pencil. This tax abatement adjustment will have a delayed effect on the market due to the nature of real estate and the projects that have already broke ground.

The next few decades should be a very exciting time for Cleveland and the surrounding area. With the big plans on the horizon from key players such as Bedrock and other companies, the recipients of the many brownfield grants in areas like Midtown, it is safe to assume these growth trends will continue.

The key is getting people to Cleveland. The Downtown Cleveland Retail Strategy developed, by Downtown Cleveland, Inc, and Destination Cleveland, will roll out in 2024 and aims for more quality retail in the neighborhood. If completed, one can expect the results to draw more people to Cleveland to shop and to live.

In addition to new-build apartments popping up around town, it is reasonable to expect continued adaptive reuse of distressed office assets. These can be converted into new, high-rent multifamily properties. This can help move downtown Cleveland towards a milestone of 30,000 residents.

Downtown Cleveland has been a national leader in repurposing obsolete or unwanted office buildings into residential and/or hotel uses. So far, 10 million square feet of office space has been converted to housing and hotel rooms, with 80 percent of those conversions happening in just the last five years, according to Downtown Cleveland Inc., a nonprofit development corporation. That has aided downtown’s recovery from the pandemic in which remote working has become more popular. Ohio Bell successor AT&T has left 45 Erieview vacant since 2019.



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