NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

Still a Force to be Reckoned With? Chicago's Industrial Competitive Position in a National Context

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the May 10, 2018 meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at The Estate by Gene & Georgetti in Rosemont to hear insights from experts on how Chicago compares to other gateway markets across the country from the perspectives of users, investors and developers.

The session moderator was **Erik Foster**, *Principal, Capital Markets Group,* Avison Young. Panelists were **Traci Buckingham Payette**, *Executive Vice President, Industrial Brokerage,* CBRE; **Jeffrey Fischer**, *Executive Vice President – Industrial Services Group,* NAI Hiffman; **David Nielsen**, *Senior Vice President,* Bentall Kennedy; **Fred Regnery**, *Principal,* Colliers International; and **Mark Saturno**, *CEO,* IDI Logistics.

As with so many questions related to real estate, whether the Chicago area is a force to be reckoned with depends largely on location.

According to panelists, if a company is already situated in the market, then the area around the Windy City has a compelling hold that makes it very likely those organizations will remain indefinitely. On the other hand, when Chicago is set against a backdrop of other regional and national options, the local industrial market isn't so alluring to prospective newcomers.

Fred Regnery referred to the latter scenario as Chicago's "brand" problem.

Often, how companies choose where to locate "is not that scientific," said Regnery.

"A lot of times, it's as simple as anecdotally, 'I've read a lot of bad reports on the state finances, and I know a couple of warehouse guys having problems hiring.'"

"Brand really is important, despite what the reality is," he continued. "And if you do get into the reality, it's labor, it's the cost of labor, it's the availability of labor, it's the right to work that other states enjoy" that poses a challenge to Chicago.

Fundamentally, however, the market is "very strong," Traci Payette said.

"Land pricing is probably at an all-time high, vacancy is at an all-time low, tenant demand remains strong," she added. "Developers continue to find land sites, though they are harder to find, and they continue to build. So overall the Chicago market is doing really well."

The strength of the market is widespread, with nearly all of the submarkets' vacancy rates typically between 3 and 4 percent, she added. The I-55 and I-80 corridor vacancy rates of 7 to 8 percent are "not shocking" or "concerning," Payette added, because tenant demand is projected to remain strong for at least the next year or two, and core distribution activities are heavy in those corridors.

Tenant activity, said Jeffrey Fischer, “is so impressive right now.”

“If you wait a minute, somebody’s jumping in right behind you,” Fischer continued. “If you don’t jump on it right away—if you’re not actively negotiating, if you’re not engaged—you’re going to find yourself searching for another asset.”

Over the last few years, said Regnery, Collier’s ratio of big box projects to in-fill projects has shifted dramatically. Whereas big boxes formerly represented three-quarters of their projects, now they are about 40 percent.

He attributed some of that reduction in big-box volume—which he defined as 300,000-square-foot distribution requirements and up--to Illinois “not even (being) in the mix, if it’s a new tenant coming from out of the marketplace.”

“Within the marketplace, (for) tenants that are here, activity has been good. But if you look at the last seven big box deals that we track, they were all already companies that had a presence in Illinois,” said Regnery.

“Part of it’s just the brand of Illinois, which does matter, part of it is labor expense, part of it that you can service the Illinois area from a lot of different states here in the Midwest, which isn’t the case if you are on the East Coast or the West Coast,” he added.

Bentall Kennedy, a pension fund adviser, exited Chicago from 2010 to 2017 but is now back in the market via a $10 billion open-end Odyssey Index Fund, said David Nielsen. Of the seven-year hiatus, he described the investment committee’s view as “Chicago is great, it’s big, but you can build forever and the rents never grow.”

“To be here, we want to be in-fill locations—new, modern product that 10 years from now our clients or long-term hold will want to own it,” Nielsen added. Bentall Kennedy has three or four “smaller deals” in the Chicago area, he said, and “we like it here. We see it as a relative value play.”

According to Mark Saturno, Chicago, relative to the national market, “is still a very desirable market from a user standpoint. Centrally located, great transportation, population proximity—all the reasons people have always liked Chicago.”

However, the market “struggles a little bit today with labor availability. It’s all about labor today—about access to labor and can (companies) find the type of labor they need willing to work at the wages they can pay at the warehouses,” said Saturno.

From an investor standpoint, Saturno added, the 75 basis-point spread on cap rates is not as high as it needs to be to compete effectively with other U.S. markets. He points to Chicago’s relatively lackluster growth in rental rates: “If you were looking at average rents over the last three years (nationally), those rents have gone from five to six to seven bucks. Chicago’s average rents have gone from $4.25 to $4.50 to $4.76. Still trending upwards, but just not at that same rate of growth.”

Part of the reason why Chicago is passed over by potential tenants is a result of companies looking to fill a void in their logistics network, and “they already have a presence here” or in a nearby market such as Indianapolis, said Payette.

However, Illinois could “be doing a lot more” to provide incentives that draw companies. “At least, say, `Hey, our doors are open. Let’s have a conversation, let’s talk,’” she suggested. “Instead of just having this negative press that’s out there all the time and deterring companies from even looking at the state of Illinois.”

On the other end of the spectrum, as an example of a satisfied area company, Fischer alluded to a Fox Valley firm that has been in the area for 40 years and has about 400 to 450 employees. That company “loves the labor,” and has plans to grow in the next couple of months, he said.

Based on working on four build-to-suit projects for Amazon over the last 18 months, Saturno shared an anecdote that highlights the prominent role that labor availability plays in the company’s location decisions. Amazon uses a multi-variable algorithm that draws on the demographic makeup of areas where the company has already been successful in locating facilities.

“We submit every (potential) site to them to see if they are interested, and they tell us in about 15 minutes whether or not they are interested,” said Saturno. “…obviously they’re more sophisticated than your typical warehouse user, but it just shows you how they’re very focused on labor.”

In addition to relatively high labor costs, heavy taxes throughout the entire Chicago area play another significant role in hampering investor interest, said Nielsen.

The outlook for rent growth in Chicago is “slightly below” the national average, said Nielsen. “Is the spread enough? I’m not sure that it is, but it’s a relative game for all of us…For a market this large to get this spread, our concern is, ‘Is it going to keep compressing?’”

As for demand drivers, panelists noted the population base as well as inland ports that are a boon for regional distribution. And on the question of whether it is a ”landlord’s market,” Payette said that is a fair description for most submarkets, with the I-80 corridor being one exception.

In the Chicago market, Bentall Kennedy has devoted significant attention recently to the O’Hare market, with an eye toward aggregating B and C product and “putting something together of size there,” said Nielsen.

Meanwhile, pre-leasing buildings has fallen off, said Fischer. “It kind of goes against the grain that tenant activity is so great…the spec activity that I’ve been involved in, it gets leased up, it happens. But the pre-leasing part just isn’t part of our equation.”

For buildings of at least 700,000 square feet, about half of the construction the past five years has been build-to-suit and the other half spec, said Payette. “When you get into those larger facilities,” she said, “the tenants are thinking about it years in advance and they’re thinking about exactly what they want to build.”

Often, however, there is “a lot less pre-planning and foresight,” Saturno noted. “We are always pushed to the limits, it seems, to get somebody into their building on time. They want it to be quick. They are behind schedule, they need to be in the facility, so we are always looking for ways to expedite that process.”

One outgrowth of these tight timelines, he added, is that more tenants are inserting a financial damages clause into contracts in the event they are not able to get into their new building on schedule.

On the topic of e-commerce and the logistics behind the “last mile,” ease of access and transportation by car make outlying locations such as Waukegan and McCook preferable to urban locations such as Goose Island, panelists said.

Another deterrence to building in-fill locations is the time it takes to locate and build out a relatively small site, said Saturno. On the other hand, re-purposing malls—because of their proximity to high-density populations with higher income levels—is one “last mile” location strategy, he added.

When asked about some positives occurring regionally, panelists pointed to several examples. One is the successful attraction of 2 million-plus square feet of occupancy at the DuPage Business Center in West Chicago over the past six months. That stems from the community's mayor pushing for incentives that include 50% property tax and utility abatements. Another bright note, cited by Payette, is the aggressive promotional efforts by the **Will County Center for Economic Development**.

The organization does "a really nice job promoting Will County and I think that's part of the reason you see tremendous growth in Bolingbrook, Romeoville, Joliet, Minooka, Monee," Payette said. "…If you could have the other counties promote the same way, and even the state, I think it would go a long way."

During a question-and-answer segment, panelists fielded an inquiry about what they consider to be strong secondary industrial markets in which to invest.

Saturno touted Cincinnati in part because it was selected to be the Amazon Prime hub, which "bodes real well for the long-term growth there. The labor supply is good (and it has) close proximity to the rest of the Midwest."

He also gave a qualified endorsement of Louisville, cautioning that it's "not a very liquid market from an investor standpoint and not a very deep market."

Elaborating, Saturno said liquidity flows largely from outside institutional investors pouring money into a market "and that's part of why people love Chicago—even in the worst market conditions, you can still trade Chicago real estate."

Nielsen said Bentall Kennedy likes the growth and demographic make-up of Denver, although the mountainous topography makes it "tough to build."

"It seems like people move to Denver and they don't leave—(they) go out and just love it," said Nielsen. "It's got natural resources, it's got the tech."

On the topic of consolidation, Saturno predicted it would continue to be a trend in the industrial market as investors see it as "a scalable business."

"People with large capital are continuing to look for places to place it," he added. "They also look for operators."

Nielsen echoed Saturno's views, adding that it is "just tough to aggregate good industrial…There's value if you can do it. We are trying to build portfolios on a one-off basis. It just takes a long time."

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