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CMBS Research

How Three Cities Have Retooled After Unsuccessful Amazon Bids

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Morningstar Perspective

Crystal City in northern Virginia and Long Island City in New York are already making progress as the sites for Amazon.com's new headquarters, dubbed HQ2, but what about those cities Amazon left behind--the ones that didn't make the short list? A year ago, the multinational technology company, whose original headquarters is in Seattle, cut the list of over 200 applicants down to 20. Amazon was looking for a metropolitan area with over 1 million people, with access to mass transit routes and proximity to major universities and an international airport. Charlotte, North Carolina; Houston; and Salt Lake City were among the many that did not make the list, but Morningstar Credit Ratings, LLC believes they have made strides to invigorate their respective economy and stimulate job growth. Each city has a different level of exposure to office property loans underlying commercial mortgage-backed securities, but we believe there is minimal near-term default risk for any of them.

Charlotte

While Charlotte didn't make the final cut for Amazon's HQ2, the city has a lot to offer with other interested companies, and its job market and population are on the rise. In January 2018, Charlotte Regional Partnership CEO Ronnie Bryant told the *Charlotte Observer*, "The bidding process forced Charlotte to dig deep to highlight its best qualities, which Amazon said were its business climate, airport, fast-growing millennial population and public transportation infrastructure." While Amazon found Charlotte lacking in tech talent, Bryant isn't concerned about the city's long-term potential. "We don't need to have any heartburn over Amazon. We've got a very strong portfolio that we will reap great rewards from in the future." He added that the group has 98 other active economic development projects that they are working on. To advance these projects, the Charlotte Regional Partnership combined with the Charlotte Chamber of Commerce in November to create a new enterprise: The Charlotte Regional Business Alliance, which began operations on Jan. 1. Charlotte's tech talent comprises only about 47,150 workers, which is indeed short of other competing cities that had more than 105,000 tech workers, according to the *Charlotte Observer*. In addition to the city's lack of tech workers, Charlotte's universities didn't measure up to those of other bidders in North Carolina. Back in April, CEO Bob Morgan of the former Charlotte Chamber said, "We do not have the level of higher education in the Charlotte market that you see in the Triangle." The Research Triangle--near Raleigh, which did make the 20-city list--comprises the trio of Duke University, the University of North Carolina at Chapel Hill, and North Carolina State University.

While Charlotte didn't land HQ2, local media outlets reported in June that the Charlotte City Council approved $13.4 million in incentives to add an Amazon distribution center north of Charlotte Douglas International Airport. It is unclear if the new distribution center is a result of making the HQ2 bid. The city has been focusing on improving its economic conditions, and officials believe 1,500 jobs will be added along with 2.5 million square feet of proposed warehouse space. The overall vision for the airport's surrounding area is a mix of industrial and commercial uses.

Charlotte is also one of the top-growing U.S. cities in both jobs created and population. According to the Charlotte Regional Business Alliance, the target areas for future employment include the advanced manufacturing, financial services, information technology, and energy and power industries. The city's major employers are Bank of America, Lowe's, Wells Fargo, and other large corporations. The Charlotte Regional Business Alliance lists on its website several companies that have expanded throughout the Charlotte metropolitan statistical area in 2018. One of the largest professional service companies, Ernst & Young LLP, has invested about $8.2 million into Charlotte with plans to create about 375 new jobs over the next five years with the development of an innovation center. Also, Yokohama Tire Corp. opened a 25,000-square-foot research and development facility in October, with an expected $5.9 million investment to the area. According to a November 2018 press release, Honeywell will relocate its global corporate headquarters to Charlotte. The company hopes to bring in about 750 jobs to the center by the end of 2024. The company's chairman, Darius Adamczyk, stated, "Charlotte is a top-10 destination city in the U.S. that will readily enable us to recruit and retain the world-class talent we will need over the long term to support Honeywell's strategic focus on leading technology and software solutions." The year closed out with AvidXchange, a business-to-business payment solutions provider, announcing it is adding 1,229 new jobs at its Charlotte headquarters. In addition, ServiceMac, a mortgage subservicer, announced plans to launch a new operations center in South Carolina's Lancaster County, which is south of Charlotte. The company will add approximately 1,000 new jobs over the next five years.

Charlotte attracts young professionals thanks to its affordable cost of living and thriving job market. A third-quarter 2018 report from CBRE Econometric Advisors ranked Charlotte as the 26th-largest U.S. office market, with total employment of 1.2 million workers. The city's employment rate has risen to an average 3.3% over the past five years, compared with the national average of 1.8%. The office market predominantly serves the financial and service sectors. A business-friendly government has kept office demand steady. According to CoStar Group, Inc., rents in the office sector climbed to 6.6% with a vacancy rate below 10% in 2018. There has been an uptick in leasing activity throughout the central business district and the Airport and Ballantyne submarkets for tenants seeking open suburban space, easy access to transportation hubs, or a central downtown location.

In terms of CMBS, Charlotte's office sector is performing well, with minimal near-term default risk. The total exposure of CMBS office properties within the Charlotte MSA is $640.2 million. The $24.6 million CitiFinancial loan, which is 7.9% of GSMS 2007-GG10, was transferred to the special servicer when the property's sole tenant, CitiFinancial, vacated in 2015. The tenant is subleasing a portion of its space and is obligated to make its rental payments until lease expiration in 2020, so net cash flow should not be interrupted. All the remaining office properties within CMBS are current with their loan payments.

Houston

Houston offered approximately $268 million in cash and tax incentives and proposed three potential sites for Amazon's headquarters: the former Humble Oil building downtown, the closed Sears in Midtown, and a 150-acre industrial site in the East End. Both Dallas and Austin made the initial list, but Houston did not. Bob Harvey, president and CEO of Greater Houston Partnership, said it was a "wake-up call" for the city in a statement to local media. Harvey and Mayor Sylvester Turner believed Houston's weak local technology industry was to blame. Critics also pointed to the city's inadequate infrastructure. Long known as a major energy hub, Houston is in a state of transition. There are several initiatives under way to address the infrastructure issues and diversify its industries. Houston has experienced a turnaround in the local economy with returning levels of job growth from recovery efforts from Hurricane Harvey. However, with Houston's dependency on oil, its economic recovery is uncertain, as oil prices have declined in fourth-quarter 2018. We are cautious regarding Houston's CMBS office market, but we believe the city is positioned for growth with minimal near-term default risk.

After the city failed to make Amazon's list, Houston's transit leaders vowed to improve the area's transportation, according to the *Houston Business Journal*. The city joined Transportation for America's 2018 Smart Cities Collaborative. The program allows Houston to collaborate with other cities to tackle transportation challenges. In 2012, Texas Central Partners proposed a project to change the way people travel between Dallas and Houston. The plan involved constructing a 240-mile high-speed rail line that could travel up to 205 miles per hour. In September 2018, the project gained momentum when Texas Central secured a $300 million loan from Japan Overseas Infrastructure Investment Corp. and the Japan Bank for International Cooperation. According to KERA News, company officials believe construction could start in late 2019 or early 2020, with the train in service in the next five to six years.

Like Charlotte, Houston has a small number of computing and software-focused workers compared with other cities, and this absence of a strong tech culture likely hindered its chances. Amazon is accustomed to being part of a high-growth tech scene, like Seattle's, rather than an oil and gas hub culture. This was probably a key factor in knocking Houston out of contention for the company's second headquarters. However, several innovation initiatives are under way, including the 2017 launch of a technology and innovation task force that aspires to develop an "Innovation Corridor" for tech startups and venture capital. The former Midtown Sears location will serve as the anchor of the innovation hub. In addition, the *Houston Business Journal* reported that the Cannon, a coworking space, began to construct a 120,000-square-foot mixed-use property last April; Lawson Gow, CEO of the Cannon, expects the site to open March 1. In August, the Texas Medical Center Corp. and Baird Capital, a venture capital firm, partnered to invest in medical tech startups. Houston has been gaining momentum in the innovation space and appears dedicated to developing its digital economy.

Within CMBS, Houston's office sector is performing as expected, and we project minimal near-term default risk. As of January 2019, office properties represent $125.4 billion, or nearly 13% of the U.S. CMBS universe, with the Houston MSA accounting for about $2.5 billion, or 2%. Within the Houston MSA, there are 10 loans with a cumulative balance totaling nearly $329 million that are with the special servicer. Three of the specially serviced loans are real estate owned, two loans are delinquent, and the remaining are current. The largest REO loan is the $17.2 million World Houston Plaza loan, representing less than 2% of COMM 2014-LC17. The property became REO in December 2017 after the largest tenant, an oil and gas service company, vacated at its May 2017 lease expiration. Our $8.9 million valuation suggests the property is worth less than the balance of the loan; we expect a loss of up to $9.0 million.

According to CoStar, Houston's office market fundamentals have been lagging for nearly four years. There has been sluggish leasing demand, increased levels of sublease space, and high vacancy. However, the office market's outlook is improving, with a slowing supply pipeline and an improving labor market. Moreover, Houston is an increasingly important industrial market and regional distribution hub. E-commerce and logistics activity are strong. In 2017, Amazon and FedEx Corp. each completed distribution facilities exceeding 800,000 square feet. In addition, Amazon also completed a 1-million-square-foot facility in early 2018. For Houston's commercial real estate and CMBS office markets, we remain cautious but believe the city is on course with its efforts to improve, and despite the obstacles, Houston is positioned for growth.

Salt Lake City

Salt Lake City should remain a fast-growing technology center because of its talented local workforce and positive business climate. The city is an easily accessible location with a great outdoor recreational environment that appeals to active millennials. While small, the local tech talent is there, and the government hopes to retain some graduates in the area with incentives. The state is often cited as a good place to do business, with reasonable taxes, regulations, and encouragement of local businesses. No significant problems have developed in the Salt Lake City CMBS office market. Projected new development in the downtown market could raise vacancy rates, but the city continues its growth and its focus on technology and general business expansion.

Ultimately, it appears the city was too small and too close to Amazon's existing headquarters in Seattle to make the initial cut. Salt Lake City is only about two hours by air from Seattle, leaving the East Coast more than four hours away by air. Also, Amazon's intentions were relatively clear from the 20-city short list. Most of the finalists were in the Midwest or the East Coast. If Salt Lake City had been on the list, "we would have been the smallest candidate," Val Hale, executive director of the Utah Governor's Office of Economic Development, told the *Salt Lake Tribune* on Jan. 18, 2018.

But the city's and state's endeavors were not in vain. Salt Lake City captured the first Amazon fulfillment center in the state with a new 800,000-square-foot regional fulfillment center in the city's northwest quadrant where Amazon has hired some 1,500 people to staff the $250 million distribution facility. According the *Desert News*, city and state authorities had been wooing the company since 2017. The facility did come at a cost to taxpayers, as the company was offered an eight-year, $5.7 million tax incentive. Gov. Gary Herbert said then that this was a major accomplishment to attract the attention and investment of one of the world's leading retailers. "It's a big shot in the arm for Salt Lake City, Salt Lake County and the state."

Even without winning the Amazon headquarters, the city has been growing quickly. Utah's tech industry has grown faster than any other state by producing a tech job increase of 3.6% between 2016 and 2017, according to a report by the Computing Technology Industry Association. Tech employment, which accounts for 8.6% of all jobs in the state, ranks Utah as 10th in the country with the highest concentration of tech workers compared with overall employment.

Salt Lake City's mix of outdoor recreational activities, including some of the best skiing in the country, and technical talent has earned it the nickname "Silicon Slopes." The area extends between Salt Lake City and Provo, at the base of the foothills of the Wasatch Mountains.

Thanks to a business-friendly climate, Utah has expanded beyond the farming and mining industries it was originally built on. Some of the established and newer tech companies to the Silicon Slopes include Dell Technologies and many startups in industries as far-ranging as online clothing retailers like Jane.com, to software developers like Domo, Inc., to global genealogical research by Ancestry.com, all of which are Internet-based. In December, biotechnology company PolarityTE, Inc. expanded its corporate headquarters to include a 40,000-square-foot building in the city. The company's other location in Salt Lake City will serve has the hub for its manufacturing and research and development. In addition, WalletHub ranked Salt Lake City 11th out of more than 180 of the largest U.S. cities as the best place to start a business, and one of the cities with best access to financing. However, it was also ranked as one of the cities with the lowest availability of human capital.

Ultimately, the region does not possess the depth of talent Amazon needed. Although Utah's eight public and 22 private colleges and universities have produced notable alumni in computer science and graphics—including the founders of Pixar, Adobe, and Atari—the area is small. As stated by the *Salt Lake Tribune*, on Oct. 4, 2018, the combined student population of the colleges in the state is nearly equal to Salt Lake City's resident population, which, according to the U.S. Census Bureau, had an estimated population of about 200,000 in July 2017, the latest for which data is available. However, graduates in the past have tended to relocate to Silicon Valley, Boston, and other larger areas with an abundance of job opportunities and higher salaries than have been offered in Salt Lake City.

To help stem the tide of departures of tech talent, on March 21, 2018, Gov. Herbert signed into law the Talent Development and Retention Strategy bill, which provides an annual appropriation of $2.5 million in loans to students where repayment would be waived if they worked at a qualifying job in the state. With these efforts and general economic improvement, the relocation trend seems to have been stemmed and technical talent is growing in numbers.

As the market grows, more loans should be originated for the CMBS market. For now, no meaningful negative issues have developed. The CMBS office sector in the Salt Lake City MSA is performing well and has shown minimal near-term default risk. There are 22 office loans in the city and surrounding area, with a total current balance of $426.4 million. All the loans are performing, with debt service coverage ratios that range from 1.01x to 3.41x. None of these loans are in special servicing.

According to CoStar, as of the first-quarter-to-date, the Salt Lake City central business district and periphery submarket has a 7.4% office vacancy rate on a combined basis. Average vacancy for 4- and 5-star office properties is approximately 15.0%, up from roughly 8.0% in 2016. As projected, the newer and higher-quality office buildings may face increasing vacancy with some new construction in 2019 and beyond.

Prime Real Estate

Charlotte, Houston, and Salt Lake City are just three of the many cities that lost out on the opportunity to land the second headquarters of tech-giant Amazon. But all three cities appear poised for growth, with Charlotte's employment rate outpacing the national average, Houston's efforts to improve its infrastructure, and Salt Lake City landing Amazon's first fulfillment center in Utah, creating 1,500 new jobs. Charlotte and Salt Lake City in particular are on the rise, both in terms of population and local economy, and many corporations have recently expanded their footprint in each city. Houston's initiatives to broaden its innovation abilities, in addition to its infrastructure plans, could position the city well in the coming years. By courting Amazon, all three cities have been able to examine their strengths and weaknesses and can learn from Amazon's feedback when the next big corporation comes along.

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