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COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

S.O.S. / Salient or Stagnant: The State of the Suburban Office Market

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the April 14, 2016, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at the Riverway Auditorium in Rosemont to hear an expert panel share their insights on various facets of the suburban office market. Their discussion came against the backdrop of a rising trend of urbanization in Chicago's recovering market.

Jack McKinney, *Senior Leasing Director, Head of Agency Leasing*, Cushman & Wakefield, served as moderator and was joined by expert panelists Bill Barry, *Senior Vice President, Commercial Mortgage Production*, Draper and Kramer, Inc.; Dan Deuter, *Senior Vice President – Capital Markets/Institutional Properties,* CBRE, Inc.; Ned Franke, *Executive Vice President*, Cushman and Wakefield; and John Grissim, *Senior Executive Vice President,* Lincoln Property Company.

In his opening remarks, moderator Jack McKinney made it clear that highlighting suburban office market struggles has been an equal-opportunity endeavor in recent years.

"Ever since the collapse of the home loan market and single family residential area, especially in the northwest, the suburban office marketplace seems to be under siege, or at the least, continues to be maligned by the press, lenders and even investors," McKinney said.

A recent case in point: a story in Crain's Chicago Business on suburban office vacancies climbing to nearly 19 percent during the first quarter of 2016, its highest level in two years.

"Demand for office space seems to be kind of tepid," McKinney added. "The economy and tenant balance seems to be fragile and much, or at least some, of the product may be flawed out there."

Setting those valid concerns aside, panelists said significant portions of the suburban office market remain viable, particularly Class A properties.

It would be a mistake to view the suburbs as one homogenous whole, they emphasized. In fact, the market outside Chicago “is more bifurcated than it has ever been,” said Dan Deuter.

“You have to peel back the onion, A versus B and C, and the B and C market is really where all the struggles are,” he added.

The suburban Class A market’s 13 percent vacancy rate is close to downtown Chicago’s 11-percent record, and much lower than the 21-percent rate for B and C properties in the suburbs.

Even Class B properties in the suburbs, those that are “well-located and functional,” are sparking demand.

“A lot of investors are throwing the baby out with the bathwater and just red-lining the suburban market,” Deuter said. He sees opportunities through investing in amenities and fixing a given property’s problems to attract and retain tenants.

He also pointed out that slightly more than half of the 70,000 office jobs created in the Chicago metro area over the past four years have occurred in the suburbs. “Everyone is shocked when we show them the net absorption statistics,” he said. “The suburbs have outperformed (Chicago) by about 1.6 million square feet of net new demand.”

One key difference that has helped frame perceptions: Chicago’s Central Business District (CBD) has one unified voice and the promotional apparatus wielded by Mayor Rahm Emanuel.

Another element favoring existing suburban office stock is the absence of new supply, in part because replacement costs have doubled since the last cycle, Deuter said. “There’s a lot of runway for these high-quality buildings to push their rent without the threat of new supply coming in, so rents are growing, particularly in the A sector.”

Further stoking the market is that cap rates are at historically high spreads, about 200 basis points. “So there’s an opportunity to get higher yields in higher-quality assets in the suburbs and get higher returns on a risk-adjusted basis.”

High-quality locations spark much more action, as was the case when Medline decided last year to sublease Kraft Heinz’s Northfield headquarters, said Ned Franke, who represents Kraft Heinz.

While acknowledging the recovery curve “may be incredibly steep,” Franke said he believes “the worst is way behind us. I don’t see rates dropping or vacancies spiking right now.”

Millennials’ desire to work in the city is a key factor prompting companies to explore moving downtown, according to Franke.

“That’s affecting people, so it’s very much in the discussion,” he said. “Today if you’re meeting with a lot of larger companies, everybody wants to talk about it but not everybody is going to take action…This panic about everything going away (from the suburbs to the city) is overblown."

Dubbed by McKinney a "crusader and evangelist" for the suburbs, John Grissim replied that he likes opportunities in both Chicago and the suburbs—"it's just a matter of when" to get deals done.

One advantage for the downtown over the suburbs is the ability to re-purpose more properties from one use to another. By contrast, an estimated 16 percent of suburban office space nationally is obsolete, said Grissim.

"If you're a B and C owner of property here in Chicago, in the suburbs, I've got to tell you, I feel terrible for you," Grissim said. "I don't know your exit. I don't know what you do with that stuff."

However, he noted there is "upside" for "quality B buildings" with good locations and other positives such as a beneficial floor placement, sufficient parking and the ability to add amenities.

One tip he offered to those interested in investing in the suburbs is to be "very selective about what markets, what specific buildings you buy." A mistake he has made in his career: getting "enticed by per square foot price, but the issue was you just couldn't lease it and you can't create demand."

"It's not just buying," he added. "Once you've done what you're going to do (over the course of owning or managing a property), you've got to sell."

Asked about lenders' interest in the suburbs, Bill Barry said his firm meets with two or three lenders in a typical week and their focus is on categories such as apartments, industrial uses—especially multi-tenant—and grocery anchor developments.

"Suburban office is way down on that hierarchy," Barry said. "Now, that being said, you can still get it done."

Two suburban types with particular potential are "stabilized suburban office and the valued-added plays," he said.

Meanwhile, "the market is so much deeper" in the downtown, said Barry. Some of his firm's clients are buying vacant buildings in the West Loop to redevelop. That activity is aided by numerous variables—higher leverage, better spread, less amortization and "the biggest thing is it's so much more competitive, which drives better terms," Barry said.

In the suburban market, Oak Brook and O'Hare are generally regarded as stronger areas to develop. On the other end of the spectrum are the western portion of the east-west corridor and especially the Northwest suburban market, which is "extremely difficult," said Barry.

“You’ve got to remember the lenders that had issues during the recession—that’s where they really were hit,” he added.

In-fill, transit-oriented, mixed-use developments are particularly strong in suburbs such as Evanston, said Deuter.

“Those kinds of markets are where you can start to get the urban investors intrigued by the 200 basis point cap rate spread,” said Deuter. “…these investors can generally get valued-added returns without taking value-added risks.”

Prompted by McKinney inquiring what the “have-nots” can do to be a successful seller, Deuter said expanded parking, upgrades of common areas and adding other modern amenities are among the most important steps.

“If you’ve got some things you can’t fix, low ceiling heights or narrow window lines, then you just have to compete on pricing,” he added.

At that point, Grissim interjected that for certain lower-grade properties, “there’s just no hope…they should be gone.” Further dampening those properties’ prospects, even if their owners wanted to re-purpose them into a new use such as apartments, the municipality where they are located may not approve that re-use, he added.

All is not grim for the entire B and C categories. Over the last four years, the net absorption in the suburbs has been 2.6 million square feet for A properties and 2 million square feet for B-C properties, said Deuter.

“That’s the well-located, functional B assets,” he added. “You’ve got to dig through everything.”

Although a company may threaten to move from one suburban location to another, that kind of declaration is more tactical—“to create leverage” in negotiations, said Franke—than realistic. One of the primary reasons, panelists said, is the disruption such a move would create for workforces’ commuting pattern.

“More people, interestingly, are asking about suburban Metra stations than ever before” to accommodate and attract workers, Franke noted.

For some Class B and C properties, said Deuter, “pricing will just fall where opportunistic local operators will see opportunity and pounce on it” and invest money to make it a functional office asset again or convert it to another use.

“There’s also going to be the next wave of (suburban) demand when Millennials start to decide to finally get married and buy a house,” he continued. “…not everybody is going to be able to afford schools downtown, and suburbs are not going to die.”

After referring to a recent report that more millionaires are moving out of Chicago than any other American city, McKinney asked panelists if the fiscal woes that have beleaguered local and state governments are causing concern among investors, lenders and tenants.

Panelists responded in varying fashion.

Barry said “some investors are concerned” and “are being very, very selective on whether to invest here,” while lenders have not indicated any reluctance to doing business locally or statewide. The impact of taxes on the cost of apartments has led to underwriting changes in that area, Barry added.

Deuter acknowledged that he’s in touch only with those who have overcome any hesitation they may have about the local government’s financial woes.

“I think the groups concerned about it already are not talking to us,” he said. “If they’re talking to us, they’ve gotten comfortable with it. It’s surprising, frankly, to me that it doesn’t come up more often.”

Referring to the fiscal troubles, Franke said, “Nobody likes it, but I don’t see anybody rushing out the door.”

Grissim offered a vantage point that placed the area governing bodies’ economic doldrums in a broader context. Pointing out a new wave of foreign investors have been active in the Chicago property market, he said, “The truth of the matter is, it’s better here than it is there. They’re trying to get money out of their countries, so it (the city and state’s financial trouble) doesn’t affect them at all.”

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