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Crain's BlogsJoe CahillOn Business
Developers forgetting lessons of the bubble
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What is this, 2006? New hotels, apartment buildings and shopping centers are going up around Chicago faster than the market can absorb them.
A few examples from the past week:
Albert Friedman and White Lodging Services Corp. are on to **another Gold Coast hotel project** just seven months after completing their last one.
William Smith of Smithfield Properties LLC is building a **295-unit apartment tower** at LaSalle Street and Chicago Avenue, just half a mile from a 367-unit project by Newcastle Ltd.
And **new shopping-center construction** is set to rise 16 percent this year.
If only the rising tide of development were driven by surging demand for apartments, hotel rooms and stores. But it's not. Supply is losing touch with demand, just as it did in the mid-2000s and the late 1980s, to name the most recent outbreaks of a recurring real estate syndrome.

FAMILIAR SCENES

We can recite the next scenes of this movie from memory. Oversupply depresses rents and room rates, squeezing cash flows and sending some properties into bankruptcy. Loan writeoffs and foreclosures follow in short order.
"We're going to end up with properties that struggle to meet debt service and stay open," says hotel industry consultant Ted Mandigo of TR Mandigo & Co. in Elmhurst.
My colleague Alby Gallun reported on signs of a glut in the **downtown hotel market,** where some 7,600 rooms are under construction or planned. If they're all built, total supply would jump 17 percent by 2016, on top of a 12 percent rise between 2010 and 2013, Mr. Mandigo says.
Growth in room rentals, meanwhile, slowed to 2.3 percent last year from 5 percent in 2012. Mr. Mandigo predicts a 3 percent pace over the next three years.
Prices already are sagging under the growing supply. Revenue per available room, an industry sales metric, fell in September, October and November, the first string of three monthly declines since 2010.

SAME STORY IN APARTMENTS

Much the same story is playing out in the downtown apartment market, where developers flocked after building more condominiums than people wanted during the bubble years. After adding 2,695 units last year, they plan 2,271 in 2014 and 4,000 more in 2015, according to Appraisal Research Counselors, a Chicago real estate research firm.
Never mind that "net absorption," the increase in apartments actually rented, fell 13 percent to 988 last year.
Predictably, prices are starting to drop as empty apartments accumulate. Rents at high-end rental buildings downtown fell in the third quarter, the first year-over-year quarterly decline since 2009.
"Unfortunately for landlords, the supply side will continue to expand at record levels for at least the next two years, putting continued pressure on rents and occupancy," Appraisal Research predicted in a recent report.
Nowhere is denial of economic reality deeper than in retail real estate. Vacancy rates are rising as big chains like Sears, J.C. Penney and Best Buy close stores. Data from CBRE Inc. show average asking rents in the Chicago area have dropped below $17 per square foot, compared with $20-plus in the mid-2000s.

BEYOND CYCLICAL

This is more than a cyclical downturn. Online retailing has **fundamentally altered the industry.**
People are doing more shopping online and less in stores. ShopperTrak, a Chicago-based firm that monitors retail traffic, recently reported that store visits have declined by half since 2010.
That striking figure has ominous implications for retail real estate. Brick-and-mortar stores won't disappear. But in the future, we won't need as many as we did before people could do so much shopping without leaving home.
Yet shopping center construction is rising again, even as empty storefronts built a few years ago dot the landscape.
The persistent disconnect between supply and demand in real estate arises from several factors, some peculiar to the industry, others rooted in human nature.
In the apartment sector, for example, plenty of yield-seeking capital is available to finance projects in a market that has produced strong returns in recent years. "There's a lot of money out there for people who want to build apartment buildings," says Ron DeVries, vice president at Appraisal Research.
Lenders and investors see apartments as a safer real estate bet than offices or condominiums, which burned so many when markets collapsed.
At the same time, developers tend to believe that their project is special in some way that will insulate it from the negative effects of overbuilding. That's not as delusional as it might sound. Vacancy rates and price pressures aren't evenly distributed across all buildings. New buildings tend to draw buyers and tenants away from older buildings. We've seen this in the downtown office market, where glitzy new towers filled up even as the broader market sank.
Excess capacity "impacts the older, more mature properties disproportionately," Mr. Mandigo says. While it's true that new buildings don't bear the brunt of their impact on the market, eventually everybody suffers if supply and demand get too far out of whack. Downtown condo developers learned that a few years back, when a glut swamped new and old buildings alike. Let's hope others heed the lesson before it's too late.
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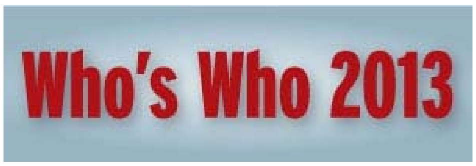

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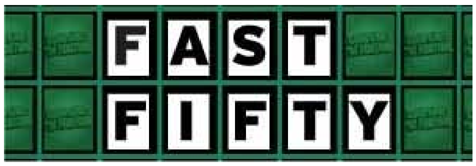

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This year's rundown includes many familiar names and a few you've probably never heard of. They're all hard-wired for growth.

Full Feature

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