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METRO FOCUS | INDIANAPOLIS

More interstate highways converge in Indianapolis than in any other city in the US, which makes it one of America's most accessible cities, a true "Crossroads of America." In 2005, however, Indianapolis' tagline could have been "show me the money!"

by David Reed

In recent years, Indianapolis—along with the rest of the Midwest—has been the recipient of vast influx of capital. Traditionally, properties in major metropolitan areas (New York City, Los Angeles, Boston, Chicago, Dallas and others) have been highly sought after and therefore, more expensive. Investors are willing to accept lower investment returns in order to own properties in these premiere locations.

Current market trends make these properties virtually unaffordable for many investors because prices have risen to record highs, yet cap rates have dropped to record lows.

Cities like Indianapolis offer more affordable deals with less volatility, moderate risk and stabilized return potential. We at CB Richard Ellis have seen 14 of our last 16 deals purchased by new investors to Indianapolis bringing capital into the market.

Investment

Following the political turmoil of the early 1990's and resulting stock market uncertainty, real estate has risen in stature as an asset class among investors. This trend has increased competition for lucrative and stabilized investment opportunities. In particular, three significant trends have shaped Indianapolis' 2005 commercial real estate landscape: unprecedented volume, record breaking pricing and changing investor/product mix.

In 2005, national sales of CBD office properties increased 20 percent over 2004. Suburban office property sales rose 46 percent and industrial sales volume increased 71 percent during the same period. While Indianapolis saw increased sales across all product types, three significant portfolio transactions stand out, each approximately 1 million square feet in size with a combined value of over $325 million: Brascan, a Canadian company, brought international capital to Indianapolis with its purchase Castleton Office Park; Keystone at the Crossing was owned and managed by TIAA for more than 20 years before Berwind Property Group (BPG) closed on this acquisition in late 2005; and BPG sold its stake in Precedent Office Park to locally based HDG Mansur concurrent with its acquisition of Keystone at the Crossing.

In the downtown market, HRPT Property Trust from Boston purchased National City Center (NCC), a 650,000 square foot office building in the heart of downtown Indianapolis. NCC shares a 16-story atrium with the Hyatt. Simon Property Group will be vacating 180,000 square feet in this building later this year as HRPT and Hyatt collaborate on a multimillion dollar renovation of the common areas of the building. We expect this large block of space with fresh finishes to be well received in the market. Only a few years ago, investors preferred net-lease properties and sought to avoid leasing risk, however, current cap rates for multitenant properties have dropped below those for single-tenant assets. And an increasing number of buyers are relying on redevelopment or repositioning strategies to enhance their investment.

Average cap rates for office building transactions have dropped by seventy basis points since January 2005. Prior to 2005, suburban office space had never sold for over $125 per square foot, yet 2005 yielded multiple deals ranging from $150 to $205 per square foot. The industrial sector saw cap rates drop more than fifty basis points and pricing pressure increase on nearly all class A bulk property trading for cap rates at or near 7 percent. The resulting price per square foot ranged from $38 to $42.

Office

In 2005, absorption was largely driven by organic growth in small-to-medium-sized companies that expanded and moved from Class C space to Class A or B. As an example, GSA moved from 85,304 square feet in Corporate Center North to 128,000 square feet in Intech I and II. Additionally, Indiana Secondary Market for Educational Loans (ISMEL) moved from the Circle Building to Capital Center, and in doing so, more than doubled their square footage. The most vital trend in the Indianapolis office market was the sheer trade volume of investment grade office. With increased activity by TIC funds, private equity funds and increased pension fund buyers, the demand and competition for stabilized assets remains enormous.

Vacancy rates decreased from 2004, averaging 16 percent for 2005 due to activity in the suburbs. Vacancy in suburban Class A space dropped 3.5 percent in 2005, repeating its 2004 performance when it dropped 5.7 percent.

Historically, the suburban market has been more vibrant than the CBD market. For example, since 1994 the suburban base has grown 49 percent while the CBD base has remained virtually unchanged. Primarily this disparity is due to the suburbs' close proximity to population growth, ease of access due to Indianapolis' interstate infrastructure and free suburban parking. These factors combine to underscore the Indianapolis suburban markets' ability to absorb nearly 1 million square feet during the past two years.

Industrial

Indianapolis' central US location, inexpensive transportation costs, geographic reach and competitive real estate costs continue to attract large national distributors, yielding national recognition as one of the best US locations for big box bulk distribution facilities. The Indianapolis area also remains a competitive option for tenants and developers due to low land costs, competitive construction costs and accessible labor. Access to airfreight and ground transportation operations such as FedEx and UPS and competitive freight also make Indianapolis particularly attractive to logistics providers. Further underscoring Indianapolis allure is the $974 million, 1.2 million square foot expansion currently underway at the Indianapolis International Airport. The new terminal building will be built in the "midfield" area of the airport property, between the two main existing runways, and includes a new terminal, concourse, and parking garage as well as road and airfield improvements.

Despite increasing construction costs caused by rising materials prices and flat rental rates, local speculative construction was extremely strong in 2005. In fact, as of January 2006, Indiana will see thirteen facilities totaling more than 5.7 million square feet under construction. Eight of these new buildings are speculative buildings representing more than 4 million square feet, which demonstrates greater developer confidence in the Indianapolis market than in surrounding states. Lauth is building a 688,000 square foot building in Greenwood known as Southpoint, The Alter Group is finalizing plans for a new 430,000 square foot space in Plainfield and Panattoni has built two spec buildings totaling more than 1 million square feet that are 75 percent leased. The Precedent leased its 456,000 spec building at Mt. Comfort Road to CAT Logistics, which has since purchased the building.

Vacancies declined from 8.2 percent at the end of 2004 to 7.2 at the end of 2005 and we expect that trend to continue as the market growth absorbs new construction and subleases. Rental rates have remained flat throughout 2005 although increases in construction costs and operating expenses will put pressure on rates to move up as developers try to balance supply and demand.

Retail

The Indianapolis retail market has seen increased vitality in recent years, a trend that continued throughout 2005 with numerous new developments. Completed in 2005 and located just west of the city center, Plainfield's Metropolis Lifestyle Center is Indianapolis' most exciting retail development. It's among the newest examples nationwide of the "lifestyle center" retailing concept; this concept represents developer, investor and retailer efforts to adapt to changing consumer tastes by offering a centralized location in which to work, live and play.

Metropolis Lifestyle Center, developed by Premier Properties, is the second center of its kind to be completed in the Indianapolis area. The first was Clay Terrace, located in the affluent suburb of Carmel, which was completed in October 2004.

This retailing concept has proven highly popular and successful across the country, and thus far, both Metropolis and Clay Terrace appear to be poised for the same success in the Indianapolis market.

In spring of 2005, Duke Realty broke ground on its Marketplace at Anson. This 1,700-acre planned development in Boone County reiterates and meets the ever-growing need for tightly linked residential, retail and work experiences. Further east in Hamilton County, Republic Development is also meeting lifestyle center needs with Saxony, in the I-69 and Olio Road Corridors. In partnership with Gershman Brown & Associates, Simon Property Group recently announced plans for its mega-lifestyle center, Hamilton Town Center, located on 97 acres just west of Saxony and scheduled to break ground spring of this year. Offering nearly 1 million square feet of retail experience, the Saxony development is purported to cost over $100 million.

Traditional retail also is bustling in Indianapolis. The Fashion Mall has recently added Crate & Barrel, the company's only Indiana store; in fact, 40 percent of the mall's tenants are their only retail outlet in the state of Indiana. The Fashion Mall, which currently counts Williams Sonoma Home, Saks Fifth Avenue and Restoration Hardware among its tenants, will welcome the arrival of Tiffany's in 2006.

Retail development has also hit the heart of downtown Indianapolis. According to Indianapolis Downtown Inc., 2005 saw the addition of 240 condominiums and 234 apartments, which subsequently generated new retail opportunities. A rise in cost of building materials has forced residential developers operating in downtown to accommodate retail in order to build financially viable space. Indeed, luxury apartments such as the Villaggio at Page Pointe and 757 Mass Ave, include ample, street-level retail space targeted at upscale eateries and service vendors.

Multifamily

The Indianapolis multifamily market has recovered steadily in the past 12 months, due in large part to improving market fundamentals. With over 8,600 new jobs and 7,600 new households created in 2005, multifamily occupancy also increased.

In the past several years, the availability of affordable single-family housing has caused substantial turnover in the Indianapolis multi-housing market. Median single-family sales prices increased 3.4 percent in 2005, fueled in part by an estimated 7,600 new households formed during the same period. The number of single-family permits declined in 2005, however—a trend that bodes well for the multi-housing industry sector.

This decline in new single-family construction, combined with continued increase in new household formation, should equate to higher occupancies in 2006. Given these trends, concessions naturally began to decline in 2005. The ownership entities behind numerous Indianapolis properties such as AIMCO, Equity Residential and AMLI, have begun a leasing strategy called "right pricing."

This approach allows for frequent adjustments to market rents based on factors such as unit availability, traffic, time of year and overall property vacancy.

Since 2002, new multifamily construction in the Indianapolis area has averaged almost 2,200 units annually. In 2005, new construction dropped below 1,300 units. While currently new construction is occurring in all areas of Indianapolis, the largest concentration is on the south side f the city. This new inventory is largely comprised of Class A and B-plus properties and conventionally financed. Several Section 42 communities are also in planning or construction phases.

Among the newest and most exciting developments in the multifamily sector is the rapidly increasing requirement for student housing located near major universities and colleges. Rented furnished or unfurnished to individual tenants via by-the-bed leases, these properties often offer amenities specific to the collegiate student, including easy access and transportation to campus, durable finishes, extensive privacy and security measures, numerous community areas and social activities, etc. This need is being met not only by new development, but also through renovation of older properties. Investors are flocking to this investment type because of its burgeoning reputation as a highly sustainable and predictable income stream, as well as the continued rise of annual college enrollment.

David Reed is managing director of CB Richard Ellis' Indianapolis office and has nearly 20 years of experience in commercial real estate.