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Chicago

Spring 2018 Market Overview: How Capital & Investors are Shaping Chicago's Landscape

This is a summary of the April 26, 2018 meeting of the ULI Chicago District Council, which gathered at the Union League Club in Chicago to hear from a panel of major Chicago investors and developers as they identified and explained current investment trends impacting the Chicago real estate industry.

Their remarks included the flow of capital to particular neighborhoods, risk and allocation amid rising interest rates, and the relationship between local leadership and Chicago's investment market.

The moderator was Brian McAuliffe, *President, Institutional Properties*, CBRE, Inc. Joining him on the panel were Barrie Bloom, *Senior Vice President*, GEM Realty Capital, Inc.; Lee Golub, *Executive Vice President*, Golub & Company LLC; and Brad Gries, *Managing Director, Head of U.S. Transactions,* LaSalle Investment Management.

From the get-go, panelists offered a range of perspectives on just about any topic raised by moderator Brian McAuliffe. Those differences flow, at least in part, from their companies' varying areas of emphasis in the Chicago market.

For LaSalle Investment Management, Brad Gries pointed to ground-up industrial development, not only in Chicago but across the country. "The industrial development sector has been fueled by strong tenant demand as well as cap market demand, and compression in the cap rate."

For Golub, the focus the last few years in Chicago has been the development of high-rise residential Class A apartments, as well as buying Class B, or older high-rise residential product, said Lee Golub. From there, the company upgrades the building to enable raising rents.

At the same time, Golub has sold "a lot of office product over the past few years," he said. "We're (now) on a campaign to buy more office in the city and the suburbs here."

Meanwhile, GEM Realty Capital has developed transit-oriented locations, particularly in the suburbs where tenant improvement (TI) costs have been half the cost seen in Chicago's Central Business District, said Bloom. Net rents are similar to what can be obtained in a B-plus building on Wacker Drive, she added, while TI packages are half as expensive.

"We're really looking for a great cash-on-cash, long-term hold," she said, noting that long commute times are playing a key role.

"This is particularly (true in) the North (Shore) suburbs," Bloom said. "In talking with tenants, it was clear they were biking to work, they had a 10-minute drive so if they needed to go home, they could. It did not impact their ability to attract young talent and that was very important for all of them."

Others echoed the view that cash yields are crucial, as moderator Brian McAuliffe noted, "The driver of current yield is critical to a lot of the transactions we're seeing in the marketplace."

For core real estate holdings, 90 percent of the total return comes out of cash flow, compared with 75-80 percent three or four years ago, said Gries.

"Chicago has shown less volatility and more stable cash flow than you'll find in a lot of other markets," he added. "That is an attractive feature, certainly, of investing in Chicago."

On the topic of challenges in raising funds, Bloom said, "What's interesting to see the past couple of years is the mega-funds are just getting bigger…We've seen a gap in the middle market. What happens internally is though you have a $1 billion fund size, you look at smaller check sizes because you're not having as many people chase it. We've seen a little bit of a spread there."

Globally, noted Gries, there has been a shift away from core properties as investors "are looking out the risk spectrum, both for return as well as diversification. A lot of them are seeking new, non-traditional asset classes, more niche asset classes that they feel like there's demographic tailwinds behind or excess return, relative to risk."

Based in Chicago for its nearly 60-year history, Golub has ventured beyond the city whenever "there's a relationship or a reason where we think we add value," said Golub.

"We've really gone to where the opportunity is," he continued. "And through that, we've done deals and created relationships in lots of different places."

Golub cited a few examples, including a San Francisco development that flowed out of an architect's involvement there with a high-rise rental project. That led to a 409-unit apartment building and Golub is also part of a 700,000-square-foot office building under construction, in partnership with The John Buck Co.

The company has an office in Minneapolis and is in the process of opening an office in Denver, as Golub is interested in "making a concerted effort to do deals there."

Internationally, employing an entrepreneurial, opportunistic approach, Golub has been developing projects in Central and Eastern Europe for the past 25 years, including Poland, the Czech Republic, Slovakia, Hungary, Romania and Russia, he added.

LaSalle's global strategy "hasn't shifted materially," said Gries. "We're constantly updating our strategy and pivoting where we see fit, whether it be by region or product type or risk profile."

For example, the company is "much more opportunistic in Asia" and "more defensive in Europe," with "a pretty good balance here the U.S."

Of the company's $60 billion in assets under management, $18 billion is in the U.S., with $1.7 billion of that amount in Chicago. "Relative to benchmarks…we are probably more bullish on Chicago than many investors globally. There is some bearishness globally as it relates to just how Chicago is positioned, partly due to supply concerns, partly the fiscal situation in Illinois and real estate taxes."

Panelists also addressed the state of the Chicago market over the past several years, compared with the major 1970s-1980s era trend in apartment conversions to condominiums.

While there have been no conversions in recent years, "there will be conversions in the future," said Golub. But I don't really know when. I thought it would happen by now, but it's a function of a change in how people look at owning versus renting."

One significant difference for making a property purchase is the amount of deposit required today (20 to 30 percent, at least) compared with a generation ago (10 percent), Golub said.

De-conversions, meanwhile, are "an uphill battle," he added, especially if you do not have a large proportion of investor units because you need 75-percent approval by a condo association in order to de-convert. "If the (condo) board doesn't have control of that, you're fighting an uphill battle. It's just not worth it."

There are exceptions, however, including a $60 million transaction that Golub reached in the 292-unit Century Tower building at Lake and Wells in Chicago.

"It's a concept that is certainly here because the value of the rental market is so high---it's a complete 180 (degrees) from 15 years ago, from 20 years ago when condos were so much more valuable than renting," Golub said.

Other condo projects in the Golub pipeline include a smaller boutique project at North Avenue and Clark Street, and, in partnership with institutional investor CIM Group, [a re-purposing of the Tribune Tower on Michigan Avenue].

To be fiscally viable for the developer, the condo units must command prices in the $900 to $1,000-per-square foot range, said Golub. Another key shift is the imperative for developers to be able to build "on spec."

"Today the pre-sale concept is a difficult one for the purchasers," Golub elaborated. "If you're able to go spec, you're going to have a lot more success. People still are leery of developers who announce projects who might not have the financial backing to pull it off."

Within the industrial market, Gries said LaSalle historically has targeted submarkets "that are fueled by the most velocity from a tenant demand standpoint." Regionally, that has equated to the O'Hare and I-55 corridor markets.

O'Hare "is still running strong," but I-55, "at least from a leasing demand standpoint, has cooled off a little bit," Gries added. "There's still exceptional investment demand for both of those submarkets. Cap rates are still very low, there are still investors willing to buy."

Debt markets were also explored, with Bloom noting that mezzanine lenders have "come down hundreds of basis points recently" and "as a borrower, we are re-financing everything that we can that's floating…we're seeing the debt lenders trip over themselves to lend" because "their volume is down significantly."

Echoing her remarks, Golub said "debt markets are extremely hot right now…you can get unbelievable deals."

"We never want to do a CMBS deal we don't have to, because we've been around long enough to know the only thing you can predict in real estate is that it's a cycle: it's going to go up and it's going to go down," Golub continued. "If you're on the down side of the CMBS market in a debit structure, it really sucks."

The value of "having someone to talk to if things go bad" is significant, he noted. "When we talk to our institutional partners about debt, we try to get the least expensive money we can with someone we can look at across the table who will be there."

As for which neighborhood in the city has the most potential for development growth, Golub said, "I believe the only place for super growth to happen is South Loop."

He also pointed to Lincoln Yards, the 70-acre riverfront setting between Lincoln Park and Bucktown, as having potential. However, for that location he has "questions of infrastructure, ease of getting around. I've always felt I want to be in places where it's easy to get around."

Panelists were mostly pessimistic on whether Cook County real estate taxes have stabilized or "worse is yet to come," as McAuliffe phrased it.

Gries offered only "I really hope that they are stable," while Golub and Bloom predicted that "worse is yet to come." Bloom added, however, that in speaking with tax consultants, she learned that if a property's real estate taxes are "approaching 25 percent of your effective gross income, then maybe (the taxes) are actually stable."

In terms of rent growth, Bloom and Golub believe the suburban market will be the most likely area to outperform the rest of the market, while Gries foresees Fulton Market outpacing neighboring areas.

Panelists also offered a variety of views on which product type presented the most opportunity in the area, ranging from condominiums (Golub) to the O'Hare industrial market (Gries) to single-family homes for rent in the suburbs (Bloom).

Later, during a question-and-answer period with the audience, Bloom expanded on her bullish view of single-family home rentals.

The increased difficulty of obtaining mortgages, along with the chilling effect of seeing parents and older colleagues losing money on home ownership, will steer a significant share of Millennials toward renting in the suburbs, she said.

Panelists fielded several other inquiries from attendees, including one about the merits of different potential Chicago locations that are part of the city's bid to woo Amazon HQ2. The city is on the shortlist of 20 North American municipalities to become the home to the ecommerce titan's second corporate headquarters.

While noting that the city's high percentage of highly educated people is "a compelling stat," Bloom said she believes Amazon will locate HQ2 in Atlanta.

"My opinion is they're not coming here," said Bloom. "I spent so much time in Atlanta and other growth markets. For me, it's hard to imagine they're not going to go to one of those growth markets."

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