2022

MID-YEAR PERSPECTIVE ON CHICAGO REAL ESTATE MARKETS

DePaul University
DRIEHAUS COLLEGE OF BUSINESS
The Real Estate Center

ULI Chicago

HEADWINDS EMERGE IN THE WINDY CITY, YET ARE TEMPERED BY A LEVEL OF OPTIMISM

The Sentiment of the real estate community in Chicago in 2022 is very different than any of the five years The Real Estate Center at DePaul University has been producing this report.

Headwinds are gaining steam locally, nationally and internationally, as commercial real estate professionals are concerned about construction costs, labor issues, inflation, interest rates and speculation of a recession. While all these factors are taken seriously, there is a growing consensus that these too shall pass, just like the initial COVID concerns, the Great Financial Crisis and other notable, historical headwinds the market has experienced.

At the same time, there is less confidence that age-old Chicago issues—crime, the effectiveness of the local political system and Cook County property taxes—can be resolved quickly or easily, especially as these matters are also top of mind for investors and lenders.

Among the key findings of the 2022 Chicago Mid-Year Sentiment Report developed by The Real Estate Center at DePaul University and the Urban Land Institute Chicago District Council (DePaul – ULI Report) include:

- In looking to the balance of 2022, nearly 65% of commercial real estate professionals are "trending toward concern" (41.2%) or are bearish (23.7%) about Chicago's CRE markets.
- That dynamic changes when looking ahead to 2023 when those with an optimistic outlook (32.5%) narrowly beat out those who are concerned (28.1%), and an overall feeling of optimism (and bullishness) is greater than concern (and bearishness), 50.9% and 49.1%, respectively.
- Key matters of concern in the Chicago market, especially downtown, include crime and property tax uncertainty with people such as Lee Golub, Principal, Golub & Company perhaps best summarizing the issue by saying, its an important issue in Chicago and many other parts of the country, but something that is critically important to address quickly and thoughtfully.
- Along with an overwhelming belief (more than 62%) that the trajectory of downtown vacancy will increase through 2023, there continues to be widespread flexibility in return to the office requirements and the manner in which they are enforced.
- It is no surprise that the strongest perceived asset classes are industrial, data centers, suburban and downtown multifamily and self-storage assets. Property types most likely to face distress include enclosed malls, downtown and suburban office buildings and hotel/hospitality assets.
- While not a real estate-centric issue, more than 75% said their firms either have formal Diversity, Equity and Inclusion programs (48.7%) or have enacted policies to advance that very important initiative 28.8%.

According to experts, the greatest challenges that the Chicago market faces is the uncertainty that high profile issues generate. Many investors don't take kindly to uncertainty, whether acquiring assets or infusing capital into businesses.

In spite of it all, there are many professionals who are both realistic about the area's challenges and maintain a level of optimistic forward-thinking. "We are our own worst critics; familiarity breeds contempt," Mary Ludgin, Head of Global Investment Research, Heitman, said. She also recalled comments from one year ago when she said we are in the very early chapters of a long book—with an emphasis on long! (Think War and Peace.)

Rick Sinkuler, the Douglas and Cynthia Crocker Endowed Senior Managing Director of The Real Estate Center at DePaul noted that Chicago—it's people, its businesses and those who invest in its real estate—is resilient. "There is nothing that can be thrown at us that we cannot solve, as long as we put in the time to understand the issues, and work together to resolve them." ■

Photo by Doogie360

THE CHANGING NATURE OF GENERAL SENTIMENT

Real estate professionals generally have been an optimistic group when it comes to looking forward.

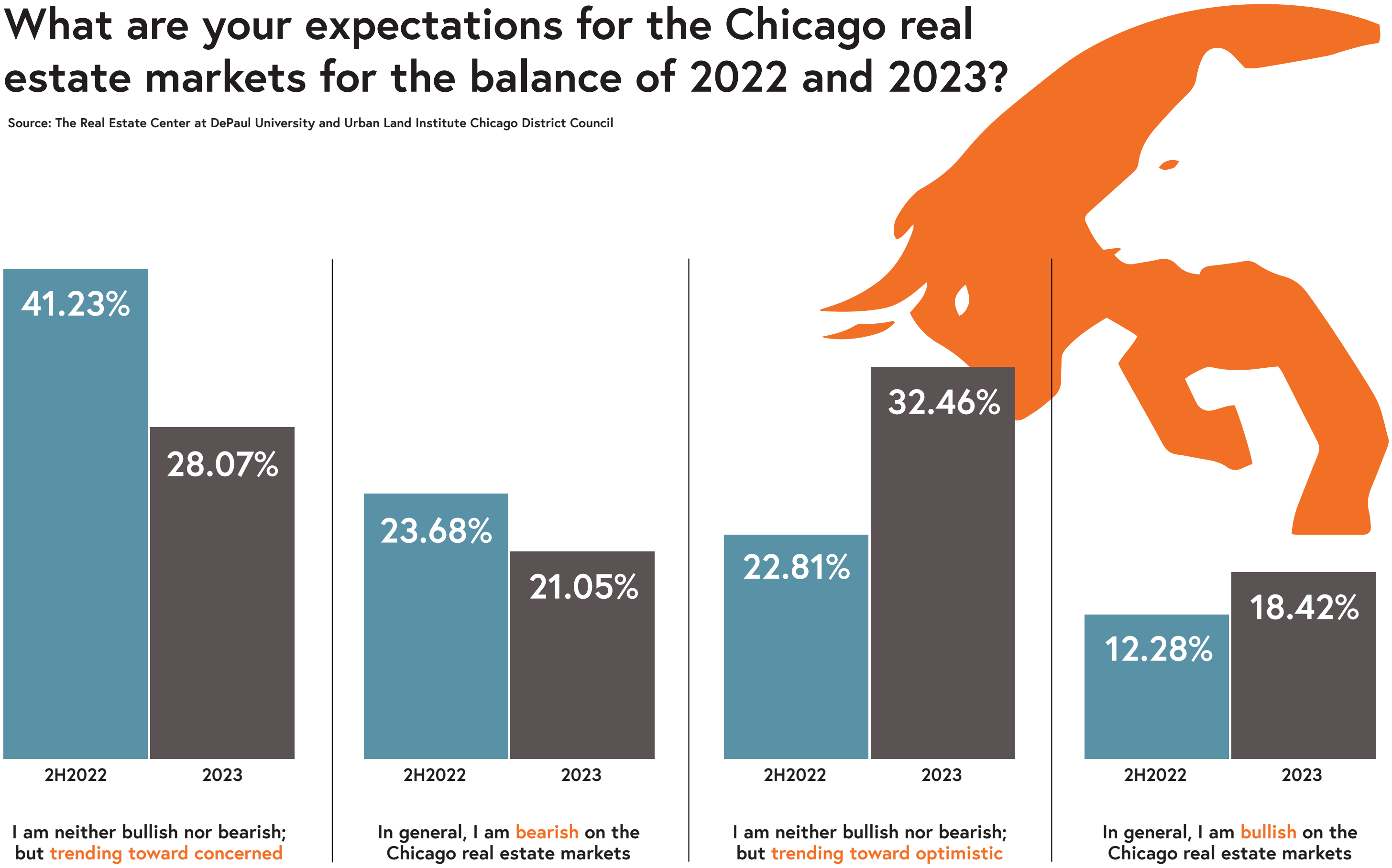
Yet after a year when there was so much optimism—the glass wasn't just half full, it was brimming—the outlook has hit a speed bump, based on the prevailing sentiment for the second half of 2022 and the long view for 2023.

According to the DePaul-ULI survey, more characterized themselves as trending toward concerned (41.2%) than in any other period measured by the Mid-Year Report. Combined, nearly 65% are either bearish or trending toward concerned, compared to 40% last year. The overall outlook for 2023, according to the survey, is mixed with the bulls and optimists (50.9%) narrowly beating out the bears and the concerned (49.1%).

A possible explanation for these results include that there has been so much to contend with in 2022—inflation, rising interest rates, supply chain issues and the war in Ukraine. While some of those issues were present before, the pandemic only exacerbated the challenges and continues to be a significant undercurrent.

What are your expectations for the Chicago real estate markets for the balance of 2022 and 2023?

Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council



Real estate professionals acknowledging today's various headwinds while assigning responsibility to the effect of a pandemic that lingers on. In written comments submitted as part of the survey one participant wrote, "We still haven't fully escaped the pandemic's impact. We're still waiting to see what transpires during the next 12-18 months."

Brian Atkinson, Managing Director, Hines, said, "Professionals and businesses will look back at actions being taken and say 'that was a Covid-based decision."

The cumulative effect of that has been to morph the optimism that was present one year ago into concern. For perspective, one year ago approximately 60% were bullish or at least optimistic about the market.

The more optimistic outlook for 2023 likely is the result of the prevailing attitude that in times some of the issues will be sorted out and resolved. This parallels a sentiment suggested by Charles Wurtzebach who in the 2021 report said, "We were dragged into the pandemic kicking and screaming and we want it to be over!" The same is likely true for the way people want to look at the market today.

Adding to the shifting sentiment are concerns that current economic conditions are laying the groundwork for a recession. Based on current conditions, Lee Golub is relatively certain that there will be a recession.

"If a recession does come, I am not sure how long or how deep it will be, but it is coming," he said.

Others like Michael Gold, COO, Pine Tree, agree in general with Golub, acknowledging that the potential for a recession is among their greatest concerns.

PROTECTING THE OFFICE ECOSYSTEM

One of the biggest topics for discussion is the return of the workforce to the office, even if on a hybrid basis. It's a complicated topic given Covid's pesky resilience and businesses trying to remain their competitive edge. In Chicago and across the US, we've already witnessed a number of false starts, where businesses planned to welcome employees back to the office only to have another strain of Covid emerge requiring a pause in plans.

"The big driver is implementing a hybrid work policy," said Lisa Konieczka, Executive Managing Director, CBRE. "The continued evolution of the pandemic has impacted the formalization of individual company policies."

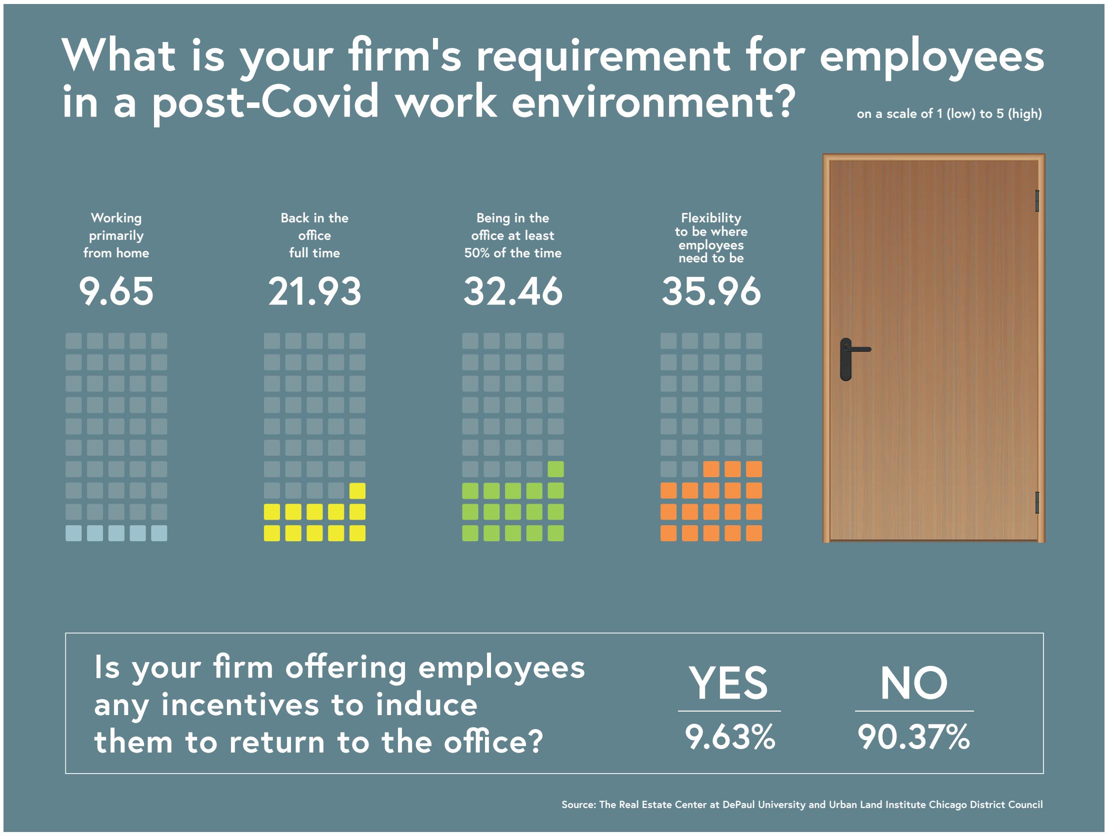
According to the DePaul-ULI Survey, businesses requirements for employees in a post-Covid work environment is varied, with 36% citing flexibility to be where they need to be to get the work done, 32.5% expected to be in the office half of the time and 21.9% saying back in the office full time.

At the same time, according to one written survey response, enforcement is an issue and/or inconsistent. "Employees are expected to be in the office three days a week, but at this stage it really isn't being enforced."

Hines' Brian Atkinson, who primarily markets space in downtown office buildings like Salesforce Tower, are eager for a workforce return downtown because of the broader commercial real estate and business community ecosystem. That ecosystem includes restaurants, sandwich shops, hotels, theaters, museums and the arts district.

"It's a larger mission and an ecosystem we need to protect," Atkinson said. "You feel the vibrancy when people are there. Right now that feeling isn't a sustained, Monday through Friday occurrence. But it is building."

Every week the occupancy rate, based on electronic monitoring the workforce entering buildings, continues to rise. The concentration of those going to the office seems to be centered primarily during the middle of the week: Tuesday, Wednesday and Thursday. Depending on the source, estimates range between 30 and 40 percent of people entering into buildings. That level puts Chicago at



a slightly lower level than a number of large cities.

The conflict in getting people back to the office pits the short-term advantages and benefits of convenience and flexibility against some of the long-term effects that may not be apparent now but could have significant consequences down the road.

Keith Largay, Senior Managing Director, JLL, believes there could be significant, long-term implications the longer employees stay away from the office and aren't part of a work environment that existed pre-Covid.

"Think forward 3, 5 or 10 years to what the labor pool looks like if they haven't made connections, been mentored and/or participated in person," he said. "I am skeptical about the people who don't go back and don't learn. What will that mean for their long-term career trajectory as well as company innovation and progress."

Ludgin suggests that one of the issues is that working from home has afforded conveniences, but in the process has built up some rust. "It's time to get the rust off. Senior leaders need to show up and be part of the lure to bring younger employees to the office. Junior staff need and thrive on the access to experienced professionals – the learning opportunities that come from proximity are critical to their growth," she said.

Steven Weinstock, First Vice President, Regional Manager and National Director of Self Storage Division, Marcus & Millichap, agrees with the idea that we need to get back to the office.

"We need to fully benefit from the collective experiences that exist in the traditional office setting," Weinstock said. "People need the spillover knowledge that comes when someone in a meeting says something that spurs on further conversation, generates new ideas and/or allows us to solve problems for clients."

Employers and building owners are doing what they can to make it comfortable and attractive to be in the office, with large building owners being the most proactive in organizing social activities and networking opportunities. According to survey results, real estate professionals said that only 9.6% of firms are offering incentives to come back to the office.

Ludgin suggests that while some companies may be offering incentives like free lunches, social gatherings and parking, others are saying, "Come for the culture and the learning."

CRIME: YOU CAN FIGHT IT BUT CAN'T UNDERWRITE IT

This year's report covers two specific topics – crime and DEI – that are not new issues in Chicago or the rest of the US, but for myriad legitimate and politically opportunistic reasons have been drawing considerable attention.

Concerns about crime in Chicago was one of the most consistent topics raised in the survey's comment sections and in interviews with key sources. With the assumption that any score over 4, on a scale of 1 to 5, is significant, real estate professionals are most concerned about crime's impact on investor perception (4.16) and attracting tourists, among others, to downtown retail and entertainment districts (i.e., the Magnificent Mile, State Street and Millennium Park) (4.11). Concerns about its impact in getting people back to work (3.80) cannot be overlooked.

"The perception of Chicago is critical," said Ludgin. "Crime, some of which is pretty insidious, will undermine why people come here, as investors, tourists or job seekers."

How significant will the impact of crime in Chicago be moving forward?

on a scale of 1 (low) to 5 (high)

4.16
Sentiment of investors considering acquisitions in Chicago

4.11
Ability to attract tourists to help retail and entertainment sectors

3.79
Getting people to go back to work in the city

Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

The impact of crime knows no boundaries and continues to expand into areas inside and outside of the city with high-profile crimes such as smash and grabs at high end downtown retailers and the murder of a teenager near Millennium Park. And while crime rate comparisons in Chicago are often mixed, Chicago's salacious reputation when it comes to crime makes the city an easy target for national media and political agendas. Yet it is important to note that Chicago is not the only major City to be grappling with crime.

"Crime has hurt retail, impacted the condo markets. Unfortunately, some people are thinking twice about living in the city," said Golub whose firm has been one of the prominent owners of office and condo assets on Michigan Avenue.

Hugh Williams, Principal, MK Asset Brokerage, and Director Entrepreneurship/Strategic Relationships Sterling Bay, notes that crime, and the types of crimes that impact investor sentiments typically are a function of density.

"The types of crimes that may be the most highly visible, or draw the most national attention, are crimes of opportunity in high profile areas that affect commuters or tourists," he said. "Additionally, crimes that rely on the element of surprise and are driven by a group of people, ie smash and grabs, also command a lot of attention due to the sensational nature of mob-type activity."

Ludgin noted the role social media plays in how quickly large groups can assemble and change the mood and composition in an area—at the Bean, along Michigan Avenue, at Oak Street Beach and in neighborhoods throughout the city.

"The reality of social media is that you can almost instantly attract a critical mass of 400 or 500 people to any location in the city," she said. As the city has witnessed on numerous occasions, those actions only increase the likelihood of trouble.

Golub acknowledged that crime is both a critical and complex local issue that also has far-reaching implications. "Crime is one of the most important issues for the city to tackle," he said. "Residents and employees in the city need to feel safe, and the powers that be need to do more about the current crime situation in the City."

PROPERTY TAXES

On some levels and in certain areas, Chicago's real estate community gladly accepts the status quo—the strength of the industrial market, the bounce back witnessed in the downtown multifamily sector and the continued relative strength of suburban multifamily.

Yet the status quo in two areas—uncertainty regarding property taxes in Chicago and Cook County and the perception of the effectiveness of city government officials—is not appealing to many.

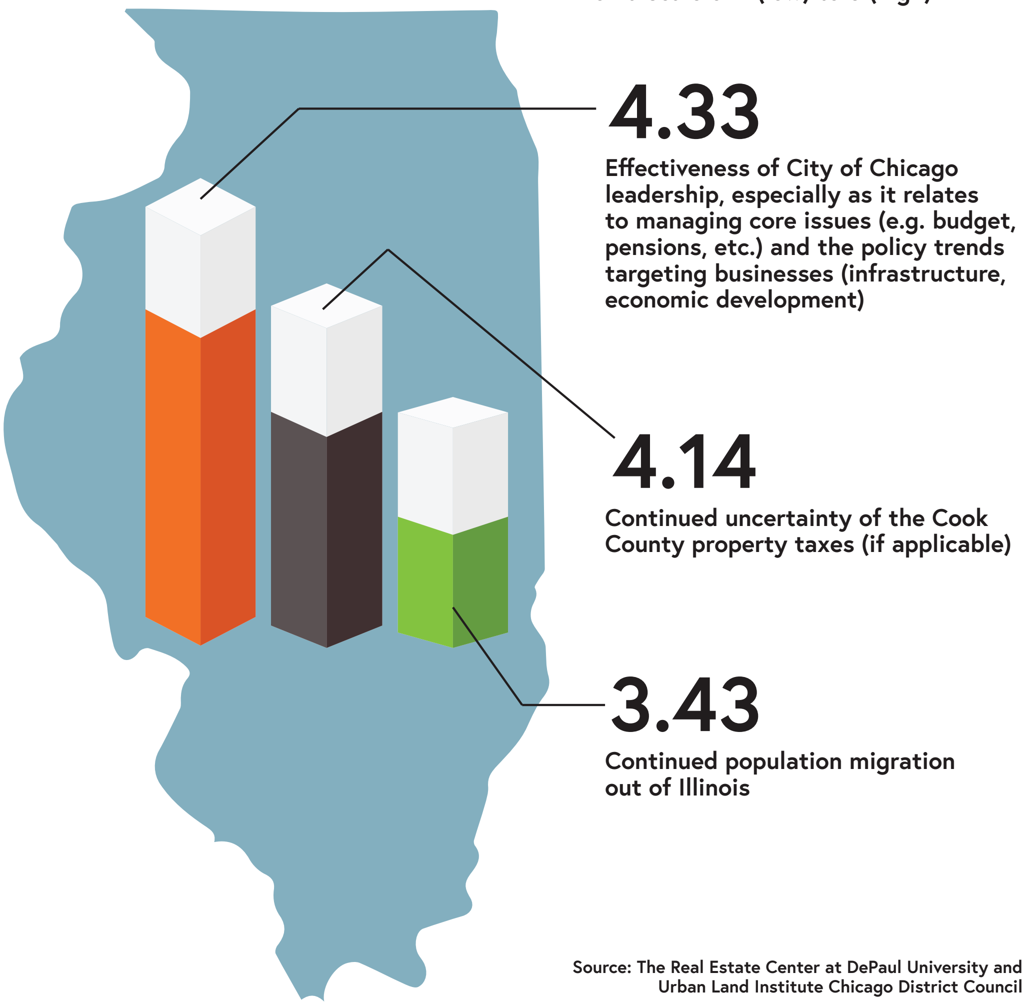
In a year-over-year comparison, Chicago real estate professionals' concerns about the effectiveness of City of Chicago Leadership and the continued uncertainty of the property tax situation remain intense, but essentially unchanged. In 2022, participants scored the effectiveness of City leadership a 4.34, on a scale of 1 to 5. That number was 4.33 in 2021. Property tax uncertainty scored a 4.15, on a scale of 1 to 5, in 2022 versus 4.27 in 2021.

"Despite public commentary to the contrary, the property tax situation in Cook County remains mired in the troublesome status quo. Further, so-called reforms have done nothing to eliminate uncertainty that has been a hallmark for a very long time," said Brian Forde, Partner, O'Keefe Lyons & Hynes. ""In fact, it seems to be getting worse with policies that focus primarily on shifting the tax burden from residents to commercial property owners rather than getting valuations correct, or equally important, repairing issues with Cook County's inequitable classification system."

At mid-year 2022, the schedule for tax bill mailings and the due date of the second property tax installment had not been announced. There is growing speculation that the second installment would be issued after Thanksgiving and due on December 31. Further, because of state/county statute, the deadline for the first installment for next year will be March 1—a very quick turnaround. The last time

How concerned are you with the following locally and/or state-specific issues and their impact on doing business here?

on a scale of 1 (low) to 5 (high)



Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

the second installment was due that late was in 2008, as a response to the Great Financial Crisis.

“Some will argue that every property owner/investor knows two installments are due each year, so there should be no surprises,” Forde said. “To a certain degree they’re correct. Yet there has been enough uncertainty with the amount and timing of that final installment that there will be some hardship made worse by the aftermath of the pandemic and other economic conditions.”

There also is concern about how the late cycle of assessments will impact the Board of Review and potentially cost taxpayers even more. “Taxing delays mean the taxing districts must borrow money at high interest rates until tax bills are sent and paid. So when the whole cycle of assessments and reviews are delayed, it creates even more uncertainty with the amount and timing of that final installment. This can lead to hardship coming on the heels of the pandemic and other negative economic conditions.”

In a sentiment shared by many Chicago CRE professionals and expressed by Forde, “Investors, and their lenders, crave certainty and definition of the expense items that are as substantial as property taxes,” Forde said. “It will help give sellers direction and the complete picture that they, and prospective buyers, have only been able to speculate.”

Some real estate professionals interviewed for this report, such as Ludgin, give the Cook County Assessor’s office credit for the transparency they are trying to bring to a system that has long failed to create confidence or certainty. ■

DIVERSITY, EQUITY & INCLUSION

The issues, opportunities and concerns of diversity equity and inclusion go well beyond bricks and mortar and those who develop, own, lease and manage these spaces. It is an issue, perhaps like no other, that knows no business boundaries.

Shawn Clark, President of CRG, characterized diversity as “a giant issue” admitting there is not enough diversity in the real estate industry. “We’re an established, $2 billion firm. It’s hard to imagine the difficulty of trying to break into the business with all of challenges any business faces today,” Clark said. “We all have to do our part.”

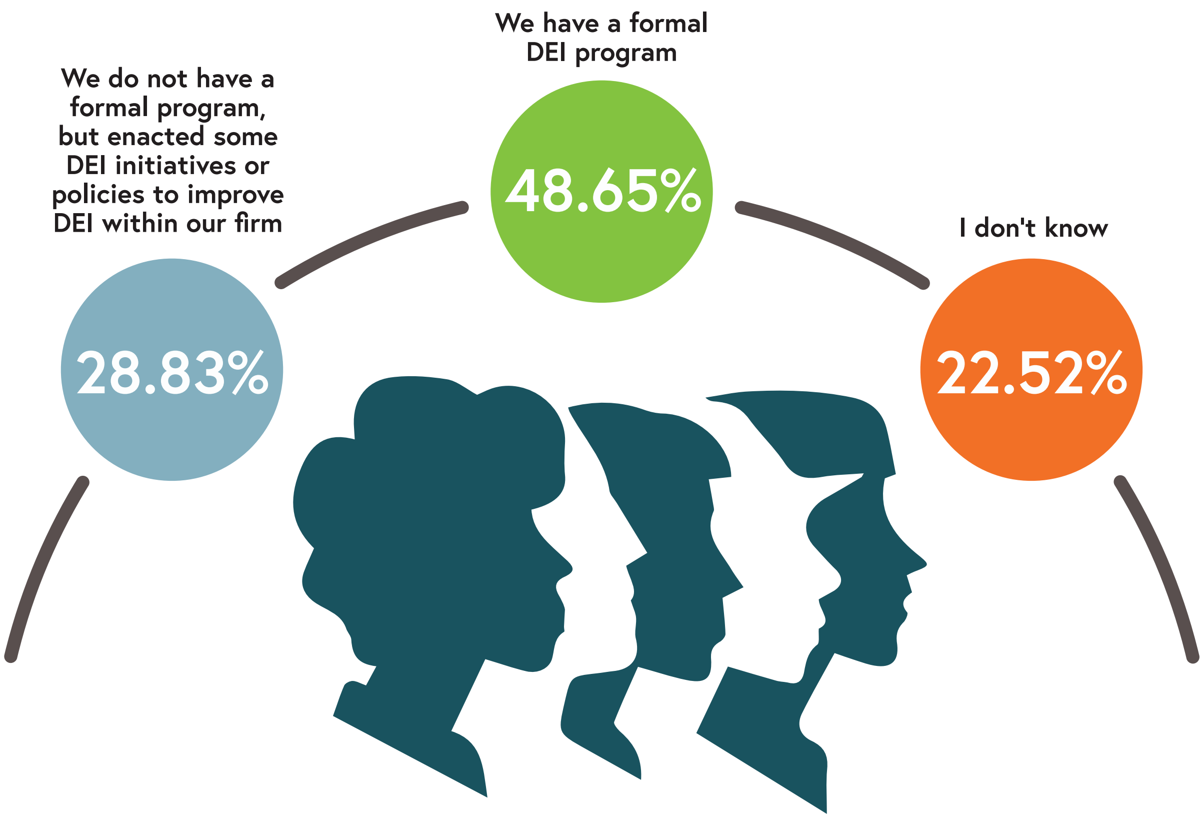
In the survey of DePaul and ULI connections and members, more than 77% said that their firms either have a formalized DEI program (48.7%) or, in the absence of a formalized program have enacted policies and initiatives to improve DEI within the firm (28.8%).

“The importance of DEI is reflected in the prevalence of the discussion,” said Molly McShane, CEO, The McShane Companies. “In the last two years it has been a topic of discussion and focus in every industry.”

In 2021 Hugh Williams was hired by Sterling Bay Companies to establish partnerships with minority-owned businesses. It’s no secret to Williams, or really anyone in the industry, that real estate is a relationship business.

“People of color, minorities and women typically are standing on the banks of those relationship rivers and streams,” Williams said. “In order to help companies get bigger and better, you have to meet people where they are, not expect them to be fully formed in the manner that you are acclimated to. You have to look at perspective and opportunity from a different lens.”

Has your firm advanced any internal organizational policies and practices to address diversity and equity?



Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

He says the businesses he is meeting and talking with aren't necessarily looking to become the next big name developer. They are looking to get better at what they do, to build and grow their business whether it's in construction or professional services. It isn't always a function of skillset, the what you know; it's a combination of the what and who you know. The ability to align with a company that is in "the relationship stream" can create tremendous opportunities.

"The importance of diversification, equity and inclusion is clear. With it, we are more creative and we perform better because it adds more quivers to our bow," McShane added. "The path to get there is a lot less clear."

In a sentiment echoed by many, the key is the discussion and the ability to learn from one another—what's working and what's effective.

"If the task at hand was easy, the problem would be solved. It is important we share strategies and best practices which will raise the tide that lifts all boats," McShane added.

CRG embraces its responsibility to respect diversity, equity and inclusion in every aspect of it's multi-faceted development strategy, Clark said. It includes the realization that with its national platform, young people including women and people of color can learn the business from the ground up and ultimately emerge as the next generation of leaders. CRG also understands the benefits of tapping into partners and subcontractors that can be plugged into a project before ultimately becoming a preferred vendor. Clark describes that CRG's commitments are designed to accelerate the Company's mission to drive meaningful, lasting change in every market where they operate.

THE VIEW FROM THE MONEY

The 75 bps increase in interest rates made big headlines, in large part because it was the most significant increase since November 1994. While that was a bold move, and created some general market volatility, in the short term, it has not severely impacted lender activity. Yet the reality is that, most financial sources were prepared for another increase because of what had already occurred and the intense speculation that more increases were coming.

"We haven't seen a slowing for financing as a result rate increases for both acquisitions and construction," said Greg Warsek, Group Senior Vice President | Senior Regional Manager, Associated Bank. "I expect that most experienced developers and investors recognize that we were at historic low levels, and even with the recent increases, the short- and long-term interest rates are still very low."

He emphasized that no one is panicking. In fact, real estate professionals ranked the ability to secure equity or debt as the least threatening to maintaining sound levels of CRE investment activity.

Sinkuler believes that perhaps the most important message sent by the Fed with the interest rate increase, and the possibility of further increases at that same level, is that it intends to act decisively to curb inflation that at one point may have been characterized as transitory, but clearly has been a more impactful issue.

"One thing is certain," Sinkuler said. "The Feds are serious."

There is a general consensus that investors in every asset class will be impacted to a certain degree, by the interest rate increase. However, Warsek's opinion is that industrial and multifamily are likely to be the most impacted since they have been the hot asset classes—where the most money has been invested—for the last few years. At the same time, he says that industrial developers, for example, may be far less concerned about interest rate increases than they are about the availability and cost of construction materials like tilt-up precast walls and roofing materials which are in short supply in part because of supply chain issues.

Interest rates may not be the only things that change. As the long-term cost of funds increase, leverage may need to be altered at some point so that project underwriting continues to align with the permanent loan takeout. "We underwrite to the takeout position, so one of the big questions is what will happen to cap rates moving forward," Warsek said.

In looking ahead to both the balance of 2022 and 2023, Warsek calls himself cautiously optimistic. "I am not too concerned yet, we are definitely monitoring the Fed actions closely," he said. "I am hopeful that the Fed can soft land the economy and contain this inflation without dumping us into a recession," he said.

As part of underwriting, lenders like Associated Bank typically build in an interest rate cushion into loans for both short- and long-term interest rate increases. ■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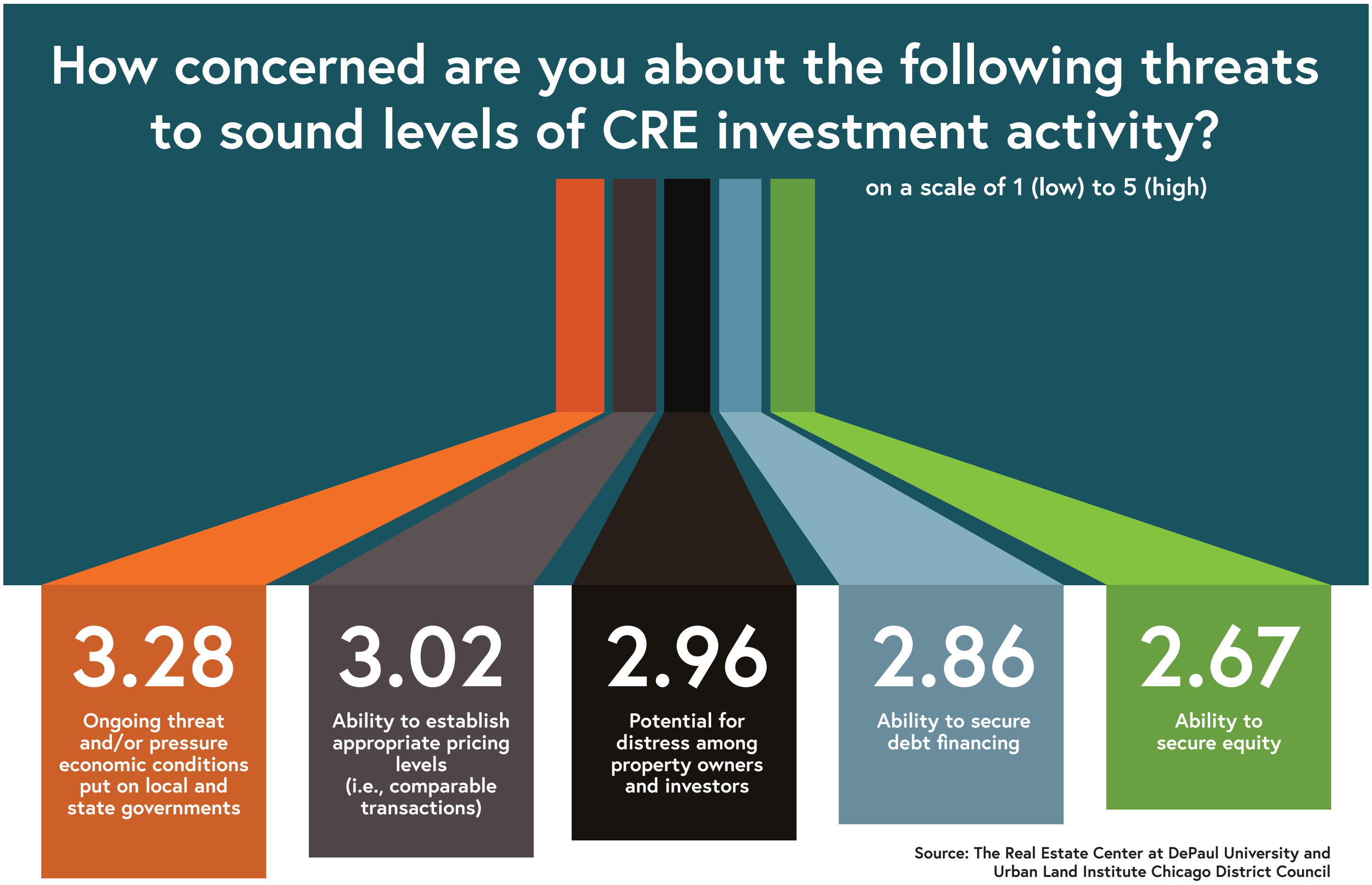


Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

CAPITAL MARKETS REVIEW

From a capital markets' perspective, the market for certain asset classes is bifurcated and barbelled. Trophy office assets do very well, as demonstrated by the top sale price paid by the buyers of 110 N. Wacker Drive. The same is often true in the Fulton Market area, a market characterized by the supply and demand for office space and multifamily developments there. It also seems that each new lease signed is at a higher rental rate than the last—a trajectory that bodes well for sale prices.

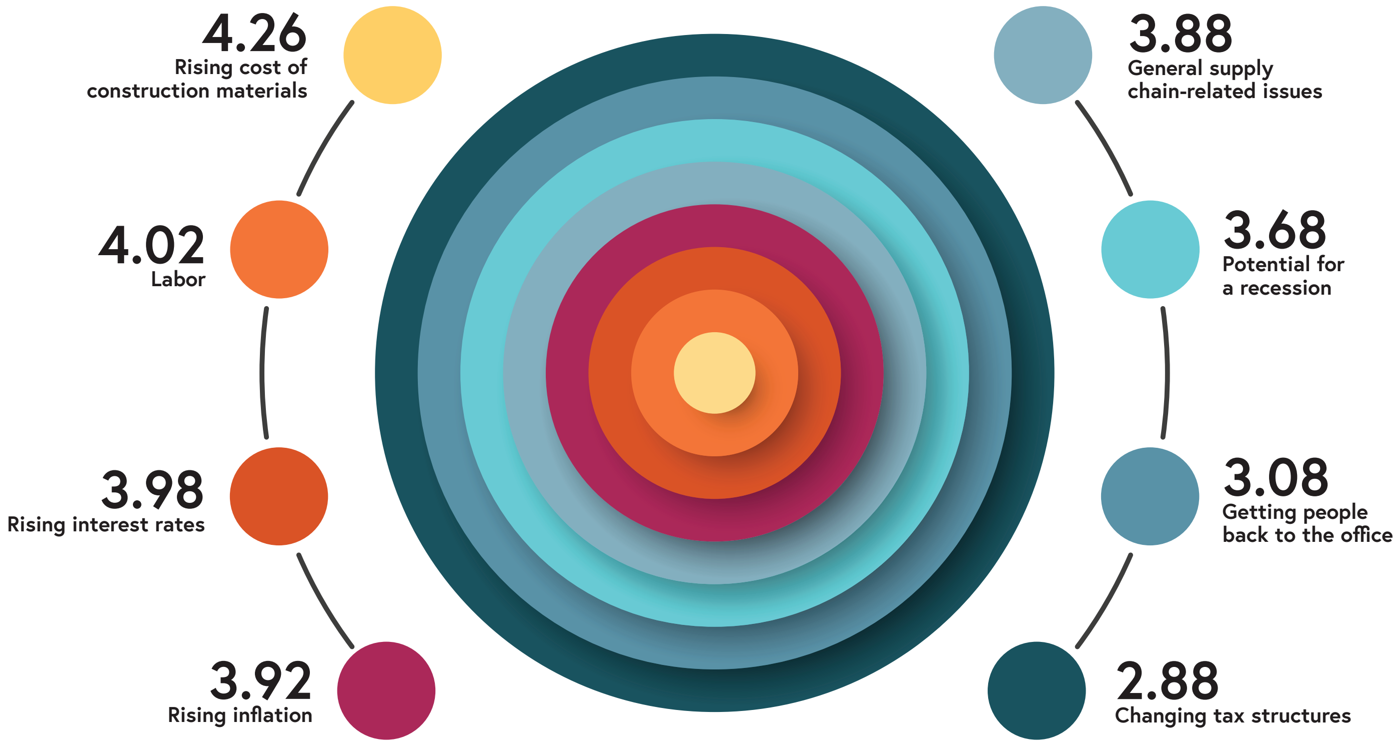
Largay said there are increasing signs of distress in the market, specifically in the office sector, adding, "The process of distress, though financially painful for the current owners and their lenders, is necessary, because market conditions call for a basis reset for distressed, underperforming assets."

With that reset in pricing, there are/will be investors willing to step forward and make a capital investment to reposition a property and make the asset relevant again within its competitive set. Alternatively, a price reset may allow for opportunistic investors to convert certain assets to another use such as, depending on the property, multifamily or hotels. The bottom line is that there is capital for redevelopment—with the right business plan.

According to professionals like Weinstock, a real estate bubble is unlikely. The economy is fundamentally strong despite inflation and its impact is being priced into transactions given the Fed's projected interest rate movement. But there is still demand for investment properties, though the demand varies by size of the investment.

How concerned are you by each of the following market factors?

on a scale of 1 (low) to 5 (high)



Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

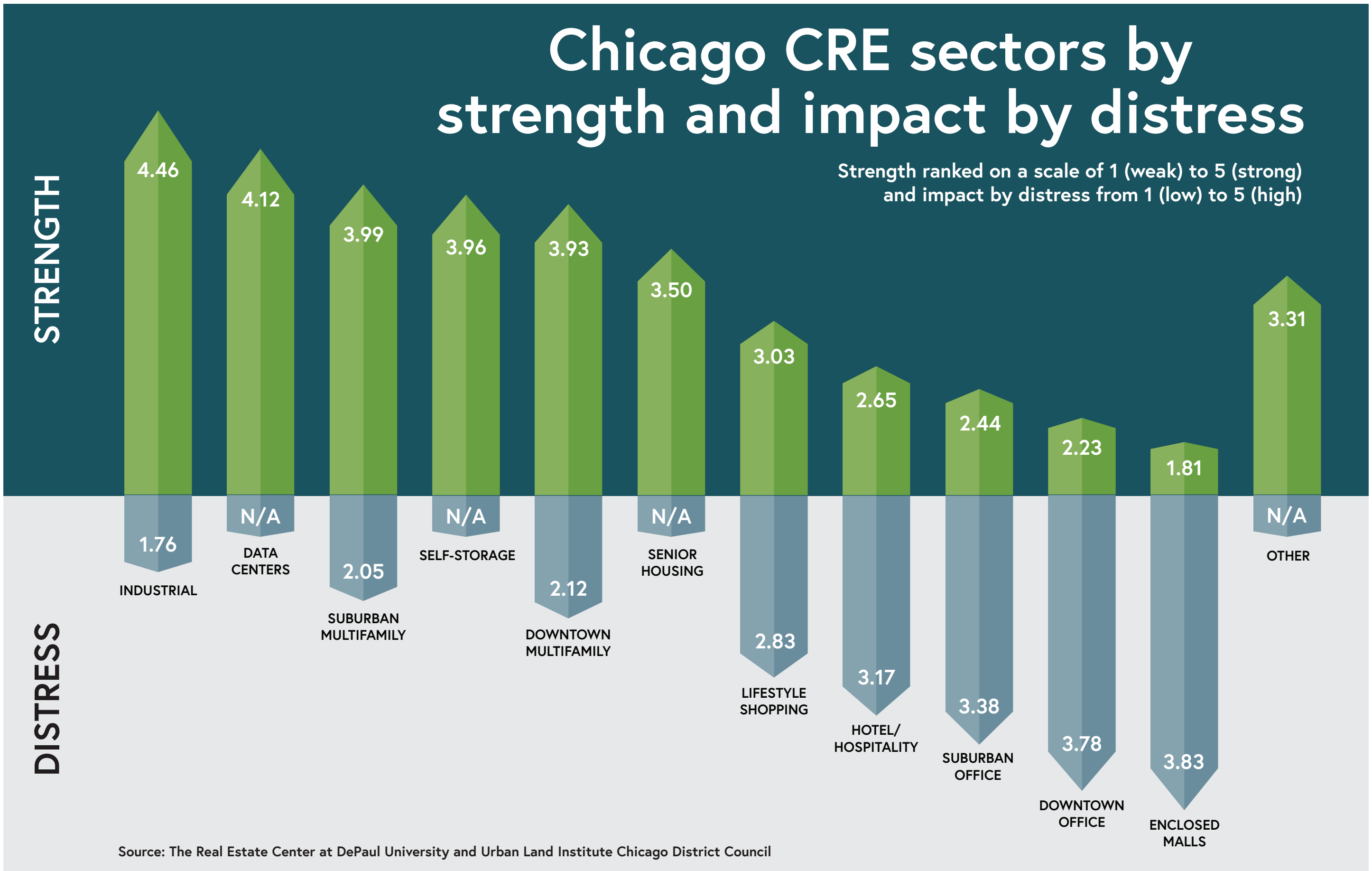
"There is no shortage of liquidity in the equity or debt markets," Largay said. "There is plenty of debt, but it is priced higher because of the uncertainty in the market. The biggest question is how it will be priced, and what other underwriting terms may have shifted with the market."

Weinstock notes that there is still plenty of activity and interest in assets that range from $1-20 million, although that may be somewhat tempered by location and property type.

For investment activity at all levels, though, he said that the unknown factor is when does the cost of capital start to impact pricing. "As lending gets more expensive, borrowers will plant their feet and not pay the extra freight," Weinstock said. "With fewer financing options, pricing will come down and the bid-ask gap will narrow."

As Weinstock was quick to note, he's not too worried because real estate is a series of repeating cycles. The market has been there and seen this before, it makes adjustments and finds its new footing.

While it has been covered throughout the report, and not to be redundant, the lack of certainty and clarity relating to Cook County property taxes, along with the outcomes some already have seen, scares investors. Investors don't like to be scared or uncertain.



A LOOK INTO THE CRE SECTORS

THE OFFICE MARKET

Sometimes things have to get worse before there is improvement. That appears to be the case when it comes to the industry's view on the vacancy rate downtown. More than 62% agree strongly or at least somewhat with the statement "Vacancy in the Chicago office market will maintain its upward trajectory in 2022 and 2023."

Those sentiments, at least for the downtown market, are substantiated by research from CBRE that suggests the office market has hit the bottom, with a 4-1/2 to 5 year supply of space. There are additional statistics that suggest occupancy in downtown office buildings is increasing each week. Kastle Systems, for example, puts the level at nearly 40% nationally, but a little lower for Chicago. CBRE's Chicago stats say occupancy is more than 30%.

The physical office environment continues to evolve as companies reinvent space to ensure their infrastructure is supportive of the business. "It is increasingly important to have 'we' space for meeting and 'me' space for closing the door and getting work done," Konieczka said.

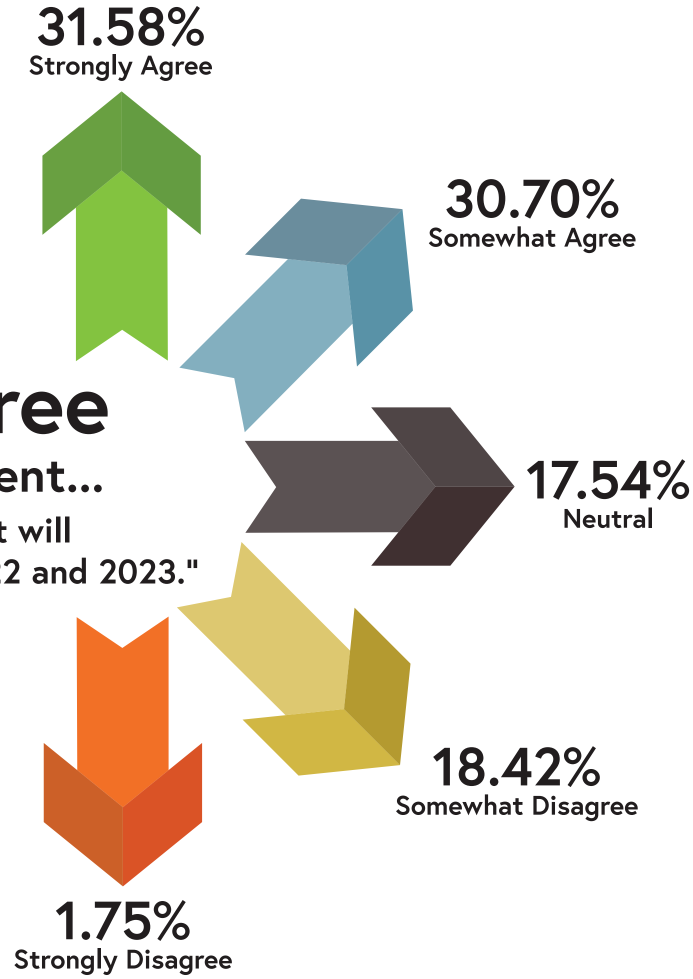
Another factor impacting the downtown office market has been the workforce figuring out Covid-safe commuting.

"At the beginning, commuting was a big concern, Konieczka said. "People's perceptions change. Concerns about gas prices and labor issues supersede concerns about public transportation."

Agree or disagree

with the following statement...

"Vacancy in the Chicago office market will maintain its upward trajectory in 2022 and 2023."



Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

Experts predict that demand will be different moving forward, and how that translates to space needs requires greater consideration. If companies allow for remote working 40% of the time, space needs may not translate to a 40% decline in space needs. “It may only translate into a 10-15% reduction,” Konieczka said. “The key will be how people develop and finish their space to accommodate a lot of people periodically.”

Like cycles that have occurred before, the downtown office market is a tale of the haves and the have nots as well as a flight to quality. Some of the newest buildings—new construction or comprehensive redevelopment—regularly field calls for space availability, even though little space may remain.

That is not to say that renewals aren’t taking place; they are, but just for a shorter term, until there is greater certainty for individual users, said Atkinson. Like everyone in CRE, Atkinson’s greatest concerns center on future economic conditions.

“The broader recessionary concerns and the uncertainty they create, are there,” Atkinson says. “It’s a challenge after two years of back and forth.”

In spite of the sentiment that office vacancy will continue its trajectory, there are signs of optimism. In June, for example, Abbott executed a lease for 100,000 square feet of space at Willis Tower downtown. This represents suburban-based Abbott’s first significant office lease downtown. It demonstrates how established companies are taking a long view and looking to solve recruitment and expansion needs by committing to downtown.

THE INDUSTRIAL MARKET

When asked about the health of the industrial market, Hugh Williams, who works with industrial clients (users and developers) in Chicago and nationally, pointed to Prologis' initial offer to acquire Duke Realty. Prologis-- was offering a premium, plus upside.

"When you see that, and with vacancies in the sub 4% range, it signals strength and optimism," Williams said. "We are at one of the high water marks. No one knows if we are at the top, but over the recent long-term, the strength of the market has only gone in one direction, and new baselines have been established."

He characterized it as an interesting time in industrial real estate. "Exit cap rates were at an all-time low, but recently we have seen underwriting standards change and there has been a change by +/-50 basis points. So, the investment community is re-evaluating their outlook. There may be greater upward pressures based on interest rate movement," Williams said,

Like all people leading development firms, McShane is concerned about rising costs—the number one concern of the overall market. "In underwriting a deal, if costs go up, revenue must go up," she said. "With the level of rent growth that has been occurring in many markets, we've so far been able to cover those additional costs."

McShane did note that while Chicago does not lead the pack in terms of rent growth, right now with demand being what it is, the 8-9% growth positions Chicago well.

Clark also described how developers and construction firms, along with the clients they represent, must be willing to be creative and address issues a little differently. He described how on a recent project in Country Club Hills, the rapidly increasing cost of steel prompted CRG to purchase the necessary steel for the 1,033,450-square-foot industrial building before they closed on the 70-acres of land. In the end it was a fortuitous move. If the steel had been purchased as typical, the cost would have been more than double.

Real estate professionals like Clark also note that while Amazon has generated considerable activity and opportunity in the market, many other ecommerce and related companies continue to fuel steady demand for existing and newly developed space.

"We are living in an uncertain world," McShane said. "Rising interest rates certainly have an impact. Yet if demand characteristics remain strong, the issues should be surmountable."

McShane did offer that as big an issue as costs are, she too is concerned about the property tax situation, especially in Cook County. "This is not an easy transition, but I think we can get there. I am optimistic that we ultimately will be able to underwrite real estate taxes with greater certainty."

"There are some that don't like Chicago, for its politics or its crime. But the interesting reality is that in addition to being a dynamic industrial market itself, it also drives growth and opportunity to other markets. Based on its location, reach, impact and infrastructure, you have to deal with the City of Big Shoulders," Williams said.

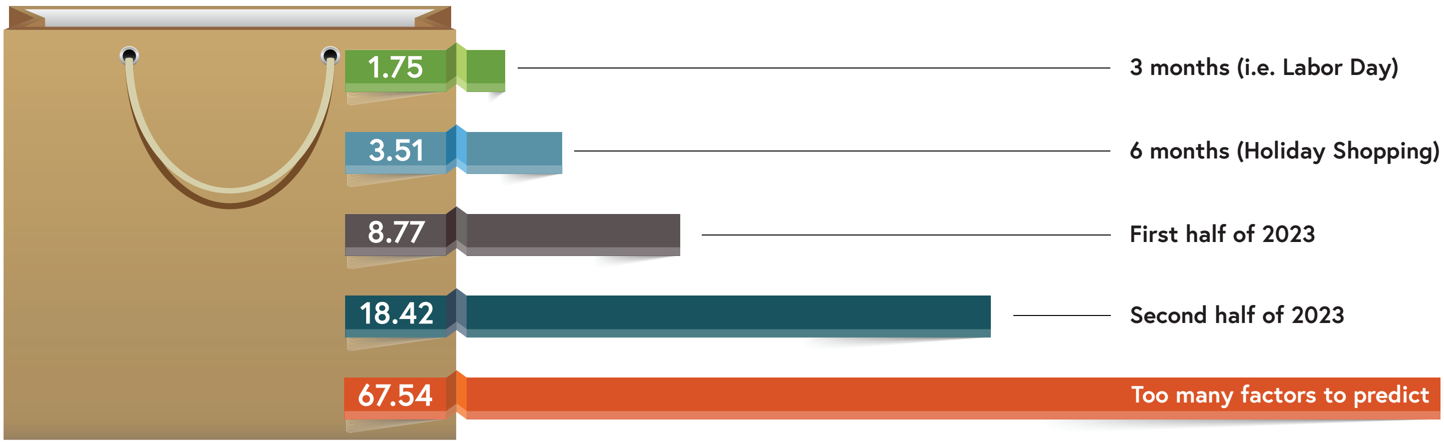
Earlier in the year Amazon made announcements locally and nationally that come as a big surprise to the marketplace because the ecommerce giant has been such a leader in the marketplace.

"Because they are ubiquitous, any news they make is big news," Williams said. "Yet you also need perspective and context. We are at a point when there are lots of geopolitical headwinds that people should pay attention to before being overly concerned about what Amazon is or isn't doing."

Many real estate professionals, like Clark and Williams, also note that while Amazon has generated considerable activity and opportunity in the market, many other ecommerce and related companies continue to fuel steady demand for existing and newly developed space.

McShane, who remains bullish on the industrial market, said, "Going from just-in-time to just in case is real strategy businesses are using, and it is driving demand," she said. "As long as that continues industrial is in a good place."

How long will it take for a retail recovery downtown (Mag Mile & State Street)? on a scale of 1 (low) to 5 (high)



Source: The Real Estate Center at DePaul University and Urban Land Institute Chicago District Council

THE RETAIL MARKET

The overall state of the retail market in the Chicago metro area is on solid footing, although there certainly are areas that are not faring as well as others.

"The market has strengthened over the last two years," said Pine Tree's Gold. "We expect the strength in the market will continue, but not at the same acceleration."

For retail property owners like Pine Tree, the current market conditions are far better than expected in the early stages of the lockdown. Gold attributes that to the tremendous amount of uncertainty where it wasn't clear whether online shopping would be the dominant means of purchasing or it was a relatively short-lived solution before things reverted back to what people were used to or a hybrid was established.

"There certainly are different patterns and practices than there were two years ago, but there is a renewed acceptance of brick and mortar retail," Gold said.

The acceptance is not universal, however, as two of Chicago's world famous retail hubs, The Magnificent Mile (Michigan Avenue) and State Street have been more challenged than ever. According to the DePaul-ULI survey more than two-thirds of participants said there are too many unknown factors to predict when retail will recover downtown. For those who have owned and/or developed property along Michigan Ave. that either has retail or relies on retailers, the most important issue is crime.

Gold agreed and said, "It starts and ends with crime. The city needs to get the crime matter in line for there to be a chance of a downtown retail recovery."

There are primary factors pointing to optimism in the Chicago retail market: retailer performance and the leasing velocity taking place. The concerns, of course, center on broader macroeconomic forces like the ability to control/curb inflation, rising interest rates and the possibility or likelihood of a recession.

"We're operating under the premise that retail will continue to grow and thrive," Gold added. "It's a little too early to speculate, but it does feel as though economic disruption is on the horizon."

Yet various retail specialists said they like the position of retail versus other asset classes offering that there is strong return potential for the risk involved.

Because of that, Pine Tree for one is in a position in 2022 and beyond to be net buyers of retail property in Chicago. Gold said the firm is taking advantage of opportunities to sell where it makes sense, but that the risk premium is strong enough to be net buyers. "There are great corridors, great properties, in every market. You simply need to find the right corners, have the right retailer mix and underwrite properly."

THE MULTIFAMILY MARKET

There are reasons that the sentient for downtown and suburban multifamily markets is strong, and the likelihood of seeing much distress in the near term is low. Most notably, it's all about the numbers: according to industry statistics, the suburban occupancy rate has never been higher at +/-98%, and the downtown rate has regained its pre-pandemic luster at +/-95%.

"We are now at a healthy, historical occupancy level," said Phil Lukowski, Managing Partner, Waterton.

Near mid-year 2022, rents for the average Class A apartments are reaching record levels with year over year increases of 17% in the suburbs and 19% in the City. As the numbers reflect, there is a general lack of supply—though the pipeline for downtown units is building—allowing landlords to have the upper hand.

"Immediately after the start of Covid, the market saw a significant drop," said Phil Lukowski, Managing Partner, Waterton. "But we've seen a tremendous bounce back that has pushed occupancies and rents higher and concessions lower."

Experienced professionals like Lukowski expect that the strong multifamily market will continue, though there are increasing concerns about what a solid pipeline of new product will do to the market, perhaps as early as 2023 and more likely in 2024. In the downtown area, Fulton Market has a lot of activity, with new development scattered throughout the city.

"What has been a strong homebuying market as well as increasing interest rates could help the multifamily market as first time buyers will find it more challenging to afford to buy a home," Lukowski said.

Another factor to consider, both for the downtown and suburban markets, is the potential impact of a recession. Depending on the depth and breadth of a recession, and what that does to job growth, the market could once again see a reduction in the formation of new households (renters) because people don't have the financial means, or jobs, to support today's rents.

In looking ahead, Lukowski suggests that there may be a rebalancing of asset prices on the horizon, with some corrections expected. He noted, too, that especially downtown there have been limited trades occurring.

He cited various factors, including concerns about crime downtown which he said, "taints the appetite of people buying here." Also a factor downtown and in Cook County are property taxes. "The property tax hits have been happening with the reassessment process," Lukowski said.

Lukowski expects that as speculation of what property taxes will be turns to reality as tax bills are issued, there will be an uptick in trades. "Owners will be able to better predict their NOI and buyers and lenders, who go through a similar analysis, will price in these final tax results," he said. ■

Photo by Tang Man

CONCLUSION

It is an interesting time in commercial real estate in Chicago. There are myriad financial and geopolitical headwinds that threaten what for many sectors has been a tremendous run and/or a welcomed recovery from the pandemic. Yet at the same time there continues to be a level of optimism and resiliency when it comes to investing and/or doing business in Chicago.

As challenging as the headwinds may become, and as painful as more locally-based issues, such as crime and commercial property taxes are, there are investors who continue to believe in the future of Chicago. While it may be based, in part, on a "right corner, right project" viewpoint, there remains an appeal about the Chicago metro area and a belief that we will work out our issues.

Earlier this year CRG, which is leading the development of One Fulton Market in partnership with Shapack Partners, was working to secure financing for the mixed-use development that will occupy nearly a full city block (62,000 square feet) in the most established eastern section of Fulton Market. The project will include apartments, office space, a hotel and Class A retail space.

"Some of our potential investors/lenders raised questions about the City, and issues like crime and property taxes, among other things, that were of potential concern," Clark said. "In the end, financing was secured because of the belief in Chicago's long-term future and the strength in this location."

Atkinson is one of many real estate professionals who also is optimistic about Chicago on a long-term basis. "We'll have our scar tissue, like we had with 9/11. We'll look back on things and say, 'that was a pandemic decision.' However, as people like Sam Zell have said, 'Urbanization has been happening for 500 years. This period of time won't change the trendline, it's only a disruption.'"

From Weinstock's perspective, corrective measures may continue to be taken, but he adds, "Don't fret the reverb. In the long run it will all create opportunity." He likened it to a rose gardener who prunes the rose bush back to nothing but thorns so that it can come back bigger and stronger.

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