

Thoughts On Chicago's Commercial Real Estate Market And Potential Implications For The City – Prof. Joseph Pagliari

*By: Prof. Joseph Pagliari, Jr.**

Nationwide, commercial property values have already fallen by approximately 15-20% for large, institutional-quality assets over the last 12-18 months; smaller, lesser-quality properties have likely fallen further. To be sure, the decline in values is uneven across property types (*e.g.*, industrial properties have handily outperformed office properties) and geographies (*e.g.*, many “sunbelt” markets have outperformed more-traditional strongholds like New York, Chicago, San Francisco, *etc.*).

There are several reasons. Some of them macro, while others are micro. On the macro front, the rise in interest rates over the last 18 months has led to an adverse repricing of the cash-flow streams associated with owning income-producing real estate. Additionally, COVID-related lockdowns lead to substantial revisions in the ways tenants utilize commercial real estate. Foremost among these effects is the work-from-home phenomenon which has dramatically slashed – at least for the time being – the need for office space (particularly in those metropolitan areas facing long commute times) as well as the number and frequency of industry conventions, conferences and the like.

The lockdowns also accelerated certain pre-existing trends, most prominently the manner in which consumers shop. These disruptions from Amazon and other online retailers have particularly devastated the value of many shopping malls. Moreover, there is much consternation among commercial real estate investors that we have not yet seen the bottoming of property prices. Questions abound: Will the Fed continue to raise interest rates? Will the macro economy worsen? Will Russia's invasion of Ukraine spill over into a larger conflagration? Will China invade Taiwan? This burgeoning list is unsettling at a minimum.

On the micro front, these over-arching macro trends are either mitigated or aggravated by local choices about taxes, business regulations, services (including policing and schooling), the quality of infrastructure, *etc.* Lurking in the background of these local choices lies the fiscal condition of state and local authorities – with unfunded pension plans a looming crisis in many parts of the country. Funds (*e.g.*, tax revenues) directed to these unfunded liabilities have the effect of “crowding out” spending on other crucial public sector-provided services. Moreover, severe financial pressures tend to cause decision makers to make sub-optimal decisions (*e.g.*, long-run benefits are sacrificed for short-term savings).

It should come as no surprise to anyone paying even scant attention that Chicago, along with Cook County and the State of Illinois, are prime examples of local forces adversely effecting these macro real estate trends. This is seen not only with regard to commercial property values, but also with regard to the values of single-family homes – where Chicagoland home

price appreciation has been consistently among the worst-performing markets in the country.

The combined forces of crushing taxation (among the five worst states in the country), rising crime rates (as one proxy, merely observe the number of weekly shootings), failing public schools (only 25% of Chicago public school students are proficient in math and reading skills for their ages), horrific fiscal imbalances (Illinois has the worst balance sheet of any of the 50 states), *etc.* has unsurprisingly led to commercial property falling harder in Chicago than the country as a whole.

While there are legions of property-specific examples, let's focus on just two high-profile submarkets: the Magnificent Mile and the LaSalle Street corridor. With regard to North Michigan Avenue, falling retail sales have led to the knock-on effects of falling rents and occupancy levels. In turn, property values are plummeting. Perhaps the best-known example occurred last spring when the owner of Water Tower Place decided it was no longer worthwhile to reinvest in the property and therefore decided to transfer ownership of the property to the mortgage lender.

Similarly, the hallowing out of office buildings lining Chicago's famed financial district has led the mayor to call for the redevelopment of these office buildings as mixed-income residences. Of course, these office-to-residential conversions are only feasible when the values of the office buildings are dramatically written down. To any veteran real estate observer, the cataclysmic fall in property values along these two famed boulevards was inconceivable as recently as five years ago.



Chicago's LaSalle Street

Should the citizens of Chicago be concerned? The answer is unequivocally yes! Even if your first reaction is “I don't give a hoot” about the financial devastation being experienced by most commercial property owners, the value of commercial real estate supports a great deal of taxation. In turn, these taxes pay for all sorts of government-provided services.

As one example, it has been earlier estimated that commercial properties pay more than 35% of all property taxes in the city. While this figured has likely shifted with recent events, let's consider the following thought experiment: What if commercial property values fall in half (and the residential values remain unchanged)? Then, the residential property owners face an approximately 20% increase in their property taxes. (Perhaps a more-likely political reality is that residential property owners face both significant increases in their property taxes and significant decreases in government-provided services.) Furthermore, other state and local taxes are threatened as submarkets like North Michigan Avenue and LaSalle Street decline in popularity and usage – perhaps the most immediate effect is seen with regard to dwindling sales taxes (which supply a significant percentage of local government services).

Finally, the results of Chicago's latest mayoral election do not comfort those real estate investors who had hoped for profound and effective changes in the direction of the state and local political economy. The concern is that these strong headwinds lead to a vicious cycle of more of the same (increasing taxes, failing schools, crumbling infrastructure, falling property values, *etc.*). To those who say it cannot happen here, consider that Detroit was once the country's fifth-largest city and one of its richest.

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