CORE INDUSTRIAL REALTY

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A Look Ahead for Chicagoland Industrial Real Estate

With inflationary pressures easing, the Federal Open Market Committee (FOMC) is signaling to public markets a reduction to the target rate at their mid-September meeting. Given their historically cautious approach to managing expectations and market reactions, we strongly anticipate a ¼% reduction to their target rate despite some pundits calling for a ½% reduction. It remains to be seen what impact a rate reduction will have based on how much of this anticipated reduction has already been baked into relevant market capital costs. Without the benefit of foresight, our best guess for future reductions to the target rate would be an additional lowering of ½% by or around the end of 2024. While many real estate investors and adjacent participants in real estate related activities are eager to see interest rates march lower, we must recognize the true costs to lower interest rates. The underlying factors that determine the need for the federal reserve to lower rates contrast with what drives a strong industrial real estate market, namely demand.

Employment Drives Industrial Real Estate Markets

Given the overweight domestic nature of the U.S. economy, we must be sensitive to employment rates, productivity gains made relative to competing international economies, and the impact of technology on both the previous two factors . To simplify, if you want to gauge the health of the industrial real estate market domestically, look closely at the unemployment rate. The consumers, and their ability to pay for the goods that need to be made, assembled, packaged, handled, shipped, and distributed, is what drove unparalleled demand for industrial space during the pandemic. Further, geopolitical issues as well as a close examination of supply chain dependency and interconnectivity have impacted demand for U.S. industrial real estate in a positive manner. The post pandemic new normal, appears to be a strong one for industrial real estate, certainly here in the greater Chicagoland area.

Cost of Capital and Cap Rates

How quickly the FOMC reduces their target rate over the next 12 to 24 months will impact many real estate related decisions moving forward. A lowering of the capitalization rate for industrial real estate purchases is a likely result for multiple rate reductions to the target rate moving forward. This lowering would in turn elevate prices for industrial from current levels, assuming rental rates stay constant or continue to increase. Demand for space will dictate rental rates and demand will depend on the overall health of the U.S. consumer. From the supply side, Core Industrial Realty tracks the greater Chicagoland vacancy rate overall at ±6% (with substantial deviations in certain submarkets that comprise the total market here). Historically, a 6% vacancy rate for industrial is a neutral rate which favors neither tenant nor landlord, thus a healthy market.

Diminished Speculative Deliveries

The first half of 2024 resulted in substantially diminished speculative industrial delivery and the second half of the year will provide for less. The lack of speculative delivery should reinforce a healthy balance in the industrial vacancy rate and likely reduce the vacancy moving forward. This will in turn enable rental rates to keep their gains from the past three years (barring any major shocks to demand). A lack of available and properly zoned land for industrial will also keep industrial supply in check. Assuming unemployment remains relatively low (4% to 5%) consumers of industrial space will see the need to remain in infill markets, (the established major submarkets throughout the greater Chicagoland area).

Key benchmarks we track closely at Core Industrial Realty: Overall and submarket vacancy, annual rent escalations, landlord transactional funded tenant improvements, prevailing capitalization rates, time on market (exposure) and demand. Our predictions for these key benchmarks:

Vacancy Rates

We anticipate vacancy rates to trend downward for the overall industrial market in Chicago with continued tightness in key infill markets. Watch for a slow and steady decline of vacancy rates overall as diminished speculative deliveries for 2024 will enable lease up of existing vacancy for big box speculative industrial in periphery market locations. This will not happen overnight (as nothing does in industrial) but slow and steady given the runway before any significant speculative square footage can or will be delivered to the market. Smaller space vacancy should remain low given the lack of overall depth in this product type within established markets. Barring an economic shock of some proportion, the overall vacancy rate for industrial should trend downward. While lower capital costs are engineered to stimulate investment, their effectiveness is often unclear. Demand will be borne on consumer health and employment with moderate influence coming from capital costs. We see vacancy rates at the end of 2024 closer to 5.5% than the present 6%.

Annual Rent Escalations

Annual escalations seem to have settled in at 3.5%. By historic standards, 3.5% for industrial is very healthy. While we experienced a brief period during and immediately after the pandemic of 4% and greater for some annual escalations, the prevailing rate post pandemic is 3.5% pending specific tax and operating expense structure per transaction. For a period of 25 years the annual increase to base rental rate fluctuated between 2% and 3% with 2.5% as the default rate over the last many years leading up to the pandemic.

Landlord Funded Tenant Improvements

Landlord funded tenant improvements, by some accounts, were up over the past few years despite a tight market and lack of concessions offered by most landlords. This was due to the significant increase in every cost aspect of construction-related activities. While overall construction prices have stabilized and, for some key commodities, we have seen a noticeable decrease in pricing, look for landlord funded tenant improvement costs to remain stable or increase slightly over the next 12 months. There will not be multiple tenants competing for space anytime soon. Landlords will have to make necessary changes to existing buildings to re-tenant and to maintain or nudge higher their rental rates. The alternative will be tenant-funded improvements and rental rate concessions.

Cap Rates

We see class capitalization rates trending downward as capital costs decrease over the next 12 to 24 months. Watch for 10-year treasury yields to be near or below 3.5% by the end of 2024. The best of the best class A industrial investment (those that may be able to provide rent growth or a higher probability of renewal than the standard), likely will dip back into the high 4 capitalization range with the bulk of class A product selling right around a 5 capitalization rate. Class B product should stabilize in the 6.5 to 7 capitalization range. Expect ample capital available for the right speculative industrial play as quickly it will be over a year since such capital was deployed. Expect also ample capital for investment overall in industrial as other real estate classes struggle with performance, identity, and predictability.

Time on the Market

Exposure times to the market for landlords will extend. There simply is not the urgency to occupy that there was for industrial during and post pandemic. An election year and the policy uncertainty that comes with it does give larger consumers of industrial space an excuse to kick the can down the road and delay decision making. Landlords in the past that were sensitive to delays in lease up would often try unsuccessfully to expedite the decision-making process with further incentives or reductions to price. This will likely not happen moving forward but spaces will stay vacant for longer than landlords have grown accustomed to over the past several years.

Tenant Demand

Demand is the wildcard. There are a few viable paths demand can take, and forecasting is difficult. In a perfect world, demand is buoyed by the anticipated reductions to the cost of capital. In this scenario the residential real estate market would heat up again and spur home improvement activity along with new home construction and the purchase of durable goods. If these things happen, look for strong demand to rejuvenate industrial demand from the post pandemic nap it has briefly taken. Look for residential to have a positive impact on industrial in 2025. Alternatively, we could see an extremely measured pace of rate reductions by the FOMC that does little to stimulate residential real estate markets and demand remains tepid with infill markets performing the best by a margin. Large retailers and multinational companies have put not only their supply chains under a microscope but their inventories as well. This self-examination has prompted less need for space. These changes were made in anticipation of weaker consumer sentiment and budget tightening ongoing because of multiple years of excessive inflationary pressures. Now that inflation is seemingly under control, how long before the average consumer regains their confidence and does their part to spur on the domestic economy?

Core Industrial Realty

As Core Industrial Realty approaches our second anniversary, we are extremely grateful for the many transactions and accomplishments in our brief history. We were pleased earlier this year to hire Carrie Santos as head of Research here at Core and we have grown our database significantly since Carrie's arrival. Our new broker additions continue to learn and now execute on the fundamentals we taught them. We are actively looking to expand our broker stable here in Chicago and hope to share new hires with you soon.

THANK YOU!

Most importantly, we recognize that none of these things would be possible without you, our customers, and trusted partners. Our goal from day one has been to provide our customers with a unique and better experience than what they have been accustomed to. I believe we do and will continue to provide superior service through tailored solutions for each project we take on. Nothing is a given here at Core. We strive to be detail oriented and, in many respects, perfectionists.

Best regards,

Noel S. Liston
Managing Broker