Event: 4th Annual Bisnow Industrial Real Estate Summit

June 2nd, 2014

On Thursday, May 29th, Bisnow's 4th annual Chicago Industrial Real Estate Summit was held at the Hyatt Regency O'Hare, covering the active industrial market, future developments, capital market trends, acquisitions, and dealmaking.

John Picchiotti, NAI Hiffman's Chief Operating Officer – Brokerage participated in the "Leasing & Development" panel.

Panel: Acquisition & Dealmaking

Trevor Ragsdale – Managing Director & Vice Chairman US Industrial Council, JLL
Aaron Paris – Principal, 4K Diversey Partners
Randy Podolsky – Managing Principal, Podolsky|Circle CORFAC International
Jim Clewlow – CIO, CenterPoint Properties
Jojo Yap – CIO, First Industrial Realty Trust
Jim Carpenter (moderator) – Executive Director, Cushman & Wakefield

Carpenter – Each of you has gone through a significant change since the last cycle. What organizational changes have you made and what opportunities are you trying to capitalize on using that strategy?

Yap – First Industrial creates a lot of value through emergent investing, and we're now one of the most active industrial emergent investors in the country. Going forward, we have a longer-term strategy that we believe is sustainable and will give our shareholders a longer, stable, growing cashflow by investing in high-quality distribution warehouses throughout the country.

Clewlow – CenterPoint used to be a Chicago-centric firm, and we were bought in 2006 by CalPERS following a joint-venture with them in 1999. They bought it for the national logistics platform that we operate today. We're in every port and intermodal market, and we look at the logistical benefits of every property whether its 32' clear or 12' clear. We're studying what the advantages are to that site such as drayage to an intermodal or a port, and all of the transportation costs that are involved in someone's real estate decisions.

Podolsky – Our brokerage platform through CORFAC International is an international brokerage network, but we remain a smaller niche player in the development market. I like building 50,000, 60,000, and 80,000 SF buildings and I'm okay with that. We're looking to fill in to markets where the big developers don't want to be, and we think we'll find many of those opportunities over the next few years.

Paris – We've seen cap rate compression all across the country, and we could no longer develop at 250 basis points over the exit – which was too much risk for us, so we sold our portfolio of properties.

Ragsdale – Users have gotten tremendously more sophisticated over the last five years. Whether we're dealing with a local private company up to the largest public organizations in the world, all of them are asking for transparency in the development process to understand how their credit impacts the overall capitalization structure of the deal.

One Oakbrook Terrace Suite 600
Oakbrook Terrace, Illinois USA 60181
+1 630 932 1234

Podolsky – I have had no less than six local banks contact me during the past few months saying "we have the money, it's yours, it's very affordable, and we've just closed multiple loans for ten years, non-recourse, and no prepayment penalties whatsoever." The money is back and you don't have to go to life companies to get it.

Yap – Based on our experience, there are four things that affect cashflow the most: rent growth, downtime, tenant improvements and leasing commissions, and capital expenditures. Over the life of a lease, tenant improvements, leasing commissions, and downtime – if you're less functional than a competing building – will kill your yield. As a long-term investor, you might think of developing a building where rents will increase and a building that will remain very competitive, so it will more easily lease during the next downturn. The cap rate spread becomes a secondary measure, or a barometer of the market.

Clewlow – Capital has clearly returned, but it's highly concentrated in primary markets and in core or build-to-core product. There is a shift away from class "B" and "C" product, and an over-focus on the class "A" building.

Carpenter – As we recover from this cycle, investor demand has gone from class "A" buildings in primary markets to class "A" buildings in secondary markets. Class "A" vs "B" spreads are now as wide as they have ever been. What do you think will make that spread decrease and make those buildings more attractive?

Ragsdale – The convergence of real estate and supply-chain thinking in corporate America that has occurred over the past ten years has really changed the way the companies go to market and what they're looking for. Corporate-end users are looking to maximize throughput in their buildings, which means deeper truck courts, more staging for tractor trailers, many more dock doors than many people expect, higher clear heights, and getting more mechanized inside the building.

Yap – The biggest shortage for space over the past couple of years was in 500,000 SF or larger "big-box" buildings. No one is building that type of product, and we've seen the most rent growth in those buildings across the entire nation. During the recovery, there has been a trickle-down effect from large companies that continued to perform well throughout the recession to mid-sized and smaller companies, which are now starting to grow and lease more of that class "B" product. As a result, soon we will see rent growth in these buildings, which will lead investors towards that class "B" product as well.

Clewlow – Over the last three or four years there has been a focus on logistics because a lot of companies couldn't grow their earnings based on revenue growth and were focused on the bottom line and efficiencies. As our economy continues to pick up steam, I think that's where the class "B" product really kicks in. It's location-driven. Chicago was a manufacturing hub – while we've lost a lot of that, and some may even be coming back – a lot of the users that we talk to today are looking to be close to I-94 or I-294 where the labor force is. They would take a 16' building in the city over a 32' clear building in Joliet because their labor supply is in the city.

Paris – What's happening in the West Loop is displacing hundreds of small industrial businesses. These are players that have to be close to downtown Chicago, but are getting displaced by high-end apartments and fancy office buildings for Google. Where do they go? They are part of the demand that will take some of the class "B" space.

Ragsdale – As omni-channel and multi-channel distribution becomes more and more prevalent, the demand for same-day and next-day delivery has the potential to revitalize class "B" product.

Carpenter – You can't really talk about industrial real estate today without mentioning the impact of e-commerce. Are we really seeing increased demand due to same-day delivery service?

Ragsdale – There are only a few companies out there today that are really ahead of this curve and figuring out ways to do same-day delivery. I think it's too soon to tell what all the downstream impacts will be, but there's no doubt that the push for faster delivery times will revitalize infill markets as companies look to use existing, functional product to get the goods to the consumer more quickly.

Carpenter - It's difficult to quantify what percentage of net absorption comes from e-commerce. However, as a broker, when you walk a building today, a lot of companies are doing e-fulfillment in a 50,000 SF warehouse from some small website. Is every tenant an e-commerce tenant today?

Yap – If you are a retailer you have two real choices: if you're too small or don't want to make the investment, you can go through Amazon or Overstock, however that's not a net demand for space for us warehouse owners. Otherwise, the company can try to do their own e-commerce. They may still have a traditional brick-and-mortar warehouse, but will convert part of their space to an e-commerce solution, resulting in a net increase in demand.

Podolsky – Given all the logistics and distribution conversations we're having here today, we have to keep in mind that someone has to make the product, someone has to have the parts, and someone has to put them all together. I believe there is still tons of demand for companies like this to locate in the Chicago market, despite the local tax concerns.

Carpenter – All of us have been through the cycle. If this were a baseball game, what inning would we currently be in and why?

Yap – In terms of valuation of class "A", I think we're in the 8yj inning, valuation of class "B" in the 6th inning, development 5th or 6th inning, and rent growth we're in the 5th or 6th inning.

Clewlow – I think it depends on what the product is and where it is. I'd suggest that we're in the 2nd inning.

Podolksy – I believe that we're in the pregame when it comes to cycles. We haven't even hit the first inning and it's just heating up.

Paris – I think the risk of inflation and deflation are almost equal, despite the U.S. economy being the strongest in the world. For most of us I'm in the 6th or 7th inning, if I'm an emergent builder I'm in the 9th inning and the game's almost over.

Ragsdale – Through my experience with corporate occupiers, they are just now getting ready to spend money by investing in their distribution network, investing in their buildings, taking down new space and building their inventories.

Panel: Leasing & Development

Brian Liston – Partner, Liston & Tsantilis (moderator)
John Picchiotti – COO – Brokerage Services, NAI Hiffman
James Martell – President, Ridge Development
Mark Goode – Principal, Venture One Real Estate
Ryan O'Leary – Vice President – Leasing & Development, Duke Realty
Britt Casey – Executive Director – Industrial Services, Cushman & Wakefield

Liston – Let's start out with the overall market conditions. What are you seeing?

Picchiotti – Overall vacancy is at 8.3%, which is low even when you look at some of the key submarkets. Central DuPage is at 4.6%, which is historically low, and also when you look down at the I-55 Corridor, vacancies are right around 8%. If you've been in this market for a while, vacancy in the I-55 Corridor has always been in the mid-to-high teens. Currently there is about 10 million SF under construction; with 30% of that development being speculative. Another 10 million SF is planned to begin in the next few months, and that space is split 50/50 between speculative and build-to-suit. We are starting to see the trends moving forward and there is certainly a wind behind us. Since the middle of 2010 we have seen 15 consecutive quarters of positive net absorption, totaling about 50 million SF in that time.

Martell – We are seeing a surge of small users really driving occupancy across the country. Occupancy is being driven by those 50,000-300,000 SF users, suggesting there is certainly growth in the economy. The big boxes are out there and they take a lot of space with each transactions, but I think the real growth in occupancy is coming from all the small and medium-sized users right now.

Goode – Everyone talks about e-commerce companies taking 500,000 to a million square feet, but someone has to be making what these companies are selling. These smaller manufacturing companies and the companies supplying the e-commerce giants also need space.

O'Leary – The fundamentals are there. We are seeing rent growth across the board and I really feel like it's a landlord's market right now. Demand is still there and seems to be continuing and I think we'll see another good quarter across most of the markets during the second quarter.

O'Leary – Occupancy levels are at a point where all landlords are trying to push rental rates. Over the last 18 months they are up about 15-20%, which is a pretty good growth rate, and that's why I think we are seeing a lot of this development kick off. We are delivering into the market far less than what we were back in 2006 and 2007.

Goode – Whatever is happening today will be different in five years. The reality is that the only reason rents will go up is that supply is less than demand. The reason you are seeing this demand is because of things that are hitting on all cylinders like the housing and auto industry improvement. Everyone is buying something new each year and those people making the products need a place to do so.

Picchiotti – When you look at the last down cycle that we had before 2003, the market was delivering close to 15 million SF in new construction deliveries. The market in Chicago over the last 20 years has averaged about 14.5 million SF and in this last cycle, since 2008, the market has averaged less than 4 million SF of new deliveries.

Liston – Where do you see cap rates going and what are they tied into?

One Oakbrook Terrace Suite 600
Oakbrook Terrace, Illinois USA 60181
+1 630 932 1234

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Martell – Hopefully they remain lower and will stabilize, continuing to stay where they are for some time. There is a generation of investors that have moved from being a value-add capital to a core capital buyer.

Goode – Some of the major investors in the U.S. are not from here. As long as that foreign capital is coming to the U.S. our cap rates will stay low.

O'Leary – Two years ago the whole investor spectrum was only buying core, long-term leased product. Now they are stepping out on that risk spectrum a little bit more, trying to get that extra little piece of that deal.

Casey – The influx of the European capital, along with money trickling into the U.S. from other countries, has substantially modified U.S. investors' constraints as far as returns based on the foreign capital requirements.

Liston – What are you seeing out there in terms of acquisitions in the market?

Picchiotti – There has been a lag with deliveries, leading to class "B" product trading since the class "A" product isn't there. Right now we are in a low point with new construction, but with the pipeline of new construction you are going to see a lot of acquisitions spike as this new product is delivered and leased. Right now there is not a lot of class "A" product trading, but I think that will change once these buildings are delivered.

Goode – We are actively buying anything from a 20,000 SF building to a 650,000 SF building, vacant buildings, older buildings, and then will renovate them. What we do is try to buy it at a basis that allows us to be competitive, thus allowing tenants in our building to be successful.

O'Leary – Over the past 24 months we grew about 2.5 million SF through acquisitions. We focus more on developing and build-to-suits, but will buy buildings that have a little more risk but only were we are able to achieve a better cap rate or yield.

Goode – We are Chicago-centric here. People want to live and work in this great city, despite a questionable political system. All of the suppliers and manufacturers want to be here, our housing market is increasing, downtown and suburban construction is picking up, and that is what is spurring all this need for additional industrial space.

Liston – What are you seeing in regard to development in the market?

O'Leary – We have seen an increase in build-to-suit development across the board, not only in Chicago, but nationally as well. Tenants are becoming increasingly comfortable with where the economy is headed. We just finished a 750,000 SF facility for Weber-Stephens Products in Huntley that consolidated a few facilities and expanded its operations because they wanted to stay close to the manufacturing base.

Martell – Most of you have heard that we completed a 1.7-million SF build-to-suit lease for Michelin in Wilmington, which was the major kick-off in the 2,500-acre mixed-use project that we are developing. We also just finished a 50,000 SF refrigerated building for fresh food products that will allow 50 box cars to travel back-and-fourth to California. When looking at development, it's not just the rent, but it's the cost of occupancy. To really win a business today you have to come up with the lowest cost occupancy because rent is such a small component of the expenses that companies are paying.

O'Leary – Despite our state's increasing taxes, we are still able to attract big businesses to the area. Michelin and Weber-Stephens Products are two good examples of this.

Martell – Some of the boxes that we have missed are e-commerce companies. Chicago has an issue with e-commerce business because you need to locate these facilities within close proximity to overnight services like FedEx and UPS facilities. Chicago isn't an ideal situation for Amazon or Walmart because that location isn't possible in this built-out market.

Goode – When you talk about development you have to think about what our buildings really do. A building is really sheltering whatever is being done inside of it from the weather. What's happening now is companies need to things differently than they had before. Build-to-suit facilities have been much more prevalent than a speculative facility because tenants are looking to have a customized building.

Picchiotti – If you look at the buildings built back in the mid-1990s, which at the time were state-of-the-art, you don't see the same clear heights or trailer parking that users are looking for today. We are currently only building less than 1% of our inventory, which is a very low amount of deliveries. In the late 1990s land in Bolingbrook was perceived as a pioneering play, but now we see the I-55 Corridor as close to being an infill market. I think the next generation will be seeing a lot more tear downs and redevelopments.

Casey – It is easy to look at some of these regional users that have bypassed Illinois for surrounding states, but we do have our wins. An example of this is Method, who looked at a four state area before choosing the Pullman District outside Chicago.