



COMMERCIAL REAL ESTATE
DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

“What’s the Real Story with the Office Market?”

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the Sept. 27, 2011 meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at the Riverway Auditorium in Rosemont to hear insights from Paul Lundstedt, Executive Vice President, Grubb & Ellis; Andrea VanGelder, Managing Director, Jones Lang LaSalle; and Francis Prock, Principal, Colliers International. The panel was moderated by Kevin Clifton, Executive Vice President, CB Richard Ellis.

To evaluate the state of the office market, at least on a statistical level, rounding off simply won't do. Changes the past few years have been so incremental that the decimal is in the details.

To wit: vacancy rates have gone from 22.8 percent in 2009 to 23.3 percent last year to 23.1 percent through the first half of 2011. For those same three intervals, unemployment in Chicago was 10.3 percent, then 9.8 percent and most recently 9.5 percent.

And for the next 12 months, the outlook for the suburban Chicago market is more of the same, according to panelists. That persistent plateau stems largely from individuals and organizations continuing to analyze whether the market has truly hit bottom as they strive to weed out opportunity from an overabundance of optimism.

Thereafter, 2013 and 2014 hold the promise for a substantial increase in activity in a market that's slowed dramatically since its robust period of roughly five years ago.

One subplot that emerged prominently among panelists was “flight to quality,” with Class A properties where most of the action is and will continue to occur. In some instances, companies in B-level properties are able to move into a Class A space and pay lower rent, Francis Prock said.

As a result, an increasing volume of B properties are vacant, with dim short-term occupancy prospects. The net effect is the flat-lined vacancy rate that's been prevailing in the region.

“Every time there's a bit of good news...there's the equal and opposite other side of that coin, with larger users giving up big blocks of space,” said Andrea VanGelder.

“There are clear differences in different sub-markets, in terms of economic health,” VanGelder continued, noting that as you travel west and especially northwest, more tenants are vacating space.

Panelists agreed emphatically that it remains a “tenant’s market.”

“Most tenants do see this as the bottom and they want to take advantage of it,” VanGelder said. In addition, large tenants with lease expirations around 2014 “are out shopping,” often for Class A properties and resulting in a “Class B glut,” she said.

“Vacancy rates will stay flat for six months, hopefully some of the ghost space will be eaten up....barring a double-dip recession, I see my clients cautiously optimistic,” VanGelder said. “They are tired of the uncertainty and they have to run their businesses, and as lease terms get closer, they don’t want to get stuck holding the bag.”

Paul Lundstedt referred to 2009 as “a complete death march,” particularly in the investment world: “There was no debt available to drive any transactions....people with 100 percent equity were the king of the market.”

In 2010, though, the “lending world came back” and the Commercial Mortgage-Backed Securities (CMBS) market slowly re-emerged, Lundstedt said.

Momentum at the start of this year has abated, however, in the shadow of economic turbulence. “Recent events are causing people to step back,” Lundstedt said, causing people to wonder, “Is this recovery really happening?”

The number of office investment sales dwindled from 50 and 48 in 2006-2007 (amounting to more than \$2 billion in each year) to 12 in 2008 and then 17 in 2009. Last year, sales grew to 27 totaling \$571 million.

So far in 2011, there have been 12 such sales (with total value of approximately \$300 million). Lundstedt predicted year-end figures would be 17 to 20 sales, in the neighborhood of \$400-\$450 million in volume.

He pointed out that most of the 2010 deals were toward the end of the year, and most of this year’s deals will prove to have been in the first half of 2011. “Here we are sitting again wondering, ‘Where are we going right now?’” Lundstedt said.

Looking ahead, though, he sounded a hopeful note. Nationally, when the market comes back—Lundstedt threw out three years as a rough timeframe—“the coasts get really frothy,” he said, and find the Chicago area especially attractive as a spot to diversify funds.

“We’ll see that recovery take place, but right now that bulls-eye is very, very small for suburban Chicago,” he noted.

A firmly entrenched trend is the move toward Class A space. For example, with Sara Lee downsizing, its vacated properties “are pretty much spoken for in two large deals” even before they hit the market, VanGelder said.

This flight to quality is “very location-specific,” said Prock. “It’s almost building-specific.”

He added that as buildings reach a certain occupancy level, there will be upticks in rent. In some cases, such an increase should happen in the next year, while at other sites it could take a couple of years, Prock said.

In response to Kevin Clifton’s inquiry about how B Class properties can attract tenants, VanGelder said that with concession packages dropping rates so low, “you really can’t do much more.”

“The reality,” noted Prock, “is a lot of a space has to be absorbed before this B property is going to go....Pricing’s been pushed down so far you can’t really go much further and maintain the level of concessions.”

One helpful inducement, panelists said, is having furniture already in place for prospective tenants.

Overall, Lundstedt sized up the situation as a “race between the (economic) recovery and the day of reckoning.” Some building owners, he added, need to accept that their properties are “not worth what they were.”

The re-setting of value on distressed properties lowers the overall market value, Prock said. “These distressed buildings are really creating the new market,” he added. “And that’s going to continue.”

Employment growth, panelists said, appears to be spotty—so much so that Prock described it as more company-specific than tied to any particular industry.

As for the competition between the suburbs and downtown Chicago, panelists said that the lower rental rates and concession packages, such as building owners offering 12 or 15 months of free rent, have sparked interest among suburban companies. However, the intrigue usually wears off when they consider the longer-term overhead of taxes and operating costs.

Having a suburban location, Lundstedt noted, can be about half as expensive as being in a similar building in Chicago. As he expressed the common sentiment: “It feels good to be down here (in the city), but boy, this is expensive.”

In the future, Lundstedt anticipates an increased attraction to Chicago’s Central Business District, though “astute people are looking at the suburbs” because it is an opportune time to buy there—“a contrarian theory to some degree,” he acknowledged.

Another topic discussed in some depth was that of the blend-and-extend transaction wherein tenants renegotiate leases before they have expired. Terms might include reduced rent and

physical improvements to their space, with building owners drawn to the longer-term security of maintaining a tenant.

“Have we stolen from the future?” Clifton asked.

Panelists generally agreed that those deals have limited future deals. A key question for owners, said Lundstedt, is whether blend-and-extend deals help them to “exit at an appropriate pricing level.”

“Does it expand potential buyers?” he asked, then provided a partial answer in noting that private and public REITs seeking a stable transaction are looking for solid credit and terms in a property’s tenants.

From a building owner’s perspective, blend-and-extend makes more sense when dealing with a major tenant—for example, one that occupies at least half of a building, Lundstedt added.

Meeting Sponsor:

NAIOP Chicago
1700 West Irving Park Road, Suite 208
Chicago, IL 60613
Main: (773) 472-3072 | Fax: (773) 472-3076 |
www.naiopchicago.org