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SUBURBAN CHICAGO CITY HIGHLIGHTS

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Suburban Chicago Multifamily Market

The suburban Chicago apartment market is one of the most attractive multi-housing investor markets in the Midwest. Historically increasing rental rates and generally stable occupancies, along with an anti-apartment mentality by municipalities results in supply constraints. These are the primary reasons for long-term rent growth, net operating income (NOI) growth and price appreciation. Investors often turn to Chicago's stability to diversify portfolios from the wide swings seen on coastal multi-housing investments.

The suburban Chicago apartment market has traditionally been characterized as a barrier to entry market with limited new supply and steady demand leading to consistent and solid rent growth. The barriers to entry and solid demand had led to long-term rent growth trends in excess of inflation. Several quarters in 2006 and 2007 saw effective rent growth in the 4- to 6.50-percent range on a year-over-year comparison. During the last 5 years, supply has been virtually non-existent and condo conversions depleted more than 10,000 units from the inventory. In fact, only 200 units were delivered in the Chicago suburbs in 2009, and none are expected to deliver in 2010 and possibly even 2011.

At most, one or two new projects on average per year have been delivered during the last 10 years. Recently, the projects have been smaller in size, with some totaling 90 to 112 units and rarely exceeding 200 units. Suburban communities continue to promote Not in My Backyard zoning with a preference for condominium housing. This, in turn with the capital markets issues, has led to a freeze in rental starts. The past 6 years has experienced an average of only 207 new apartment units being added per year to the entire Chicago suburban market.

Multiple signs point to a bottoming of the market between the first and third quarters of 2009. According to Appraisal Research Counselors' (ARC) second quarter 2009 apartment report, occupancies were up 40 basis points to 91.7 percent from 91.3 percent in the first quarter of 2009, the first gain since the second quarter of 2007. The trend continued into the third quarter, with overall occupancies hitting 92 percent. Given the approximately 200,000 metropolitan statistical area job losses, physical occupancies have held up relatively well. Typical long-term rental occupancies in the Chicago suburbs are in the 93 to 97 percent range and have averaged 93.5 percent during the last 13 quarters. Average rents were $1.06 per square foot according the ARC's second quarter 2009 report, rising slightly to $1.07 per square foot in the third quarter. While down from the 2008's year-over-year levels, negative rent trends appear to be slowing and stabilizing, despite the continuation of operators buying occupancies via rent concessions.

Despite the recent turmoil in capital markets, investor enthusiasm for Chicago multi-housing properties remains robust. For core A and B+ investment opportunities, sale cap rates and investor yield expectations remain aggressive, as capital continues to outstrip the availability of investment-grade multi-housing properties to purchase. There is a substantial going-in cap rate gap between investor demand for A and B+ assets and B- and C assets.

Transaction velocity is showing signs of improving, as several transactions closed in late June and provided data points for investors. Fourteen transactions more than $7.5 million closed at going-in cap rates between 6 and 7.50 percent. Investors were able to secure Freddie Mac or Fannie Mae debt between 5.35 and 5.75 percent at 75 to 85 percent loan-to-values and achieve positive leverage and 8 to 10 percent cash-on-cash returns. Given Freddie and Fannie's commitment to continue to provide liquidity, investors in multi-housing can obtain debt with superior terms relative to other asset classes, enabling transactions to continue to occur.

At CB Richard Ellis, we expect 2010 to be a year where operations stabilize and owners focus on driving NOI growth through operational efficiencies. The cooling housing market is reducing tenant turnover and causing would-be home buyers to remain renters for a longer period of time. Subprime issues are resulting in former homeowners reverting back into the rental pool. Occupancies are projected to rise into the 95 percent range in 2011 and beyond, and effective rent growth is projected to average 3 to 6 percent due to concessions that will burn off and true market rent growth in the market.

While the weakened economy has recently impacted market conditions, the Chicago suburban market is poised to achieve significant rent growth starting in 2011. Reasons for this growth include declines in home ownership trends, with for-sale housing demand waning in lieu of rental demand; strong demographic trends, particularly from the 24-35 age group, which is a prime renter cohort; a growing propensity to rent, as young professionals desire more lifestyle flexibility; an empty-nester demographic that is looking to downsize into maintenance-free living; and increasing commuter costs that are causing renters to look for transit-oriented development locations, capitalizing on Chicago's excellent mass transportation system.

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Suburban Chicago Industrial Market

The Chicago Industrial real estate market is dead…or is it? In 2009, we saw a dramatic decline in activity and for many developers, a 90 percent-plus reduction in development due to the lack of capital and virtually no traditional sources of financing, declining values and overall economic uncertainty.

Vacancy increased to nearly 12 percent, up a percentage point from the third quarter of 2009 and up almost two points from 2008. Forecasts for 2010 suggest another 1 percent jump but also the probability of stabilization. However, any meaningful recovery will take at least 12 to 24 months depending on how quickly market fundamentals improve. Overall net absorption was just less than a negative 16 million square feet compared to a positive 6 million square feet in 2008. Sublease space contributed close to 6.5 million square feet on top of 6 million square feet in 2008. This points to the weakening business climate, which is causing companies to dispose of excess space or close down altogether. On the construction front, Chicago has seen a 60 percent reduction since 2008 with only slightly more than 8 million square feet delivered, versus almost 19 million square feet in 2008. To complete the picture, rental rates declined 10 percent during the past 2 years and are expected to decline further in 2010 before stabilizing.

Statistics are great and for the most part are more of a history lesson confirming what we already know; the market is bad. More important though is to look forward; what are developers doing to weather the storm? The answer is they are looking for different opportunities that present themselves, staying flexible and being more diverse. Activity taking place today falls into four categories: specialty building; location-sensitive buildings; government, civic and healthcare projects; and large logistics projects.

A great example of specialty and location-sensitive deals in 2009 are the Mori Seiki USA Inc. and the Big Kaiser Precision Tooling Inc. build-to-suits at the Huntington Woods Corporate Center in Hoffman Estates, Illinois. Mori Seiki, a large machine tool manufacturing company, relocated from Arlington Heights and now occupies a 103,000-square-foot office, showroom, training and warehouse facility specifically designed to accommodate its needs for the next 20 years. Additionally, this facility was recently sold to a New York investment firm for $314 per square foot. Big Kaiser supplies tooling for the machine tool industry. Relocating from Elk Grove Village, Illinois, the company constructed a 32,000-square-foot office, showroom, training and warehouse facility to expand its market presence in the United States and to better serve clientele, which includes Mori Seiki.

Many local developers are focusing on the government and health care business. Stimulus dollars and the federal government's desire to jumpstart the economy has created activity on the national and local levels for projects, and developers are retooling to handle this new business and thrive. The larger logistics projects are fewer in numbers but no less important to the overall market as efficiencies are being created and costs are being controlled.

Finally, here is a new term that the industry might be hearing more in the coming months as developers and owners scramble to fill product that has not moved, shove-to-suit. With decreasing prices, many users in the market are being more flexible and trying to adapt operations to fit into existing buildings rather than constructing new facilities. Users are more willing to forgo the build-to-suit route and instead are forcing projects into an existing building that, while not being perfect, also comes with a 20 to 30 percent lower cost and significantly shorter ramp-up time. Developers who can perfect the shove-to-suit business might have a leg-up moving forward!

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Suburban Chicago Office Market

The Chicago suburban office market is still feeling the effects of the recent economic downturn despite optimism that the recession is over.

Overall vacancy in the suburban market rose to 17.7 percent in the fourth quarter of 2009, a 1.9 percentage point increase compared to the same time in 2008. The Northwest Suburbs submarket was hit the hardest, measuring a 3.1 percentage point increase to 18.7 percent when compared to the previous year. While overall vacancy in the suburban market is still on the rise, sublease vacancy reported a 0.1 percentage point decrease in 2009, indicating the bottom could be near. This is a positive sign for a market largely hit by corporate downsizing and consolidations. The 2009 overall gross asking rental rate decreased to $19.88 per square foot, a $0.79 decrease from the rate posted for year-end 2008. Rental rates are expected to decline even further to pre-2005 levels.

A unique challenge facing the suburban office market is competition for tenants among different municipalities within the same market. In each of the suburban markets, there are bordering cities competing to drive economic development to its own area. This has created a reoccurring cycle of over-development that keeps supply outpacing demand for office space. Even in the midst of this current recession and the tight lending markets, several new office buildings are being constructed in the suburbs. Adding new supply to an already soft market can guarantee that rents will remain flat or decrease throughout the next business cycle.

Several recently completed developments have added supply to an already over-supplied market. Calamos Real Estate's CityGate Centre in Naperville, Illinois, has added 211,000 square feet of new Class A space to the East-West Corridor submarket and has leased only 38 percent of its space. The Harp Group's new building at 9501 West Boilermaker Boulevard in Rosemont, Illinois, has added an additional 120,000 square feet of space to the O'Hare submarket and is only 75 percent leased. Bridge Development's new 160,000-square-foot development in Lincolnshire, Illinois, was recently completed and remains vacant, affecting the dynamics of the North Suburban submarket.

Going forward in 2010, it will be interesting to keep an eye on these suburban markets to see how much further they will decline. Several prominent buildings have already gone into foreclosure, with more to follow. With the issues of competing municipalities, continual overbuilding and stagnant or declining rents, it has been a very challenging landscape for suburban office landlords to be successful. Chances are none of these challenges will dissipate, so it is likely the suburban markets will continue to suffer, barring an economic jolt last seen during the dot-com or mortgage-boom eras.

— Joel Berger is managing director at Chicago-based Bradford Allen Realty Services/TCN Worldwide.

Suburban Chicago Retail Market

The retail market in Chicago, mirroring that of the nation, has been plagued with vacancies as a result of retailers suffering from lack of consumer demand. From 2003 to 2008, roughly 80 percent of the American gross domestic product (GDP) was comprised of spending. This means that the country's output, or contribution to the world, has been focused on consumption. By contrast, from 1990 to 2006, the earnings of individual workers in the United States increased by less than 0.5 percent per year, while the GDP increased about 3.6 percent per year. This consumer psychology led to increased debt and home equity lines of credit given to many unqualified borrowers. The additional debt introduced to the American economy enabled people to spend money on items they were not, in reality, able to afford.

How does this shift in consumption impact retail real estate in the third largest metropolitan statistical area in America? It moves the consumer to buy goods based on need and reduces the retail therapy or impulse buy. In the same way, business owners also make cuts in acquiring goods for luxury and begin focusing on the items needed for basic survival. Add to that a staggering 11 percent unemployment rate in Illinois, which continues to rise, albeit at a slower pace, and the continued fear of increased job loss, and the results reveal a retail industry with fewer and fewer consumers with the desire or the money to spend on goods and services. So, any rebound to the consumers' previous habits will probably be years away.

The effect on retail real estate is dramatic. If the retailers do not make sales, rent is not paid. If goods are supplied locally, then this affects other sectors of real estate such as the industrial market that warehouses all these goods. The lack of need for warehouses decreases the need for workers and, then, the need for homes and so on. So, what is the way around this for the next couple of years? First, the owners of retail assets have to realize the precarious position tenants are in and why. After this realization, landlords need to act to keep centers occupied and tenants in business. There are many creative solutions, but basically the tenant is looking for reduced rent and reduced commitment. If a landlord believes in the caliber of the operator and the business, then the landlord should help the retailer to survive during this market. Although the value of the real estate may drop due to the rent reduction, keep in mind that something is far better than nothing. Also, investors looking for properties should bear in the mind the real rate at which a property will lease if a tenant vacates.

There is still a need for people to buy goods, and that need continues to create some movement in the retail investment market. However, the far-out suburbs are going to be tougher to lease up, so it is recommended to buy such assets at a price that can sustain vacancy and low rents until the economy begins to recover, creating more jobs, homes and population in the outlying areas. However, if one can buy properties in dense, mature areas, whether it is in the city or an established suburb, national retailers will make more of an effort to keep these stores open. National retailers want a presence where there are more shoppers and brand recognition. If the location is right, and there is the ability to hold on to a property and sustain a lower-than-usual rent, the investment may be a good one. Keep in mind our population continues to expand, and there is only so much land in desirable retail locations.

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