Event: 11th Annual CIP Industrial Summit

April 29th, 2014

On Thursday, April 24th, Chicago Industrial Properties' 11th annual CIP Industrial Summit was held at the Crowne Plaza Chicago (O'Hare), covering the state of the market, financing and investment trends in the market place, and the comeback of development. The event consisted of four panel discussions, three of which are summarized below.

Chris Gary, Vice President with NAI Hiffman's industrial services group participated a one-on-one conversation, while Adam Roth, Executive Vice President with NAI Hiffman's industrial services group and Industrial Services Director of NAI Global Logistics, participated in the "State of the Market" panel.

Panel: A One-on-One Conversation

Chris Gary – Vice President, NAI Hiffman
Timothy Beaudin – President and CEO, IndCor Properties

Gary – We are here today to talk about IndCor Properties, the new player on the block, but in order to understand IndCor we first have to talk about the parent company, The Blackstone Group.

Beaudin – Blackstone is one of the largest real estate investors worldwide in the market today. The way they are set up is by funds, starting with Fund I and are now up to Fund VII. Inside each of these funds they raise money and they have full discretion on the money they raise. Their strategy has always been to diversify that investment. IndCor likes the simplicity and value-add of industrial properties. It's hard for Blackstone to come in and do $10-$20 million transactions; they are not set up for that and prefer the large portfolio transactions. During the downturn of 2010 they came in and started buying, purchasing 45 million SF of industrial assets, and was the genesis of how IndCor was started. After starting in 2011 with only 45 million SF of industrial property, we now manage over 117 million SF today.

Gary – You also own equity on the office side and are a major player there.

Beaudin – The office market is really mature and is different from industrial product. Last year we sold close to $5 billion in office transactions in core markets across the U.S. and will probably repeat that again this year.

Gary – You talked about the funds, what is their focus and how are they organized?

Beaudin – They are all diverse, but are operated individually and one at a time. While the funds are invested in North America, Blackstone is very active in Europe and Asia, and with the downturn of their economy we saw an opportunity to invest in modern logistics facilities and not so much on the value-add side.

Gary – Who is the typical investor in these funds?

Beaudin – It's diverse, but the big ones would be pension funds, endowment, and sovereigns make up the vast majority of investors for its funds. Success has been critical to breeding new investors.

Gary – Blackstone is a publicly held company and swayed by quarterly reports, but as a landlord, how do you take a look at the long-term view?

Beaudin – You are always battling the pressures of public reporting as far as your results and market expectations. Blackstone operates under a very simple mantra: buy it, fix it, and then sell it. When you are in the fix it business, which is IndCor's focus, the focus is more on the longer term value.

Gary – In terms of "fix it" are you buying building that are in need of T.I. work?

Beaudin – To date, we have focused on buying large portfolios over $500 million, and when buying them, we make sure that the asset's physical quality has been improved by the previous owner. From there it takes about 6 to 18 months for our "fix it" process to take place from when we buy it to the time we feel confident that we have updated the space and it is ready to be sold.

Gary – So in terms of a hold period, I know every building is different, how long do you generally hold an asset?

Beaudin – Our hold strategy has been generally three to six years and we have never sold an asset to an investor; all of our sales have been to users.

Gary – With 117 million SF, where does this put you with competitors?

Beaudin – We like to think we are the largest "pure play" industrial company in the U.S. We are not in the development business, we are in the business to buy assets, and IndCor owns 100% of its assets. Blackstone is an international company and a very simple company for investors to understand.

Gary – Why has IndCor felt having a broader reach, in over 30 markets, has been the right decision?

Beaudin – There is no doubt that core and costal markets are the most desirable locations. We also believe that there is value in secondary markets like Reno and Austin. Goods move to these assets in the secondary markets and we have been able to take advantage of that. Also, demand has been trickling down into those secondary markets, and that is where we have been able to find value-add opportunities. E-commerce's accelerating growth is playing a large role in decision making on diversifying your dots on the map. We have benefitted from the strong activity in these secondary markets due to the millennial generation wanting same-day, or next-day deliveries, and this has brought the concept back to the drawing board of having more locations across the country.

Gary – How do you view the cyclicality of trying to time markets and getting in and out, or do you not?

Beaudin – We aren't really market-timers; we are focusing on fixing what we have, and converting that to our next capital investment and looking for stabilized portfolios. We have to bridge that fixing part, which is leasing. Of all the assets we buy, which are portfolios, they are on average 85% occupied when we acquire them.

Gary – How have rising interest rates affected investing?

Beaudin – Everyone expects interest rates to go up… but when? Rising rates, longer-term, will be good very good for business and the economy, but it has been a painful process to go through in the meantime.

Gary – Some of your recent purchases of class "B" buildings has been a little different strategy than some of your competitors, tell me the thought process that went behind that.

Beaudin – When you buy large portfolios you get a wide mix of property types, but when you acquire properties correctly, and invest capital into them and update them to keep them modernized, there is an opportunity seen in all sectors in the market whether it is a class “A” or class “B” building.

Gary – How does IndCor view Chicago as a market?

Beaudin – I don’t think that anyone who has a national industrial portfolio can exclude Chicago assets. It is a key market, though it is a difficult market to buy in. Any of the core markets are difficult to buy in, and we would like to gain more traction with value-add properties in the Chicago market.

Gary – When you get together for your quarterly meetings with your peers, what do you talk about and what are some things that worry you about the future?

Beaudin – I think Blackstone is very focused on forward thinking, projecting where business is heading and looking at market trends. One of the biggest concerns that we probably all have is over-building. We have to be able to manage construction and it is happening at a much quicker rate on the industrial side. Another concern is the current political state at home and abroad.

Panel: The State of the Industrial Market

Carter Andurs– Senior Vice President, Marketing Officer, Prologis (moderator)
Tom Boyle – Principal, Transwestern
Adam Roth – Executive Vice President, NAI Hiffman
Matthew Stauber – Principal, Colliers
Robin Stolberg – Vice President, JLL
Jason West – Senior Director, Cushman & Wakefield

Stauber – Taking a look at the big picture, we are seeing vacancy rates similar to those in 2007. We are trending in the right direction as vacancy continues to drop. Construction is back on pace. User sale activity was down significantly during the first quarter, but overall market indicators show user activity picking up.

West – We all lived through 2008 and 2009 with limited demand, and now over the past couple of years we have seen consistent demand with vacancy rates dropping. Capital markets have been on fire, and have been back heading in the right direction. We are witnessing a return in construction, both speculative and build-to-suit. Activity feels solid across the board.

Andrus – Who are the active users?

West – In terms of food groups, we have seen a little of everything: manufacturing, packaging, distributors and processing. E-commerce and 3PL activity also has been active. Demand has been coming from a lot of different sectors.

Stolberg – We are seeing a lot of larger corporate headquarters evaluating consolidating and taking advantage of the soft office market. Companies are moving their offices into industrial space.

Andrus – Is there a segment or product type that seems to be the most active?

Roth – It really breaks down to particular submarket or corridor, and it came down to larger buildings being better. Since the beginning of the year, the 50,000-100,000 SF users seem to be coming more into play as there were four deals in that size range completed in the past two months in the I-55 Corridor.

Boyle – The bread and butter of the Chicago market is that 40,000-90,000 SF user, and we are now seeing more of a balance back in the market.

Andrus – What about class “B” space… is that recovering?

Roth – I would say yes it’s active again. When you start to trend towards smaller users who aren’t so heavily distribution-based and are local, it suggests that demand is returning.

Boyle – I think class “B” space is important, but the most dominant characteristic in the market right now is the class “A” vacancy rate. This has brought back the land market as we see a land buying craze going on up north.

Andrus – Which submarkets are performing better than others?

Boyle – Five years ago when we would meet with a company we would show them options in Northern Illinois and they would have little interest in looking at anything north of the border. Now the tune has changed and those companies are saying “get me out of this state.”

Stauber – We have to solve the problem of companies jumping ship and leaving Illinois for neighboring states such as Wisconsin and Indiana. We continue to see class “A” space in the infill markets like O’Hare and Central DuPage markets continue to be absorbed. We are starting to see land prices creep up. Class “B” space will be pulled up by the class “A” space.

Andrus – When companies are evaluating their supply chain, is Chicago on the map when they are making these decisions?

Roth – The reason people are talking about Wisconsin and Indiana is because we are the “big guy,” with more than 1.2 billion SF, and we are going to lose business them because we are so big. We have logistical infrastructure that cannot be replicated. E-commerce and fulfilment are very fast growing sectors, however in all fairness; e-commerce is a much smaller percentage than traditional brick and mortar shops and is going to grow at a faster pace. There is a lot of pressure on the transportation industry - trucking is going to implode. We have to be on top of our consumers and suppliers because in a year transportation costs are likely to be 15 to 18 times the cost of real estate. You are going to choose Chicago because we have access to population.

Andrus – Are you seeing favorable conditions for landlords with reduced concessions in the market?

West – I-55 in particular has seen conditions tightening up. There are multiple deals competing for spaces, rental rates are going up, and concessions are going down. It is a rude awakening for tenants looking to renew when they see the sticker shock.

Andrus – How are you advising tenants now that rental rates are rising and concessions are reducing?

Stauber – We have to use data to educate tenants to not only the numbers that are out there, but to the speed of their decision.

Stolberg – A lot of these users feel like they can sign a short-term renewal as a backup option and we have to manage user expectations that landlords are not going to renew them at the same rental rates. This is forcing more long-term and medium-length decisions to be made.

Andrus – Are you seeing any slowing of the process in decision making due to increasing rental rates where tenants have to go back internally to create a case?

Stauber – I'm not seeing that, it's more of an education process. The larger box companies are finding it's cheaper to do a build-to-suit based on the amount of capital and pressure that is out in the market place than an existing building. Chicago has been very disciplined as it relates to speculative construction in relation to other markets in the U.S.

Andrus – Where is spec happening and what is the justification?

West – Spec is happening in select areas around the whole metro market where there is demand. I-55 is a great example of spec projects that are targeting small to mid-sized users. Rental rates are supporting new construction, and lack of available quality product is driving the demand. With the lack of land sites remaining in the I-55 Corridor, users are being pushed down to the I-80/Joliet Corridor for larger build-to-suits.

Andrus – Are we over-building in any submarkets?

Stauber – If you look at O'Hare there is a lot of spec projects that are up with minimal leasing completed, but it is still too early to tell. We are seeing healthy demand in manufacturing product with heavy office components.

West – I think the groups that took the risk on the front end of the cycle, that got out of the ground early, are going to be rewarded, but the groups jumping a little late are going to be a little dicey and could find more competition than what they bargained for.

Andrus – If you were going to invest your money today, where and what would you buy?

West – There are too many dollars chasing class "A" product and I feel like the class "B" product that is functional and well-located would see premium yields.

Roth – I'd look at infill, I wouldn't be afraid of Cook County, and would look at rail-served. I would look really hard at particular rail carrier-served buildings. I believe same day deliveries are going to be a fad, and we will see more along the lines of next day delivery.

Boyle – I like the infill, multi-tenant, class "B" properties depending on where you are up north I would invest in a decent bulk site.

Stolberg – I would put my money into the biggest building I could, under 400,000 SF, in Lake County. Something that is a little functionally obsolete that you could perform some capital improvement to improve its class status.

Stauber – I would agree with everyone else with the class "B" space to invest in, but I would specifically look to O'Hare for a unique space that couldn't be offered to tenants elsewhere.

Andrus – With interest rates relatively low, are you seeing increased user demand, and what's happening with pricing?

Stolberg – My team has been seeing user sales at $75-$85 PSF, which is back to 2006-2007 pricing. We are seeing family businesses have a generational change in management.

Stauber – User demand is up on the purchase side. The trend has been sale prices rising, and it will continue to do so as fewer options are available with tightening conditions. Then you are going to see the comparable data out there that will be supporting lower asking prices.

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Panel: The Return of Development

John E Greuling – President and CEO, Will County Center for Economic Development (moderator)
Daniel Fogarty – Vice President, Conor Commercial Real Estate
Howard Green – Executive Vice President, Meridian Design Build
Tim Hennelly – President, Great Lakes Region, Ryan Companies US, Inc
Kevin Matzke – Managing Principal, Clarius Partners
Adam Miller – President, Summit Design + Build, LLC

Greuling – How do you see the speculative market recovering in Chicago?

Hennelly – It is surprising that just for years ago we thought it was the end of the world, and the fact that it only took four years for the market to recover is amazing. It went from being a tenant's market to a landlord's market, and overall the spec market is healthy in certain submarkets. You won't likely see any spec buildings going up in the I-80/Joliet Corridor, but with all the capital entering the I-90 Corridor, we are going to see more speculative construction in that region.

Greuling – What's driving your interest in speculative space and who do you see as the users for this space?

Matzke – We needed to fill a gap and it was really a supply and demand situation.

Greuling – Cook County is turning into an interesting investment opportunity for build-to-suits, can you tell us about that?

Miller – Method Cleaning Products looked at numerous different sites for over a year before selecting its site in the Pullman neighborhood for their build-to-suit. A lot of the options were based on incentives and workforce, and the Pullman neighborhood was able to offer a great story for Method.

Greuling – Are you finding the investment market robust and full of opportunity?

Fogarty – I don't want to make it sound like it's easy, but there is a lot of opportunity out there. We are seeing activity starting to pick up in the class "B" and "C" buildings. Last year, there were more investment sales completed in Chicago than anywhere else. That speaks to the liquidity of this marketplace.

Greuling – We are seeing political geography influence our deals. I never thought that Chicago would be a flyover location early in a site selection process, but it has begun to happen. What are some of the mechanics of getting a building up?

Green – With the influx of spec product it feels like everyone is back in the pool at the same time. Everyone is trying to rush to get their project completed first and that is pushing back suppliers back in their ability to deliver precast and steel. We have to figure out a way to get out ahead of this. On the technology side, things are changing as e-commerce demands are different; needing larger clear heights, more power, and additional parking.

Greuling – How do you feel the manufacturing, food, energy, transportation and logistics build-to-suits fit with our market here in Chicago?

Hennelly – Chicago has historically always done well with the big box distribution players who want to come to the I-80/Joliet Corridor and Will County. Capital really wants these deals to come to the market.

Matzke – In Cook County, food users have done better during the downturn, and have continued to do well. In general we see food as a robust demand driver going forward.

Greuling – What is the importance of local cooperation in terms of regulations and rules, and how that can put a competing community to the head of the line, or the back?

Fogarty – It's a huge piece that we look at when we look at development. If there is any sense of swimming upstream we will move on to find a better opportunity where we can get better support from a community. One thing we have noticed recently is that pretty much every community is welcoming business with arms wide open and wants to be your partner. That wasn't necessarily true in the last uptick because things were so robust and municipalities were then coming to us say, "Here is what we would like you to do and what can you do for us," and that's not the best partner you want to have.

Matzke – The challenge we have seen is at the higher level, the state level, and the local politics. Talks of incentives come up very quickly in conversations and are a big part of the equation, and we need to find a solution to compete with Wisconsin and Indiana in attracting businesses.

Miller – In Chicago, we are seeing a lot of cooperation with companies coming into the city.

Greuling – What can the state do in terms of incentives, and keeping businesses from crossing over the border? Is it just money?

Matzke – If there was more transparency in the incentives program. If the state could put together some kind of program that could evenly distribute incentives it would be beneficial to everyone because we are all in this together.

Hennelly – The industrial market won't be impacted as much because there will always be a need for it, and Chicago is a centralized hub, but where we will feel the impact is in office headquarters. There is an uncertainty of pension funds, so it could deter executives from the area.

Greuling – What will really challenge the spec or build-to-suit market moving forward?

Matzke – It is clearly a positive trend that speculative building is back. Bigger users are looking to build-to-suits to accommodate needs, or we are losing them to Wisconsin or Indiana. I just don't know if the demand will continue to drive speculative building.