NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

Industrial Development: Will the Momentum Continue in 2018/2019?

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the October 4, 2017, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at The Estate at Gene & Georgetti in Rosemont to hear a panel of top industrial developers recap their experience in 2017 and discuss their plans, thoughts, and concerns for 2018. Their discussion came amid Chicago's industrial market setting record lows for vacancies and cap rates as well as the seventh consecutive calendar year of increasing development starts.

Serving as moderator for the session was Paul White, *Managing Director,* LaSalle Investment Management. He was joined by panelists Jim McGill, *Managing Director - Central Region Capital Deployment,* Prologis; Brian McKiernan, *Senior Vice President, Development,* CenterPoint; and John Pagliari, *Partner,* Pannattoni Development Company, Inc.

How thriving is the industrial real estate market? At the end of 2007, the vacancy rate for the sector nationally was 7.2 percent, which at the time was generally considered to be "pretty good," according to moderator Paul White. Since then, the vacancy rate has dropped to a tiny 4.6 percent.

In short, the market is booming, with some markets enjoying the highest rents, lowest vacancy rates and lowest cap rates ever, said White.

Heady times are not guaranteed forever, though—an economic reality that reverberates in the wake of the Great Recession that hit nearly a decade ago. So how long will this momentum last? In remarks that zeroed in frequently on the Chicago area, the second-largest industrial market in the nation, panelists voiced optimism that there is no imminent threat of a downturn.

At the same time, though, they cautioned against unbridled bullishness, saying it should be tempered in certain submarkets, when considering the turnaround time for certain projects, as well as when weighing one's risk tolerance.

“Tenant demand is still strong,” said Brian McKiernan. “We’re cautious on how much risk we put on the portfolio in terms of speculative construction and for aggressive development, but I think we’re still seeing positive tenant demand.”

E-commerce is having a positive overall impact on industrial real estate, and capital markets are behaving in a “more disciplined” manner, which bodes well, he added. “I think that helps in terms of not overbuilding, which we saw was one of the factors in the last cycle” leading up to the Great Recession, said McKiernan.

To illustrate the market’s growth mode, Jim McGill pointed to some of the indicators of the robust economy. Those include the Investable Market Indexes, the ISM Manufacturing Index, consumer confidence and business confidence, all of which are “on an upward trend,” McGill noted.

However, he continued, “It’s becoming more challenging to find land, especially in global core locations. So my company is still very bullish if you can find good land opportunities.”

Locally, said McGill, “we have the highest occupancy rate ever of 98 percent…at least in Chicago, with that kind of occupancy, we’re bullish on taking more risk. We don’t have a lot of places to put our customers.”

Voicing an overarching optimism, John Pagliari said the capital markets are stronger than the tenant markets, which he described as “strong, but maybe needs some caution.”

“There’s a lot of spec building going on right now in Chicago. It’s been a little slow to develop…the capital just never seems to have enough. The appetite is unending,” Pagliari added.

As to how much longer the industry will enjoy robust returns before the next downturn, panelists were upbeat. Prologis is always prepared for a downturn, said McGill, but “we’re not overly concerned that we are in the 8th or 9th inning. The economy overall is growing at a nice pace.”

“We’re seeing our customers now paying more for better buildings and better locations…I don’t think anybody on our end is saying, `We need to stop speculative construction…we’re not putting the brakes on anything,” added McGill.

McKiernan, meanwhile, said there is a heightened sensitivity in the marketplace to “not getting overextended” and to “prune our portfolios” along the way.

National GDP growth in the 1990s was over 4 percent annually, and during the early 2000s was over 3 percent per year, said Pagliari. More recently, the figure has been 2.1 percent, he added, “so we don’t see any door closing like in ‘07 or ‘08, or any big tsunami coming and really knocking us over. We think it’ll be slow and steady for the next few years, then maybe a hiccup, and then (we should) keep on charging, so we’re bullish.”

Because of the historically low vacancy rates that are now occurring, said McGill, even a downturn won't be as damaging as a decade ago. He cited Dallas's market experience as one example: when the Great Recession hit, there was already a 9- or 10-percent vacancy rate even as 5 percent more product was being built.

"When the dance stopped, that's a huge problem," McGill said. "So (even if a downturn happens), it's still a good landlord market…you could weather a little bit of a slowdown."

It's important to avoid holding too much land, especially speculative land, in relation to your company's capital base, panelists said.

At Prologis, said McGill, a significant change over the years has been putting "a lot more focus on site planning, meaning building better buildings: circulation, car parking, car heights…we put much more focus on sacrificing yields but having a better long-term building."

Prompted by White to share what changes they have been making in this cycle, versus the prior cycle, Pagliari said 36-foot clear buildings are the norm for any building over 300,000 square feet, compared with 32 feet clear for smaller facilities. In addition, tenants favor concrete slabs, with less cuts in the floor that require less caulking, and bay sizes are bigger—at least 50 feet in every direction, said Pagliari.

As for truck courts, "you see more trailer parking now than 15 years ago…now you wouldn't build a big building without trailers on both sides of it," he concluded.

An emerging trend, said McGill, is the use of electric trucks for short-haul trucking. With that in mind, Prologis is evaluating whether to design buildings that would include areas devoted to electric charging. Companies are also giving more thought to ensuring that there is sufficiently strong pavement to accommodate users, panelists said.

Also discussed were the variables that factor into pricing for spec properties versus those that are build-to-suits with a tenant in hand. McKiernan said the spreads between the two "are getting pretty tight" in the area of 25 to 50 basis points.

One key factor, said Pagliari, is "how land-constrained the market is." With spec building, "we try to shoot for at least 15 (basis points)." Generally, though, "our company prefers building build-to-suits…we're willing to give up profits to reduce risk," he added.

In prefacing a question about the impact of the state's shaky financial reputation on business, White introduced a set of sobering statistics about Illinois. Those data points included the state's ranking dead-last (by far) among all 50 states with a BBB-minus credit rating, being one of only three states to lose population between 2010 and 2016; and ranking 46th in a 2016 Forbes ranking of states' competitiveness based on taxes—and that came before Illinois' state income tax rate was hiked by 32 percent.

Although panelists noted Illinois remains strong overall because of the large population that needs to be served, they pointed to cracks in the foundation. Pagliari said the state's woes have "crushed us" when it comes to providing an opening for Wisconsin to

lure away businesses, and McGill noted that losing population “has a ripple effect through the economy.” Tenants “are concerned about it,” added McKiernan. “They’re looking at lease terms, how long they want to commit in this kind of environment.”

The favored local sub-markets for larger companies are O’Hare, I-55, and Central DuPage County, said Pagliari. “When we go to sell something, whether vacant or partially leased, we know those big institutions like those markets,” he added.

On the next tier down, for submarkets, are I-88, Lake County and some in-fill spots in Chicago, said Pagliari.

Local tax rates are an important factor, said McGill, with Prologis being more comfortable locating in places like Elk Grove Village, where the tax rate is 8 percent, rather than Franklin Park (13 or 14 percent), for example.

McKiernan cited the I-80 market as one “we’re always concerned about…it tends to be one market that gets overbuilt” with spec construction.

Noting that all the panelists work for firms with a national scope, White sought comment on management and investment committee’s views of Chicago and the Midwest against that broader backdrop.

In capturing the consensus of the entire panel, McKiernan said there is a more conservative outlook in the region, so “the investment pitch is just a little bit harder.”

Underscoring the differences by region, White shared data on the strength of the Los Angeles and Inland Empire markets, which boast vacancy rates below 3 percent for the vast majority of that area.

In a segment that wrapped up discussion, panelists fielded several questions from the audience. A few related to construction costs, with panel members noting the impact of wages represent about half of building construction costs. In some locations, such as Chicago and Dallas, there is an especially strong pace of construction. Particularly in those areas, work crews are in high demand and the competition is fierce to retain quality subcontractors while meeting construction deadlines.

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