COMMERCIAL REAL ESTATE
DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

“Should I Be a Buyer, Seller or Both?”

by Patrick Ferrell, NAIOP Chicago Staff Writer

This is a summary of the May 12, 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 John Grissim, senior vice president, Lincoln Property Company; William Barry, senior vice president, Draper & Kramer; James Hutchinson, managing director, LaSalle Investment Management; and Bruce Miller, international director, Jones Lang LaSalle. The panel was moderated by Jim Clewlow, chief investment officer, CenterPoint Properties.

This year is stacking up to be the year of the middle.

The stretch from 2006 and 2007 provided the highs, and 2008 and 2009, obviously, provided the lows. Transaction numbers in 2011 and 2012 won’t reach as high as they were before the crash, but they’re on the rebound, according to the panelists.

“I think the worst is behind us; the market is coming back,” Grissim said.

What’s even more significant from a “middle” standpoint, Grissim said, is that the industry will see more middle-of-the-road, “not the super distressed, not the core,” properties hitting market this year.

For example, Grissim pointed to Orchard Point, a 275,000-square-foot office complex down the street in Rosemont that is 50 percent leased and recently hit the market.

“I’m not sure who the buyer is going to be, maybe a buyer, maybe an investor. I think a lot of this product is being brought to market . . . and I don’t know how that stuff is going to price yet,” Grissim said. “It will be interesting to see the data points. This is going to be the year of the middle because that stuff hasn’t shaken out yet.

“I think I’m going to try and play in the middle, and hopefully we’ll make some money.”

Clewlow started the conversation by asking the panelists where cap rates were heading.

“Cap rates for me are something we really don’t look at,” Grissim said. “Most of the people we partner up with are looking for value-added investments. There’s a return we look at when we make deals. Most of the stuff we look at is not cap rate driven. It is return driven.

“We are trying to put, call it, 65 percent, 70 percent leveraged. We’re looking for, I would like to say, mid-teens return on our money. A lot of guys will like to get to 20 percent levered return. I haven’t found it.”

For his part, Barry said cap rates “have come down dramatically,” in large part because debt is healthier now than it was a few years ago.

“If you think back two years ago and were sitting in this room in May of ‘09, we remember where interest rates were if you were doing any borrowing,” Barry said. “The attitude was everybody thought there was never going to be any capital available again.

“We were doing 10-year fixed rate deals in the 7s and 8s. Fast forward to today, two years later, and industrial portfolios are selling. Ten-year money on those, you’re looking at mid- to high 4s and in many cases interest-only basis. To me, that’s what’s driven cap rates and IRR thresholds down. You’ve got much more attractive debt than we had two years ago, and even 12 months ago.”

Hutchinson echoed Grissim’s thoughts: “We’re less focused on cap rates because the properties are not very well leased, and it’s hard to compute a cap rate.”

Hutchinson’s investment team is more interested in “the price going in and exit price.” For example, the group recently bought a 20-percent leased property in the East-West Corridor for $90 per foot. It is hoping to sell the property in five years for $150 per foot.

“We’re going to lease it at a little below today’s rents and hold them flat until lease out,” he said. “We’re not expecting a lot of recovery on the leasing market.

“We’ve seen a fair amount of that activity not just in Chicago but around the country. I’m not sure exactly what the cap rates are, but there are good deals out there.”

Miller said cap rates are relevant for one segment of property: core, highly leased assets. “If you look at downtown, for example, some of the trophy buildings that have been traded, the cap rates have been mid- to low-6s.”

The discussion then turned to who are today’s most active buyers, sellers and lenders.

Grissim said his firm largely turns to insurance companies as its biggest lender. It turns to banks only for quick-turnaround loans, he said. Active buyers include private pension funds. “At the really low end you’ve got private investors, where they are buying B product for (a) super cheap price per foot,” he said.

“Pretty much everybody is back,” Barry said. Commercial mortgage backed securities “are the biggest thing that is back. (But) you’ve got to give it more time to get back to doing the smaller deals.”

Currently, Barry said, CMBS are underwriting loans of 65 percent of value, sometimes up to 70 percent. But “competition breeds aggressiveness” and will drive that number higher: “If we have this panel a year from now, we’ll be back to 80 percent.”

Clewlow then asked the panelists which markets are hot.

“There is a huge trend towards core and taking risk out of the portfolio,” Hutchinson said. “Chicago is one of ten markets in the country really seeing activity, but if you get out of downtown Chicago or East-West Corridor, even in the North suburbs, there is not a lot of buyer or lender activity.”

“The one thing that will buoy Chicago is for the past year or so there has been enormous bias towards the coastal markets: New York, San Francisco, Seattle,” Miller said. “They’re starting to look at the interior of the United States, and I think that’s what’s driving a little bit of the increase.

“Honestly, I think there is opportunity everywhere. There is opportunity even in the Northwest suburbs if you find the right asset and the right motivated seller.”

Grissim then ran through some transaction numbers over the past few years to tell the full story:

In 2003, there was $800 million of product sold in suburban Chicago, with an average price per foot $119. In 2007, there was $2.1 billion in product sold at an average price of $200 per foot. Last year, only $400 million in product was sold at $77 per foot.

“I don’t know what it is going to do this year. I assume the volume will be up and the price per foot will be higher,” Grissim said. He then pointed to a suburban sale that his group just closed. The group met its final price, but the buyer pool was extremely limited.

“The pricing has been great, but it’s a very shallow pool,” Grissim said.

Barry then cautioned that even though deals are moving forward, they are taking longer.

“From a lender side, the origination staffs are not what they were in ’05, ’06, and ‘07,” Barry said. “They haven’t hired these people back. As the volume of deals has increased, our biggest issue has been trying to get lender feedback.

“It’s really created a problem for a buyer that has to have that debt closed.”

Bottom line: How does Chicago compare to other markets, especially given Illinois’ political and fiscal woes?

“Illinois is the laughing stock of the country, and even the world,” Hutchinson said. “It’s a bigger problem if that doesn’t get resolved at some point. But I don’t think that is keeping people from here. I think most people assume it will get resolved.”

“From a downtown perspective, as people can start underwriting significant rental rate growth, we are going to see an improvement,” Miller said. “We’ve taken up the vacancies pretty quickly. As the engine of (economic development) really gets going, you could have that vacancy rate go away pretty quickly. We’ve got a few sectors that are really employing lots of people.

“We’ve got companies like Groupon hiring people every day. As some other companies begin to add people, I think we could see more movement in that vacancy rate.”

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