

THE MIDWEST'S REAL ESTATE SOURCE

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CLEVELAND CITY HIGHLIGHTS: SIGNS OF STABILITY, POTENTIAL CHALLENGES GO HAND IN HAND

According to Colliers Ostendorf-Morris' third-quarter 2008 Market Report, despite the challenges posed by the current economic condition, Cleveland's office sector vacancy is at a 3-year low. The vacancy rate dropped for the fifth consecutive quarter, while rental rates increased from the second quarter to the third. The market recorded positive absorption in the third quarter of approximately 283,000 square feet. Vacancy and absorption levels are both expected to continue to trend positively in the fourth quarter, while the average rental rate is forecasted to remain at its current level. The pace of construction is slow, with only 81,900 square feet of office product completed in the third quarter (137,834 square feet year to date).

For more on the Cleveland market, turn to page 26.

CLEVELAND OFFICE MARKET FUNDAMENTALS - THIRD QUARTER 2008

	Inventory (SF)	Vacancy
Q3 2008	97.17 million	13.14%
Q3 2007	96.6 million	14.2%
Q3 2006	95.91 million	14.26%

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A CLOUDY FORECAST

Professionals from around the industry try to predict the unpredictable for commercial real estate in 2009.

Kevin Jeselnik



"Walton is no different than any other company looking at this market — we don't have a crystal ball," says Dan Frisbee, CEO of Kansas City, Missouri-based Walton Construction.

Frisbee's sentiment is especially timely now, as the industry turns a wary eye toward the new year, and attempts to anticipate the challenges and opportunities that may appear. In this year-end issue, *Heartland Real Estate Business* has sought input — predictions and all — from a collection of Midwest-based commercial real estate professionals in various segments of the industry.

Walton Construction is one of the many companies in real estate that has positioned itself strategically over the past decade, and now finds itself stable in the face of the current economic climate, but wary nonetheless.

SEE 2009, PAGE 32

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Permit No. 140

Dan Frisbee
CEO
Walton
Construction



A CLOUDY FORECAST

2009 from page 1

The company is expecting a decrease in revenue in 2009 of approximately 10 percent compared to this year. With annual revenue of approximately \$700 million, the predicted decline is significant but manageable.

Walton made a decision at the beginning of this decade to allocate resources within the company to military construction (MilCon) projects, in an effort to offset the risk/reward process inherent in the hard-bid, commercial construction sector.

According to Frisbee, "the company liked the highly selective nature of MilCon. Walton is still very much in the hard-bid market in all of our divisions, but it is very competitive and the margins companies are taking on those projects are extraordinarily low."

"We are in a very difficult industry, and sometimes I think that people underestimate our value," he adds. "So you go where you are valued, and those arenas tend to allow for higher margins. Approximately 2 years ago, we made the decision that it wasn't necessarily going to be about volume;

the idea was to become a better company, one that is dependent on higher margins, not volume."

The company is also focusing more on the healthcare industry moving forward, while continuing to bid and work on projects in office, retail and the other major property types.

"Walton is going to take its resources and focus on the best markets," Frisbee says. "We are still very much involved in the commercial markets, but we are cautious there."

Because of predictions of decreased development activity in 2009, constrained by the lack of available credit, Frisbee believes that companies will need to turn their focus to internal operations and make sure they are operating as efficiently as possible.

"The unpredictability [of the financial market] is unbelievable," Frisbee says. "If companies were prepared for this credit crunch, they are going to weather this storm." □



Walton Construction is providing design/build services for the U.S. Army Corps of Engineers' development of the LEED-certified Fort Riley Custer Hill Barracks in Fort Riley, Kansas.

OUTLOOK: BROKERAGE

The most important trend in commercial real estate is the tight credit market, but more importantly will be the impact on values.

Currently, demand is steady but tentative. The additional complications from the credit market is slowing the brokerage process and causing doubt among users, buyers and sellers. The disconnect between value perception and market value is widening. Closing this gap will be the fastest way to get back a stable, vibrant market. How do we close the gap? We need the credit markets to come back to early 2008 levels.

From a small business viewpoint, the tight credit can hamper companies' ability to keep employees and to overcome slow-paying customers. The banks and lending institutions must realize that not all customers are alike, and that long-term, good paying customers need to be given the appropriate credit and viewed as historic long-term customers who pay. Forcing viable companies out of business with tight credit is counter-productive to the purpose banks were created to serve.

Opportunities in the brokerage community will appear in the coming year. Consumers will need good representation more than ever. Our industry is informational by nature, and knowing the values and financial position of landlords and owners will determine when and where deals should be done. An experienced broker will know which landlords have cash, and therefore have the ability to complete tenant improvements. If they do not have cash and cannot

borrow more, tenants are taking a huge risk signing a lease in their property. The broker is also subjecting himself to similar risks in taking on representation of such landlords and owners. Good representation allows tenants the security of having this information when making decisions on which property to pursue for their relocation.

Over the coming year, there will be fallout resulting in the loss of marginal brokers and developers. The current market conditions, difficult as they are, serve the good purpose of eliminating the unqualified from our industry. Larger brokerage companies will be downsizing, and smaller companies will merge or be eliminated. Other parts of the industry will experience similar changes. The remaining companies will be more dominant carving out more defined niches. Those remaining will be the best in their field and consumers as a whole will be better served in the long run.



Daniel P. Cawley
President/Principal
Cawley Chicago Commercial
Real Estate Company

OUTLOOK: CONSTRUCTION

On a macro level, the housing bust, weak credit market and economic slowdown are having a profound effect on all classes of commercial real estate at this point. Right now, Graycor is basing its forecasts on a downturn that will be longer and deeper than anything the industry has experienced since at least the early 1990s.

Graycor services all segments of the commercial real estate market, and many challenges are the same across the various property types. Cost is always important to clients, along with quality, consistency, speed and other factors. In challenging times, people place greater emphasis on figuring out how to do more with less. Graycor's preconstruction services group is busier than ever working with clients to find ways to manage costs. That said, downturns demand a careful review of our business partners' abilities to make good on their commitments. A major subcontractor or supplier failure can be lethal to a project. Low bids can be tempting, but we believe that clients are ultimately more interested in their actual costs at project completion than they are in bid-day promises that might not be attainable. These can be times when subcontractors and suppliers already under stress are tempted to make commitments they can't keep, and general contractors can be tempted to pass those commitments along, even though they, too, may not be able to absorb the risk. Ultimately, clients can end up taking on much more risk in their construction costs than they realize. It is our challenge to identify and manage these risks.

Graycor has grown under the same family ownership since 1921. Throughout its 87 years in business, the company has seen many economic downturns, and there have always been growth opportunities. Unlike other large construction firms, Graycor has been careful through the recent boom years to retain and enhance its ability to win smaller renovation, addition and new construction work. For example, if a contractor's business is based on high-rise construction, it is probably feeling pretty uncomfortable right now. Graycor's business is primarily built around clients with small to mid-sized commercial projects. During the 2002 economic downturn, the company enhanced this capability by acquiring Capitol Construction, which had a long-standing niche in small to mid-sized retail, restaurant, hospitality and office work. The key in down times is to be positioned to take advantage of any opportunities as they arise.

In addition to acquiring Capitol Construction in the 2002 economic downturn, Graycor also acquired Inland Construction Company during the recession of the early 1980s. Each of those acquisitions ultimately helped the company broaden and deepen its commercial construction capabilities. It is possible that the current downturn will provide another opportunity to acquire talent either in the form of individuals, alliances or entire company acquisitions, which ultimately will allow Graycor to enhance its services and compete more effectively. The current market is a prime time to be on the lookout for these opportunities.

Most people I speak with believe the next 12 months will be challenging. It is hard to see commercial construction returning to peak levels at any point in 2009. One potential trend is that long-term operators with good access to capital will be more active in this period because they will be trying to use the current downturn to position themselves advantageously for when the upswing begins.



Matthew J. Gray
President
Graycor Inc.

OUTLOOK: DEVELOPMENT

Duke Realty Corporation anticipates that 2009 will be another challenging year for commercial real estate developers due to the combined effects of an extremely tight credit market and a slowing economy. Obtaining capital for new development will continue to be difficult as lenders are increasingly stringent in their guidelines, and interest rates are at levels that make borrowing unaffordable from a development standpoint. The market for dispositions, which has historically provided a source of funding for new developments, has also tightened. Many investors that are interested in purchasing properties and land have been unable to procure the capital necessary to complete the deal.



Jim Connor
Executive Vice President
Duke Realty Corporation

Overall, we have seen a decline in interest in bulk industrial properties across the United States. We expect this trend to continue as more businesses reduce their inventories and, consequently, their need for warehouse space. Duke has had several deals come to fruition lately and is pleased to report that its industrial portfolio is more than 90 percent leased in all but two of its markets.

The office sector remains relatively steady. Though new leasing activity has slowed down within Duke's portfolio, renewals are strong and there have been very few existing tenants requesting lease terminations.

The development of medical office buildings holds strong potential for Duke in the next few years. The healthcare real estate division, BremnerDuke Healthcare Real Estate, is currently developing medical office buildings around the country for major health networks and has developed a reputation as a leading developer of medical properties. Typically, strong demand exists for space in medical office buildings affiliated with hospitals and the financial returns are stable over the long term.

Looking ahead into 2009, Duke has decided to virtually shut down its new development starts in light of the current economic environment and the issues the entire industry is facing in the credit markets. There is a strong backlog of new development and third-party projects in the pipeline, which will help the company to withstand the downturn.

Next year, the focus will be centered on liquidity, as the company continues to work diligently to recycle cash through the disposition of assets and to attract new sources of funds in the joint venture arena. In addition, Duke and other institutional developers will be regularly monitoring the public and other capital markets in order to take advantage of opportunities as they arise. In the meantime, Duke remains focused on the continued lease up of its development portfolio, with a goal of increasing our overall occupancy to above 90 percent.

Although it is doubtful that 2009 will be a banner year for commercial real estate developers, there are some bright spots on the horizon for developers that are positioned to weather the storm.

OUTLOOK: INVESTMENT SALES

Because of the turmoil surrounding the stock market, the fuel price spikes at the end of the summer and the general uneasiness regarding the state of the economy, combined with the presidential election and the potential increase in capital gains taxes for tax-deferred investors, there has been a severe flight to liquidity among investors of commercial real estate. There are transactions still being completed, but there is a flight to quality and value, and properties that may not encompass those attributes that sold relatively easily over the past 48 months are very difficult to sell now. Once the new administration takes charge and the bailout begins to take effect, hopefully some of the lenders will start to loosen up the purse strings and investors will regain some form of a comfort level and begin to invest again.

For investors, I believe there justifiably should be a flight to liquidity, and they should be careful regarding what real estate they acquire. An investor should look at well-located real estate with low rents, where they would have a very good residual

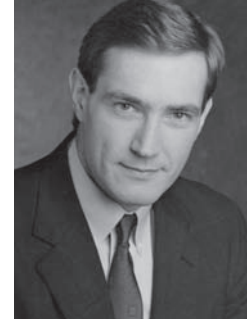
value, and they could duplicate or increase the existing rental stream with tenants that they believe are going to be in business for some time. Millco Investments recently the sale of a Chase Bank property in Montgomery, Illinois, that had a \$160,000 ground lease and an additional 30-year lease term. There were multiple offers at a 6 percent cap rate within 2 weeks of listing the property, while most net-leased bank properties are trading in the 7 percent range now. The reason the Montgomery property traded at a 6 percent cap rate was that it boasted a low rental stream and was well located across from a new Walmart in a market that is expected to grow steadily over the long term. The low rental stream made it affordable for a larger portion of the marketplace, as opposed to being priced at a more expensive value, and that is why it sold. But there are not a lot of similar deals on the market today. There are more properties with compromised credit, compromised lease terms, with suspect rental streams or in suspect locations. Those are the properties that investors should avoid.

OUTLOOK: FINANCE

The biggest trend impacting the commercial real estate lending industry is the ongoing credit crunch that is casting a cloud over the entire financial climate. As a lender, KeyBank is caught right now between providing financing for well-qualified projects by experienced developers and a need to retain capital on our balance sheets. We are stepping in to finance a lot of multifamily and senior housing projects that other banks cannot or will not, either because they are constrained by lack of capital or because they don't have the conduit relationships we do. Many lenders, including KeyBank, are focusing on the multifamily sector. Close government sponsored enterprise (GSE) agency relationships with Fannie Mae, Freddie Mac and the Federal Housing Authority (FHA) allow lenders with long-standing conduit relationships to provide solutions for developers that others without strong agency ties cannot.

KeyBank has always had conservative underwriting standards, but now more than ever the company is closely scrutinizing each transaction. A couple of years ago, it was enough to determine that a project had sound fundamentals. Now that is just the beginning. For example, an auto distribution center that is leased up through 2019 may look attractive right now, but it could experience challenges as the market shifts, especially if there is a cataclysmic realignment in auto manufacturing. KeyBank is focused on helping existing clients stay profitable and doing everything the company can to partner with them for the long term.

There are three sectors where we see opportunity for 2009: Agency lending for multifamily housing; seniors housing, including continuing care centers; and small-balance



Elliott Quigley
Senior Vice President,
Midwest District Manager
KeyBank Real Estate Capital

multifamily lending. KeyBank has a robust multifamily lending program that offers finance solutions for sound apartment projects through Fannie Mae, Freddie Mac and the FHA, and that business is expected to continue to grow. Senior housing is another sector we are bullish on, as the American age demographic continues to shift higher and demand for assisted living facilities rises. Also, there will likely be significant growth in the sub-\$5 million multifamily lending area, and here again lenders with GSE agency relationships will be able to offer the best terms to borrowers.

Underwriting standards will continue to become more conservative, while consolidation in the banking industry means that the pool of lenders will be smaller. Together, this means that fewer projects will qualify for less dollars. Agency lenders will be comparatively better positioned than others, because they will be better able to offer more and varied solutions, due to their relationships with Fannie, Freddie and FHA.

Next year is going to be a rough one for borrowers and lenders alike, and it will be mutually beneficial to work more collaboratively with one another to find solutions in a tough economic environment.

It is difficult to guess when the commercial real estate market will turnaround. I think it is going to take a solid 12 to 18 months, because the economy is in disarray and lenders and investors lack confidence. The prime rate has been slashed and lenders still aren't loaning money. Investors need to be very cautious until there is some positive growth seen in the economy, whether it is in retail sales, product, imports or another arena. Retailer activity and sales will be the first indication of confidence that things are turning around. Retail is the first to get hit, and if retailers are showing signs of expansion, that will be a sign of positive growth. But such activity isn't likely to occur for at least a year.

There will be some opportunities in the marketplace for investors with equity set aside. Many owners will need to sell properties for a number of different reasons — they are over-leveraged, for estate reasons, for liquidity, for organizational purposes — and investors with cash at the ready will have many opportunities if they are patient.

Robert Miller, President, Millco Investments