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Chicago

Emerging Trends in Real Estate 2019

This is a summary of the November 8, 2018 meeting of the ULI Chicago District Council, which gathered at the Union League Club in Chicago to hear a national real estate forecast through the Emerging Trends in Real Estate® report for 2019.

The moderator was Joseph L. Pagliari Jr., *Clinical Professor of Real Estate*, The University of Chicago Booth School of Business. Joining him on the panel were Jennifer Boss, *Executive Vice President Portfolio Management*, Heitman LLC; Michael Eglit, *Managing Director, Real Estate Debt Strategies*, Blackstone; and David Scherer, *Principal*, Origin Investments.

All experts on regional and national real estate trends, they discussed a variety of subjects, including how interest rates will affect commercial real estate pricing, the risks of mezzanine lending and investing, and the relative strengths and weaknesses of the Chicago real estate market. They also offered their outlooks for 2019.

This year, the Emerging Trends in Real Estate program drew from entirely local talent, rather than the past practice of bringing in an expert from out of town. In addition, the session featured a moderator who inserted macro-trends throughout the 75-minute program with a panel layout reconfigured from the standard side-by-side to a quasi-roundtable.

The result was a more intimate, as well as more Chicago-centric, overview of the state of the real estate market and the outlook for next year.

In his opening remarks, moderator Joseph Pagliari offered an assortment of observations related to the market now being in the midst of a bond-yield surge. Among other statements, he said short-term rates are projected to rise (by about 60 basis points for one-year rates, to roughly 3.25%) and long-term rates are projected to stay flat (up about 25 points, to 3.3%, for 10-year rates), “barely higher than the one-year rate.”

Jennifer Boss, with Heitman for 24 years, the past seven as a portfolio manager responsible for $4.5 billion in assets, said the long-term outlook on the bond rate is “very favorable” for real estate.

"We look at this as a short-term price correction for now…we do see some short-term disruption but based on our assessment of spreads to various investment alternatives, we're nowhere near where we were back in 2007, 2008," Boss said.

On the topic of where we are in terms of the economic cycle—the question of "what inning" it is in—panelists agreed that it is late in the cycle, a pronouncement that has been happening for at least the last year or two.

Mike Eglit, who for eight years has been with Blackstone, the largest private owner of real estate in the country, likened that protracted status to the fact that "some games go into extra innings."

"Some games are just really long. If you have third graders like I do and you're watching those kids pitch, some of those innings…" he said, his voice trailing off to audience laughter. "It feels like we're late in the game. We just don't know how long the seventh or eighth or ninth inning will last."

"Our (company's) view is we won't have a recession until after the next election in 2020, or really in 2021," Eglit added. "Of course, that can change. It's a volatile projection, but the economy is doing really well, the real estate fundamentals, as a whole, are doing pretty well. It's kind of a stable environment that we are in, on the macro level."

With regard to the cap rates, a factor to consider is the spread to treasuries, which is not "historically wide" in the 2000s, Eglit noted.

"I don't think that real estate is necessarily overvalued," he said. "I don't think that cap rates are significantly too low. If you think about the office market, the retail market, the industrial market primarily, and how it's changed over the last 10 years, it is really, really significant."

Another significant trend with long-term implications is the infusion of more capital pouring into real estate from across the globe, including money going into large pension funds, Eglit said.

"All this money chasing a subset of the buildings that exist out there—that has institutionalized the asset class, and cap rates, and values, and expected returns will forever be lower," he said. "Values will be forever higher, returns will be forever lower than what was expected even five years ago, and 10 or 15 years ago, for sure."

David Scherer is one of two principals at Origin Investments since its 2007 founding. The firm has offices in Chicago, Charlotte, Denver and Dallas and is focused heavily on

multi-family housing, with interest also in office space—an asset class that has "outsized risk" currently, he said.

Automation is a key factor in that risk: "Simply put, robots don't need office space," Scherer said. "I've talked to enough C-suite executives who are investing many multiples of billions of dollars in automation."

"I don't think fund managers have leveled with investors," he continued. "Value-add isn't 16 anymore. It's 12 ½. Core-plus isn't 13, it's 11; core is nine. Until we re-price, people need to start to understand what's available for returns."

Prompted by a question from Pagliari, Scherer said he believes that the trend toward fewer people being homeowners (from the high-60s, percentage-wise, down to 60%) is "a permanent move," making multi-family housing less susceptible to market disruptions.

Boss echoed that sentiment, noting its resilience in the face of market downturns; even if office space goes unoccupied, she said, people continue renting apartments. "We're all over that sector," Boss continued. "We have always over-weighted it."

She also cited a trend toward more people, Millennials particularly, renting houses and townhouses.

"You've seen the housing market slow dramatically in recent months…there are a lot more renters for what was traditionally ownership housing—townhome units in good school districts, single-family homes in good school districts," Boss said. "But there's opportunity across the spectrum for apartment (investing), for sure."

Also, in response to an audience member's question, Scherer said he foresees more development in Chicago's suburbs than in the city itself, largely because of the suburbs' relative affordability.

"It's going to be difficult to get development off the ground as much in urban cores moving forward, because the numbers aren't going to work…all parts of the equation are being squeezed," said Scherer.

Another topic discussed was the distinction between "gateway" cities (defined as Chicago, Boston, Washington, D.C., Los Angeles, San Francisco and New York) and non-gateway cities.

Noting that investors are typically willing to take a lower rate of return in those gateway cities, Pagliari questioned if the market is "wrong" about doing so. Among other fiscal-

solvency measures, he pointed out that five of the six gateway cities are in states that are in the bottom six of all U.S. states in terms of per-capita underfunded pension liabilities (with Washington being the sixth city).

"Wealthy people, if sufficiently motivated, move," said Pagliari, "so states risk losing them if they raise taxes too much." Facing that, another alternative is to reduce services—and that is likewise unattractive to real estate investors.

In response, Scherer said that of the 42 assets his firm has purchased over the past seven years, five have been in the Chicago area. Of that figure, the firm has sold two assets already and plans to sell two additional assets over the next two years.

He described Illinois as "an outsized risk," adding, "I really do love the region and the city, and I will remain here. But as an investment manager, it's not a risk I'm willing to assume."

"I might be wrong, but my gut tells me the cap rates here don't reflect enough the fiscal uncertainty and most likely commercial real estate is a very easy target," Scherer continued. "One firm, or one person, or a very small number of people control huge assets, and that's not a lot of votes. It's a lot easier to raise my taxes than an entire neighborhood. I don't see how Illinois balances these equations."

Also, a graduated income tax, as proposed by Illinois Governor-Elect J.B. Pritzker "puts the onus on people who own wealth," said Scherer.

"I can't tell you how many conversations I have with people about people wanting to leave the state," he added. "It's not really rational…but elasticity is not rational. It's a feeling you get when you feel like you're being taken advantage of."

Markedly more optimistic were Eglit's observations. Among other points, real estate investors tend to undervalue high-quality real estate in the bigger, better markets and overvalue the lower-quality real estate in the tertiary or secondary markets, he said.

"We do better when we sell the better stuff, and worse when we sell the worse stuff," Eglit said. "…we see time and time again, there's just not a lot of liquidity for secondary or tertiary markets."

Blackstone has more "conviction" now about the value of gateway markets than five or 10 years ago, based on its experience over that span.

In addition, young talented people want to be in the major markets, regardless of cost, and Chicago is a draw in that regard, Eglit added. However, he did note the "fiscal

headwinds and crime headwinds" besetting the city are having a chilling effect on international institutional investors.

Looking to other major cities, Boss said that in Texas, while there is no personal income tax, commercial real estate property owners are being "aggressively" taxed. As a result, of all its holdings—including Illinois—taxes on her company's assets in the Lone Star State consume the largest percentage of revenue/

"It's not as simple as it seems on the surface," she said. On top of that, the "tax uncertainty" of what the future holds is another factor. "It's been terrible recently, where it's eaten up all of our appreciation gains in places like Austin, San Antonio, and Dallas," Boss added.

In response to an audience member's query about what Illinois can do to reduce its well-earned reputation for regulatory "red tape," panelists emphasized developing a plan toward fiscal stability—including addressing the mounting pension debt—and creating an environment of "certainty."

"It's all about certainty, and it's all about the lack of certainty here," said Scherer. He suggested Illinois implement a "grand bargain" of raising revenue through a measure such as a graduated income tax rate structure, or higher property taxes—as long as it was accompanied by lower-cost government "we can pay for."

Unlike in other cities where his firm has a presence, such as Charlotte, among homes with prices above $700,000, their value has leveled off over the years and "that's not sustainable," Scherer noted.

"You read about Amazon, why they (may) want to come here," Scherer continued. "One of the first reasons mentioned was our housing prices are so cheap. Well, if you own a home, that's not such good news."

For Illinois government leaders, he concluded, "it's going to take the hard decisions, not just the easy ones where you say, 'Hey, let's raise taxes!' but not do the rest. That will only make wealthy people leave faster and we'll have a smaller tax base."

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