NAI Hiffman

Event: NAIOP Chicago | What Investors Are Looking For

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On Thursday, March 20th, Tony Pricco, Principal with Bridge Development Partners, LLC moderated a panel discussion on current trends in the debt and equity markets and what today's institutional investors are looking to buy. Panel members included:

Paul Boneham – Executive Vice President, Bentall Kennedy
Steve Roth – Executive Vice President, CBRE
Laurie Smith – Principal, Blue Vista Capital Management, LLC
Paul White – Managing Director, LaSalle Investment Management, Inc.

NAI Hiffman has summarized this conversation below:

Pricco – We're seeing things getting fairly frothy again in the industrial market. It's been reminiscent of 2007 again, but then came 2008. What are each of you seeing as far as trends? Is it still core, core-plus, then everything else or are we starting to reach into secondary and tertiary markets and class "B" and "C" buildings? What are you investors looking for as far as yield versus risk profile?

White – I'd say investors are looking for all of the above. There seems to be as much capital as there was during the latter part of the last cycle, but there seems to be less product available for sale because there is less development going on. Where we're seeing the most capital and the most activity has been in the major coastal markets and the major inland markets like Chicago and Dallas for class "A" buildings. Pricing has returned to the levels seen in 2006 and 2007, and in some cases it has exceeded those prices.

Roth – There's no question that there's a tremendous amount of class "A"-quality product coming to the market, and there has been a tremendous amount of capital and demand for that product type. The bigger question that has been in everybody's minds over the past year or two is whether institutions will go into a market and buy class "A" product, or will they buy class "B" product. What we're seeing right now is the institutions buying the class "A" product in a primarily class "B" market, instead of them buying class "B" product in what's considered a class "A" market.

Smith – What a difference a year makes, because a year ago you would have heard everyone saying "I want to be in San Francisco or New York and I want to focus on core class-"A" product". All of a sudden the yield has narrowed on those properties, and so now we're hearing "find us opportunities" and "any idea would be welcome" because they need to find a place to put their money that will get them something more than an 8% or 9% yield.

Roth – Form a cap rate perspective, we're now seeing peak pricing in the Chicago market around 5.5%. You go out to southern California, you're probably seeing deals getting done in the 4s. In the meantime, there remains a wide disparity between where you're seeing the class "A"-quality deal and the class "B"-quality deal, around 200 basis points. Back in 2007, that disparity was closer to 75 or 50 basis points.

Smith – If you look at cap rates as a spread over 10-year treasuries, historically all of the asset classes were really narrow, but then 2009 came along and we saw the highest spread we had ever seen. Apartments and CBD office were the first to recover, but the other asset classes continued to see that significant spread. Those are now starting to come back down, especially for class “A” industrial product.

Boneham – It’s a great time to be a seller. It’s a great time to be a borrower. If you look at 2008 and say “here’s the definition of a recession – a complete lack of access to capital”, this is the opposite, but this too shall pass.

White – The weight of capital right now is huge and completely overwhelms the amount of supply. The fundamentals for class “A” major markets have been very strong. We did a study last year looking at vacancy rates for class “A” space in the major markets, and it was consistently 30%-50% below the overall vacancy rate. One of the reasons why the gap between class “A” and class “B” has been so wide is because the expansion was so widespread during the last cycle that all sizes and all sectors were hitting on all cylinders. Right now that isn’t the case. We’re starting to see more activity in the smaller space, but a 600,000 SF class “A” building in the I-55 Corridor has been a much better bet over the past few years than a 50,000 SF or 100,000 SF building near O’Hare.

Smith – Class “A” does respond better through the cycle because there is a flight to quality every time there’s a hiccup in a cycle. Everyone looks at it as “I won’t get hurt as badly if I have class “A” product”.

White – Class “A” rents in industrial and every market I am familiar with have been growing, and in some cases strongly. Looking at the I-55 Corridor here in Chicago, rents have grown from around the mid-twos to the low-threes or mid-threes. The demand continues to push the rents up.

Pricco – How does debt come into play in helping to boost the yields on some of the product you buy?

Smith – We use debt quite often if we’re buying something with cashflow. If we are buying something distressed, we’ll pay all-cash. With the debt that’s available at today’s interest rates, you’re getting a great cash-on-cash deal, even on product that may be only 75% occupied. If you don’t have to rely on the back-end residual for your returns, that’s very compelling. I think if interest rates continue to increase, we’ll see some adjustment in cap rates.

Roth – For the most part, what we’re seeing in the debt markets is that there is an abundance of capital out there, but people are chasing pricing down more than chasing risk up.

Smith – Our concern with rising interest rates has primarily been when we decide to sell these assets, what is the next buyer going to be looking at as far as a cap rate. We’re trying to pay close attention to the forward yield curve, and trying not to pretend that a 6% cap rate today will be a 6% cap rate tomorrow.

White – For industrial, cap rates for the most part in major markets across the country are between 5% and 6%, with Atlanta at the high end, and a couple coastal markets below 5%. Those are 2006-2007 level cap rates. Some markets, like Dallas and Houston, are seeing cap rates below where they were during the last cycle. The question that has been on investors’ minds for at least a year is “what does rising interest rates do to these cap rates”? At some time there will be an inflection point. My own view is that when the 10-year treasury reaches the low-to-mid threes cap rates start to move.

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Pricco – What about "build-to-core" strategies in different product types?

Boneham – The history in our firm has been a focus on "build-to-core", we've been engaged in it for over 30 years. The sweet spot that we focused on for the past few years has been urban high-rise apartments. These projects have performed well, the issue is where we have to cycle off because land costs are up, construction costs are up, and rents are starting to hit an affordability ceiling. The next obvious choices are industrial and CBD office.

White – It's not like every core investor out there is going to make a massive shift to "build-to-core", because there still are so many risks, but there are certainly more today than there were a year ago.

Pricco – What's the feeling when you bring a project to committee, is there more money looking at Chicago, or do investors still want to focus on the coast?

White – I'd say Chicago is still absolutely in the mix as a major market. Some may shun Chicago for office, certainly suburban office, but the other three property types are still definitely in the mix. For investors who love to buy in the coast, it has been exceedingly difficult, so over the past three years we have invested a lot of industrial money in markets where it's easier to buy like Chicago, Atlanta, and Dallas. Long-term, the issues with the state government will continue to be a topic, but that's not stopping investors from paying the lowest cap rates in the county in California, where they have issues as well.

Boneham – We're quite heavily invested in Chicago, but it's always been difficult for us to invest in industrial product here because there are corn fields as far as the eye can see, so there is no real constraint on supply. Instead, we remain heavily focused on the urban markets and have significantly reduced our footprint in the suburbs. The discussion of Chicago politics and the fiscal concerns with the state really doesn't come up. We continue to see Chicago as a very vibrant, dominant primary market.

Smith – It's been hard from an opportunistic or value-add perspective for people like us to buy in Chicago because it's kind of a "steady Eddie" market, especially in terms of industrial.

Pricco – Looking forward 12 and 24 months, how are allocations in real estate changing?

Smith – We closed our third fund in June of 2013, and everybody was still scared. What I'm hearing now is completely different – "find us a place where we can get some yield and bring us any type of opportunity that differentiates us". To me it looks like investors are releasing the reigns from the risk perspective.

White – The allocation to real estate has been fairly steady, but one thing to look for is if interest rates do rise and bonds become more attractive, that could siphon some money from real estate in the future.

Boneham – The average allocation of real estate when I took my first job in the early-1980s was about 3%, today it's 9.5% for U.S. pension funds. CalPERS just raised their allocation from 9% to 11%, with the only reason they stopped at 11% because they had serious concerns about setting a bar they couldn't meet. I think just looking at pension fund space, there is a lot of room for allocations to increase. The U.S. remains first for investing if you're really looking for long-term security, good returns, and relatively low governmental risk.