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Know Your A,B,C's

More than alphabet soup: Understanding building classes and availability

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The landlord conundrum: reinvesting to thrive or reinvesting to survive

The workforce recruitment and branding advantages of occupying office space in the newest and most amenitized buildings in Chicago is a significant component of the much-discussed "flight to quality" trend that has arisen in recent years. Coupled with the additional leasing trend of "flight to capital," where tenants are seeking space in buildings that are financially resilient with little debt, this has created a clear divide in where leasing activity is concentrated among Class A, B, and C buildings.

Tenants seeking the highest quality office space are jockeying for the newest, shiniest, or most recently repositioned offerings in the market. Those buildings that offer both the flight to quality and capital trends are becoming limited, with, at times, only single-digit percentage availability. Headlines are shouting, "Vacancy has never been higher," but there is real nuance within the market. Conversely, Class B and C buildings largely continue to experience significant vacancy, and landlords will have an important question to ask themselves: Can I or should I reinvest?

Building owners want to maintain the ability to sell their property and be able to manage any debt service payments without getting into financial difficulty. Owners who make minimal enhancements to the property only when necessary are often "investing to survive." When "investing to thrive," however, owners see a path to augment the financial value of the asset by repositioning it or making substantial upgrades. By investing in their property, thereby increasing its attractiveness to tenants, a landlord has a path toward value creation through increased leasing activity and securing higher rental rates.

For landlords who invest to thrive, repositioning can pack a punch. However, many factors come into play. Assets situated in prime, public transit-friendly locations and within neighborhoods that offer a true "live, work, play" dynamic will have the advantage and make the business case around repositioning more supportable. Upgraded amenities attract tenants, but to capture the market, these buildings must also be in a convenient setting that offers easy commuting.

What does class have to do with it? More than you think.

Building classes are typically defined by how the real estate community and tenant advisors view the property and how those buildings are distinguished to the tenant market. Yet, there is no exact science to building categorization. Real estate professionals may disagree on the slight details but can generally agree on a building's overall status. The application of how buildings are informally classified as A, B, or C also provides advisors with vital information in determining the building profile and selection for a tenant client's real estate requirement.

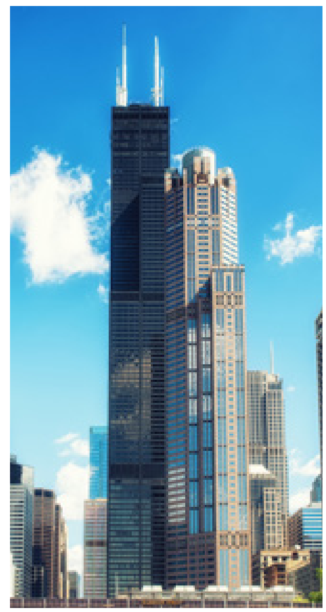
Class A encompasses many variables of which there are three main categories:

1. **New trophy**
(built 2016 – current)
2. **Second generation**
(built in the 2000s)
3. **Older generation**
(built in the 1970s – early 1990s)

> Today, the Class A building design aesthetic is focused more on cleanliness, modularity, and the abundance of spatial volume.

A new trophy designation applies to a newly delivered glass and steel building, such as a high-rise like 150 N Riverside, or an older yet iconic skyscraper such as the Willis Tower. The former are often the most expensive and have the least amount of available space, which indicates that there is great demand in the market. Companies seek occupancy in these properties for a range of reasons, such as their substantial amenities and convenient locations often near public transit. They may also view the building's profile as a validation or extension of their branding. Even though some Class A buildings are older, if they are of high quality, in a well-situated location, and offer a comprehensive array of amenities, they will still be in the top-tier class.


150 N Riverside


Willis Tower - 233 S Wacker

To maintain their standing in the market and remain competitive, both second and older generation Class A properties are undergoing major renovations to ensure tenants have all the current amenities they seek. This includes newer tenant lounges, modern gyms, food options, and even curated outdoor spaces for recreation and private events.

One of the key criteria that tenants seek in an office space is an abundance of natural light and air. Newer trophy buildings offer this based on their underlying design, which afford floor-to-ceiling window heights. Second generation buildings are designed with more contemporary architecture including thin steel and full glass curtain walls. The newer design aesthetic is focused more on cleanliness, modularity, and the abundance of special volume. For example, second generation buildings including 71 S Wacker, 1 S Dearborn, and 111 S Wacker are all over 90% leased. In today's market, we are seeing few new trophy and second generation product with high availability.

Older generation properties offer tenants a similar experience to second generation buildings but they may not have the level of amenities or building technology, be in the most convenient location or have the most efficient floorplates. The older generation may still appeal to tenants who are less concerned with a window line that provides floor-to-ceiling light and air and instead admire the building's history or intricate design details. These buildings still offer a high level of quality but can be found at an occupancy cost discount compared to new construction. Location and setting still play an important role, and landlords who invest in the building by adding updated amenities can expect to see low vacancy. The comparatively ornate buildings built in the early 1990s, including 181 W Madison, 77 W Wacker, 190 S LaSalle, the CME Center, and The Franklin, are experiencing a market resurgence and renewed tenant interest due to their reinvestment.

Properties that are categorized as Class B tend to be office buildings predominantly constructed in the 1970s and 1980s. These may not consistently have a tremendous amount of investment in them, and as such, their older infrastructure is evident, and the amenities available in the building are limited. Some Class B buildings can be found in a less convenient location, may suffer from view or light obstruction, or may not have any prospect of reinvestment based on distressed ownership.

The landlord of a Class B building may also have an ownership position that was sufficient to service the building at the beginning of its possession but now may not be tenable due to a diminished occupancy basis and the ramifications of hybrid work. It is difficult to repopulate these buildings as these are not in the locations or offer attractive spaces tenants seek. Yet, some of these buildings may have a particular type of character as an attractive feature, such as being an old department store or post office that has been rebuilt from the inside out. For example, the Old Post Office is now a Class A building with low vacancy due to its extensive redevelopment.

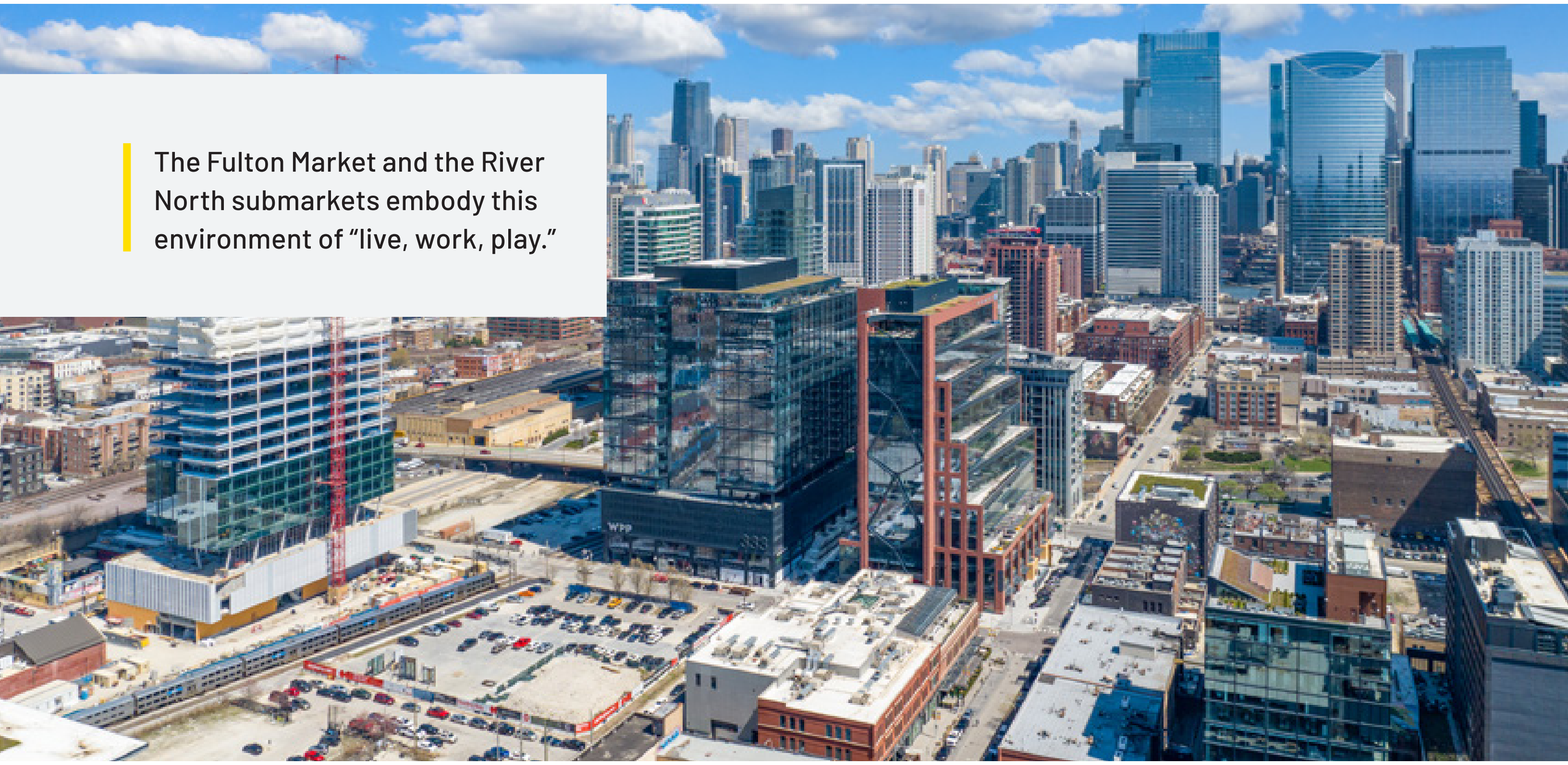
The Class B building owners that are going to succeed will have four critical traits:

1. Convenient and commute-friendly location
2. Floorplate that offers modular design with limited view obstruction
3. Ability to make appropriate upgrades to keep the appeal and value of the building to current and prospective tenants
4. Can offer and execute favorable financial concession packages

The goal of a Class B building landlord will be to limit tenant relocations and, in better cases, attract new tenants who see the value proposition of being in a well-maintained, higher-quality building, that is near public transportation but that does not mandate the highest rents. Buildings that are succeeding today are in better settings, for example, in the West Loop near convenient transportation, or have owners with the capital to invest in the property. Class B buildings that seek to redevelop and invest to thrive or survive must have a steady tenant base that can help service any debt the landlord may hold.

The final class of buildings is Class C. These older buildings are not highly amenitized and offer above standard services to their tenants. They come in many shapes and sizes and across submarkets. Class C mainly competes on price and location. These properties are attractive to tenants seeking inexpensive office space with access to the downtown talent pool or customer base. A Class C building can succeed if it offers a certain charm. Two examples are the Heyworth Building located at 29 E Madison and 25 E Washington designed by architect Daniel Burnham, which are in the East Loop submarket. Both properties are in landmark buildings and do not offer a depth of amenities or upgrades yet are both over 80% leased.

Old Post Office (interior) - 433 W Van Buren



> The Fulton Market and the River North submarkets embody this environment of "live, work, play."

Making the investment to do more than survive

Landlords are taking a close look at their individual circumstances and weighing what it takes to survive in a market where activity is concentrated on the cream of the crop. For the owners who choose to invest, they have the ability, in the right location, to shift from a Class B to a B plus or even an A minus. An example of a complex looking to make such an investment is 10 & 120 S Riverside, which is going through a $75 million renovation and is investing to thrive. The complex is well-located near mass transit, so the investment in renovating the building will allow it to be more competitive. This strategy creates a better overall value proposition for a tenant because they are attaining a convenient quality location, an abundance of amenities, and an effective rent, which decreases as concessions are negotiated. If tenants can find buildings that can play in that space financially, that is where new leases will be secured.

The flight-to-quality phenomenon means more than just space. Fulton Market is a very vibrant area with companies such as Google, McDonald's, BCG, and Valor Equity Partners, which are anchored there. When Google relocated to the neighborhood, it created a ripple effect. The area became more desirable over time due to the proliferation of and demand for restaurants, entertainment venues, and residential units. The Fulton Market and the River North submarket most aptly embody this environment of "live, work, play" in Chicago. Companies that relocate to these areas will be able to attract a new generation of talent who view these submarkets as ideal to work in.

For the Class B and C owners who cannot invest to thrive or survive, whether due to financial issues or lack of activity, it will likely become a survival of the fittest. Neighborhoods that have clusters of buildings that have not been improved will experience increased levels of vacancy. The properties that are not renovated and continue to age will either be placed into special servicing or be taken over by a receiver. As a result, the market will be left with a smaller but, on average, higher-quality inventory.

What else will availability and building class reveal later in 2024?

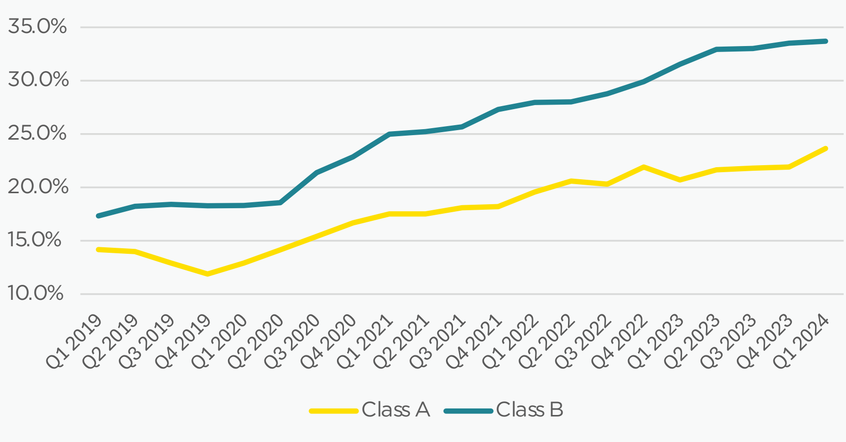
As companies gather more information and make strategic decisions about their real estate needs, some foreshadowing is occurring. Tenants are still rightsizing their office space, but it is more likely to be a trickle rather than a downpour. Since 2020, many companies have reassessed their real estate strategy and have rightsized. The market is experiencing a plateau effect, with availability stabilizing in the sublease or direct space market and is expected to be more incremental than gradual.

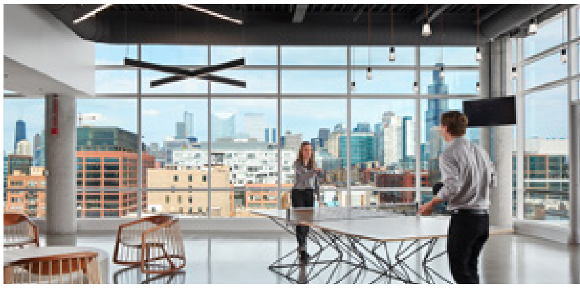
The foreshadowing indicates that the rate of increase will slow in tenants giving back space as they are better informed with critical data to make timely and forward-thinking decisions. Companies today have a better understanding of how to calibrate their needs and what tools they need from real estate advisors to figure out how to adapt, but they also recognize the shift and stabilization in transitioning from remote work to returning to the office.

The value and appeal of the office remains a tangible factor for occupiers and their workforces. Young professionals seek mentorship and career exposure, and as these spaces are built, the employee will experience the benefits of higher levels of in-person engagement and what it does for company culture. The new generation of talent will not want to work in a stark, dark, dated environment because many are recent graduates from expansive, highly amenitized and well-serviced college campuses. They will look for certain elements of their previous experiences to be continued in their new workplaces. The expectation is a city like Chicago will offer more than what they previously experienced on a college campus. In many ways then, for new talent the place of work is considered an extension of student life with the community it brings and the amenities employees can experience. The office plays a key role in the next phase of life for recent graduates.

In the next 24 months, we will start to see a resolution around the role of the office, and it will be reflected in availability rates and leasing activity. Some tenants will compete for trophy space when and if it becomes available, and second-generation Class A buildings will do well, especially with leasing activity on high-rise floors. All in all, whirlwind changes are not likely, but the devil will be in the details, specifically location and commuting ease. So look for nuances, especially among building classes. Investing to thrive and investing to survive will continue to be a theme that dominates building classes and availability for the near future – and it will be the survival of the fittest.

Downtown Chicago Office Availability by Class





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