NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

Submarket Focus: O'Hare, West Cook and the Impact of the Infrastructure Work Surrounding the Airport

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the February 15, 2018, 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 insights from experts on the outlook of the O'Hare-area industrial market. With rents and values reaching all-time high, the market continues to maintain its status as the heart of the region's industrial market.

One of the main themes of their discussion: as infill properties are in more demand than ever and access surrounding the airport is transformed by massive roadway infrastructure projects, is there even more room to run, or is the market at risk of overbuilding?

The session moderator was Steven Disse, *Executive Managing Director*, Colliers International. Panelists were Michael Plumb, *Principal*, Lee & Associates; Tom Rodeno, *Principal*, Colliers International; and John Schoser, *Managing Director,* Morgan Stanley.

The health of the O'Hare industrial market is a strong indicator of not only the health of the economy in the Midwest, but the entire nation—that's a consensus view of moderator Steven Disse and panel experts.

The market is vibrant, with 185 million square feet in O'Hare and West Cook County. To put that into context, said Disse, that figure is 75 percent as much as the Miami-Ft. Lauderdale market, and 30 percent larger than the Seattle market. Both are among the hottest markets in the United States.

Since 2012, two dozen spec projects, most of them teardowns, in the O'Hare market have totaled six million square feet. That activity accounts for about 3 percent of the overall market size, noted Disse, so "we're really not overbuilding and it's going to be very difficult to overbuild."

In his opening remarks, Tom Rodeno touched on the diversity of businesses in the industrial market. The biggest misconception, he said, is that the market is dominated by air freight users when, in fact, they account for less than 10 percent of it.

"There's roughly 10,000 companies between O'Hare and 290 North and they kind of feed on each other," Rodeno added. "What makes O'Hare so successful is that you have all the highways that converge on the airport. And if you're looking to distribute and try to move things around the Chicago metro area, it's probably the best area to be to get the quickest access."

The rising dot-com presence has also spurred on increased demand for smaller, in-fill locations that enable those e-commerce operations to get closer to their clientele, said Rodeno.

Michael Plumb echoed the observation that the market's strength stems in part from its diversification. "There's no one typical user," he said. "It's a very resilient market. You see a lot of functional obsolescence in the O'Hare market, but it's still extremely strong."

With so many manufacturers having an entrenched labor workforce, any moves they make amount to a "shuffle around the airport…when you have that, you typically enjoy stronger occupancy," Plumb added.

Progress toward the eventual completion of the **Elgin-O'Hare Western Access Project** will be a continued boon for development in communities to the southwest of the airport, such as Bensenville, Franklin Park and Schiller Park, said Rodeno.

That evolution, said John Schoser, has "absolutely" factored into Morgan Stanley's strategy of investing in properties in that area.

"Historically you have looked at Elk Grove and that side of the airport. This has ringed the airport. We've seen demand, we've seen tenants jump to the south side (of O'Hare) and rents come up," Schoser continued. "The bulk of that work has yet to be completed. It certainly was part of our overall investment thesis as we were thinking about building that portfolio.

Panelists also discussed the impact of property tax rates, including the implications of where, and whether, to invest in properties based on the likelihood of a given municipality granting a parcel **Class 6B designation**. Such a designation provides a tax abatement that makes those properties more attractive to prospective buyers.

Uncertainty over the future of the Class 6B designation, caused by major tax code reforms in late 2017 led to great volatility at that time, said Plumb. While the tax code change was repealed in January, and the status of 6B has been restored for the time being, it raised a question for would-be buyers: "How do you underwrite an investment where 6B could be pulled away?" said Plumb.

In addition, some municipalities have "ratcheted up" what they seek from property owners—such as upgrading the drainage system or other infrastructure upgrades—as a condition of granting 6B status. Those heightened requirements are causing companies to re-evaluate whether a given property is worth the investment, Plumb noted.

As for those communities that are not renewing 6B designations that were originally granted over a decade ago, Rodeno had this to say: "It'll be interesting to see how landlords and tenants approach the expiring 6B. Who's at risk? Will they share the risk?"

Meanwhile, other communities (such as Franklin Park, Bensenville and Wood Dale) that have new buildings with new 6B classifications are in a strong position to pursue those tenants who have been receiving tax relief, but are facing a future without it, said Rodeno.

Schoser expressed cautious optimism that communities “will get it figured out.”

“Each of these municipalities needs this infrastructure, needs these jobs, needs this employment, so you hope that cooler heads will prevail, and they figure out that extending this (6B) program,” or something similar, is the prudent course to take, said Schoser.

He referred to the “mind-numbing” back-and-forth negotiations that play out between landlords and tenants. One viable approach for landlords is to establish a gross lease figure—“here’s your number, pay the number.”

In terms of investment strategy, historically Morgan Stanley’s investments in the Chicago industrial market have been “scattershot,” said Schoser.

“It was a building here or there,” he recalled. “Aggregating in the industrial sector is tough. If you have $23 billion, and you want 25 percent to be invested in industrial, doing that $1 billion at a time is going to take a really long time.”

“(But) if you thoughtfully pick the eight markets you want to be in where you feel like job growth, distribution, employment—all those sort of factors—and really dig in there, that’s where we spent our time,” he continued.

Morgan Stanley’s first big industrial purchase during the current cycle came in late 2012 in Elk Grove Village, said Schoser. Thereafter, the firm started to see more opportunities “to focus on pretty robust demand…industrial really is the flavor du jour, everybody wants it. The growth there is pretty dynamic.”

On the topic of what constitutes functional obsolescence for a building in the O’Hare market, panelists said it is when the land value exceeds the value of whatever is under roof. One ingredient that helps extend the life of a given property: the diversity of users, with divergent preferences on features such as clear-heights. For example, some manufacturers prefer 14-foot clear buildings over taller-clear sites because it results in lower utility costs, noted Rodeno.

Classifying a building as Class A or Class B is subjective, and hinges on location, said Plumb. For instance, the same building deemed to be Class B along the I-55 corridor could be considered Class A in the O’Hare market, he noted.

Another factor blurring the lines of A versus B properties: what Schoser terms “this last-mile frenzy.”

“That is reshaping how institutions will look at what is characterized as Class B,” he added. “…If you want to participate in that segment of the sector, you’re going to have to take the blinders off as to what you thought was traditionally more core stuff. It is tough when you take a ragged portfolio of B stuff to committee, but location sort of trumps all.”

During a question-and-answer phase, among the topics that were addressed:

*Whether Cook County was at a strategic advantage or disadvantage, in terms of tax and other overhead costs, compared to neighboring counties such as DuPage County. Schoser called it “a wash,” emphasizing that it’s important to evaluate the risks and potential rewards for a property on a case-by-case basis.

“Who’s to say DuPage County taxes are not going to go up faster than Cook County taxes?” said Disse.

*The growth of data centers moving into the market, which Rodeno estimated at a “couple million square feet” of occupancy.

*Morgan Stanley’s growing investment in the market, which Schoser pegged at about two million square feet. “We’re fortunate to have a little bit of everything...our push has been to build a portfolio that gets us to divide down to something much smaller, or (to have) something much bigger.”

“They are very, very responsive,” Disse said, praising Morgan Stanley’s approach. “They are willing to divide buildings from Day One.”

*The outlook for cap rates. Disse forecast compression in the Chicago market, whose spreads, compared to the coastal markets, are upwards of 75 points. That is well beyond their former spread in the 25-point range.

Schoser agreed with that forecast, noting that “there’s a lot of money chasing not a ton of deals today. I think that given the relative and real health of the Chicago industrial market, there is as much or maybe more interest (among prospective buyers) as there has ever been.”

With so many investors holding onto properties for a long time, added Disse, there is “an unbelievable shortage of quality industrial in the $25 million to $200 million range in gateway markets.”

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