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The Real Estate Center

2019
MID-YEAR PERSPECTIVE ON CHICAGO REAL ESTATE MARKETS

Intensity of CRE Convictions Are Changing

Sustaining Sponsors of The Real Estate Center at DePaul University (The Real Estate Center) and members of the DePaul Real Estate Alumni Alliance (DREAA) continue to find strength in the Chicago real estate market. However, the intensity of their convictions is changing.

While various national economic factors are shaping the perceptions of the markets, state and local taxing uncertainties–property tax, transfer tax and progressive tax–along with the unproven records of newly elected officials are weighing heavy on the minds of commercial real estate professionals in Chicago. As experts are quick to comment, one thing investors dislike as much as anything else is uncertainty.

According to the second annual Chicago Mid-Year CRE Sentiment Report produced by The Real Estate Center at DePaul University, approximately 52 percent of participants characterized the market for the first half of 2019 as consistently strong. That number was 69.8 percent one year ago.

Other findings of The Real Estate Center's Mid-Year CRE Sentiment Report include:

- A slight drop off, from 31 to 29 percent, in the CRE professionals who are bullish on the markets but a substantial increase, from 4 percent to 20 percent, in those feeling bearish.
- 97 percent of participants say state and local financial/government issues–from the pension/financial crisis to property tax concerns–are impacting the markets in Chicago. At the same time, most conclude that it is too soon to rate the impact a new Governor and Cook County Assessor are having on the commercial real estate industry.
- The national factors that are influencing perceptions and could have impact on the markets in the future include trade wars/tariffs, the potential for a slowdown in corporate growth rates and the interest rate environment.
- Mirroring other parts of the country, survey participants find industrial and multifamily assets to be the most attractive while identifying retail and suburban office properties as the least attractive.

"In general, CRE professionals in Chicago want to be optimistic that there is plenty of strength and momentum left to keep the cycle moving positively forward," said Charles Wurtzebach, Chair, Department of Real Estate and Douglas & Cynthia Crocker Endowed Director, the Real Estate Center, DePaul University. "Yet there are concerns and obstacles that can't be overlooked; it is impacting market sentiment." ■

Chicago: Consistently Strong But Weakness Gaining Strength

Beauty and the strength of the Chicago real estate marketplace both are in the eye of the beholder. Underscoring the results of the survey, experts interviewed for the Chicago Market Mid-Year Sentiment Report had varied opinions about the relative strength of the market.

Brian Rogan, Vice President and Senior Private Banker, Wells Fargo, characterizes the overall Chicago market as strong and healthy. He pointed to increasing values, the abundance of debt capital available and good activity levels across virtually all property sectors.

"I think it is going to continue, barring any big, fundamental economic crisis," Rogan said. "My long-term view remains positive for current owners and future developers."

Well over half of the participants—62 percent—noted that the Chicago real estate market is either consistently strong or strengthening.

"There is strength in the market, and growth. Leasing activity is strong, concessions are manageable and owners can be more proactive," says Michael Newman, President and CEO, Golub & Company. "Attitudes are generally positive, but they can get and do get tempered when various other factors specific to the city, the county or the state get factored in."

son, a Managing Director at Hines, agree that some companies are coming from the coastal markets because of the talent pool and the comparatively lower cost basis Chicago has to offer.

"We've seen the volume of activity remain consistent; and consistency is a good thing," said Jennifer Rench, Vice President, Executive Account Manager, Chicago Title Insurance Company. "But the transactions appear to be more complicated, to have more pieces and/or partners, which means it is taking longer to get deals closed."

As strong as the opinions of the market may be, the concerns for the market—most of them tax related—are getting stronger and stronger. An increase in income taxes through Governor Pritzker's graduated income tax will impact the ability to recruit business and talent to Chicago, something that has been characterized as very successful during Mayor Emanuel's time as Mayor.

While just over 60 percent of those surveyed see strength in the market, almost 40 percent characterize the market as weakening; a number that is twice the level of 2018.

Additional concerns, prevalent in both the downtown office and in pockets within the suburban industrial market, is the level of speculative development taking place.

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> Occupier Specialist, CBRE

Newman also said he sees more product offerings being brought to market after a slow period at the end of 2018.

"There is a lot of good momentum. Even with the city's financial concerns and the reassessment, there is still positive momentum," Justin Hucek, Occupier Specialist, CBRE, said.

Hucek stated that absorption of space in the downtown office is at the highest level since 2016, the result of companies moving to Chicago and others adding more space. Co-working companies and tech firms are driving activity. Hucek and Brian Atkin-

"There are some concerns becase the space is not pre-leased and is being marketed at a rental rate that is higher than a typical Fulton Market rents," Atkinson said. "The question is how does it impact the momentum of that market, and what is the trickle-down effect in the CBD?"

Hucek agreed with Atkinson in the impact the delivery of new construction could have on the marketplace. "Chicago has absorbed much of the new product to date, but with new deliveries in 2019, '20 and '21, the question is -- will the market keep up?" Hucek said. ■

Taxes Are Taxing Real Estate Opportunities

Almost 98 percent of survey participants say that local issues—the financial position, property tax and transfer tax increases and the potential implementation of a progressive income tax—are having an impact on real estate activity in the Chicago area.

Of the 98 percent, 70.8 percent say those issues are hurting activity; 27.1 percent the impact has been at least nominal. Only 2.1 percent say it has had no impact at all.

According to participants, the impact is being seen on various levels. Many note that institutional investors and those not as aware of or comfortable with the local dynamics likely will not consider acquisitions in Chicago. If they do, it will only be after careful and intense scrutiny.

For example, an out of state pension advisor, commenting on the recent announcement of the offering of a seven-building, 1.2 million square-foot downtown office portfolio questioned what prospective owner would be comfortable acquiring the entire portfolio with the significant and uncertain tax liability looming over the properties.

Atkinson believes that the lack of clarity of the tax situation, both personal and property taxes, will create a level of uncertainty for the next three to five years. "That uncertainty and the presumption of costs could be problematic, in terms of users and owners executing their respective strategies," he added.

He said that both tenants and owners are asking 'what does that mean to me?', adding that the answers aren't as predictable as they once were.

Others, like Newman, believe that the predisposition of local and state government to raise or create new taxes comes across as a movement against entrepreneurship and value creation. In the long run that approach to solve government crises may lead to instability.

"We're unique in Illinois, and in Cook County, because of lingering financial issues," said Shane Garrison, Chief Operating and Chief Investment officer, RPAI, said. "It is a significant structural problem."

Garrison suggested that if Chicago was one of 20 potential markets for acquisitions on a long-term basis, almost all of them are more appealing than the Chicago area. He cited three factors leading to that conclusion: the potential for a progressive income tax, an increasingly inordinate property tax burden and the potential in the multifamily sector for rent control measures.

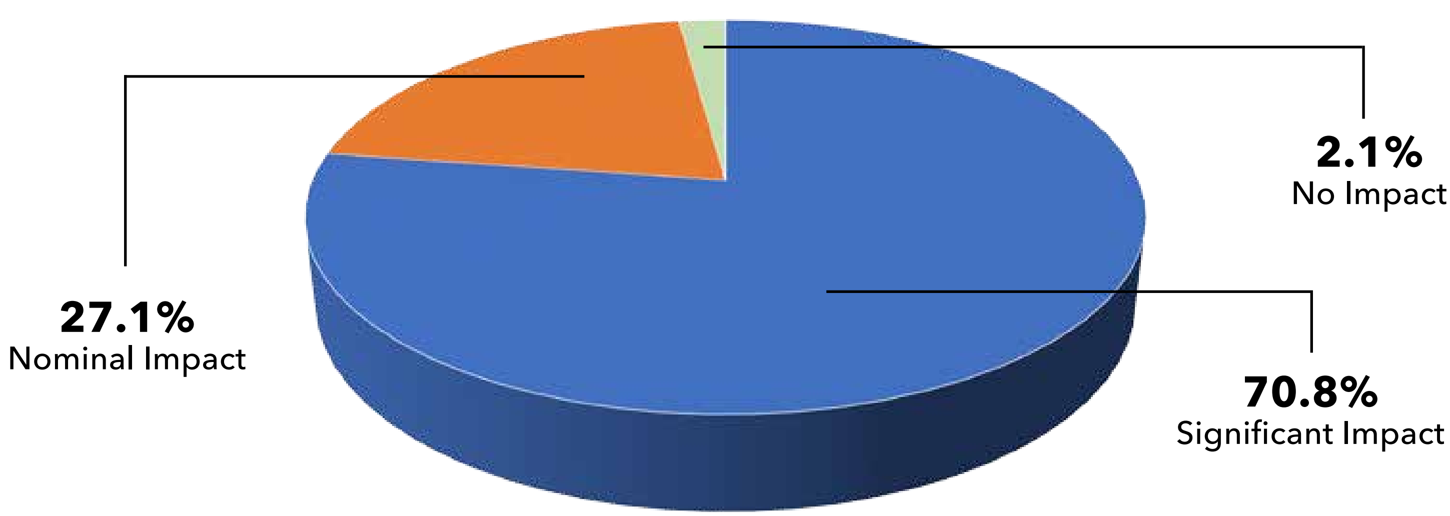
"When you combine those factors with negative population growth, it is very difficult to come up with a compelling investment thesis to come and invest capital here," he said.

Others are concerned that the newly proposed progressive tax plan would hurt the ability of the City and the State to attract dynamic organizations that are engaged in national searches for new headquarters or regional office locations.

Rench believes that the pace of transactions will quicken the closer we get to the end of the year. "People generally feel like there is time now, with no driving force or sense of urgency," she adds.

In summing up the financial and political issues prevalent throughout Illinois, Newman said, "You can't tax yourself out of problems. It's not a good equation." ■

Local Tax Issues Impact on Real Estate Activity

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Plenty of Bears Joining the Bulls at Play

In 2018 Chicago sports fans welcomed the resurgence of the Chicago Bears, a team that had been on the cusp of making a comeback over the last number of years.

The bears are back in even greater force in Chicago's real estate community. Those with bear market beliefs increased the most substantially in 2019, to 17.7 percent, from only 3.9 percent last year. Almost 30 percent (27.5 percent) of participants continue to be bullish about Chicago's real estate markets for the balance of 2019.

At the mid-point of 2019, 45.1 percent—nearly the same as last year—say they are neither bullish nor bearish but trending toward concerned. Yet the number trending toward optimistic also changed rather dramatically, to 9.8 percent in 2019, from 21.2 percent in 2018.

Atkinson acknowledged being an optimist. He suggested his optimism is we'll-founded because regardless its issues, Chicago is still a great place to do business.

"It is a robust market," he said. "If you believe in Chicago, and I do, then you can get comfortable will some of the risks and uncertainties associated with owning a building or making a significant space commitment here."

On the outlook scale, Hucek considers himself to be just right of center, leaning toward bullish.

At least for the balance of the year, Hucek expects the trajectory of activity to continue, while echoing that a lot of factors could change the dynamics. Over the longer term, Hucek along with others pointed to national factors such as the tariffs and trade wars out of Washington along with the area's long list of local factors that will play an important role in shaping activity.

"Chicago is still a great place to live relative to the coastal markets given its affordability. That will continue to drive growth and expansion as companies and investors want to have Chicago in their portfolios," Hucek added.

"I think we are cautiously optimistic," Rench says. "No one is negative or nervous about market indicators taking a dramatic turn. We're simply being realistic about where we are in the cycle, and the opportunities ahead."

Newman talks frequently with buyers, sellers and potential partners about prospective deals. He said that when discussions turn to opportunities in Chicago there often is some hesitation with investors questioning whether it is a smart time to come to Chicago.

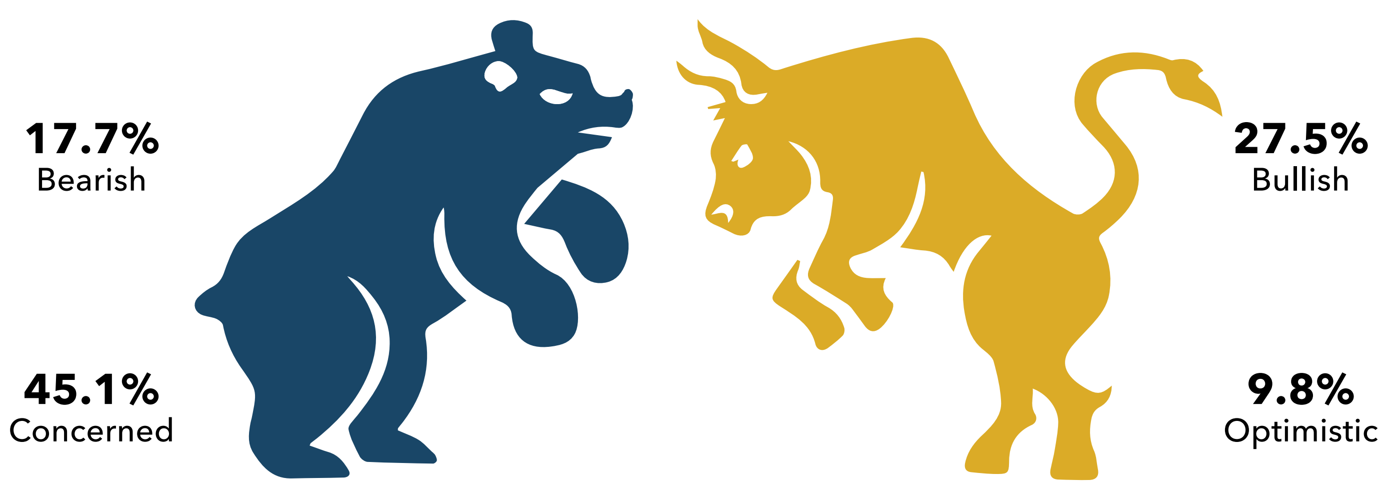
Still, Newman counts himself as a concerned optimist. "We're here and have been for 60 years," Newman said. "We remain bullish on Chicago through the various scenarios and challenging times," adding that some of the challenging political climate is not a new story in Chicago.

Rogan took a more middle ground approach saying he isn't bullish or bearish on the market.

"A bearish outcome may be coming, but nothing points to that in the near term. Activity should remain strong; it may not exceed peak levels, but it will continue," Rogan said.

Somewhat linked to the bullishness investors have on the market, Newman suggested it will be interesting to see the dynamics between bid and asking prices. "The question remains whether there will be enough trading taking place for people to feel good about pricing," Newman said.

Market Expectations in the Second Half of 2019

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National Factors Impacting Activity

Last year at mid-year there was widespread uncertainty about future interest rate movement. Rates had already had several bumps higher, more were expected and the outlook for 2019 wasn't clear. As a result, the interest rate environment was the greatest concern of more than half the participants, 51.9 percent.

While there is greater clarity to the interest rate picture since the end of the year, it remains the greatest economic factor causing concern in 2019, according to 34.7 percent.

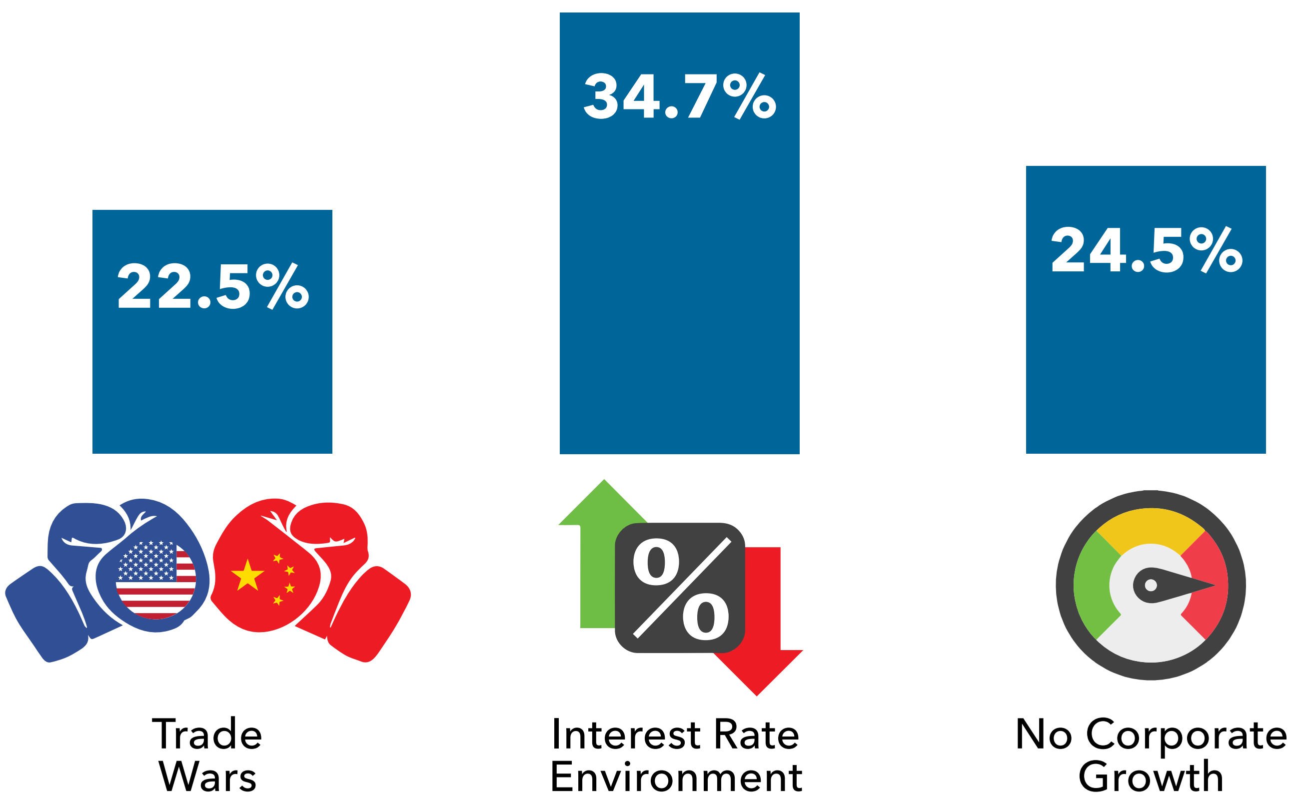
The potential for trade wars was identified as the third greatest concern among survey participants. It is important to consider, however, that in spite of ranking third at 22.5 percent, the concern has doubled in prominence from last year.

Editor's note, just before the survey was closed, new tariffs were announced against China and retaliatory tariffs were announced by China against the United States.

According to the 2019 Mid-Year Sentiment Report, the second greatest concern is the lack of corporate growth, a concern that may have been mitigated, for the time being at least, by the recently announced First Quarter Advance GDP number of 3.2 percent. At the same time, it is unknown at this time the effect that a prolonged trade war with China could have on growth in the United States.

One participant in the survey wrote that the porridge is not too hot or too cold, as if to indicate that no single economic concern is too great or alarming at this point in time. The real estate professional further expressed, "Trade wars are transitory, interest rates will stay low for the foreseeable future and low volatility is always lurking near the scene of the disaster." ■

Greatest Areas of Concern Impacting Activity

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Most Attractive Assets

In identifying which asset classes are the most attractive, the Chicago area follows national stories and trendlines where industrial property is seen as one of if not the most attractive property type.

Participants are in agreement that the industrial markets have continued to experience strong demand and leasing activity, particularly for food users and those requiring last mile facilities.

An interesting angle to the Mid-Year Report is that participants seemed to have either a very positive or rather negative outlook on the attractiveness of industrial assets. Almost 61 percent of participants ranked industrial as most attractive while 26 percent viewed it as the least attractive, perhaps sensing the market has reached its peak. There are certain markets, where spec development of big-box warehouses has reached a peak but the demand for that space yet to lead to significant absorption.

Multifamily assets were the second most attractive, followed closely by downtown office properties, in spite of the response that apartment sale pricing appears to be showing some signs of weakening.

Rogan for one believes multifamily investments will remain the most attractive, both downtown and in the suburban markets. Across virtually all property sectors he sees markets as industrial and downtown office property cap rates continue to compress, the appetite for suburban office properties will gain momentum because of an attractive, risk-adjusted return that often carries a 200 to 300 bps spread.

While retail properties generally are the least attractive asset class in Chicago, from a lending perspective, most capital sources still rank grocery and necessity urban infill retail as one of the top investment categories.

Larger, class A, strong sale and diverse, luxury brand retail is also in demand. Other retail (big box, enclosed mall) tends to see more conservative capital markets execution, but we have seen some increased activity from buyers who are attracted to higher equity yields.

Garrison said RPAI isn't looking for any new investment opportunities in the metro areas because of the uncertainty and the fact that Garrison says it is hard to allocate funds to Chicago on a risk adjusted basis. This is in contrast, Garrison says, to markets like Dallas, Washington, D.C. and New York, among others.

Instead, the company's focus is centered on executing management and leasing plans for properties already in their Illinois portfolio. For Garrison and RPAI, the greatest opportunities arise from not being limited to a center's existing configuration.

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>
> **Shane Garrison**
> Chief Operating & Investment Officer, RPAI

or pockets within a market that are being impacted by supply and demand fluctuations.

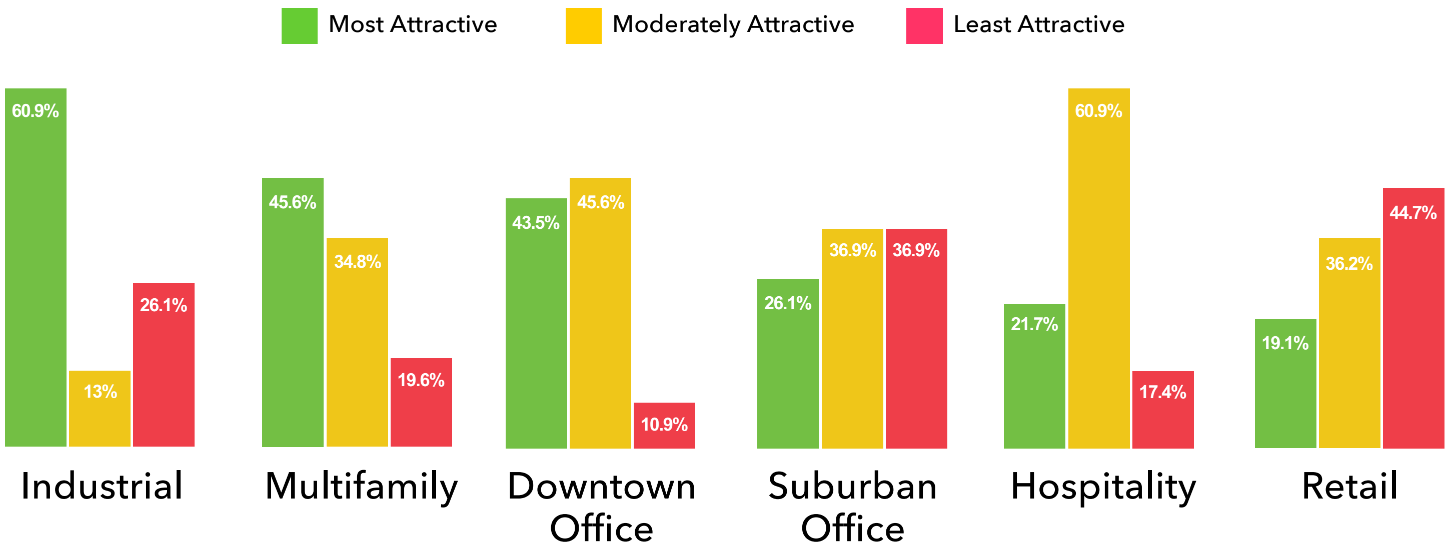
"The long-term view for current owners and future developers (in general) remains positive," Rogan said.

At the other end of the spectrum, retail followed by suburban office properties were rated as the least attractive investment classes. There are some in the industry who believe that

"We think it's important to invest in the underlying real estate—property whose metrics demonstrate the long-term potential to go vertical," Garrison said.

In that vein, RPAI invests in what it calls the edges. On one edge these are more convenience-oriented centers that include properties that have extreme population density but lower incomes and a tenant roster where consumers get in and get out. This contrasts with the other edge where there is a higher

A Closer Look at the Most Attractive Property Types



density of income and educated consumers—the experiential centers where shoppers will be more leisurely in their visit.

"If you have a retail allocation that needs to be met, you are seeing fewer great assets to acquire to reach that allocations," Garrison said. "For now, and understandably so, we are seeing extended hold periods for good assets."

The shifting sentiment on the outlook for the Chicago real estate markets offers a variety of different viewpoints. While fundamentals in general are sound and creating a position of strength, yet there is a level of uncertainty that exists, particularly in the City and Cook County.

With the existence, to a certain degree of a bid/ask spread between buyers/sellers that has widened and may be making it more challenging, Newman also said that some owners, like Golub, may be more inclined to refinance properties rather than marketing them for sale.

"Uncertainty is very problematic when you are trying to create value, bring jobs and clean up an area," Newman said. "The property tax situation along with the changing dynamics of the City's stance on development is creating uncertainty for owners and developers."

Newman said that as an investor you need to know how to underwrite the uncertainty, but as a seller you can pursue other options, like refinancing. "In the end, it causes the markets to pause," Newman said.

When putting the attractiveness of Chicago real estate in perspective, most experts agree that outside investors have to account for the unknown, which in this case is property taxes.

Rogan noted that property taxes alone won't cripple the ability for an investment transaction to get done. "Yes, property taxes aren't going away and you have to get comfortable with the prospects of change," Rogan said. "But at the same time, local investors could be comfortable with the property tax situation but determine that asset prices have reached the top of the market and forgo a transaction." ■

Conclusion

"This is an unprecedented political climate with the recent elections of a new Governor, Mayor, Cook County Assessor as well as a number of new aldermen to the City Council," said Wurtzebach.

"Most everyone supports the new Assessor's emphasis on transparency and hopes Lori Lightfoot will continue the momentum Mayor Emanuel established. But there is widespread agreement that meaningful change takes time and can at times be painful."

Like others, Atkinson agrees it is too soon to gauge the effectiveness of newly elected officials like Pritzker, Kaegi and Lightfoot, yet he believes their positions and platforms—particularly for Pritzker and Lightfoot—will be a strong advocates for business.

"From an economic standpoint, we need cheerleaders for the city. Emanuel was a great cheerleader, and the hope for the future is that others also will be great advocates," he added. ■

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- Michael Newman, President and CEO, Golub & Company
- Jennifer Rench, Vice President, Executive Account Manager, Chicago Title Insurance Company
- Brian Rogan, Vice President and Senior Private Banker, Wells Fargo

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