

The Industrial Mag Mile(s): I-55, I-355 & I-80

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the September 26, 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 development outlook for the Interstate 55 corridor submarket, as well as along Interstates 355 and 80.

The session moderator was Matthew Grusecki, *Senior Vice President*, Northern Builders, Inc. Panelists were Susan Bergdoll, *Vice President, Leasing & Development*, Duke Realty; James Carpenter, *Executive Managing Director, Capital Markets*, Cushman & Wakefield; Juan DeAngulo, *Managing Partner & Co-founder*, Elion Partners; and Jeffrey Kapcheck, *Senior Vice President*, CBRE, Inc.

This is a summary of the September 26, 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 development outlook for the Interstate 55 corridor submarket, as well as along Interstates 355 and 80.

The session moderator was Matthew Grusecki, *Senior Vice President*, Northern Builders, Inc. Panelists were Susan Bergdoll, *Vice President, Leasing & Development*, Duke Realty; James Carpenter, *Executive Managing Director, Capital Markets*, Cushman & Wakefield; Juan DeAngulo, *Managing Partner & Co-founder*, Elion Partners; and Jeffrey Kapcheck, *Senior Vice President*, CBRE, Inc.

In the midst of global and national industrial real estate trends, there is a continual tension between looking back and scanning the horizon. To what extent should decisions be built on the clear foundation of past experience and conventional wisdom? When glimpsing into a hazy future, whose forecasts are the most trustworthy?

Those complementary skills are putting real estate professionals to the test in the region's submarkets as they weigh the well-known, and well-worn, path against emerging and disruptive forces and trends.

For investors and developers eager to avoid obsolescent property uses, it also pays to steer clear from being too much on the future's "bleeding edge."

Those variable points on the risk-reward spectrum were the undercurrent to a spirited and wide-ranging dialogue among panelists. The backdrop heading into their discussion: after more than 30 years of unprecedented development, the Interstate 55 Corridor submarket is almost completely built-out. In addition, along Interstates 355 and 80, new developments offer occupiers compelling alternatives with less traffic congestion and lower occupancy costs.

All three areas are developer and institutional investor favorites, although it is an open question whether user demand and rental rates are keeping pace, or if falling cap rates are hiding sluggish leasing and an overbuilt submarket.

After the preeminent O'Hare industrial market, the I-55 corridor is "1-A," said James Carpenter, who characterized I-355 as a "tweener." More upbeat about the I-355 area is Susan Bergdoll.

"People, especially lately; since the supply (of real estate) in 55 proper has diminished and people can't find what they're looking for, they've been going to 355," she said. "I think that pricing has been the same as 55 proper," in terms of both leasing and cap rate.

To her surprise, the tolls on I-355 are not having a chilling effect on prospective businesses locating in that area. "Nobody has said a word about the tolls," said Bergdoll.

Jeffrey Kapcheck echoed Bergdoll's outlook, noting that the pace of deals has been strong in that area, including his own company's development of Pinnacle Business Park in Romeoville. The fourth quarter of 2018 should see "significant transactions" in the Lockport area, he added, with rental rates surpassing some of the rates in the I-55 area. "I think it has overperformed there."

Moderator Matthew Grusecki noted that 10-year treasuries have risen from 2.24% to 3.05% in the past year, yet Chicago industrial real estate is enjoying record-low cap rates. "What's the dynamic here and where do we think this is headed?" he asked.

There are a variety of macroeconomic factors to consider, said Juan DeAngulo. A related question, he added, is whether 2 percent is the "right inflation target anymore." He noted that he believes cap rates will remain steady and long-term industrial returns have been driven largely by unlevered returns and anticipated rent increases.

"We are definitely in uncharted territory in terms of the equity that's out there and different alternatives (with) people (providing) the liquidity (through) pension funds and other institutions," he added. "Personally, I have always been a believer that we're not going to see as much direct correlation between interest rates and cap rates."

If 10-year treasury rates rise into the mid-3s, and toward 4 percent, then "definitely you will see a change in the market," said Carpenter. To bolster his point, he referred to the summer of 2016, when the 10-year rates approached 3.25 percent and "the market took a pause" for one or two months.

On the subject of first-mile versus last-mile properties, Grusecki noted that Chicago's Bridgeport neighborhood has seen the development of 6 million square feet of new product, with a projected build-out of 30 million square feet.

For his firm, Elion Partners, Bridgeport is a primely located area "that should stand the test of time," said DeAngulo. "We were very excited about the opportunity (to invest in the area), as long as we could do it under the structure of an indefinite timeline, without any kind of time pressure."

He sees the investments providing long-term value, while delivering yield to investors. "We're not in a hurry," DeAngulo added.

On the topic of labor availability, all of the tenants in Bridgeport have "exceeded their expectations in the speed and quality of labor that they have been able to attract," he said. DeAngulo also voiced optimism that the pattern will continue: "Chicago has a culture of people driving for good jobs."

Prompted by Carpenter's question on the role of automation in place of labor, DeAngulo said it's a topic his firm has explored, such as driverless trucks. For now, though, they are opting to "stick to the fundamentals that are closer to today and what tenants are looking for today, and we'll see what happens in the future."

Labor availability is "on everybody's mind," with the I-55 area holding an advantage over areas such as I-80 based on proximity to Chicago, said Kapcheck.

Asked about the "Amazon effect" on companies, including their preference for where to locate, Kapcheck said "it's all over the board." Some tenants are "vehemently opposed" to being near the e-commerce giant,

while others welcome close proximity. The latter sentiment stems partly from their desire to woo Amazon employees.

"They've obviously been great to our business," he added, referring to Amazon. "I don't think they're a hurtful entity. But clearly it's been top of mind for a lot of people."

Bergdoll was among those who shared views on the regional future of "last-mile facilities"—those brick-and-mortar sites that are the final link for e-commerce companies' delivery of products. Strong candidates for those uses, she noted, are older buildings that need to be retrofitted as they are "not quite functionally obsolete, but headed that way."

She pointed to [Venture One's work retrofitting a facility for Amazon](#) on Western Avenue as one prime example of this trend. Another, in the suburbs, is located in Carol Stream.

"It's not just taking older buildings and reworking them," Bergdoll continued. "Some of the product type that is in all of our portfolios today works just fine for these facilities out in the 'burbs."

Carpenter shared an anecdote that reflects the intense interest in last-mile facilities. He described a million-square-foot site with eight buildings accompanied by ample truck docks and trailer storage areas as well as great access to I-55. It's a site "nobody would have even driven to" a decade ago, but 105 prospective investors expressed interest in the site, whereas a typical offering might attract about 60 investors.

On the subject of absorption of space, Kapcheck said he is bullish. After the Great Recession descended on the economy one decade ago, some developers and investors found themselves stuck with buildings, he said, but "we haven't really built that much more."

In the Chicago market, he acknowledged, there are concerns about "the velocity of the tenant base right now coming into the market. Tenants are taking more time to make decisions," roughly twice as long as other markets like Los Angeles, Dallas and cities in Florida

However, added Kapcheck, "I don't think we are overbuilt. The buildings we are building are more generic in nature and will appeal to a lot of different tenants. If you don't have time for a build-to-suit, we've got a lot of great product in Chicago. And rental rates are rising."

Without a doubt, the shadow of the Great Recession—and the residual impact of developers being stuck with properties that lay fallow for years—looms over the market. When Duke Realty purchases a site, the goal is to put it into production within 18 to 24 months, said Bergdoll.

An analysis of new deals over the past five years in the I-55 market guided the firm on a recent decision to acquire a 543,000 square foot site in Romeoville at the end of 2017. The company's review found 18 deals between 250,000 and 600,000 square feet, six deals between 600,000 and 750,000 square feet, and only three deals of more than 750,000 square feet, said Bergdoll.

Those findings steered Duke away from purchasing an 800,000 square foot option. "We sold that flexibility and nimbleness to our executive committee," she said.

There is risk in not building, too. In Bridgeport, Elion Partners lost a few prospective tenants because the firm "couldn't build fast enough for them," said DeAngulo.

"For us, now having a portfolio that has the ability to handle a building that is built on a spec basis—we'll probably always have that availability," he added.

Elion is now building a 40-foot clear spec building, an investment with an additional cost of about \$1.25 to \$1.50 per square foot, as compared to a 36-foot clear space, said Grusecki. DeAngulo described it as an effort "to get ahead of the game."

"Ten years from now, if whatever tenant is there now is leaving, 40-foot clear is not going to sound that great," DeAngulo continued. "It's going to be the norm, or maybe even obsolete."

Not many tenants are using 40-foot clear buildings, said Kapcheck, but he noted the dimension is “here to stay.” Carpenter echoed that perspective, observing that Amazon is among those investing heavily in robotics and the cost of the technology—for tasks such as packing products—is projected to decline as labor costs rise.

With at least 10 buildings that are 70 feet high, Amazon is at the vanguard of an undeniable trend. Eventually, those “that can’t afford the automation are going to be out of business,” said Carpenter.

“If you believe that e-fulfillment is the wave of the future—and most people make that bet—then I think the only answer to the labor problem inside the warehouse is automation,” Carpenter explained. “And that’s going to point to a totally different type of facility. And if the most interesting company in the world in this space is building a 70-foot tall, three-story building full of robots, you better figure it out.”

During the final stages of their discussion, panelists touched on the ramifications of consolidations, as well as the influence of foreign investment.

DeAngulo referred to “a fundamental shift in the behavior of equity.”

“Investors are becoming more and more acquainted with the concept of reinvestment risk. They literally don’t want their money back,” he said. “They don’t want to sell... There isn’t an assumption that there will be another deal or another allocation where they can roll that money into.”

According to Carpenter, the willingness of foreign investors to be patient for many years is a key factor,. He pointed to Norges, Norway’s pension fund that was a co-investor in KTR Capital Partners when Prologis acquired it.

“Their holding period is infinite. Chinese come over and laugh at us for IRRs. ‘Those silly Americans—a 10-year hold? I’ll own this until your children are dead,’” Carpenter said, conveying the philosophy. “They don’t have to think about it, and their return expectations are much lower.”

Meeting Sponsor:

NAIOP Chicago

1700 West Irving Park Road, Suite 208

Chicago, IL 60613

Main: (773) 472-3072 | Fax: (773) 472-3076 | www.naiopchicago.org