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The Real Estate Center

2021 MID-YEAR PERSPECTIVE ON CHICAGO REAL ESTATE MARKETS

In collaboration with

CoreNet Global Chicago Chapter

REAL ESTATE INVESTMENT ASSOCIATION REIA WHERE DEALS & CAPITAL MEET

Absence makes the heart grow fonder... and more optimistic

A majority of Chicago real estate professionals in Chicago is looking at the commercial markets with optimism, in spite of the absence of 2019 levels of transaction activity—leases, sales, etc.—since the pandemic triggered the pause button. Those sentiments are according to a survey of real estate professionals with ties to The Real Estate Center at DePaul University, The Real Estate Investment Association (REIA) and the CoreNet Global | Chicago Chapter.

"Capital is still flowing as investors remain optimistic," says Charles Wurtzebach, Douglas and Cynthia Crocker Endowed Director of The Real Estate Center at DePaul University. "People know that traditional economic forces like oversupply and lack of demand did not cause the 'pandemic downturn'. We were dragged into it kicking and screaming and we want it to be over! That means that pent up demand is and will be significant."

While there is optimism, most professionals are in agreement that Chicago and the surrounding markets are not without their issues and challenges, most of which are tied to issues at virtually every level of government—city, Cook County and State of Illinois. Because of these issues, the "brain drain" that was occurring pre-pandemic has not stalled.

In fact, Tom Jaros, a partner with Levenfeld Perlstein and a REIA board member, suggests expanding the explanation of brain drain to now include gray hair drain. He defines this as the experienced professionals who discovered they can just as easily plug in from a VRBO, hotel or second home in their location of choice. If home is where the heart is, the office is where the wifi is.

Key findings of the 4th Annual Chicago Mid-Year Sentiment Report include:

- Nearly 6 in 10 CRE professionals are at least optimistic, if not bullish, about Chicago real estate for the next 18 months.
- The market factors causing the greatest concern at mid-year include the rising cost of construction, materials and labor, changing tax structures and rising inflation.
- The greatest threats to CRE investment activity range from the economic conditions put on local and state governments, followed by lingering concerns about the potential for financial and economic distress.
- Real estate professionals are genuinely concerned, perhaps even skeptical, about the effectiveness of political leadership at virtually all levels of government.
- There is nothing more certain than death, taxes and property tax uncertainty in Cook County. Those concerns, and uncertainty, aren't going away.
- Industrial properties followed by multifamily assets are viewed the most favorably and the least likely to encounter future distress; indoor malls, viewed as the weakest asset class, are likely candidates for distress.

Surveys and interviews for the Chicago Mid-Year Sentiment Report were conducted in June, ahead of the recent and notable increase in the COVID-19 Delta variant(s). In follow up, various sources expressed concerns at the widescale impact that uncertainty about these variants could have on the real estate markets, nationally and in Chicago.

General sentiment for 2021/2022... What a difference a year makes!

Mary Ludgin, Senior Managing Director and Director of Global Investment Research, Heitman, said the COVID era has been like an arctic cruise, at points arduous and exhausting, but with moments of great beauty and exhilaration. She also noted the "shockingly fast" courses of action that were punctuated by the rapid decline of the markets to their fast rebound and the despair of how to combat the virus to the availability of three vaccines.

"COVID paralyzed us," Ludgin says. "But it was like a polar plunge: quick and deep and then we started to come out of it."

According to Real Capital Analytics statistics, while the market pause was fast and significant, it paled in comparison to the Great Financial Crisis. In 2008 and 2009, annual investment activity was down 60% nationally. In 2020, national activity was down "only" 30%.

During 2020, Economist Diane Swonk likened the market slowdown immediately after the start of the pandemic to a medically induced coma. "But as time wore on, we started to pull the patient out of it," Ludgin said.

That recovery now translates into healthy levels of optimism or bullishness for the next six months as well as all of 2022.

For 2021, 22.6% of participants indicate a bullishness about the marketplace while another 35.9% consider themselves to be trending toward optimistic. Fast forward to 2022 and the optimism is even stronger, with 35.9% expressing bullishness and another 25.5% being at least optimistic. In the aggregate, 58.5% are at least optimistic, if not bullish, for 2021 while 61.4% are at least optimistic if not bullish for 2022. This is opposite of the sentiment expressed in 2020 for 2021 when approximately 60% were concerned about the year ahead.

As a veteran of 32 years, and five cycles, Steven Weinstock, First Vice President, Regional Manager and National Director of Self Storage Division, Marcus & Millichap, sees similar patterns of growth, exuberance, falling off a cliff, finding the bottom and climbing back up again. He says he has always had a certain level of optimism that the market would come back and that people would evolve from video calls and meetings back to in-person connectivity.

One survey participant concluded, "the economic boom and accelerated growth will give rise to significant appreciation" while another expressed caution saying, "I believe we are in a bit of a bubble that will not last for as long as people are anticipating."

Expectations for the Chicago Real Estate Markets

2020

Bullish	**22.64%**
Neither bullish nor bearish, but optimistic	**35.85%**
Bearish	**13.21%**
Neither bullish nor bearish, but concerned	**28.30%**

2021

Bullish	**35.85%**
Neither bullish nor bearish, but optimistic	**25.47%**
Bearish	**16.98%**
Neither bullish nor bearish, but concerned	**21.70%**

Source: The Real Estate Center at DePaul University


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Greatest Concerns & Threats

How concerned are you by the following market factors? [1]

Rising construction costs	**4.13**
Changing tax structures (i.e., Capital Gains, 1031 exchanges)	**3.82**
Rising inflation	**3.50**
Getting people back to the office	**3.24**
Rising Interest rates	**3.23**
The stalling vaccination rate	**2.98**
Safe public transportation options	**2.91**

Ranking of the greatest threats to the return of sound investment activity [2]

The pressure economic conditions put on governments	**3.68**
The potential for distressed property	**3.25**
Establishing appropriate pricing	**3.22**
Securing debt	**2.64**
Securing equity	**2.48**

[1] Average, ranked on a scale of 1 to 5 with 1 being little concern and 5 being great concern. [2] Average, ranked on a scale of 1 to 5 with 1 low threat and 5 being high threat

Source: The Real Estate Center at DePaul University

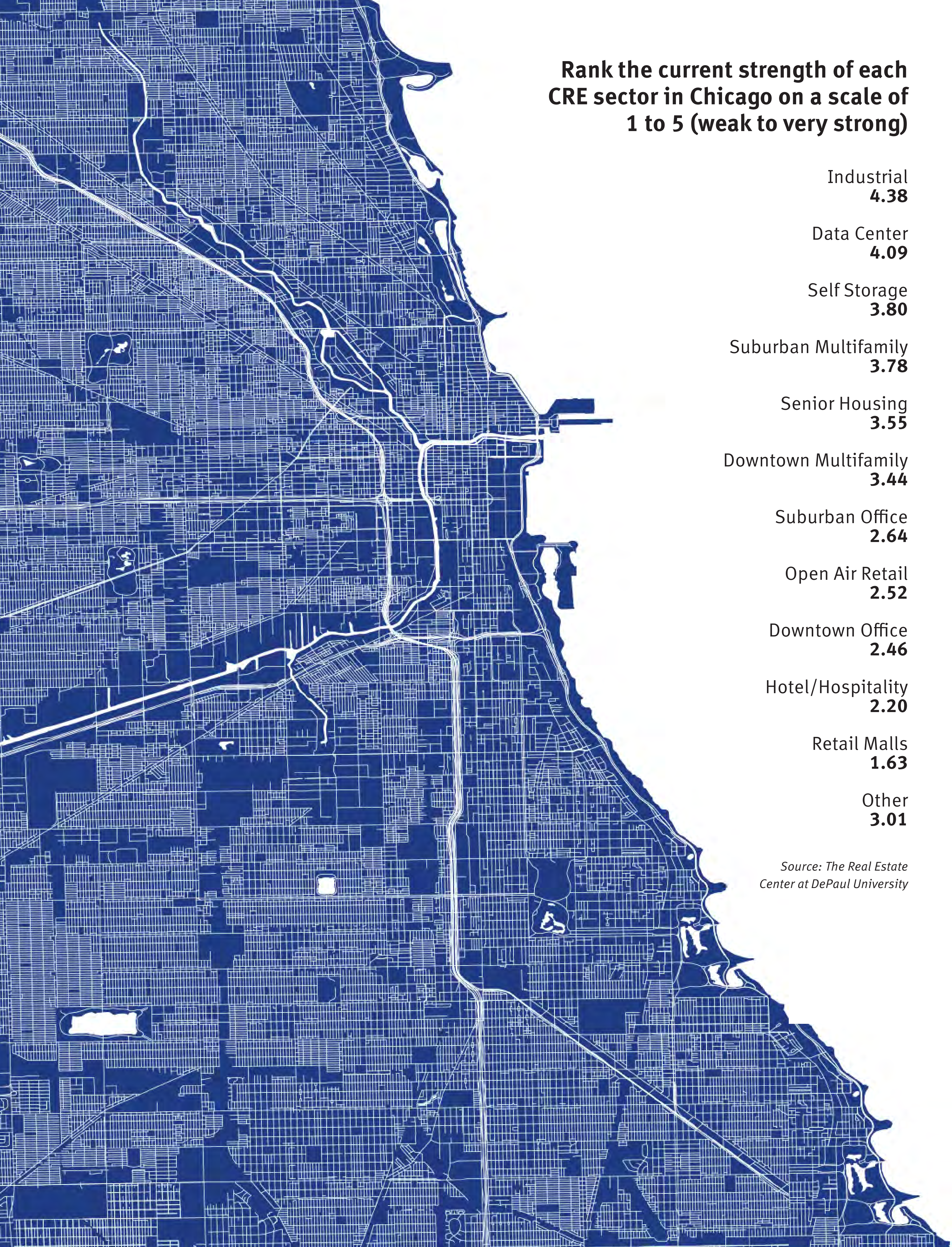
Today, the factors most concerning to CRE professionals are directly tied to financial matters. This underscores that the industry has shifted its focus away from pandemic related issues and concerns.

When ranked on a scale of 1 to 5, with 1 being little concern and 5 great concern, the greatest concern, and the factor to score an average over 4.0, was the rising cost of construction materials and labor (4.13 average). Ranked two and three were potential changing tax matters (3.82 average) and rising inflation (3.50 average).

Survey participants ranked two of three pandemic related responses, the stalling vaccination rate and the ability to for public transportation to rebound. Getting people back to the office ranked fourth (but only narrowly).

In spite of any potential concerns or threats, Weinstock notes, "2021 is exciting in ways we haven't seen in years, with a lot of dynamics going on. Availability of capital; worry about business and fiscal policies, real estate taxes, the state of government, and potential changes to 1031s."

He summed it all up by saying, "It's exciting, but that doesn't mean it's all good."



Rank the current strength of each CRE sector in Chicago on a scale of 1 to 5 (weak to very strong)

Industrial
4.38

Data Center
4.09

Self Storage
3.80

Suburban Multifamily
3.78

Senior Housing
3.55

Downtown Multifamily
3.44

Suburban Office
2.64

Open Air Retail
2.52

Downtown Office
2.46

Hotel/Hospitality
2.20

Retail Malls
1.63

Other
3.01

Source: The Real Estate Center at DePaul University

Government & Taxes (and the death of tax breaks?)

It is little surprise that the perception of government ineffectiveness at local, county and state levels is of significant concern for Chicago's CRE community. The ineffectiveness includes, but is certainly not limited to, crime, school, pension liability and various other factors. And for as much as the City has to boast and brag about, those other issues can have a significant impact on how the Chicago metropolitan area is viewed by Corporate America that may bring jobs and by investors who may bring investment capital here.

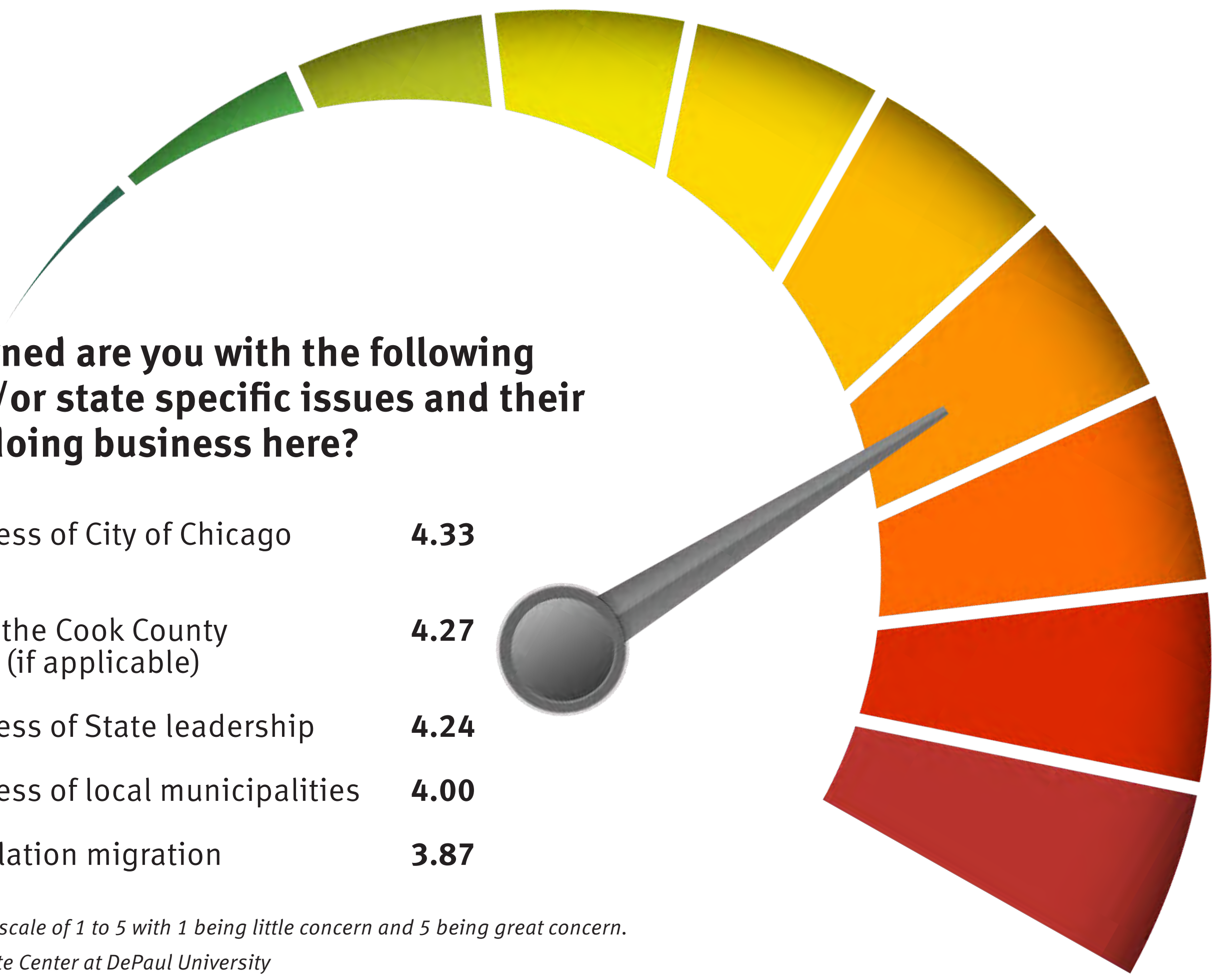
"We have crime issues which out-of-state investors hate. And we've got fiscal issues at the state and local levels – which all investors find difficult to predict," Jaros says. "All of this creates underwriting uncertainty."

Still, there are members of the real estate and business communities who believe that various elected officials are on the right track with the many issues and challenges that face the city and state. Some even point to the fact that in Chicago, specifically, there are just too many issues to tackle. Others suggest that communication, or lack thereof, may be a significant part of the problem.

"The city needs to do a better job at proactively addressing the issues, or at least how we are going to address the issues," Jaros says. "People want to know it's under control, that there is a plan."

Ludgin has a positive view of the way both Lightfoot and Pritzker handled the pandemic for the City of Chicago and the State of Illinois, respectively. She also noted that neither could have truly expected the complexities of governing during a pandemic. Regardless the job done governing through the pandemic, there is work to be done.

"It's time for a lot of people to grow up," Ludgin says. "We have to be honest and face the fact that promises have been made to pensioners that can't be kept." She suggests a real need to rewrite the constitution not to be onerous but to recognize what needs to be done.



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

The effectiveness of City of Chicago leadership	**4.33**
Uncertainty of the Cook County property taxes (if applicable)	**4.27**
The effectiveness of State leadership	**4.24**
The effectiveness of local municipalities	**4.00**
Outward population migration	**3.87**

Average, ranked on a scale of 1 to 5 with 1 being little concern and 5 being great concern.

Source: The Real Estate Center at DePaul University

Participants were asked their level of concerned with local, city and state issues and its impact on business. When ranking on a scale of 1 to 5 with 1 being little concern and 5 having great concern, each level of government scored at least a 4.0 average. These are benchmarks Illinois residents have grown accustomed to over the years. Sandwiched in between concerns about the City of Chicago, a 4.33 average, and State of Illinois, a 4.24 average, was the continued uncertainty of Cook County property taxes, a 4.27 average rating.

"We have one of the worst property tax burdens in the nation," says Brian Forde, a partner with the firm O'Keefe Lyons & Hynes, says. "In Cook County, the situation, and the burden is worse."

Cook County is the only Illinois county where commercial taxpayers (25%) are taxed 2.5 times more than residential taxpayers (10%). In the other 101 Illinois counties, taxpayers are assessed equally at 33.33%. Experts contend that the ongoing failure of state and local leaders to acknowledge or address the disparity is soon coming to a bellwether moment.

"Someone with courage and conviction needs to step up to make a change, or the end result will create a narrower range of investors looking to make acquisitions in Chicago or to explore new development opportunities here," adds Forde. "Further, it will hasten the exodus out of Illinois."

Adding insult to injury in a disparate system, during the pandemic the Cook County Assessor awarded significant COVID relief to residential property owners while not affording the same consideration to commercial property owners. This while prices for Chicago area housing were surging.

Tom Volini, Executive Vice President, Colliers and REIA board member, suggests that for some tenants—office, industrial and retail—CRE property taxes are considered one line item in the overall occupancy expense. Given that, he says that until that "cost" reaches a certain threshold, they'll simply take alternative measures to reduce operating expenses.

Forde agrees in theory but countered that the pandemic caused many businesses to look at their real estate footprint and size their space needs accordingly.

"Businesses already have taken steps to reduce their footprints, be more efficient and reduce operating costs, so reaching the 'that's high enough' threshold won't take as much upward pressure as it did in the past," Forde says. "The metrics have changed."

Investors and developers with deep pockets will be impacted much less significantly than mid-size and smaller investors. "The mid-size and small businesses make our economy," Forde adds. "That's where we are losing the battle."

A Bifurcation of Potential Investors

Depending on who you talk to, Chicago appears to be a tale of two markets. Currently, many investors don't look at Chicago, or Illinois, as a positive investment thesis, with the possible exception of industrial and multifamily assets. Those who target Chicago love that fact because, as Jaros says, local investors can buy local deals and the out-of-state competition doesn't compress cap rates into the 3s or make for general craziness.

This is in direct contrast to markets like Texas, Florida and other high growth areas where it may not be uncommon to have a deal where there are 100 signed confidentiality agreements, 25 draft letters of intent and 10 best and final offers.

"Real estate investors are not like die hard Chicago Cubs fans – those who love the geography no matter what it gives you each year," Jaros says. "Real estate investors are not loyal to a market out of sheer faith. The number of investors that love Chicago can't ensure success for every project like in some other markets."

"Using my clients as a barometer," Jaros says, "there is still a lot of investor appetite for Chicago; a lot of that comes from people who know the town, the landscape."

About Distress

In the early days of the pandemic, national real estate experts were predicting that one of the trickle down effects would be a tsunami of distressed properties. Through mid-year that tsunami has yet to materialize with the force that was anticipated. That is not to say that there won't be some level of distress.

Weinstock says there is no more profound distress in Chicago than in any other market across the country. The distress that exists has occurred because some investors/developers overreached, overbought and/or overbuilt.

"There will be distress, but in a healthy way; one that creates opportunities," Weinstock adds.

On the topic of distress, Greg Warsek, Group Senior Vice President and Senior Regional Manager, Associated Bank, says the market is not anything like we saw in the last downturn, in large part because they are very different situations.

"If not for the pandemic, the distress would have not likely existed in many sectors," Warsek says. "Because this was not a financial induced crisis, lenders were keenly focused on helping clients which afforded them the opportunity to quickly catch up on deferred interest and/or principal payments."

There is the general feeling that we're turning, or have turned, the corner. But we are not out of the woods yet. There are some struggles, like in retail where there has been some fallout. The office sector is on the watch list because no one really knows the long term effects of new strategies for getting employees back to work. But most everything is coming back. Even hospitality, he says, is riding upward trends in occupancy and daily room rates.

On the bright side, experts generally agree that the good news is that after making it through the pandemic, predictions for 2021 and beyond don't look at all like 2008, or 2000, or the days of the RTC.

According to Chicago real estate professionals, the asset types most likely to experience more than a modest level of distress include indoor malls, downtown office buildings, hotel & hospitality assets and open air retail.

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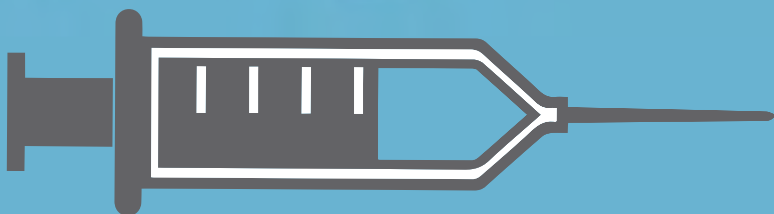
> Steven Weinstock
>
> First Vice President, Regional Manager and National Director of Self Storage Division, Marcus & Millichap

When ranked on a scale of 1 to 5 in terms of the level of distress asset classes would likely face, those named above all achieved an average rating of 3.25 or better. Indoor malls were rated 4.09 while industrial assets, at the other end of the spectrum, scored a 1.62.



What is your expectation for the post-COVID work environment (circa September 1)?

Back in the office full time	**22.4%**
Working primarily from home	**5.6%**
Being in the office at least 50% of the time	**39.3%**
Flexibility to be where you need to be	**32.7%**

Do you think being vaccinated should be a requirement for returning to work in the office?

Yes **56.1%** No **43.9%**

Source: The Real Estate Center at DePaul University

Returning to the Office/Vaccine

Returning to the office is something that is on everyone's mind—companies and their employees as well as landlords. Ludgin predicts that more firms will be going back to the office than may have been anticipated one year ago.

"The first six months of work from home went well," Ludgin says. "But by the end of the second six months the 'gee whiz' factor gave way to the recognition that not everything can or should be done by Zoom. It's less effective for mentoring and innovating."

Most people surveyed expect that by September 1 the Post COVID work environment will include some work from the office. More than two in ten (22.43%) expect to be back in the office full time, while 5.6 percent expect to be working primarily from home. The balance expects to be back in the office at least half the time (39.3%) or having the flexibility to be where they need to be in order to get the job done (32.7%).

"Sometimes the best opportunities, networking and team building take place in those transition moments before and after a meeting. You don't want to lose that," Ludgin says.

Based on more than four decades of work for a professional services firm, one respondent says, "the mentally healthiest environment is engendered by the community environment operating in an office."

The survey also posed the question of whether being vaccinated should be a requirement for returning to work in the office. Administered before the mid-July, variant-induced surge in new COVID cases, 56.1% think vaccination should be a requirement whereas 43.9% said it should not.

By the end of 2021, nearly 60 percent believe we'll have reached a point where 75% of employees will return to work, even if under flexible arrangements. Of that amount, 24.3% believe that level will be reached by the end of 3Q2021 and 34.6% say it will be by year end.

The Impact on Space

It has been an interesting 18-24 months for the built community, including architects and those in construction who are integrally involved in how tenants are changing their workspace as a result of COVID. Businesses are trying to find their way forward, not just for their immediate needs, but for the long term and how their visions, and thus their requirements, are changing.

"We're beginning to see a major shift in the way people view projects and their space. They are broadening their focus from short-term projects to get people into the office and instead focusing on the longer view," says Eric Gannon, Principal, Gensler. "We've been through a lot of experimentation and learning; a time of introspection and reflection."

Given the volume and disparity of tenants, there are no standard solutions. Gannon says it's a unique outcome for each tenant based on what they need and their overall approach to how their space will be used. In the past, people looked for easy, off-the-shelf solutions. Now they're looking at culture, mission and policy to help shape the overall environment.

"We've seen very few companies going boldly forward," he says. "There is some trepidation to define a policy and create a work environment when there is so much unknown."

In general, there has been a major shift, from viewing space as a container to space as an enabler. As a "container" there are offices, bullpens and open space planning. As an enabler there is space for collaboration, meetings (in-person or virtual); it's all very important. Gannon says the space that enables can be more effective, because of the outcomes it produces.

"The purpose of the office is to energize and come together; to do what you can't do elsewhere," Gannon adds. "It's less about focus, though that does remain important."

Just as the industry is seeing in various disciplines, the pandemic isn't the root of all that is changing in real estate. Prior to the pandemic we were seeing cracks in the structure of the office. The changes and evolution we are seeing today is more about creating greater balance.

"It's a healthy reboot," Gannon concludes. "The needs of the American worker are now being addressed more deliberately as we are thinking holistically of our well-being."

Around the Sectors

Industrial Market

Industrial investors and developers continue to be very optimistic about current and future prospects for the Chicago market.

"We continue to see a fundamental shift in industrial real estate as consumer behaviors change and firms reshape their supply chain," says Ben Paolone, Executive Vice President, Investments & Capital Markets, Becknell Industrial. "It's what gives this sector a longer runway for continued growth."

Yet he also suggests that the Chicago market is not without headwinds because of various issues that are impacting Illinois at the State and local levels. This is creating opportunities in markets outside of Chicago.

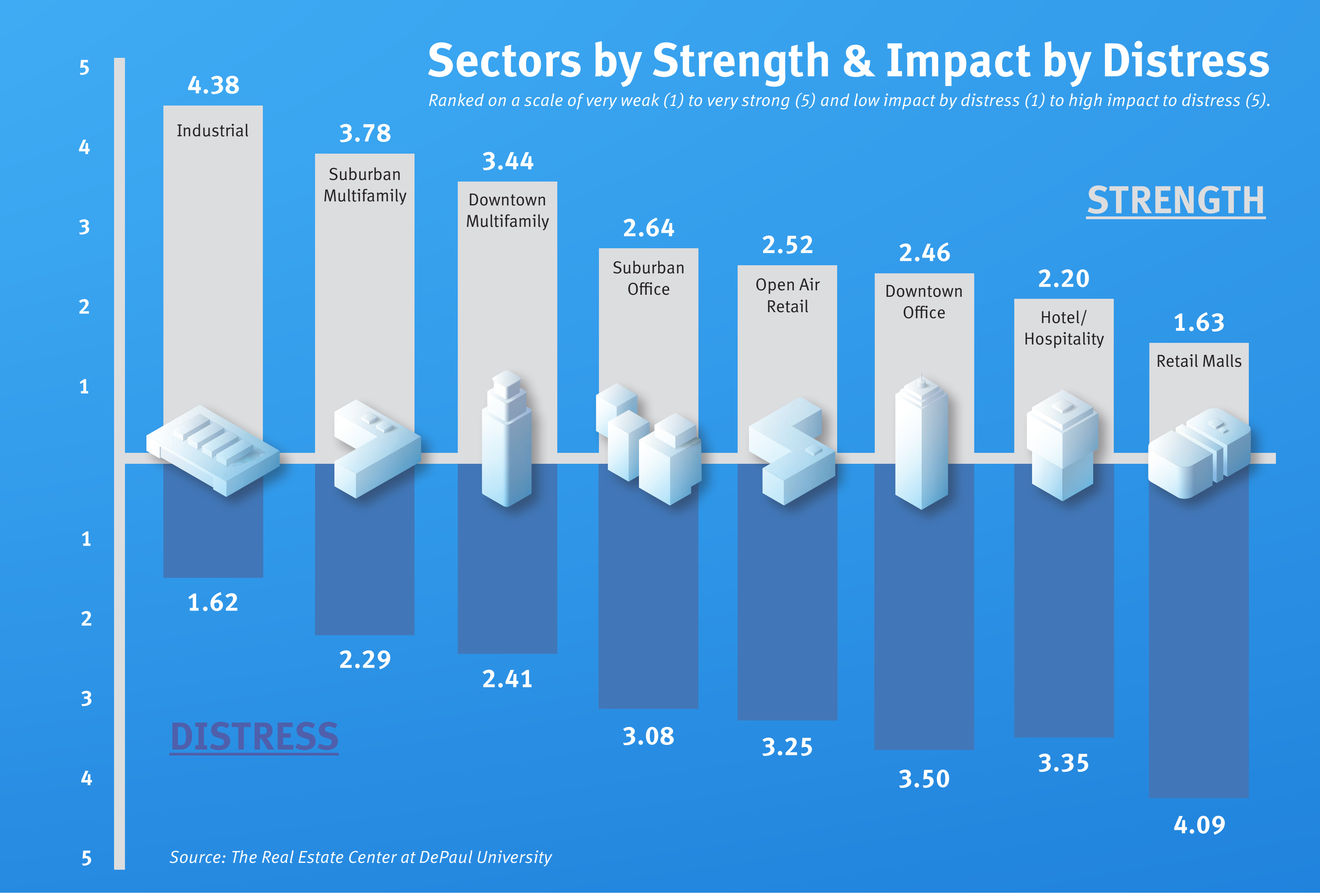
As companies evaluate supply chains, other markets may become more important. Paolone suggests that the industrial market, in Chicago and across the country, is benefitting from the safety stock concept that has some companies banking supplies to avoid supply chain issues that became evident during the pandemic.

"The pandemic opened our eyes to the challenges of just-in-time delivery," Paolone says. "We're now seeing some users increase the levels of inventory on hand, and thereby creating greater demand for space. Moving forward this is likely to become a more normalized practice."

He also notes that reverse logistics processes may be a real pain point for users. "The volume of online returns is astounding." Increasingly it will become a consideration as to whether space is carved out in an existing facility to handle reverse logistics or if it requires a separate facility.

Price increases for construction materials are as impactful on the industrial sector as perhaps any other because of the level of new development in the sector. The sector is still seeing increasing prices for steel and copper, although the trajectory may be slowing for other materials such as lumber.

"It's creating some heartburn," Paolone says, adding that no in-



dustrial projects are being put on hold. "Developers believe in the long-term prospects for rent growth and appreciation and, for now, are willing to absorb the cost increases."

The greater impact may be on scheduling. With products like steel in short supply and great demand, lead times are greater than ever and can cause start dates to get pushed.

As the survey results show, there is no reason not to be optimistic about industrial real estate in Chicago. "The market is strong and the fundamentals continue to improve," Paolone concludes. "While 2022 should also be a good year, I don't expect the same level of cap rate compression. There's only so much compression that can occur."

Multifamily

As the year progressed, investment in Chicago's multifamily property sector began showing signs of improvement. It prompts Phil Lukowski, Executive Vice President, Portfolio Management, Waterton to say he's optimistic for the sector's upward trajectory citing recent movement in new transactions and listings, and a return of demand.

Recently, the sale of a $200 million, two property 1,061 unit complex downtown was reported. It represents the highest sale price in two years. Further, new property listings in River North, the South Loop and River East are viewed as a harbinger of strong activity in the second half of 2021.

"These listings are testing the waters and will give the market greater perspective on investor appetite, pricing and cap rates," Lukowski says. "It's a good sign for the market; now we'll have to see how it plays out."

There has been a relatively strong bounce back in demand during the second quarter after softness in the first quarter. This paves the way for a measure of rental rate stability and increased occupancy. "There have been deals available to tenants," he adds. "The market is catching up; the drain on demand is being reversed."

There is broad expectation that as long as there are no COVID setbacks or hiccups in the economy that apartment markets in Chicago will be back to pre-COVID net effective rent levels by Spring or Summer 2022. Currently, however, downtown is a price conscious market. While pre-COVID there were no abatements, there are now, and there is the potential that they could increase further through the end of the year.

In Chicago and across the country, capital market activity shut down almost entirely during the second and third quarters of 2020 in response to the pandemic. The drop in demand for apartments was notable in 2020 whether the market was downtown Chicago, New York, Los Angeles or many other gateway city areas. Yet Lukowski says that today there is no shortage of capital waiting for the best time to acquire real estate in general and, more specifically, multifamily projects.

The question is whether Chicago is at the top of most investors' lists. The market locally has been slower because of an overall drop in performance, the tax and fiscal issues impacting the city, county and state, and an overall outward population migration. But Lukowski says, "Chicago isn't scarred any differently than other major cities. Demand will come back."

Investors that have a national acquisition strategy will target most MSAs, including Chicago. In the final analysis, it typically is about price and the long-term view on any given market. That usually means that firms aren't afraid to take a contrarian position for the right opportunity.

Among the primary concerns for Chicago is whether the city can compete for and attract companies that will create jobs downtown. "People want to come back downtown, especially the younger set," he adds. "It's just a matter of whether we can attract jobs that will help absorb the inventory that currently exists.

"If we keep Chicago growing, demand will be there," Lukowski says. "Taxes don't stop deals, it just means that for some, Chicago won't be at the top of the list."

Chicago Retail Market

According to Peter Borzak, CEO, Pine Tree, the state of retail in Chicago and across the country is strong when measured by spending and the level of savings people have to spend.

"Yet retail overall, and in many of the different property types, is a tale of two cities: the haves and the have nots," Borzak adds.

Grocery anchored retail, and the ancillary, service-oriented retailers that are co-tenants, has held up best over the last 12-15 months. There is great confidence in this segment of the market because it has performed well. "From a return perspective," he says, "we're seeing cap rates that are lower now than they were pre-pandemic."

During that time, open air retail proved its role as both a convenient and safe outlet, with ease of access to curbside pick-up and traditional brick and mortar shopping when it was available.

In the aftermath of COVID 19, and with the further expansion of ecommerce/online shopping, what outcomes do you think are most likely in the retail sector?

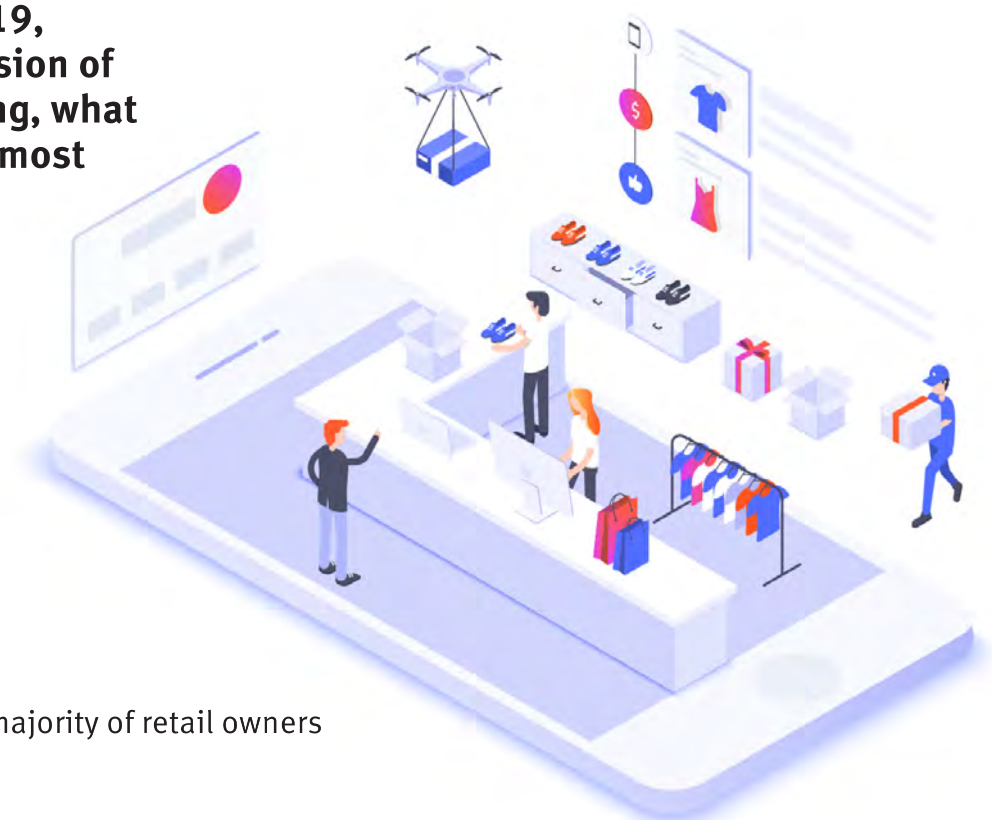
Considerable reinvention/ reimagining of centers and retail spaces
58.88%

Increased focus on converting properties, or a portion, to other uses
30.84%

Considerably more store closings
5.61%

A return to the status quo for the majority of retail owners
2.80%

Other
1.87%



Source: The Real Estate Center at DePaul University

Borzak says specific product types are not without issues and challenges. Regional malls, for example, have been on the decline for 25 years. The pandemic simply reinforced and, in many cases, accelerated the challenges. Specifically, with the advances of ecommerce, there is less need for full price department stores which are considerably more expensive to operate. This leads to the need for reinvention and/or repurposing. For some properties that will mean razing existing GLA and in its place developing multifamily communities or other appropriate uses.

One of Borzak's greatest concerns is that there is too much retail, not just in Chicago, but across the country, which certainly means that there could be select acquisition opportunities.

"Now is not the time to back up the truck and load up on retail properties as you may with industrial and multifamily opportunities," Borzak said. "But there will be opportunities."

Some of the "excess" space will become obsolete, if it hasn't already. This means that there will continue to be losers in retail—properties that are irrelevant and need to be repurposed. "Obviously, it's important for investors to discern between the winners and the losers," Borzak adds.

All of that notwithstanding, Borzak is optimistic about retail in Chicago. "Brick and mortar will always have an important place."

Borzak sees continued opportunity for retail in the suburbs with the movement there by the Millennials. There will be an ongoing need for space in the suburbs as this demographically rich group moves to the suburbs and starts families. "The pendulum is swinging for suburban retail," Borzak says. "It is likely to create opportunities."

Chicago Office Market

The general consensus is that it is not a great time to be an owner of office properties in Chicago—or other markets. Volini agrees, but explains that there isn't a clear vision of how the post- COVID scenario will play out.

"I am not saying that people aren't coming back to the office," Volini says. "Time is the mechanism for telling us what will happen."

Volini, like many others, is looking to what the picture looks like after Labor Day. Volini says he hears three primary questions from clients: what is the status of and/or the rules surrounding vaccines, will school be fully open, and what will public transportation be like?

"If people feel comfortable with the responses to those topics, the return to the office will go much smoother," he says.

There are many other factors to consider, like occupancy costs. Tenants have the ability to reduce costs with a smaller footprint. They may expand their recruitment reach by interviewing and hiring candidates from all over the country which will reduce space needs and could even reduce salary, depending on where candidates live.

"Overall, this is a much deeper picture than anyone can interpret," Volini says.

Today, there are plenty of opportunities for tenants both downtown and in the suburbs: sublease space, newly developed first generation space, and second generation space. Another option, for suburban users, is the inventory of single-story space that Volini says was helping reshape the sector prior to the pandemic. Interest in it has only accelerated.

"No one is saying that the skyscraper is dead," Volini says. "Depending on the tenant and its business, it can make a difference to go to a River North building or a walk-up style building in another submarket."

Because of the supply of space options, tenants expect better deals, but the deals and the motivation aren't there yet. "Rents aren't going down because no one is losing deals," he says. "The deals just aren't there, and there is no fire in the movie theater that is driving people to react."

"Time is the mechanism for telling us what will happen."

Tom Volini
Executive Vice President, Colliers

The pandemic has caused there to be a dramatic reduction in building sales and assets brought to market. If you're selling an office asset right now, there likely is an underlying issue: an investor cutting its losses, reallocating funds to other asset classes, or dissolving a fund/partnership. It's not likely because you've hit a home run.

Property taxes are an issue for all asset classes, but perhaps none greater than office building owners. At the same time, property taxes are less of an issue for tenants than they are for building and homeowners.

To that point, tenants look at property taxes primarily as part of their overall occupancy costs. It's easy to justify it because 'it's the market', Volini says. Moreover, tenants reduce occupancy costs by becoming more efficient with their space and taking less of it. "At some point the taxes do rise so much that there's an impact," he adds. "But each tenant's threshold, and how they reconcile it, is different."

In summing things up, Volini likens our place in the market to a Wall Street quiet period. "No one knows exactly where things are going. There is a fair amount of healthy confusion and for some tenants the best thing to do is sit tight while things get sorted out."

General Investment Activity

“The pandemic caused a pause for the entire investment market,” Weinstock says, characterizing 2020. “Initially, the market paused for 2-3 months as everyone said, ‘what the heck.’”

Some sectors such as industrial quickly found its footing and returned to pre-pandemic activity levels. Others, such as multi-family, had to wait until a newfound sense of the market was established. One sector that has fared well during the pandemic has been self-storage as households were combined and consolidated to curb expenses.

“People needed to put their stuff somewhere to make room for the kids or other family members as some people looked to save money and/or create their own family bubbles,” Weinstock said.

While Weinstock considers himself to be an optimist and believes there are big picture reasons for a positive outlook, he also acknowledges the existence of concern and doubt among some investors; their presence historically creates uncertainty. Those issues that can be stifling to commercial real estate include capital gains taxes, carried interest, 1031 exchanges, marginal tax rates.

“There are policies at the Federal level that the common investor has limited ability to influence but which can impact the market significantly,” Weinstock notes.

He specifically points to 1031 exchanges. There are opportunities right now to buy exciting, well-positioned properties that are producing good returns. “But if the strategy is to hold and sell in three years and the 1031 vehicle is gone, owners will wonder what to do next.

“The lack of ability to defer taxes impacts investment strategy and leads Weinstock to wonders whether a lot of owners/investors have thought through all of the implications of today’s market. “Again, it’s an exciting but scary time because we don’t know what we don’t know,” Weinstock said.

Another thing we don’t know, according to Weinstock, is the impact of the impending changes to the Federal stimulus programs.

He warns that COVID relief, along with the infrastructure package, can have unintended consequences. “It could all trickle down to inflation, which isn’t always bad for commercial real estate.”

When advising clients on pricing, Weinstock says brokers need to be pragmatic and neither create fear mongering nor sugar-coat market conditions. “From a pricing perspective, we’re not at the top yet; there is still time and room to be aggressive.”

Weinstock says there are reasons to be optimistic, for Chicago and for the market overall. “Despite the challenges we’ve encountered, Chicago, and the real estate market in general, continues to thrive.”

The Money Sources

In assessing the state of the market, Associated Bank's Warsek suggests that everybody now believes the recovery is in progress. In looking back to the beginning of the pandemic, he notes that Associated Bank never really stopped making loans, with the exception of the first 90 days which he called triage for clients.

"There has continued to be a significant amount of business—projects that made sense and that we believed in," he adds.

For Associated Bank, new loan commitments held up relatively well in 2020 and are expected to exceed that level in 2021 as the market bounces back. Not surprisingly, loans for industrial and multifamily projects were the most prevalent, but they also did a fair share of retail projects, too.

As the pandemic was just starting, Jerry Lumpkins was beginning his new position as Chicago Commercial Real Estate Lead, Bank Leumi. While it may have been challenging to be onboarded and "grappling with how to get started" in a virtual environment, Lumpkins noted that one advantage was that Leumi had no problem with commercial real estate loans in Chicago or the Midwest.

"While competitors shut down production to do workout and portfolio management, we didn't have that," Lumpkins says. "Regardless of the factors influencing it, I have never been busier in 25 years."

Warsek attributes the elections and the availability of vaccines as being a catalyst for activity in the first half of the year. He further notes that significant competition among banks heated up in earnest on/or about April 1.

"Before that, not everyone was back in business," Warsek says. "It's as though some banks hit the pause button and forgot to turn it back on. But that all changed; everyone wants back in to ride the upswing. It's a borrower's market."

Lumpkins acknowledges that the opening up of businesses has helped tremendously, although he has kept busy all along. "Nothing replaces being on site and 'kicking the tires'," he says. "You just can't get the same feel looking at pictures on Google Drive."

According to the experts, lending practices during the pandemic were very different than in 2008-2010, a period of time that was a great financial crisis and not a medical/healthcare crisis. "This was not '08 which was characterized by a lot of bad behavior," Lumpkins says.

Deal structure—terms and conditions—was a test of tried and true relationships. In times like the pandemic, borrowers—both developers and investors—typically stay with lending sources where there is a long term relationship. As a result, Warsek says that deal structure and terms did not really change much throughout the pandemic.

Optimism Overtakes Pandemic Concerns

There is no question that people, from the big dealmakers in all lines of business to the small and mid-size entrepreneurs to government officials to those who work in office and industrial buildings, retail centers and other facilities, are ready for the pandemic to be over.

In spite of the fact that it was a grueling 16 months, give or take, there is both a sense of optimism as well as a real dose of reality in terms of what lies ahead.

Weinstock says there are reasons to be optimistic, for Chicago and for the market overall. "Despite our own dysfunction, we continue to thrive."

Lumpkins sees good things for the marketplace, saying, ""It's a great time to be in real estate," Lumpkins says. "You just need to understand and take stock of where you are in the cycle and how you respond."

To that end, he says that everyone in the lending sector is back now—traditional banks, agencies, CMBS and life companies which he notes are being very aggressive. "It makes it tougher to win the business," he says.

Ludgin takes a more pragmatic view, looking both at the social consciousness and the business. She is "horrified" at the political discourse on myriad topics. "We have a great opportunity to say let's do things differently and help people live their best lives," she says.

Still, she says there will be opportunities, now and in the future. "Lenders have been understanding, and private debt funds can bridge for another day. There are some who still redline Chicago. But the sophisticated investor won't write off Chicago."

Wurtzebach, who also has traveled the up and down waves of cycles, understands the realities of the markets nationally and in Chicago. "Yes, there are challenges ahead that will require hard work, but the pandemic era is unlike anything anyone has experienced. It's not the Global Financial Crisis. Because of that, there is reason to be optimistic."

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