Urban Land Institute
Chicago

Real Estate Forecast 2017

This is a summary of the November 10, 2016 meeting of the ULI Chicago District Council, which gathered at the Union League Club in Chicago to hear highlights of the Emerging Trends in Real Estate® report for 2017, a national real estate forecast published by ULI and PwC.

The guest speaker was Dean Schwanke, *Senior Vice President*, Case Studies & Publications, ULI - Urban Land Institute. Following his overview, a local response panel discussed a range of topics from an outlook on Chicago-area real estate to the projected impact of national developments, most notably the recent election of Donald Trump as the 45th President of the United States

Moderator: Matthew Lawton, *Executive Managing Director, HFF*

Local Response Panel:
Timothy Ellsworth, *Managing Director, Head of Real Estate Transactions, Americas*, Deutsche Asset Management
John Gavin, *Principal*, Sterling Bay
Stephen Quazzo, *Co-Founder and Chief Executive Officer*, Pearlmark Real Estate

Guarded optimism is the overarching tone of the Emerging Trends in Real Estate® report, which was assembled from more than 500 interviews and 1,500 survey responses. That mindset, building on recent years' generally favorable business climate, is reflected in the report's headline: "Playing for Advantage, Guarding the Flank."

In his keynote presentation, Dean Schwanke noted that profitability expectations continue to be relatively strong, with 81 percent rating those prospects for 2017 in the "good to excellent" range. That represents a slight dip from 84 percent a year ago but is still markedly higher than the previous two years (74 percent two years ago, and 56 percent the previous year).

Schwanke provided a brief overview of themes communicated in the 100-page report including "Context: A Kinder, Gentler Real Estate Cycle?" and "Optionality," in which space is designed and built with the potential for shifting from one use to another. Schwanke noted a trend in retail locations being geared to convert to restaurant use.

He also noted the "crossover point," with more baby boomers retiring than millennials entering the workforce. The result is a labor scarcity that is seen acutely in the construction field, at all levels, including mid- and upper-level staff such as project managers and vice presidents. There are some factors that counteract that shift, including advances in construction technology such as pre-fabricated construction, 3-D printing of building components, and strides in construction management software.

A rising concern is the lack of housing affordability, with local government having to step up to fill the subsidy role that has traditionally been played by the federal government. Among the tools being wielded to respond to the issue is inclusionary zoning, in which developers are compelling the private sector to meet housing affordability needs.

Schwanke also noted the growth in augmented reality (AR), which holds the potential to strengthen real estate marketing efforts, and blockchain, a form of more highly secure record-keeping that figures to have a big effect on the title industry. Over the next few years, the financial industry will turn more heavily toward using blockchain, and from there it will migrate more swiftly into the real estate sector, Schwanke explained.

In the top-10 market list for investors, the top two are both in Texas: Austin at No. 1, followed by Dallas-Fort Worth. Rounding out the top 10 are cities located mostly in smaller “18-hour” markets. They are, in order: Portland, Seattle, Los Angeles, Nashville, Raleigh/Durham, Orange County, Charlotte and San Francisco.

“It’s really a complete change from the way things were maybe five, six, seven years ago, when all the gateway markets were at the top of the list,” said Schwanke. “…smaller markets that are growing are attracting a lot of interest from investors.”

Fulfillment centers and warehouses are hot sectors, in part because of the steady surge in e-commerce and the “last mile” of bringing products to consumers.

Focusing on the Chicago market, investment demand is 2 percentage points higher than the national norm, with multi-family housing leading the way, said Schwanke.

In opening remarks during the panel discussion, speakers discussed the immediate aftermath of Donald Trump’s election as President.

“What happened in the stock market (the Dow rising 257 points on Wednesday) was the opposite of what I thought would happen,” said Ellsworth. “…it was banking, healthcare and bio-tech driving it. The market clearly thinks that there’s going to be a less regulatory environment.”

Noting that only about one third of American adults have a college degree, John Gavin said Trump’s popularity flowed from his extending hope, however “unquantifiable,” to many who felt “disenfranchised.”

Stephen Quazzo was upbeat about the nation’s economic outlook.

“I certainly feel good about the U.S.,” said Quazzo, who hastened to add “Let’s clarify something—Mr. Trump is not in the real estate business, OK? He’s a marketer-reality TV star.”

"I don't think it really impacts our business, who's in the White House, who's not," Quazzo continued. "What does affect our business are things like economic growth, job growth, immigration reform, tax reform, trade."

Panelists shared observations about strengths and struggles in the local market. Among other points, Quazzo said "occupancies are still really good, but there's a limit of what people can pay. So we have really focused more on workforce housing, and older product that can be re-purposed for below" the cost of new product.

For Ellsworth's firm, core fund activity has been down but has been replaced by foreign investors who see the U.S. as "a safe-haven opportunity."

Since 2012, Lawton's firm has been involved in $40 billion in foreign transactions and "we do not see that foot coming off the pedal at all," he said.

Quazzo's company has been a net seller the past three years, at about $1 billion annually, he said. "At this point, we've sold a couple of things this year, but I don't see the market as robust" outside of major cities like New York, Boston and San Francisco.

"I think people are being cautious…it's been tough to find equity opportunities," he added.

Ellsworth elaborated on the surge in foreign investment. Whereas his firm's investor base was entirely domestic a decade ago, it is now about 15 percent from sources outside the U.S.

"For every dollar that an investor has decided to redeem, there is new capital, whether it's domestic or foreign, that views the United States and our real estate investment economy as positive, as a safe haven," said Ellsworth.

Quazzo said whereas real estate capital historically competed with private equity—trying to attain as much as 15 percent returns—its primary competition today comes from the fixed-income category. "If we can get 10, 11 percent, we're heroes without taking a lot of risk," said Quazzo. "I see that trend continuing and I think it'll be very good for our business."

On the emergence of Fulton Market as a destination for businesses, with Google serving as the anchor, Gavin said the West Loop area's popularity reflects people's desire "to go to unique places, unique spaces with architectural significance."

"We can't build the buildings fast enough out there," he added, noting that the demand for office space outstrips supply by a three-to-one ratio.

As for the real estate investment market's perspective on Chicago, Quazzo said his firm has intentionally steered clear of the city the past few years. He cited concerns with supply-and-demand and governmental taxation.

“Capital is cautious as it relates to Chicago,” Quazzo said. “We don’t get treated the same as Boston or New York or D.C. or San Francisco.”

On a bright note, Quazzo pointed out that net rents have climbed from the $30 range to the high-$30s and even into the $40s. “That’s a good sign. Whether that’s sustainable or not, I would be cautious about.”

Ellsworth said that “municipality risk”—concerns about local government bodies’ financial stability—is “something that real estate investors are paying more and more attention to” and that represents an opportunity cost that politicians often do not recognize.

As for property types, panelists said industrial and “amenitized” workplaces are particularly strong at this point, though Ellsworth cautioned that e-commerce companies should be careful not to “get ahead of themselves” as they expand.

During a question-and-answer segment, Lawton warned against dismissing the suburban market “with a broad brush.” His firm recently has been involved in, or is in the process of being involved in, large transactions at Riverway in Rosemont and Woodfield Mall in Schaumburg, he said.

“If you selectively look at these suburban markets, and if you’re a market leader and have the best asset within that sub-market, you are going to attract tenants,” Lawton said. “You’re going to keep it full.”

For Additional Information:

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