COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

2017 Industrial Outlook

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the May 10, 2017, meeting of NAIOP Chicago, the Commercial Real Estate Development Association.

Its members gathered in Rosemont to hear a panel of real estate experts recap what happened in the first quarter and discuss what lies ahead for the remainder of 2017. Topics included Chicagoland's industrial market, how Chicago compares to other core industrial markets nationwide, where opportunities still exist in the market and what stumbling blocks may lie ahead.

Serving as moderator for the session was Matthew Stauber, *Principal,* Colliers International. He was joined by panelists Kimberly Adams, *Managing Director*, J.P. Morgan Global Real Assets; John Huguenard, *International Director*, JLL; and Mark Saturno, *Chief Executive Officer, North America*, IDI Gazeley.

The industrial real estate market is characterized by stability and strength, with at least another two years of robust health on the horizon. That is the consensus view of panelists who reflected on the past, all the way through 2017's first quarter, and looked to the near future.

While everyone offered the obligatory qualifier that they can't forecast with absolute certainty, that common confident thread was woven throughout the panel's remarks.

In his opening comments, John Huguenard described lenders as reluctant to "over-leverage the spec system within the industrial market. We really have a cap on the vacancy that is coming onboard."

With a national vacancy rate of 5.3 percent, he added, "there really is a cap on how much inventory will be brought onto the market. From both the user standpoint as well as the capital standpoint, we're really much more in check than any other product type."

Part of the market's solid footing is the attractiveness of the United States as an investment location for foreign capital, he added.

“From a global perspective, we’ve got more capital coming into the U.S. as a safe haven,” he said. “So, do we still have a lot of runway ahead of us? The answer is yes.”

In her opening comments, Kimberly Adams echoed that view.

“If you look across all product types, industrial is the darling right now,” Adams continued. “The bottom line is, as we watched pension funds through the course of ’16 pull all of their money out of core and move it up the risk spectrum because returns have really moderated across the core space, debt was moving in the other direction.”

That phenomenon contrasts with the last cycle, Adams noted, when “everybody was getting aggressive at once and then everybody was getting conservative at once.”

Mark Saturno, meanwhile, said that it’s important to consider “the underlying motivations” at play.

“You’ve got lenders who are still a little bit risk-averse, realize they lost money in the last cycle, and now are encumbered by increased regulation,” said Saturno. Aside from construction lending, however, he finds lenders to be “still very, very aggressive in terms of debt.”

“The lenders are behaving like the way you think they should behave…I think they’re moderating our market,” he added.

Saturno also cited a Pension Real Estate Association survey of institutional investors with a cumulative valuation of $500 billion. In the survey, the desired allocation in real estate was pegged at about 11.5 percent, or 1.5 percentage points higher than the actual investment of roughly 10 percent.

“They’re under-allocated, and they’re really under-allocated in industrial…It’s simple supply and demand,” Saturno continued. “There is a lot of capital that still wants to be in the industrial space.”

The Gross Domestic Product had an uninterrupted 10-year expansion between 1991 and 2001, with a 2.1 percent annual rate at the close of that period, said moderator Matthew Stauber.

Comparing that period to the current expansion of nearly eight years (dating back to June 2009, and which includes a 2.1 percent GDP growth at the end of 2016), Stauber then asked panelists what fundamentals they track to try to gauge “where we are in the cycle.”

One metric that is closely watched is the interplay between absorption rates and other trends in the marketplace. Based on that, said Saturno, “we don’t feel there’s a lot of risk in overbuilding…if there is a risk, the risk is we have all benefited from increasing rents, especially in the industrial sector. I think as construction continues, we’ll probably see rents moderate.”

Amazon’s impact on the e-commerce sector is an emerging force that should not be downplayed, panelists said.

“They’re on target for another 20-plus facilities this year,” Huguenard said. “There’s a pent-up demand that we haven’t seen before.”

His company forecasts a 4 to 4.25 percent vacancy rate nationally, “so we’re certainly not overbuilt.”

“We never really have seen a real estate recession without a macro-recession before it,” said Adams. “That’s going to be ultimately what changes the game in real estate…if history repeats itself as it has for the past 50 or 60 years.”

Panelists were reluctant to speculate too much on whatever “Trump effect” may come economically from the new President’s tenure, including his push for industry deregulations.

“It’s a guess,” Adams said. “People are assuming that deregulation will spur some additional expansion….in general, people are watching interest rates, they’re watching inflation.”

Regardless of the impact that the President may have, the United States “looks a lot better than some of the other countries…we still look like a pretty good value. Overall, until something really drastic changes, I think we’re in good shape.”

One risk, Adams chimed in: if the dollar strengthens. “If we get really expensive, really quickly, that could change pricing and demand from a U.S. real estate perspective.”

In reply to Stauber’s question about capital rates, panelists agreed there is room for cap rate compression, with Saturno noting the supply-and-demand factor.

Rates have already compressed by 20 or 30 points this year, noted Huguenard. The $9.5 billion in industrial real estate trades during the first quarter—higher than a year ago—augurs a “robust” 2017 overall that should reach the $55-$60 billion trading level, he added.

The Odyssey Index, representing about $220 billion of industrial real estate across a variety of funds, has a five-year industrial return of 12.79 percent, or 2 percentage points higher than the benchmark—and the gap is even higher over the last year, 12 percent versus 8 percent, said Adams.

“Self-storage is the only asset class that did better than industrial in the last five years,” she added. “The sector has a lot going for it…you’ve got the promise for continued growth.”

Another trend she noted is that industrial real estate assets are being held longer: “With all these big funds on industrial now that want to own for the next 10 or 20 years, we’re going to see potentially less product trade,” said Adams.

“One of the biggest things that is a positive for the landlords in the room is they are not going to chase the market down,” added Huguenard. “They’re willing to sit with some vacancy, and hold out for their rental a bit longer. It’s more a preservation of capital than growth on capital. It’s a much more patient viewpoint.”

Referring to her own fund, Adams said that increasing industrial real estate’s proportion of that investment is an opportunity she’s striving toward and “at this point, the best way to increase our industrial exposure is deal by deal.”

As more institutional investors enter the market place, the need for experts on the local level is crucial, panelists said.

“At the end of the day, all these big funds…we’re all driven by performance so we can’t afford to overpay and then just suck wind on our acquisitions,” Adams said. “…we’re all driven by performance, and performance is what raises capital.”

An audience member asked what effect Illinois governmental financial troubles are having on investors’ interest locally.

Huguenard acknowledged that some prospective investors are “concerned,” but “you only need one (investor) to sell any of the opportunities.”

The foremost issue, he said, is rent growth. Nationally, there are 12 markets that experienced rent growth of greater than 10 percent last year; in Chicago, that figure was 1.1 percent, with only three sub-markets over 5 percent.

“It’s more of a rent growth story than it is the rest of the economy,” he said.

Adams said the state’s fiscal woes are “an issue for sure,” and that three to five pension plans have “redlined” the state because of the municipal risk it poses. The underlying issues that are bedeviling the state: wage growth, job growth, and population growth, all of which “suffer compared to the coasts,” she noted.

However, she added, “Chicago is still very much an important market from a diversification standpoint, irrespective of what asset class you’re looking at.”

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