Chicago Central Business District Office Market Report

Half Year 2020

Photos & Data Courtesy of CoStar

Overview

The Chicago Central Business District (CBD) is one of the most prominent markets in the country, primarily comprised of the following submarkets: East Loop, Central Loop, West Loop, River West, River North, Fulton Market and North Michigan Avenue. 2020 was again primed to be a good year in commercial real estate throughout the CBD until the COVID-19 pandemic stymied everything. The unprecedented occurrence created a shock in the market structure that resulted in a significant increase in subleases in addition to vacancy rates beginning their expected upward climb. This is an era that will likely result in more significant changes than short-term and immediate numbers may project. Attitudes towards office space, and particularly dense office space, are sharply shifting. The office space focus since COVID-19 has been on how/when to return to work, utilization factors, people working from home and stronger demand for better HVAC Systems as well as cleaning and touchless systems. Few new deals are being started; for the most part deals that are happening either were in progress or are in Class B and Class C buildings with short term extensions in exchange for rent forgiveness.

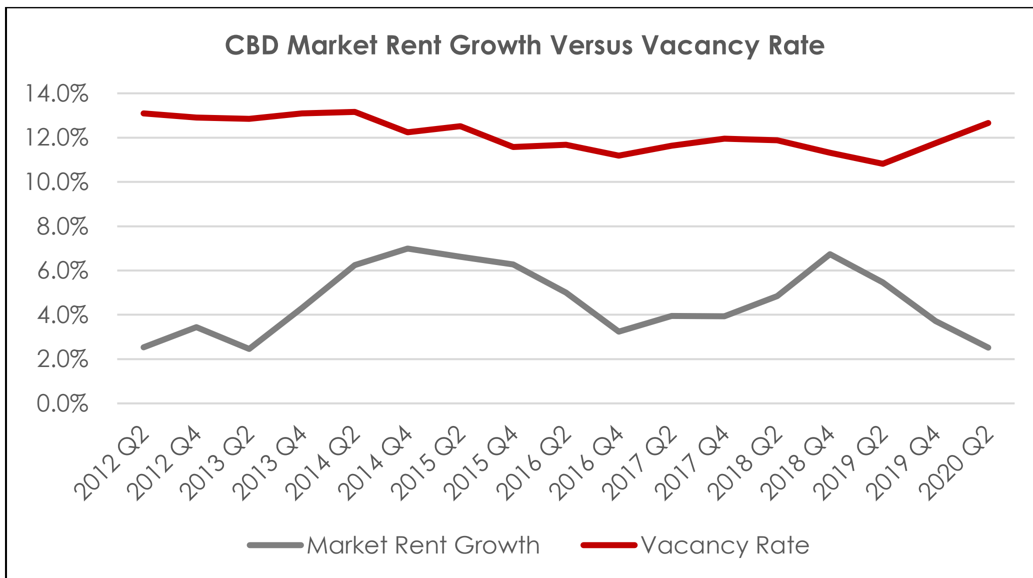
The pandemic created a unique set of circumstances around the world. Most tenants in commercial real estate were forced to leave the office and many are still in primarily work from home situations. This resulted in increased vacancies and low or decreasing market rent growth. The CBD has an overall office vacancy rate of 12.5 percent, with Class A, B and C buildings holding vacancy rates of 13.2 percent, 11.8 percent and 12.3 percent, respectively. Most CBD buildings are Class A or B as

historically many Class C buildings were either torn down or converted to hospitality or residential uses. Of the 229 buildings larger than 250,000 RSF, 210 office buildings are either Class A or B buildings and only 19 are Class C properties.

The aggregate vacancy rate has increased by 1.8 percentage points year over year (to 12.7%), reaching its highest rate since mid-2014. The vacancy rate is predicted to continue an upward trajectory due to the financial implications of COVID-19, a desire to increase work from home and maintained cautiousness in entering dense office spaces, according to McKinsey and numerous surveys.

Prior to COVID-19 taking hold, February was still beneficial to landlords although the market was slowing down. Market rates were growing at 2.6% per year until Q1 2019 when they started to dip. COVID-19 is reinforcing that trend on the few transactions that are occurring. Numerous companies are talking about the hub and spoke method, which would hurt the CBD as more space would theoretically go to suburban and/or secondary markets as corporations focus on increasing satellite offices. Prior to COVID-19, the suburban market was becoming more attractive given the substantial gap in rents, and now with the pandemic, suburban locations are becoming even more attractive given the lower overall densities in the area and in the actual office buildings. This most likely will hasten the shift from a landlord's market, to equilibrium, and eventually to a tenant's market.

Rent Growth and Vacancy



1.2 million RSF in interior construction was scheduled to be started at the beginning of Q2 2020, but approximately 50 percent of that construction was put on hold, such as a portion of Uber's project in The Old Post Office, reflecting the financial considerations after the pandemic and the overall decrease in continued demand for more office space. Further, construction costs have increased approximately 30% versus a year ago, given how construction labor is required to work in buildings.

There are new overarching impacts of the pandemic to both CBD and Suburban markets: Technology has decreased the importance of employees needing to be near a consolidated workplace. Employers are beginning to embrace the idea of taking their jobs to the talent versus the other way around. The other factor, commuting pattern changes, could have a much more profound effect as to where companies ultimately choose to put their locations. Public transportation usage fell dramatically during the pandemic, and many experts in the transportation

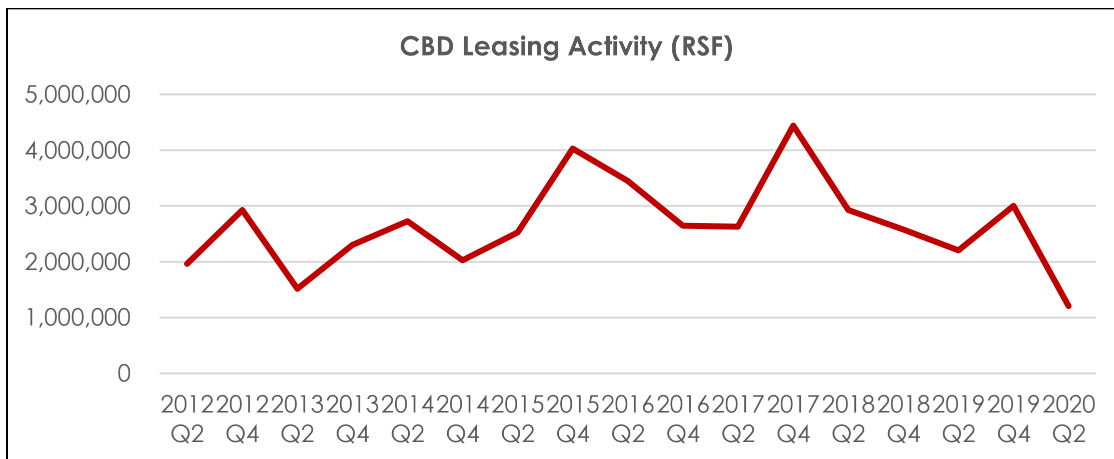
field expect the high usage before the pandemic will never return. Until people feel safe "crowded" into trains and buses again, they will opt for personal transportation (cars, ride services, motorized and unmotorized bikes, etc.) which will increase street congestion.

Leasing Overview

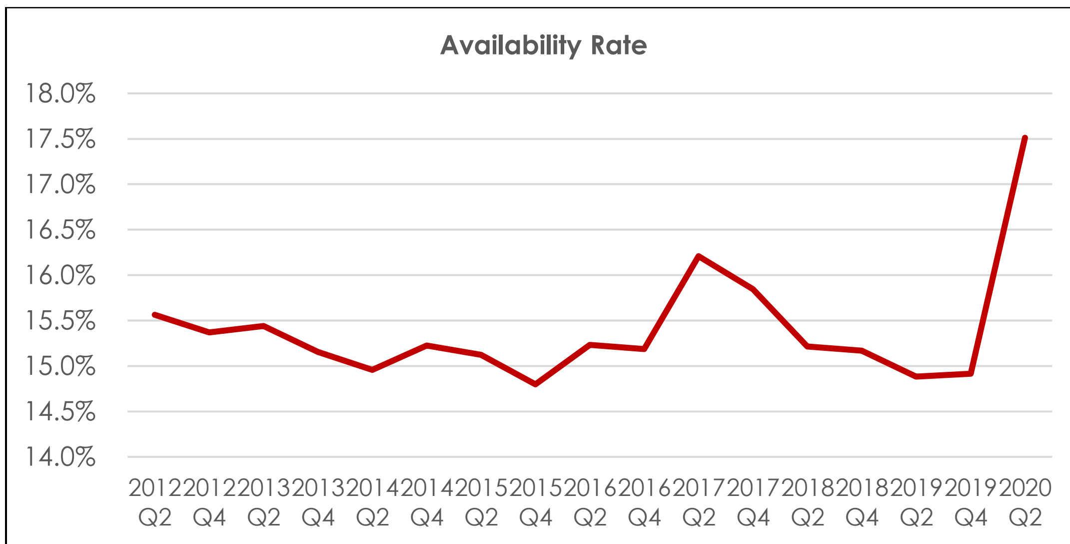
The CBD's leasing activity took an expected downturn once COVID-19 took hold. Particularly in the second quarter, activity plummeted as questions and uncertainties were present regarding the virus. As the government began to institute stay-at-home policies, in addition to later actions, the impact was consistent with real estate throughout dense areas in the United States. Leasing activity as well as net absorption reached a ten-year low as a result, though both may see partial rebounds in the upcoming quarters as the economy slowly opens.

Although some tenants are returning to work now, the majority of CBD tenants are delaying returning to work until after Labor Day and in many cases do not think they will be at full staff in their offices until after the new year. In response to this, landlords are hesitant to drop their asking rental rates (particularly in Class A buildings) because of the lack of activity. In a sense, the market is in a cat and mouse game, although on safety issues landlords and tenants appear unified.

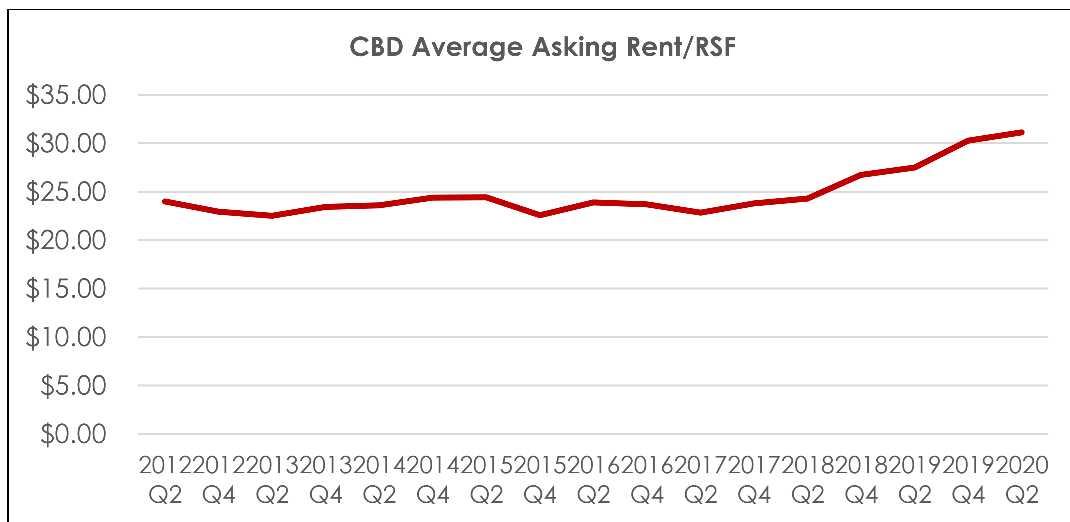
Given the technological advances of the last several years and as COVID-19 has lasted longer than businesses hoped, companies have found a larger part of their population can work from home effectively. Additionally, hybrid models preliminarily show 25 percent of the workforce can work more than 50 percent of their time from home. Consequently, even when the recovery is complete, ProTen expects vacancy rates will be higher for the foreseeable future even with social distancing. There have been a limited number of transactions to note, but some highlights include: CCC signing an approximate 140,000 RSF lease at 167 N Green Street, Lewis, Brisbois, Bisgaard & Smith renewing for 55,000 RSF at 550 West Adams, NFP Insurance signing a 37,000 RSF lease at Accenture Tower, and PHD Media signing a 33,000 RSF lease at the Aon Center.



One of the most notable impacts COVID-19 has had on commercial real estate in the CBD is in the sublease market. The availability rate, which adds space available to the vacancy rate of space still occupied and paying rent, also reached a height of 17.5 percent, the highest it has been since the early 2000's. In the second quarter alone, sublease availability in the CBD has risen by roughly 430,000 RSF. Many mid-sized and smaller companies are either listing their entire premises or a portion of their premises to offset real estate costs. Many of these subleases were originally developed to offset financial constraints, however, many now are also a result of the trend to work from home more often.

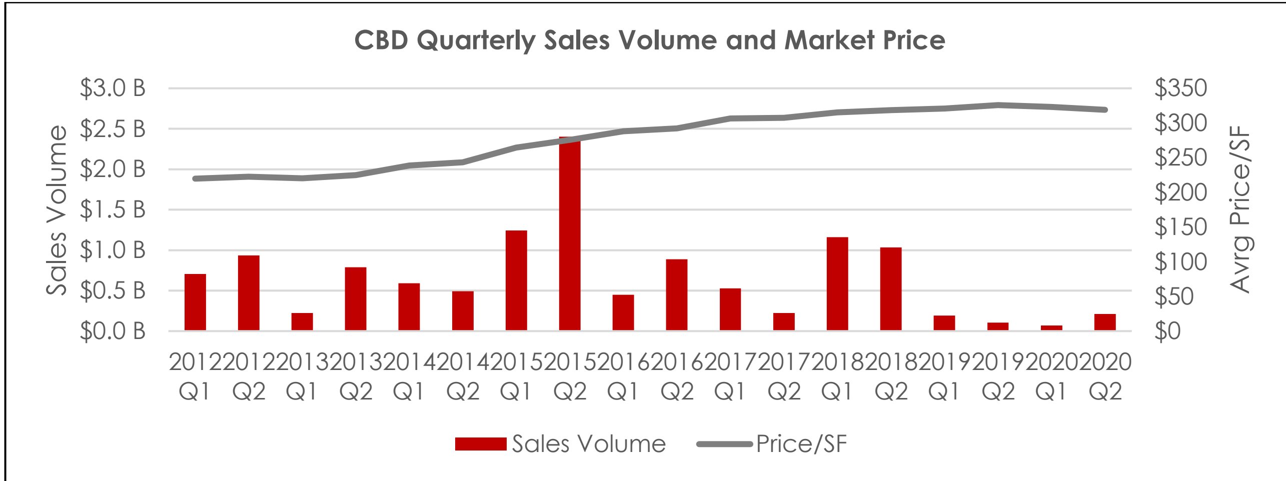


The sharp increase in the CBD's availability rate has translated to a levelled off asking rent on sublets. Prior to the pandemic, the average asking rent for a sublessor was paralleling direct asking rates and had been climbing, but it has levelled off in 2nd quarter 2020 (from 1st quarter 2020 which had seen a slight increase from 4th quarter 2019) and is likely to decline as the year continues.

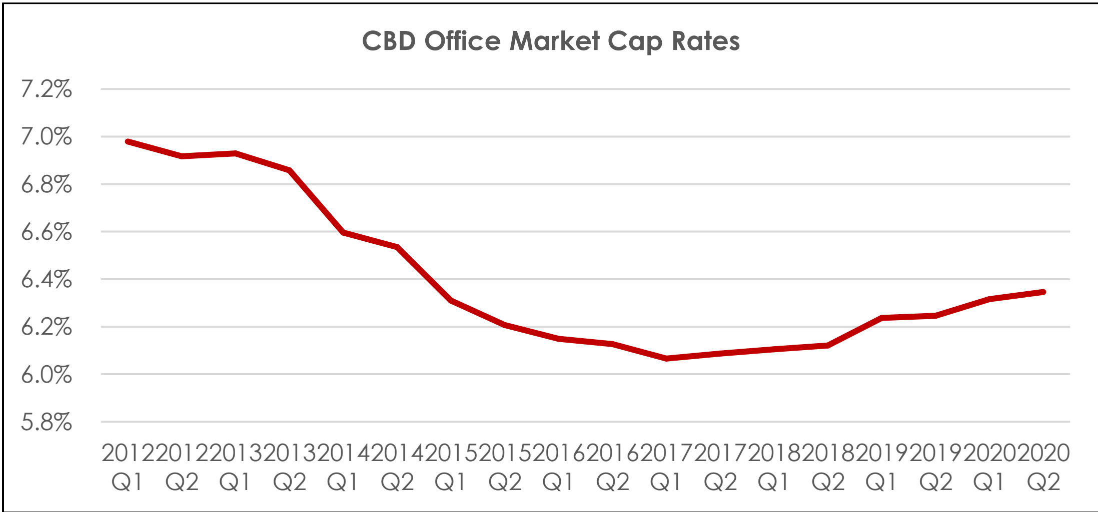


Sales History

As COVID-19 hit in mid-February/early March, sales declined significantly. Caution became the defining approach to transactions. It is not clear when and how long it will take for the market to recover from COVID-19. Some investors, such as Sam Zell, are beginning to look for distressed properties in an attempt to find bargains due to the now cautious psyches affecting the market. Landlords are looking to increase NOI for short term leases (less than 3 years), which some are projecting to be 15 to 18% of the building.



Beginning in 2016 through just prior to COVID-19, Market Capitalization Rates (Cap Rates) had decreased a full percentage point showing the strength of the buildings' rent rolls and continued demand. The Market Cap Rates in the CBD levelled off to approximately 6.3 percent for all building Classes. Class A buildings were at 6.2 percent, Class B building rates were at 6.7 percent, and Trophy Buildings were at 5.4 percent. New uncertainty with the future of COVID-19 has already caused an increase of about half a percentage point on the few sales that have been completed. Until certainty is reached regarding the pandemic, Cap Rates may continue to increase compared to the previous years.



2019 had a strong start for sales, but as property tax worries took hold, sales velocity declined. There has been only one $50 million+ purchase in the CBD in 2020: Spear Street Capital added 225 W Wacker for $210 million after having entered the CBD with the purchase of 500 W Monroe for $412 million in October 2019. The other significant purchase was of Burnham Center by Golub for $80 million. There are three buildings under contract: 333 S Wabash purchase led by New York investor Michael Shvo and appears to be moving forward. The original price in January 2020 was rumored to be $370 million; it will be interesting to see the final purchase price. It is scheduled to close in the 3rd quarter. The other buildings under contract (unknown closing dates) are 200 W Jackson (joint venture led by New York Life Real Estate Investors for approximately $150 million) and 225 W Randolph to a partnership led by Angelo, Gordon & Company. AT&T is the sole tenant and will most likely vacate the building or significantly downsize when its lease expires in 2022.