View from the Middle

BY ROBERT BACH, CRE; AND SIMONE SCHUPPAN

IN MANY WAYS, CHICAGO PRESENTS a microcosm of commercial real estate market conditions in the United States. It's a large, vibrant market temporarily laid low by the credit crisis and the recession. There are few signs of a recovery despite the more upbeat tone of recent economic indicators because tenant demand for most types of commercial real estate tends to lag job growth, which itself lags the broader economy. Signs of a market recovery are likely to show up first in more volatile, technology-driven markets such as the San Francisco Bay area or Austin before they show up in Chicago, whose recovery profile is likely to emulate the national average. Market conditions are expected to soften further in 2010 before embarking on a recovery beginning in 2011. Here is a summary of recent market conditions in Chicago and our outlook for 2010.

OFFICE MARKET

Two years after the start of the Great Recession, the office vacancy rate broke the 20 percent ceiling at year-end 2009, the highest since Grubb & Ellis began tracking the local market in 1985. Job losses and company consolidations led to more than 3.8 million square feet of negative net absorption in 2009. "Zombie buildings" are becoming a new phenomenon. These are buildings with available space that cannot fund competitive tenant improvements because of their highly leveraged loans and deteriorating cash flows. A surprising side effect could be a tighter market for tenants amidst a

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shrinking pool of buildings with the tenant improvement dollars to compete for deals.

Unlike the early 1990s' softening cycle, the current challenge is a lack of demand, not an overabundance of new supply. In the Chicago central business district, only the 800,000-square-foot Blue Cross Blue Shield building expansion is under construction, while the 160,000-square-foot 555 Corporate Center in Lincolnshire and the 105,000-square-foot Cisco building in Rosemont are the only major construction projects underway in the suburbs. Three high-rises, with a total of 3.8 million square feet, were added to the downtown inventory in 2009. They are 80 percent leased, but their tenants vacated other space that now stands unoccupied. United Airlines announced the relocation of its headquarters from the suburbs, taking 450,000 square feet of former Ernst & Young space at the Willis Tower (formerly called Sears Tower). This relieved the central business district of a large block of space.

The Chicago area has lost approximately 95,000 office-related jobs since the third quarter of 2008. Comparing this number to the increase in vacant space leads to an estimated shadow vacancy of about five million square feet, which will require at least two years of strong growth to absorb. As the economy starts to improve, companies will fill up this shadow space before making new space commitments. The only industry sectors in the area currently adding jobs are education, pharmaceuticals and government.

In 2010, many tenants will not be in a position to take advantage of the market. They are still reeling from uncertainty in their own businesses. The few tenants that are looking for new space or are renegotiating their leases may have an additional party join them at the negotiating table—the lender. Many leases now must be approved by the lender backing the mortgage of the building. This can hold up transactions significantly, which is something all parties need to consider before commencing lease negotiations.

Concession packages are changing in the Chicago area. In the past, when tenant demand slowed, landlords would offer tenants incentives as a reason to commit to their building. In the current economy, tenants need even more persuasion to embark on the cost-intensive adventure of relocation. However, cash-strapped landlords are unable to afford the generous tenant improvements that tenants have become accustomed to in recent years. One alternative being considered today is for the tenant to pick up some of the build-out cost in return for some additional rent abatement. Another option for tenants is previously occupied space where suitable improvements may already be in place. Some landlords are starting to offer incentives that are spread over the term of the lease rather than at the beginning. With rental rates decreasing, most landlords are not interested in early renewal negotiations with tenants whose leases expire beyond 2012. At the other extreme, some landlords may be unwilling to offer any concessions, since they are unsure if they will still own the building in one or two years. They will not want to invest in the property if they are about to lose it.

For the coming one to two years the Chicago office market still will be dominated by declining fundamentals and slow demand due to minimal job growth. Overall asking rental rates, which have decreased by only three percent since their peak in 2007, are expected to decline an additional seven to 10 percent in 2010. Expect the central business district to fare better than the suburbs.

INDUSTRIAL MARKET

Lease rates have been falling since the first quarter of 2008, dropping by five percent in 2009. They are expected to remain soft but not decline much further as negative absorption levels are easing while transaction volume is stable. Absorption could turn positive by the end of 2010.

Tenants continue to have the upper hand in lease negotiations. Landlords who can afford to do so are trying to entice occupants by offering increased rent abatement, concessions and aggressive lease rates. Some landlords have even dropped rental rates to below one dollar per square foot as an initial teaser rate to attract tenants. While many tenants are on the fence, third-party logistics (3PL) companies have

been executing transactions as they are forced to adhere to contracts signed one to two years prior. Many 3PL deals have been completed in the Central Will County and Interstate-55 Corridor submarkets. Exel Logistics took over 590,000 square feet at the beginning of 2009 in Bolingbrook, while Alliance 3PL leased more than 415,000 square feet at CenterPoint's intermodal facility in Elwood.

Fewer than two million square feet of industrial product is currently under construction. Speculative construction starts will be rare in the next few quarters, and build-to-suit projects will drive what little construction there is. An example of this trend can be seen in the local food industry with recent build-to-suits completed for Central Grocers, Affiliated Foods Midwest, Gordon Foods and Bay Valley Foods. Some cities are offering incentives for new build-to-suits. To attract Freudenberg Household Products, a cleaning and laundry products manufacturer, the city of Aurora granted a seven-year tax rebate capped at $1.55 million and waived 75 percent of the building permit fees for the company's new 525,000-square-foot build-to-suit project.

Property taxes have a significant impact on commercial real estate and can be one of the top expenses for property owners and tenants. In 2009, Cook County implemented a 4.2 percent tax hike for suburban property owners and a six percent increase for those within the city of Chicago. But available tax incentives can help to offset some of this increase. Lacava, a luxury bathroom design and manufacturing company, qualified for a Class 6B tax incentive that will enable the company to reduce its property taxes by half over the course of the next decade. Lacava purchased an 80,000-square-foot building on Chicago's northwest side for half the price at which it was marketed in 2006.

Rail and intermodal traffic are expected to increase over the next several years because rail offers lower costs and a smaller carbon footprint, which has become an important issue for users and municipalities. Burlington Northern Santa Fe (BNSF), recently acquired by legendary investor Warren Buffett, is the nation's second largest railroad and a leader in Chicago's freight rail industry. Chicago serves as BNSF's eastern end point for its western U.S. routes.

The Chicago industrial market is expected to show initial signs of recovery in the second half of 2010, but the recovery will be slow. What demand there is will come from owner/users and from government incentives.

RETAIL MARKET

The vacancy rate for Chicago-area retail properties soared to more than 10 percent by year-end 2009, the highest level in a decade. The construction pipeline continued to deliver space begun when the market was more promising, churning out brand-new, barely-occupied strip centers and mixed-use developments. Rental rates declined further as a result of the rapidly rising vacancy rate—a trend that will continue in 2010.

Nationally, retail sales are showing signs of firming, but Chicago will see more retailers downsize or close in 2010. Banks will continue to struggle with retail development projects such as 108 N. State Street, the former Block 37, which went into receivership at the end of 2009. Continuing a trend seen in 2009, more of the independent start-ups and boutiques that sprang up in the boom years will close. For example, in Lincoln Park, one of Chicago's wealthiest neighborhoods, more than 20 stores have already ceased operations or moved to less expensive areas. Some of the stores, including Fresh or Faux, Moonlight Graham, Entendre Couture and Ethel's Chocolate Lounge, have closed, while She Boutique moved to north suburban Highland Park. A number of mini-malls across the Chicago area sit largely vacant with only one or two stores occupied, and many of these projects are already in foreclosure.

By contrast, some grocers are taking advantage of empty shopping centers, low rates and landlord incentives. Dominick's, Whole Foods and Jewel are being wooed by landlords to anchor troubled centers.

As a result of the collapse of new housing starts, particularly in the outlying suburbs, many new retail centers have not been able to generate sufficient traffic. Instead, older shopping centers closer to

Chicago are becoming more attractive to retailers. Tenants in a position to relocate or expand can get bargain-priced space in premier locations, which would not have been possible during boom times.

No new, large-scale retail developments are planned in the near future. For example, developer OliverMcMillan LLC aims to sell a 64-acre parcel in far-northwest suburban Lindenhurst, scrapping plans for an open-air lifestyle center called Lindenhurst Village Green. The company had intended to build up to 600,000 square feet of retail space at the undeveloped site near State Route 45 and Grand Avenue.

While few new developments are in the works, there are some exceptions, most notably Walmart and Costco. Walmart announced in October 2009 that it purchased land in Rochelle for a new Walmart Supercenter. Likewise, Costco has announced that it will acquire the former Kiddieland property located at the corner of North and First avenues in suburban Melrose Park, where it plans to build one of its warehouse membership clubs.

In 2010, consumers will look for value and quality, and are unlikely to buy unless the price is right. In a similar vein, stronger retailers will look for rental rate bargains in premier locations and will hold out until they get what they want.

INVESTMENT MARKET

Investment transaction volume in the Chicago area hit an all-time low in 2009. About 120 properties traded for a total of just under $2 billion compared to a recent peak of 716 properties valued at $22.2 billion in 2007, according to Real Capital Analytics, Inc. Owners of well-leased properties with good credit tenants who are able to pay their mortgages are holding on to their assets. Only owners who really must sell will put their building or portfolio on the market.

Office: Although prices have dropped by 30 percent or more, it is not necessarily a buyer's market since rents and tenant demand continue to slip. Landlords dealing with loan maturities and low tenancies will capitulate in 2010, which will create more sales comparables and therefore more pricing clarity. Well-capitalized buildings with low vacancy rates and a stable tenant base will have the best chance to trade or receive financing through banks and other lenders. Equity capital is becoming very impatient—investors that have already raised money need to start placing it. This new and still subtle sense of urgency is a major change from 2009, when people were holding tight. The challenge will be finding assets that are performing and that owners will be willing to sell.

Industrial: Investment activity in the Chicago industrial market is expected to remain soft in 2010. Institutional buyers are still scarce and very selective although UP-REITs, which function similarly to 1031-tax exchanges, are starting to gain momentum in the industrial sector. Acquiring an investment portfolio of newer and mostly leased buildings in the Chicago area has been difficult. However, it is not impossible, as seen in the case of TA Associates' purchase of a five-building investment portfolio in 2009. The 392,000-square-foot portfolio was 95 percent leased and sold on an all-cash basis for more than $21 million. This deal could be a first sign of a slow recovery for the investment sales market. Sale-leaseback deals continue to gain momentum as companies are seeing the value in redirecting capital once locked in real estate into other aspects of their business. Many of these transactions include long-term lease deals, providing an attractive option for investors.

Retail: With many retailers having gone out of business during the past two years, retail investors are extremely focused on tenant creditworthiness. Potential investors are marking down rental rates even for retailers that are doing well. Fewer than 30 properties sold in 2009 compared to 133 in 2007. Activity is expected to pick up slightly in 2010, but more for troubled assets than trophy properties. Currently almost 10 million square feet of retail space in the Chicago area is in distress, with much of the distress in Cook County because of its 10 percent sales tax and high parking meter rates.

Apartments: In the record-breaking year of 2007, apartment properties valued at more than $2.9

billion sold in the Chicago area. By comparison, the numbers in 2009 reached just 10 percent of this amount. Mainly weak properties sold, driving the average property value to $16 million, or half the average value seen in 2007. Apartments are still seen as the most resilient of the major property types, but the mindset of investors has changed. During the boom, the focus was on high leverage and a well-timed exit strategy because the profit was to be made when the property was flipped—the sooner the better. Now, investors must deal with lower loan-to-value mortgages and tighter underwriting standards and, consequently, they are focused more on first-year cash yields. Downtown Chicago is dealing with a glut of apartments being completed along with a number of condominium projects that will be leased. In the suburbs, demand for apartments has fallen significantly due in part to the relocation of some employers to the city, the most notable being United Airlines. Suburban investors are likely to target properties close to Chicago or located near major thoroughfares and public transportation. Rental rates will decrease further through most of 2010 as landlords attempt to boost occupancy. ■