NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

A Big-Box Update: The State of Chicagoland's Industrial Development Market

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the November 2, 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 discuss a range of issues, including where the industrial market is in relation to the current development cycle, how e-commerce continues to affect building construction and design, financing structures that are moving projects through the pipeline, if the market can sustain additional development, and trends to anticipate in the coming year.

Moderator: Mark Goode, *Principal*, Venture One Real Estate, LLC,

Panelists:
Anthony Pricco, *Principal & Partner*, Bridge Development Partners, LLC
David Riefe, *Senior Vice President, Midwest Region*, Seefried Industrial Properties, Inc.
Todd Vezza, *Senior Vice President*, DCT Industrial Trust.

In a discussion book-ended by cheers for the Chicago Cubs' dramatic pursuit of their first World Series triumph since 1908, assessment of the area's industrial real estate market was a bit more muted.

It's not that times are bad: the 1.3 billion-square-foot Chicago industrial real estate market has forged steadily ahead in recent years. But when compared with other parts of the country, particularly the coasts, the area's rebound from the Great Recession has been unspectacular.

At the same time and on the bright side, according to panelists, the obstacles faced by developers and others in the local market as they complete deals and build out real estate holdings are not nearly as difficult as those found elsewhere.

Across the nation, demand is exceeding supply to create momentum in rent growth. Particularly in the Inland Empire of Southern California, that imbalance is pronounced: "You build a building—it gets leased. It's quite phenomenal," said Anthony Pricco. And for northern New Jersey, Manhattan "is an unbelievable driver," he said.

One of the forces shaping the supply-and-demand equation is the length of time necessary to move a project through regulatory requirements—upwards of two years in some markets such as Southern California.

Another factor, noted David Riefe, is that population growth in the coastal markets is stronger than in the Chicago area where "it's somewhat flat."

Success has spawned more success, said Todd Vezza. "When these development updates come back, the market rent keeps moving, and it's supported, so that performance gets better and better," Vezza said. In places like New Jersey, Southern California and Dallas, “everything is within budget…buildings are leased before they are built or delivered,” he added.

Pointing to signs of the Chicago market’s health, Riefe cited the 11 leases of at least 500,000 square feet that have been signed through the first three quarters of 2016, compared with 10 for all last year. Many of those large deals have come along the I-80 and I-355 corridors, he said.

The vacancy rate along the I-80 corridor, which was 20 percent before the Great Recession, has dropped to 5.5 percent, he noted. “Our strategy has been to find areas with barriers to entry for in-fill development and do build-to-suits in the large and small markets,” said Riefe.

Demand for space is strong in Cook County, though uncertainty over the future of the Cook County Class 6B property tax incentive is causing some to shy away from developing in the county, said Pricco.

Of Chicago, he added, “We like the city, but it’s not the demand you think. A lot of people would prefer to be just outside the city of Chicago, (because) the deals are tough and the city’s a bear to work with.”

“City development is tough,” echoed Vezza. “It’s got a lot of groundwork, a lot of environmental problems, a lot of political process you have to work through. But those are the things that add the value in my mind and why you do it…it keeps a lot of people out of it.”

Nobody knows when the cycle will end, or how severe it will be, but Vezza said one factor working in the industrial sector’s favor is its “gestation cycle” of nine to 18 months being shorter than the cycle for other sectors, such as office buildings.

“So we don’t worry about getting caught…if there was a place where maybe you would have some overhang, it would be something like the city, where it would be longer (to develop), but we don’t concern ourselves with that,” Vezza added.

Riefe expressed similar confidence in the endurance of the current cycle, pointing out that there was no significant recessionary period for 20 years before the Great Recession of 2008.

Panelists were also asked about some of the more prevalent regulatory issues they must contend with in developing a site. DuPage and Lake counties recently passed ordinances requiring more storm water detention, said Riefe, and Cook County has instituted best management practice-related requirements for dealing with storm water runoff.

“What we did with our facility up in Niles is we built permeable pavers in our parking lot, where the water would get filtered and help the quality of the storm water,” Riefe continued. “So that kind of thing slows us down, it makes in-fill development more difficult” and costly.

Even so, observed Pricco, “we’re pretty lucky in Illinois and Chicago. Just from the regulatory perspective, you go to the Inland Empire, you’re going to get sued. We have a line item in our budgets of $500,000 for settlement of lawsuits, just because of all the hoops you have to jump through…California (has) a whole different set of issues.”

Also on the list of factors making California a challenging place to develop: lawsuits, or at least the threat of them, by labor unions, said Vezza. While labor unions in the Chicago area have long been a part of projects, it wasn’t so much the case in California and there is an estimated 8-15% impact on hard costs to make the adjustment for labor unions there.

“Everybody (with a development of) over 300,000 square feet is being targeted now,” Vezza said. And as Pricco noted, there is a very real cost associated with delays: “The only thing worse than an empty building is when you’re sitting on land.”

Discussed at length was the impact of e-commerce on industrial real estate. Riefe said that of the $1.25 billion in development projects for Seefried, $750 million is in the development of five fulfillment centers for Amazon across the country: in Monee, about 40 miles south of Chicago, as well as in Jacksonville, Kansas City, Houston and Sacramento.

In response to a question from Goode, Riefe said he is not concerned that his company has placed too much faith in the future of e-commerce. “E-commerce is not going away, it’s growing every year,” said Riefe. “It’s like asking somebody in 1999 if this Internet thing is going to stay around.”

E-commerce accounts for 10 percent of retail sales, and Amazon is the seventh-largest retailer, with about one-sixth the volume of leader Walmart’s sales revenue, said Riefe.

“I don’t think Walmart’s going away,” he added. “We’re just not seeing them expand as quickly and they’re trying to get into e-commerce to take advantage of the high growth that’s occurring.”

Panelists did not single out any one company as a strong potential rival to Amazon’s dominance in the category. However, every brick-and-mortar retailer has been shifting its business model to incorporate e-commerce, added Pricco.

Home Depot is building three e-commerce facilities across the country, including a 1.6 million-square-foot traditional warehouse in Ohio that Seefried is involved in, said Riefe. “Other retailers are doing this and they are trying to catch up,” he said.

Amazon’s Monee facility, like the other fulfillment centers, has an 850,000-square-foot footprint with 2.5 million square feet overall that includes mezzanine space going up the four-level, 44-foot tall building. Amazon also builds 400,000 to 600,000-square-foot spaces that are 36-foot clear buildings, as well as “last mile” buildings between 50,000 and 100,000 square feet.

That last-mile category, representing the final phase of distribution to customers, is one that Goode characterized as the most accessible for anyone in the industry. He posed an informal query to the audience, as to whether they have been involved in at least one e-commerce-related development transaction, and nearly half raised their hands.

Goode also predicted that some retail centers experiencing declining business, in part because of the shift toward e-commerce, will become in-fill industrial locations—a point that Pricco elaborated on: “It’s all about the last mile, it’s all about the speed of delivery and we already see a lot of empty boxes…you’re going to see more and more of that.”

“I do believe it will happen, but I think it’s going to take a while,” Vezza said. “I think a lot of these municipalities have a hard time letting the dream go, the sales tax, all that kind of stuff.”

“But if the box is empty,” Pricco pointed out, “they’re not getting any sales tax.”

On the financing front, there has been increased caution, said Pricco, though for leased product it has been “unbelievable how much capital is out there.”

Concerns have heightened over the multi-family sector being overbuilt, and that could bode well for more capital shifting toward industrial investment, he added.

Most of the capital that DCT Industrial Trust plans to deploy, at least this year and next year, will be through development projects and not on acquisitions, said Vezza.

“We have our own development group, but we also look at partnering with developers who have good projects that we want to hold,” Vezza said. “We try to make ourselves relevant with financing the project, or giving them the take-out (loan), trying to strip away problem areas, or risk, the developer might have.”

When Goode asked if capital was coming from pension funds, insurance companies, REITs or foreign investors, Riefe replied, “All of the above.” Pricco cited Morgan Stanley and JP Morgan Chase as two recent investors on transactions that Bridge Development Partners was involved in.

Other sources of capital are European investors, said Riefe, who described them as “very aggressive, but they are very risk-averse” and therefore prefer build-to-suits over spec sites that hold more investment appeal to pension funds.

Driving investment in the United States is that there is “such dysfunction in the world,” Goode observed. The philosophy is more “principal preservation versus return on investment,” said Pricco. “If you’re an industrialist in Venezuela, you just want to get your money out of Venezuela.”

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