A MID-YEAR PERSPECTIVE ON CHICAGO REAL ESTATE MARKETS
Chicago real estate professionals universally agree that the commercial real estate markets have been consistently strong through the first half of 2018. However, according to a Mid-Year Chicago CRE Survey conducted by The Real Estate Center at DePaul University (The Real Estate Center), there is far less agreement on the outlook for the second half of the year.

The Real Estate Center Report surveyed more than 3,000 Real Estate Center sustaining sponsors and members of the DePaul Real Estate Alumni Alliance to gauge their perspective on various issues and trends in Chicago real estate. Follow-up interviews were conducted with select members of both groups for more in depth perspectives on the marketplace.

Some of the key findings of the Report include:

• 69.8 percent of DePaul related CRE professionals say the real estate markets in Chicago have been consistently strong in the first half of 2018.
• 44.2 percent said their outlook for the second half of 2018 trends toward concerned while 30.8 percent remain bullish for the second half; 21.2 percent are optimistic.
• Participants are almost evenly split when predicting which will be more beneficial for Chicago, the almost instantaneously created neighborhood associated with an Amazon HQ2 victory (56.6 percent) or the continuation of organic growth that has been taking place (43.4 percent).
• Interest rates have not been having a significant impact on acquisition activity in Chicago, yet the interest rate climate is participants’ leading national factor that causes the most concern on Chicago’s markets.
• Almost 86.6 percent of those surveyed said the financial and related woes of Chicago and Illinois are having at least a modest level of significance on the City and State, but few see prices falling or investors walking away from deals as a result.

According to Charles Wurtzebach, Chair, Department of Real Estate and Douglas & Cynthia Crocker Endowed Director, the Real Estate Center, DePaul University, while there is much to evaluate concerning the state of CRE in Chicago, and varying perspectives on the market, CRE professionals with ties to DePaul generally see the glass as half full.

Job growth, organic business growth and the outsiders’ view of the value of Chicago real estate are positive. Rising interest rates; financial and political concerns in Chicago, Cook County and the state; and the prospects for higher property taxes keep those thoughts in check.
“Given the sustained bullishness of the Chicago marketplace, it is rational to think that some type of correction is in order.”

Brian Rogan
Vice President, Associated Bank
By an overwhelming margin, survey participants characterized Chicago’s real estate markets during the first half of 2018 as consistently strong. Yet, according to results from the Real Estate Center Report, more than half (52 percent) are optimistic about the market, even if cautiously so, responding they are bullish (30.8 percent) and trending toward optimistic (21.2 percent). However, 44.2 percent characterized themselves as neither bullish nor bearish, but trending toward concerned.

Those who are “trending toward concerned” cite a variety of factors, including being nine years into the cycle, rising construction prices, flattening rents and increasing interest rates.

Yet those with a different perspective are optimistic because of support from recent Trump tax legislation, and capital demand. As a result, many still believe that when all is said and done, 2018 will remain healthy, while beginning to recognize the risk of slowing growth.

What Are Your Expectations For The Chicago Real Estate Market During The Second Half Of 2018?

**BULLISH**

30.8%

**BEARISH**

3.9%

**NEITHER, BUT CONCERNED**

44.2%

**NEITHER, BUT OPTIMISTIC**

21.2%
Given the sustained bullishness of the Chicago marketplace, it is rational to think that some type of correction is in order,” Brian Rogan, Vice President, Associated Bank, said. He went on to say that while there may be some pricing softness in the next year, he does not expect to see a major, across-the-board correction taking place.

Lenders are still bullish on Chicago; life companies and others are under weight on Chicago real estate; they are staffing up to greet that need to invest in Chicago.

Matthew Wurtzebach, Vice President, Commercial Finance Group, Draper & Kramer, sees that trend continuing in the second half of 2018. Some lenders and equity investors have allocations that still have more to invest in 2018 than they did in 2017.

“They have a strong appetite and are competing on price to win the best loans,” Wurtzebach said.

He predicted that the industry may see a more conservative approach to construction loans.

Stephanie (Matko) Chrisman, Vice President, Asset Management, Pearlmark Real Estate Partners, agreed that the markets are strong. She is cautiously optimistic that the markets will remain strong.

“Capital in the market is helping to push prices higher,” she said. “The unanswered question remains how many takers there will be at these higher prices.”

She advised that anyone who is able to get an off-market deal should act quickly as they are few and far between. Michael Episcope, a principal with Origin Investments, a Chicago based real estate private equity firm, expressed that he is more concerned this year than last.

“I believe the city apartment market will be relatively flat or slightly lower due to supply issues.” Episcope said. “There is still value to be found in suburban locations, but much more so on an individualized basis. Office in the city will continue to benefit from urbanization and relocation trends, and we will continue to see growth in occupancy and rates around major city transportation corridors.”

Jim Shilling, George L. Ruff Endowed Chair, DePaul University, said the greatest cause for optimism for the second half continues to be the strong job growth that is taking place. “That probably won’t change,” he added.
Nearly 52 percent of people responding to The Real Estate Center survey said that the interest rate environment causes them the greatest amount of concern for Chicago's commercial real estate industry.

The lack of corporate growth was cited by 21.2 percent while escalating trade wars were tapped by 11.5 percent of respondents as causing them concern. “Other” factors were also cited by 11 percent.

For those acquiring properties like Origin Investments, it’s hard not to be concerned about interest rate movement. “We’ve witnessed increasing interest rates but relatively no movement in cap rates. Something has to give,” Episcope said. “Further compounding conditions could be a slowdown in growth which would create a real challenge.”

Rogan, a believer that raising interest rates will have the greatest impact on the investment community, said, “Interest rates most directly impact how borrowers are looking to invest. They are looking for the best yields, and rising interest rates have the ability to affect outcomes.”

Wurtzebach said the reason interest rate increases haven’t yet impacted acquisition activity is twofold, reinforcing that the rate, while trending upward, remains historically low. He also added that there hasn’t been a discernable decline in activity levels because, until now, lenders have absorbed anywhere from forty to sixty percent of the impact of the rate hikes, a strategy that isn’t likely to continue in the long term.

“It’s a choice for most lenders,” Wurtzebach said. “Traditional lenders are feeling pressure from new entrants and have opted to compete on price before quality.”

Chrisman added that with Libor increasing, people are being more cautious in their deals. “This may not produce a significant, immediate impact, but it is causing buyers to be more conservative in the way they are underwriting deals.”

She noted that on a national basis, the level of deals isn’t slowing down, and neither is the competition for those deals.

Interest rates affect each sector differently, Shilling explained. While fluctuations in interest rates impact the cost of capital, upward pressure on rental rates can be positive for the owners of multifamily assets and those who may own single family rental properties.

“One person’s fears are another person’s advantage,” Shilling said.

In the overall picture, interest rates are not a great concern for Shilling. He explained that while a 75 basis point interest rate increase in the next year could induce a 100 basis point increase in the cost of capital, he doesn’t see that deterring most investors from placing capital in real estate.

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**What National Economic Factor Causes You The Greatest Amount Of Concern For Chicago’s Commercial Real Estate?**

- Trade Wars: 11.5%
- Stock Market Volatility: 3.9%
- Other: 11.5%
- Lack Of Corporate Growth: 21.2%
- Interest Rate Environment: 51.9%
“My biggest concern is increased supply and various other factors that could create headwinds and detract from job growth,” Shilling said.

Don Pafford, Senior Vice President, US Bank, commented further on the national and geopolitical landscapes, too, noting both positives and negatives. “I like the job growth numbers; and the interest rate increases aren’t all that bad,” he said.

However, like many, Pafford expressed concern that President Trump could do something, purposefully or unwittingly, that would have an immediate impact on the financial and real estate markets, nationally and in Chicago.

The looming threat of the impact of increasing interest rates is in contrast to participants’ thoughts on their more recent impact. Just over 66 percent in the survey said that interest rate increases are not yet having an impact on acquisition activity.

“We have not yet reached an inflection point where interest rates are having an impact on activity,” Rogan said.

He further noted that from an investor standpoint, investment decisions typically are based on the ability to secure specific target yields. Real estate, he added, is still a solid and desirable investment. ■

“We’ve witnessed increasing interest rates but relatively no movement in cap rates. Something has to give. Further compounding conditions could be a slowdown in growth which would create a real challenge.”

Michael Episcope
Principal, Origin Investments
More than 85 percent (86.6 percent) of those surveyed said that state and local financial/government issues—from the pension/financial crisis to property tax concerns to government infighting—is having at least a modest level of significance on the commercial real estate industry. More than 48 percent said the level of significance was great and 38.5 percent said the significance was modest. Just over 11 percent said the level of significance depended on the issue.

“The fiscal ills of the city itself and the ability/need to further raise real estate taxes is a concern of mine,” said Pafford. “At some point this all has to bubble up and be a roadblock, whether you’re an investor or a developer. There will come a point when investors look at the downtown market and come to the conclusion they can’t do the deal because they can’t afford the taxes.”

“Chicago had a reputation as a flyover market; a market that investors would fly over for other cities in the country,” Rogan said. “But Chicago has done a great job of building really good properties. So good that today people can’t achieve the returns they want from the coasts and are turning their attention to Chicago.”

He said that, and the fact there is so much capital out there, is why people believe values in Chicago will continue to go up.

“Local investors can wrap their heads around the tax and financial issues that are impacting the City and State,” Rogan said. “Outside investors historically couldn’t, but now the desire for yield is so great, there are no longer automatic denials for investments in Chicago.”

Some investors, like Origin, find the financial woes of the city and Cook County creating a great deal of uncertainty which makes it more difficult for deals to pencil out.

“We’re still buying, and looking for more acquisitions in the Chicago area,” Episcope said. “We are being conservative in how we are underwriting taxes so that we minimize the impact any property tax increases might have on our returns.”

According to Wurtzebach, the various factors in the city and state haven’t pushed investors to the point of seeing them walk away. Instead, they may take a more conservative approach to underwriting an acquisition.

“We hear questions about pensions and other issues from out of state investors,” Wurtzebach said. “But so far, it hasn’t stopped investment activity. Investors are still bullish; just maybe a little more cautious when considering the impact of real estate taxes.”

Shilling expressed concern about the long-term impact of the financial woes of the city, county and state and the level of outward migration it could influence. “These are issues that need to be dealt with,” he said.

Pafford admitted that he doesn’t know how we fix it but surmised that the situation has to be a concern for anyone who owns real estate in Chicago, and throughout the area.” While not disagreeing with the magnitude of the issues, others advanced the notion that in some ways, the strength of the marketplace and its ability to produce solid returns overshadows the property tax issue.

“The impact of property taxes in Chicago and throughout Cook County is significant. But people are accepting the increasing taxes because the market is so strong,” Chrisman said.

Rogan explained that the city has earned a great reputation and place in the minds of investors who before looked to other coasts for investments.
The Real Estate Center Report also asked participants to weigh in on specific sectors, and markets, of growth, opportunity and hesitation. And like some of the other questions, impressions were vastly different.

Wurtzebach stated his belief that the top three assets in Chicago are in line with national trends: multi-tenant or geographically diverse portfolios of industrial properties, multifamily and grocery-anchored retail centers. He said there is a strong debt market for all of those assets, but some have dialed back leverage.

Wurtzebach said that e-commerce is creating a great tailwind for industrial properties, and also driving exposure to strong retailers that have a need for distribution space to fulfill their on-line strategies.

In contrast to some who stated unequivocally that they had no appetite for suburban office properties, Wurtzebach said he has seen some significant activity in that space, particularly from debts funds. He said that last year Draper & Kramer funded 11 suburban office acquisitions.

“There are a lot of great opportunities in the suburbs,” Wurtzebach said. “The media has been too harsh in their criticism of suburban office properties.”

Wurtzebach also suggested that the headlines for retail are so bad that it is driving pricing down. But he also said that institutional investors are drawn to grocery-anchored centers and retail properties that are “Amazon proof”, offering a tenant roster that includes quick casual restaurants, medical space, dry cleaners and other service-oriented businesses.

He went on to say that while many people are turning their back on retail, investors with a specific thesis are finding opportunities, like an investor with the wherewithal to convert a big box retail space into a self-storage facility, or some other in-demand use.

Pafford specifically cited asset classes that he is bearish on; properties that US Bank would be very cautious of, including those in the hospitality and retail sector. He also cited multifamily assets, though he clarified that being somewhat “bearish” on multifamily doesn’t mean he wouldn’t consider a deal.

“I am concerned, in general, about supply and the city’s ability to manage that supply,” Pafford said.

The strongest asset classes, ones that US Bank is bullish on, include industrial and downtown office. Pafford said, “The downtown office market is holding its own, and there is good investor appetite for CBD properties. There is more supply coming, and we’ll see how that does.”
The Real Estate Center’s Mid-Year Sentiment Report asked which scenario—winning the battle for Amazon’s HQ2 or productive, ongoing organic growth in places like 1871, the West Loop and Fulton Market—would be more impactful for the City of Chicago.

Responses were mixed, with 56.6 percent of the participants saying Amazon HQ2 would be most impactful, though many expressed concern or a wait-and-see attitude based on gaining a better understanding of the incentive package that would be awarded to Amazon.

Those interviewed for the report were equally mixed, offering strong opinions for either outcome. Many said it is an impossible question to answer with the information that is known and, more importantly, the information that is unknown.

“It’s hard to know what the Amazon incentive package will mean; hard to gauge the impact, because we don’t know what has been offered,” Wurtzebach said.

“I don’t know if one is better,” Rogan said. “How can new jobs be seen in a negative light?”

Wurtzebach countered that, to a degree, and said, “Amazon is one tenant, and there is risk in putting all your eggs into one basket.”

“Winning Amazon HQ2 would be a big plus for all sectors. In this market, tech companies are driving growth. Amazon would help do that,” Shilling said before noting that an Amazon victory is not void of concerns.

“Sometimes you have to worry about what you wish for,” he added, comparing the issues that San Francisco and Seattle have experienced—huge infrastructure spending and major congestion—as they have grown as major tech hubs.

Other commercial real estate professionals lamented “the
BEING SELECTED AS THE SITE FOR AMAZON’S HQ2

56.6%

ORGANIC GROWTH THROUGHOUT THE METRO AREA

43.4%

What Scenario Would Be Better For Chicago Area Real Estate Markets?

shock of that type of win” in Chicago or really anywhere in the country.

“I wonder if we could absorb the shock, and the price war that could result,” said Pafford, who described himself as someone who prefers slow and steady, expressing concerns over how the city could handle an HQ2 win.

Pafford added, “I think to do what we’ve been doing, with a lot of tech like Google, WWP, and along with many others, moving to Fulton Market and the West loop, is better in the long-term.”

The experts talked about Amazon’s ability to essentially create a whole new neighborhood overnight, spur new development and impact positive job growth.

Stephanie (Matko) Chrisman put things in perspective saying, “Chicago has done very well with organic growth for at least the last 10 years, as companies have grown, expanded and relocated downtown. I think if we don’t get HQ2, we’ll still be okay.”

For Episcope, the question of Amazon versus organic growth is “not an either or situation, it’s an and.” If Amazon comes to Chicago we’ll see growth we haven’t seen in 40 years,” he said.

He also noted that over the long run, Chicago needs to sustain the growth of Fortune 100 companies to the City. At the same time, true organic growth is needed, not growth in the City that is simply the relocation of companies from the suburbs.

ACKNOWLEDGEMENTS

The Real Estate Center at DePaul University wishes to thank all those who participated in the survey, including those who were involved in follow up interviews to gain further perspectives:

Charles H. Wurtzebach (BUS ‘71), Chairman, Department of Real Estate, The Real Estate Center at DePaul University
Michael Episcope (BSC ‘94, MS ‘08), Cofounder, Origin Investments
Stephanie (Matko) Chrisman (BSC ‘04, MBA ‘10), Vice President, Asset Management, Pearlmark Real Estate Partners
Don Pafford, Senior Vice President, US Bank
Brian Rogan (MBA ‘09, MSRE ‘10), Vice President, Associated Bank
Jim Shilling, George Ruff, Endowed Chair, DePaul University
Matthew Wurtzebach (MBA ‘12), Vice President, Commercial Finance Group, Draper & Kramer
• Michelle Armstrong
  Antunovich Associates, Inc.
  Joseph Antunovich, Owner and President
• Associated Bank
  Gregory Warsek, SVP and Regional Manager
• Avison Young
  Richard Hanson, Principal
• Bucksbaum Retail Properties, LLC
  John Bucksbaum, CEO
• CBRE
  Neil Pendleton, Managing Director
• Chicago Title Insurance Company
  Terry Hendrickson, VP & Sales Manager
• DC PARTNERS LLC
  Douglas Crocker II
• DePaul Real Estate Alumni Alliance (DREAA)
  David Neithercut, Trustee and CEO
• Ernst & Young
  Richard Sinkuler (BSC ’83, MS ’86), Partner - Real Estate Hospitality & Construction Markets Leader - US Central
• KPMG LLP
  Andrew Corsini, Partner
• Marc Realty
  Gerald Nudo, Vice President
• Goldie B. Wolfe Miller Women Leaders in Real Estate Initiative
• NAIOP Chicago
• Origin Investments
  Michael Episcopo Ch Principal
• Pine Tree Commercial Realty, LLC
  Peter Borzak, Principal/Co-Founder
• Real Estate Investment Association
  E. James Keledjian, Principal
• Retail Properties of America, Inc.
  Shane Garrison (MBA ’05), Executive Vice President, COO and CIO
• Trinity Hotel Investors LLC
  George Ruff (BSC ’74), Senior Principal
• US Bank
  Donald Pafford, SVP and Market Manager
• Waterton
  Phil Lukowski (BSC ’88, MBA ’92), Executive Vice President
• The Weitzman Foundation
  Howard R. Weitzman, President and Director
  Arden Weitzman, Secretary and Director
  Howard J. Powers II, Treasurer and Director
• Charles H. Wurtzebach (BSC ’71) & Susan M. Marshall