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COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

Mid-Year Capital Markets Update - Chicago and Beyond

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the June 20, 2019, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at The Estate at Gene & Georgetti in Rosemont for a discussion on how 2019 has been faring and what can be expected as we head into the third and fourth quarters. Topics included a variety of industry sectors, including industrial, office and more.

The session moderator was Collete English Dixon, *Executive Director, Marshall Bennett Institute of Real Estate,* Roosevelt University. Panelists were Michael Caprile, *Vice Chairman,* CBRE, Inc.; Dan Deuter, *Executive Managing Director*, Cushman & Wakefield; and Steve Roth, *Vice Chairman,* CBRE, Inc.

At the outset, moderator Collete English Dixon summarized the somewhat gloomy mood of national real estate movers and shakers during a recent gathering in Chicago:

“For the first time in maybe 20 years, the general tone of this group of industry leaders was quite down,” English Dixon said. “(They were) very, very conservatively concerned about what’s going on in many sectors of the industry.”

She went on to note that the outlook was especially rocky for the retail sector, while industrial was “seen to be the baby star of the whole world.”

Over the next 45 minutes, however, panelists did not share anything approaching that level of pessimism. To the contrary, they overwhelmingly offered a much more hopeful perspective on what’s in store for the last half of 2019 and beyond.

“I can’t tell you a market that I am concerned about, even Chicago, that there’s oversupply,” said Michael Caprile. “So, investors are seeing true rent growth.”

When asked by panelist Steve Roth to elaborate on what prompted the sentiment of those leaders from across the nation, English Dixon replied that they cited “a slew of concerns.” For one thing, the economy is on the verge of attaining the longest sustained recovery in recorded U.S. history, and “many people think the market has peaked,” said English Dixon.

“And there have been absolutely defined slowdowns in certain sectors around rent growth (and) around absorption,” she continued, “so they’re putting that all together and an inverted inverted yield curve, and they’re wondering, `Are we at the door of a recession?’”

“While growth has been generally consistent, it hasn’t generally been all that crazy,” English Dixon said. “Has the Fed over-corrected?”

Dan Deuter confirmed those concerns are applicable in the office segment. But he is much more bullish about the other sectors of the economy.

“As we get late in the cycle, investor sentiment is concerned about being late in the cycle (for office) and is floating to less risky, less capital-intensive asset classes (such as) multi-family and industrial,” said Deuter. “Every institutional investor that we talk to is going heavily into workforce housing, multi-family, and industrial. Office and retail are sort of the last options. And if you’re going to look at those options, you’re much more likely to look in growth-oriented markets” like San Francisco, Seattle and some of the Sun Belt cities.

“Chicago is the market you see last on that list,” he added. “…volumes are way, way off where they have been, even (from) last year.”

With 2.6 million square feet of space in downtown Chicago, coworking has been one of the top drivers of growth locally, said Deuter. Other keys have been migration from the suburbs and a surge in tech businesses.

“I think coworking has been a really good thing for demand, but a lot of investors have concern about how many of those operators can survive a downturn,” said Deuter. “…I think the issue downtown is more supply. We’ve had decent demand from a historical perspective…The developers who have built five million square feet downtown are 96 percent leased.

Of the 10 million square feet to be built in the next three years, 30 percent of it is pre-leased, he added. A significant amount of the “growth,” however is “musical chairs,” said Roth, with tenants moving from one spot to another.

As for the suburban market and its ability to back-fill space, Deuter said one positive is that there are no speculative office buildings under construction. At the same time, “the market is more bifurcated than it has ever been,” he emphasized.

While the overall suburban office vacancy rate is 21.6 percent, “there are real pockets of strength. This is what we are trying to get investors to look at,” Deuter said.

Class A buildings in inner-ring markets such as Oak Brook, O’Hare and Evanston have a 12.6 percent vacancy rate. Likewise, trophy product is strong, with a 7.4 percent vacancy rate among the 21 buildings in that category reflecting “a flight to quality,” said Deuter. “That’s where there is opportunity for investors,”

Caprile cited a few key factors that favor continued growth opportunities for investors: the market’s not being overbuilt, and the growth of e-commerce.

Offering a different term than the oft-used “last-mile,” Caprile said he prefers to use the term “urban logistics.”

“The growth has been small in-fill tenants. Rent growth has been huge,” he continued. “Last-cycle C buildings have turned now to B-plus buildings, very functional buildings. Clear height doesn’t matter anymore. It’s about having exterior yard space for van parking, for cars, so it’s all changing. You’re going to see industrial close in (to the city) continue to grow.”

A key difference in the market now, compared with before the Great Recession, is that debt markets are seeing much more discipline in the underwriting, Roth said. As a result, there is a much lower level of risk than the 85 to 90 percent financing that characterized market activity over a decade ago.

“So, if we go into a recession, per se, I think the equity takes the hit, whereas in yesterday’s world, the debt took a hit to a large degree,” Roth concluded.

Moving to the topic of second-generation space downtown, Deuter said improving your space or competing on rate are the two prime ways to compete.

“Downtown this cycle we’ve seen a tremendous appetite to reinvest in space, which has been a great thing for the market,” added Deuter. “We’ve seen owners step up in a meaningful way and get into this amenities arms race and really create unique spaces. Demand has really responded to (that) and we’ve seen great rent growth.”

However, construction costs have climbed to the point that it has become harder to sustain profits. For example, tenant improvement costs have risen by 43 percent since 2011, said Deuter.

Pointing to another trend, Caprile said that as land gets more expensive, second-floor space is becoming more attractive in industrial buildings such as in the O’Hare market. That space may be above pre-existing office space or warehouse space.

On the issue of real estate taxes, panelists provided a positive appraisal of the situation for investors, tenants and others in the real estate realm. Their outlook belies widespread concerns about the impact of Cook County Assessor Fritz Kaegi’s reformation of the office.

Caprile noted that labor issues, including access to sufficient labor and labor costs, easily outweigh property taxes as a concern. Labor accounts for about 9 percent of business expenses for industrial users, whereas rent cost ranges from 4 to 7 percent, he said.

“Nobody likes paying more taxes, but it’s not a driver of why a tenant makes a decision in normal real estate,” Caprile noted. “In a big box, somewhat. But labor is really the big push… As you educate investors, there’s less concern about buying industrial in Cook County.”

In Deuter’s experience, taxes are not so much a concern for tenants, although for investors “there’s a paralysis around taxes. A lot of it is misunderstood.”

Whereas “the previous assessment methodology was a black box” that few people understood, Kaegi has brought transparency to the process, said Deuter.

“The truth is assessed values are supposed to be 25 percent of market value, (but) they were probably closer to 10 to 12 percent” for some properties, he continued. “All Fritz is doing is creating something that’s more transparent and more underwrite-able, which I think long-term is a good thing. But right now, it’s causing a paralysis.”

It is critical to look at not only your own property’s change in assessed value, but “you’ve got to look at it in the context of what happened in the assessment for the entire township,” Deuter added. “…It needs to be better understood and long term I think it’s going to provide liquidity to our market.”

Meanwhile, said Deuter, investment committees are “waiting to see how this plays out. And that is causing a paralysis, which is causing volumes to be down and bidder pools to be down right now.”

Despite county, city and state fiscal challenges, Chicago real estate represents a strong yield opportunity—in short, cash flow—for investors, panelists said.

“I truly believe that at the end of the cycle, you’re going to see better total returns in the Midwest and the Southeast than you are going to see on the (West) Coast,” said Caprile. “…we don’t use the words ‘secondary markets,’ we call them `smaller strategic market.’ It seems to work—investors believe it, and we believe it.”

Looking ahead, Caprile said he anticipates a slowdown in the industrial market, and a key indicator to track is labor: “That’s the biggest driver for tenants—skilled labor, hirable labor for all tenants. Investors need to look where that is, because tenants want to go where labor is, not where the money is investing in buildings…it’s a big, big issue for any tenant you talk about.”

It is crucial to understand the supply and demand factors at play in the Central Business District, Deuter said, while in the suburbs, “it’s the demand side and really focusing on assets that you think will attract demand.”

Roth cited “continued discipline” as a vital component.

“Debt has so much cushion that is associated with it. I’m not overly concerned about the over-leveraging that may be going on, and that we saw in the last cycle,” Roth added. “As long as that discipline continues, I think the debt markets will be fine.”

During a brief question-and-answer segment, English Dixon addressed a remark from an audience member who referred back to her opening remarks about the pessimism of investment managers nationally who anticipate an economic downturn.

English Dixon countered the audience member’s suggestion that they should return those funds to their investors.

“One of the best protectors that I know many investment managers had during the last cycle was the availability of dry powder and the fact that they could use that capital to take advantage of unique opportunities or to deploy capital to fix something, as a lot of things needed to be fixed,” English Dixon said. “…Fiduciary responsibility is the prudent management of that money. It means not chasing yield for the sake of yield and getting your fees. It’s making the right investment decision within that platform.”

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