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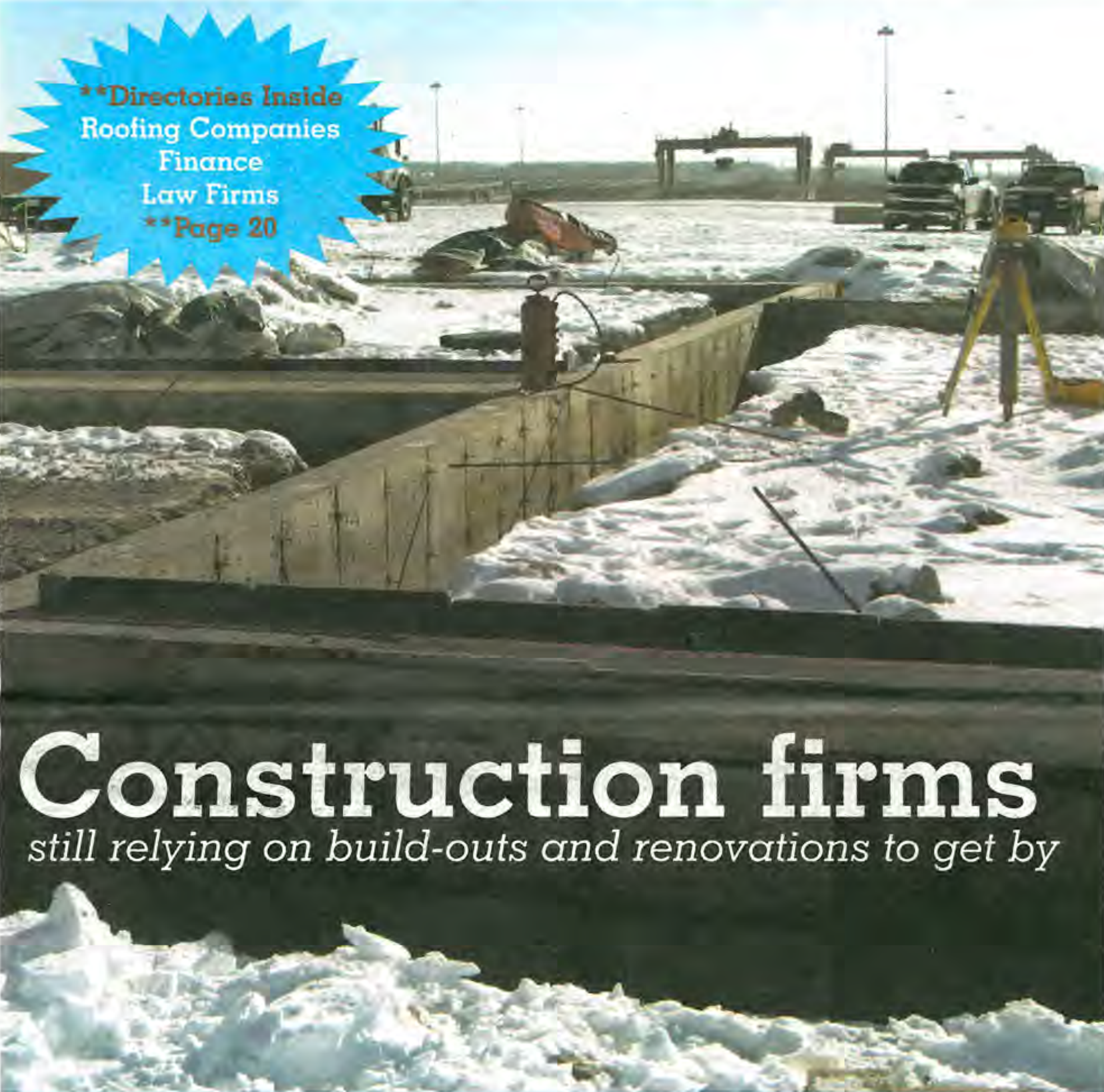

Construction firms

still relying on build-outs and renovations to get by

By Mark Thomton

The industrial leasing market has improved, but development firms are still waiting for occupancy rates and rental rates to increase before any significant construction will begin.

Despite the lack of major projects, opportunities are available. As firms begin to strengthen their balance sheets and consider expansion, many are finding that it is more cost effective to build-out space rather than pay for moving costs. Also, as investment picks up on bargain buys, owners are repositioning assets with upgrades and interior work. Some developers have also landed mid-sized build-to-suits in the past year. The activity may not equate to a plethora of new, ground-up buildings, but construction and development firms are finding ways to keep busy.

"Industrial activity is picking up," says Joseph Pomerenke of ARCO/Murray National Construction Co. "We are seeing more mid-sized build-to-suits, anything from 30,000-100,000 square feet. There is also a lot of building expansion. People are asking about expansion when reconsidering their lease."

ARCO/Murray recently broke ground as general

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Moving Forward:

Industrial Market on Track for Recovery

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This "great recession" has caused the private business sector to become more deliberate with decision making and capital expenditures. For a developer, this makes it necessary to perform even greater due diligence when examining potential clients, seeking creative ways to form new partnerships, and negotiating leases and sales relative to current market valuations. In general, cautious business decision making is a sound practice, but it can also lead to 'analysis paralysis' and a prolonged recovery period. However, the local industrial economy is experiencing improvement, and the path to recovery is expected to continue. Once the market fully returns, the next several years should provide a healthy economic resurgence, particularly within the industrial sector.

Recovery Pace

The series of economic events that led to this recession has been well documented. Although we are recovering, several recent international events are slowing the domestic economic resurgence. These issues include the instability of Libya, the rising cost of oil, and the recent disaster in Japan, in addition to the shifting political tide in the U.S. Each of these events deserves serious attention; however, every individual global, political and socioeconomic event seems to be treated as an imminent threat to the already slow moving recovery. In reality, political unrest and natural disasters occur in good times and bad. However, in the shadow of the deepest recession of our lifetime, fear is magnified, hampering decision making and causing the pace of growth to slow.

What the Numbers Show

The key to the U.S. economy's full recovery is job growth. Thankfully, the national unemployment rate dropped to 8.9% at the end of February, down from the 9.6% average national unemployment rate during 2010, according to the U.S. Bureau of Labor Statistics. The Chicago area also realized significant improvement with an unemployment rate of 8.7% at the close of 2010 down from its peak of 11.7% in January 2010.

The stock market - another leading indicator - supported a total return of 17.9% in 2010, as gauged by

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the Wilshire 5000 Total Market Index, the broadest measure of U.S. stocks. Additional gains realized this year have recently been eroded due to investor uncertainty over the aforementioned world events.

Another carefully studied key economic indicator is the Consumer Price Index (CPI), which increased 0.5% in February. Over the last 12 months, the CPI has increased by 2.1%, indicating growth but a signal that perhaps inflation could be a growing concern in 2011.

Additionally, the Gross Domestic Product (GDP) has been positive for six consecutive quarters, increasing by 2.8% at the close of the fourth quarter 2010. A 20% increase in activity over last year at the Port of Los Angeles Long Beach is a reflection of a much needed uptick in consumer confidence, which should continue to lead us further into the recovery.

Economic Influences

Positive:

-GDP has been positive for six consecutive quarters
-Consumer confidence is up
-Inflation remains under control
-Businesses have begun spending

Negative:

-The recovery has been jobless
-Credit remains tight
-Housing market remains at risk
-Activity still measured

Market Activity

Although the growth in the Chicago market is somewhat lethargic, it is headed in a positive direction. The Chicago industrial market has bottomed out with new market values now established, allowing for increased leasing activity. During the recession, buyers and sellers were separated by a wide "bid-ask" gap, resulting in an extended waiting game that made it difficult to close a transaction.

Another positive sign is last year's strong industrial sales activity, totaling 14.2 million square feet, representing a 30% increase over the previous year, as reported by CB Richard Ellis.

Leasing Activity

According to Colliers International, there was over 2,000,000 square feet of positive net absorption during fourth quarter 2010. At the close of 2010, the vacancy rate for the local industrial market stood at 11.68% on a base of 1.31 billion square feet.

This positive trend in absorption is expected to continue, with no additional space expected to come online anytime soon. The result will be a steady decline in vacancy through 2011 and into 2012. Landlords are expected to adjust rental rates accordingly, with rent growth anticipated later this year and continuing into 2012.

Current institutional investment underwriting is also reflecting the advent of significant rent growth over the next several years. Businesses with additional space requirements or looking to upgrade current space should move quickly to take advantage of this waning tenants' market.

The Return of Speculative

Highly specialized build-to-suit deals have represented most development activity over the past two years, as represented by NSK America Corporation's new single-story, 25,550 square foot North, South and Central American headquarters facility that is nearing completion by McShane Development Company. This showcase corporate headquarters will feature 60% office, showroom and lab space and is located within the Huntington 90 business park in Hoffman Estates, Illinois. Build-to-suit opportunities have been limited over the past 36 months but have represented the development community's body of work as speculative development has completely ceased.

With speculative activity at a standstill, only 2.9 million square feet of new industrial construction took place in Chicago in 2010, and a mere 2% of that square footage was speculative. Speculative activity is showing signs of returning to both coasts and possibly Houston and is expected to work its way back into the Midwest and Chicago by 2012. However, speculative activity relies heavily upon the return of the credit market.

When speculative activity does return to Chicago, the I-55 corridor may be the most likely submarket for initial activity due to its consistently high levels of activity as well as its lowest vacancy rate with the past 10-plus years.

The small and mid-sized banks that have survived the recent recession are now beginning to lend to their local customers who need capital to expand their businesses. This will fuel the real estate recovery; however, interest rates need to remain low in order to sustain new activity.

Moving Forward

The positive indicators within the economy appear to outweigh the negative. Unemployment continues to show signs of improvement, the stock market will likely sustain its rebound, GDP continues to grow and corporate profits are at record levels. On the local level, industrial leasing has improved, causing vacancy rates to decline, thus paving the way for increased asset sales and soon new development deals.

The past several years have represented a long, hard battle marked by a falling economy and frozen capital markets. Although positive signs continue to emerge, significant global issues keep tapping the brakes on this frustratingly slow recovery.

Economists predict that it may take until 2020 before we can re-absorb the 8.8 million jobs that were lost during 2008 and 2009. A stabilized unemployment level closer to 6 - 7% may be a realistic "new normal" as opposed to the 5 - 6% we enjoyed just before the recession.

Amidst the fits and starts of this recovery, the good news is the private business sector is beginning to make decisions more rapidly. Investors are feeling more pressure to push capital out the door to boost earnings and long-term growth. This will lead to buildings leasing and selling, causing capital to be redeployed. The cycle will once again swing upward just as it always has before.

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