William H. Miller, John R. Jaeger, Gail Lissner, and Eugene W. Stunard

Residential Resurgence

Well positioned to capitalize on residential demand, Chicago is a mature market that affords a stability not seen on the East or West Coast.

Twenty years ago, suburban expansion was the engine of Chicago's growth, and the market expected the real action to take place in DuPage, Lake, Will, and Kane counties. Times have changed. In 1999, Chicago issued more building permits (5,400) than Naperville and Aurora combined (4,227) and now has 3 million people compared with Naperville/Aurora's 250,000. The 12 square miles bordered by North Avenue, Cermak Road, Ashland Avenue, and the lakefront saw 3,894 units built in 1999, close to the number in Naperville/Aurora's 71 square miles. On the basis of starts (not announcements), downtown's expansion rate will exceed 5 percent per year through 2002. The city is no longer a mature market—it is again an emerging market.

As of the end of the second quarter of 2000, an inventory of 19,685 units was announced for delivery in the next three years. Appraisal Research Counselors, Ltd., a Chicago-based real estate appraisal, research, and consulting firm, estimates that about 10,291 units will be built. The explosive expansion of the market is exemplified by the fact that of the 2,588 units brought to market during the first half of 2000, 1,500 already are under contract.

The 187-unit Park Place, to open in 2002, and the 99-unit Huron Pointe, to open in 2001, placed 50 percent of their units under contract in the first month of marketing. That pace was a little slower, however, than the one-day sellout of (171 high-rise units) in fall 1999. At 25 East

Prices at the 50-story Fordham, a luxury residential tower, now average $450 per square foot.

Superior Street, the prices at the Fordham, a 50-story building with 244 residential units on a 36,194-square-foot site, now average $450 per square foot—an increase of $100 per square foot since marketing began in December 1999. As of April, 57 percent of the units were under contract. Total gross sellout will fall close to $200 million.

The Fordham originally was envisioned as a $70 million rental development with condominium penthouse units. Following the market, it metamorphosed into all condominiums and continued to evolve into a top-tier luxury high rise. Even without the benefit of a Lake Shore Drive or Michigan Avenue location, the site was purchased for $569 per square foot—$49 per square foot of residential floor space. And a new high-water mark has been set at 65 East Goethe Street, where "raw" units are being marketed for $700 per square foot (see feature box).

Suburban neighborhoods tend to be very homogeneous; one attribute of an urban market is diversity. In suburban Naperville/Aurora, the price of half of the 2,471 detached homes sold in 1999 fell between $205,000 and $335,000, with a median price of $263,000—a narrow range with a spread of only 63 percent. The homogeneity of this suburban market becomes apparent when the area covered by Naperville/Aurora—71 square miles—is considered. In Chicago's 12-square-mile downtown neighborhood, 50 percent of the 2,038 sales in 1999 fell between $166,540 and $370,000, with a median of $245,957—an overall spread of 122 percent. Chicago's diversity enables developers to sell to a broader spectrum of the marketplace.

In Chicago, it is important to differentiate by product type; overall pricing patterns are shown in Figure 1.

The performance of the downtown market has been solid; since 1988, prices have appreciated an average of 7.09 percent per year. Per-square-foot prices for smaller units (studios and one-bedroom apartments) have generally lagged the market, while the largest three-bedroom units command the highest prices. Although the sales pace for studio units is lower now than in the early 1990s, the current lack of supply is driving prices up, making studios the top performer in terms of appreciation. The market wealth is apparent. Moreover, Figure 1 is based on MLS data, which focus on resales of existing units; the exclusion of higher-priced, high-demand new units results in a downward bias in the indicators.

One Superior Place has delivered 809 new rental units to the market.

Rental Trends

With condominiums appreciating an average of 10.2 percent annually between January 1993 and April 2000, there is concern that renters simply will be priced out of the market. The situation has been aggravated by the shrinking supply of rental housing. Since 1993, 37 buildings have been converted to condominiums, taking 7,614 rental units off the market. Rents, however, have lagged appreciation in sales prices, increasing 6.7 percent annually during this period. Given that the consumer price index (CPI) increased only 2.6 percent annually, out-of-pocket housing costs are rapidly increasing as a percentage of income.

Average asking rents for the 5,149 luxury units tracked by Appraisal Research Counselors, Ltd.'s Second Quarterly 2000 Benchmark Report stand at $2.03 per square foot, which is 18.1 percent higher than rents at the 5,906 standard units tracked. The entry level for a studio is now $1,000 per month, and 63 percent of the studios surveyed exceeded that amount. Occupancies, as of July 2000, remain strong, with luxury rental buildings at 97.9 percent and standard buildings at 96 percent. Appraisal Research's second-quarter 2000 survey indicates significant tightening in the market with rents expected to increase between 4 and 6 percent in 2000.

In 1993, a typical studio sold for about 72 times its monthly rent. With studio prices increasing at an annual rate of 13.2 percent and studio rents at only 6.5 percent, a typical studio

How Low Can You Go?

Downsized four times in four years, the planned residential development at 65 East Goethe Street might have sunk under the torrent of protests from Chicago's tony Gold Coast community. Long the bastion of the city's elite, the Gold Coast neighborhood zealously guards a way of life born when industrialist Potter Palmer built his "castle" there in 1882.

Over the years, the Gold Coast grew into a community of more stately mansions, interspersed with luxury condominium towers. Then, in 1996, Chicago developer Christopher T. Carley, chairman of the Fordham Company, presented his plans to erect a high-end high rise at Goethe and Stone streets—-and the neighbors lowered the boom.

The community protested the building's height, citing fears that the 32-story structure would cast a shadow on an adjacent play lot and obstruct views from low-rise, upper-bracket residences nearby. Carley shortly returned with a proposal for a 24-story structure that both conformed to zoning ordinances and impressed the local ward's alderman. But when Carley applied for permits, city officials changed the site's zoning, decreasing the allowable square footage by 40 percent.

Again Carley downsized the structure, to the requisite 18 stories. The city responded by making the Gold Coast a historical district, with a height limit of 125 feet on new construction. Carley trimmed his building to 12 stories. The city then lowered its historical district height limit to 90 feet.

Normally, this exercise in developmental limbo—-how low can you go?—-would have killed the project. But while Carley's structure was shrinking, the city's residential market was skyrocketing. The astronomic demand and stratospheric prices for Gold Coast properties enabled Carley to proceed with the development even at its final height of eight stories, a quarter of the height originally proposed. When the development officially came to market early this year, buyers—-including several of its Gold Coast neighbors—-quickly reserved more than half of its 17 condominiums and eight townhomes at prices from $2.7 million to $6 million for raw space.

"The surge in Chicago's residential market came at exactly the right time for us," Carley says. "By targeting the upper rim of the market, in such a sought-after location, we both made the project economically viable and set a new gold standard for luxury residences in Chicago."

In reaching its final stature, just 90 feet in height, 65 East Goethe evolved from a classic Chicago high rise into a more intimate structure. Designed by architect Lucien Lagrange, who also is responsible for Chicago's new Park Tower hotel and condominium, 65 East Goethe Street features a limestone exterior with a zinc mansard roof accented by portal windows. Arched doorways, high ceilings, bay windows, turrets, a roof garden, and Juliet balconies imported from France complete the design. The individual residences are being sold as raw space, with Lagrange providing architectural services to many of the buyers. Occupancy is slated to begin in fall 2001.

Although the controversy surrounding 65 East Goethe has ended, the struggle over future Gold Coast construction continues. Recently, a neighborhood group raised nearly $1 million in a campaign to thwart old-guard Chicago developer Draper & Kramer from building a high-rise residential tower in the neighborhood. The outcome will depend on which way the economic wind is blowing and what tack the contested development takes. But the success of 65 East Goethe clearly shows that persistence and flexibility—-plus almost insatiable market demand—-can weather the storm of protest.

—**Patricia K. Vaccaro**, *a senior associate of DickinsonGroup, a Chicago marketing and public relations firm active in the real estate, architecture, and construction industry*

sells for 115 times its monthly rent today. For all unit types, the average monthly rent multiplier has increased from 107 times to 136 times since 1993.

From 1993 through 1998, no new-construction rental buildings were delivered. In 1999–2000, 1,038 units will be added. One Superior Place delivered 809 units in August 1999 and was fully leased as of July 2000. Three projects currently are under construction—at 121 West Chestnut Street (Chestnut Tower), with 229 units; at 333 North LaSalle Street (the Sterling), with 387 units; and at the northeast corner of State and Erie streets, with 254 units. Eighteen new projects containing 8,101 units are on the drawing boards; Appraisal Research projects that 3,188 units have a reasonable probability of being delivered in 2002–2003.

Two vintage office buildings in the Loop are being renovated into rental units. The developers of 343 South Dearborn Street (184 units) received $6.6 million in tax increment financing (TIF) and began construction during summer 1999. American Invsco, a developer of 201

North Wells Street (293 units), has been awarded TIF funds of approximately $7 million. Prairie District Lofts (101 units) and 900–910 West Lake Street (90 units) bring the adaptive use total to 668 units.

Demand Generators

Chicago is an emerging market that affords a stability not seen on the East or the West Coast. It rarely booms or busts and generally retains a top-tier market position on most investment, lifestyle, employment, and education surveys. Chicago's demand generators include:

- positive job growth and net office absorption;
- price appreciation;
- equity build-up for existing homeowners, who are trading and moving up;
- suburban in-migration;
- changes in the income tax structure for home sellers;
- an improving school system;
- a healthy investor market assisted by a lack of rental construction from 1991 to 1999;
- attractive price points for first-time homebuyers;
- a prolonged bull stock market;
- significant inheritance potential generated by Chicago's old-economy industries for the younger generation of homebuyers;
- strong migration patterns from smaller Midwestern cities;
- existing ethnic populations drawing new international immigrants, particularly in high-tech and professional fields;
- third place, behind New York and Atlanta, in preferred metropolitan statistical areas (MSAs) for relocation by business professionals, according to a Business Sciences International survey published in November 1999 by Cushman & Wakefield, an international real estate services firm.

Economy.com, a leading provider of economic, financial, and industry research headquartered in West Chester, Pennsylvania, projects 29,000 new jobs in the MSA for 2000, following 20,000 new jobs in 1999 and 34,000 in 1998. With about half of these jobs in the Loop and surrounding areas, the need for new residential housing of all types is evident.

Potential Demand Risks

Low interest rates clearly fueled demand and price appreciation through mid-1999. While rates have risen 125 to 150 basis points from under 7 percent to about 8.25 percent today, the market has not yet stalled and, in fact, is significantly stronger in terms of price appreciation, which may have caused many people who were just looking to get off the fence and buy in summer 1999.

A stock market correction, an international conflict, a financial crisis, major layoffs, the move of a large downtown office user to the suburbs, or a drop in consumer confidence also could dampen the enthusiasm that exists today. Economy.com states in the June 2000 Precis Report that "Chicago's population trends will be the primary determinant of its long-term outlook." While growth in the 8.1 million MSA population will be slow and steady, the city, and in particular the 12-square-mile central core, is expected to grow at more than seven times the MSA's 0.7 percent historic average.

One of the newest risk factors is demand from condominium speculators who do not intend to move into a unit, but purchase it simply to flip the contract when the building is completed. Also, herds of investors are buying units early with the intention of renting them in order to capitalize on the city's tight rental market. This creates a hard-to-track condominium rental market that can obfuscate the statistics by adding a significant amount of shadow rental units to the market.

Some developers are limiting the number of units that investors can buy to try to keep this speculative market in check, because developers run a risk if investors "walk" on their contracts in an economic downturn. Lenders also are imposing more stringent underwriting on proposed deals, with speculation caps and high presale requirements.

A Healthy Demand

Long-term projections for the city look positive. A preliminary survey by the Washington, D.C.–based Brookings Institution, a research organization, forecasts that Chicago's downtown population will grow by 36,954 from 1998 through 2010—more than 3,000 people per year. A caveat is that the city provided the information on which that projection was based from data

Figure 1: Downtown Chicago Sales Profile

(All Condominiums in 60601, 60610 & 60611)

	Total	Studio	1 Bedroom	2 Bedroom	3 Bedroom
Total Sales	15,296	1,494	6,011	5,377	2,049
Avg number sales/yearr	1,224	120	481	430	164
1999 Sales	2,038	143	789	796	263
First half of 2000	943	52	315	400	154
Average unit/square feet	1,304	595	878	1,457	2,241
1999 Average price	$323,310	$116,965	$180,452	$348,708	$642,837
2000 Average price	$372,931	$124,743	$203,647	$371,927	$674,534
1999 Average price per square foot	$226	$200	$208	$231	$267
2000 Average price per square foot	$252	$223	$228	$256	$292
1988-2000 Average appreciation	7.09%	8.51%	7.80%	6.41%	5.50%
Total Sales (000)	$3,696,492	$101,138	$755,499	$1,441,526	$1,037,745

Source: © 2000 Appraisal Research Counselors, Ltd. Compiled from MLSNI. All Rights Reserved.

on developments underway, building permits, and anticipated real estate projects.

The baby boom echo kids will become homebuyers in the middle of a 20-year growth curve extending through 2016. Chicago offers a strong residential base, true neighborhood diversity, and a "mature eclectic" lifestyle somewhat unique in major U.S. cities, and the city is well positioned to capitalize on the natural increase in demand for residential products.


River View at River East represents the $300- to $400-per-square-foot price range in Chicago's luxury residential market.

Stoking the Flame

Appraisal Research Counselors, Ltd. continues to see a "herd mentality" in the market. New projects may sell 50 percent of their units on the first weekend. Buyers (and particularly speculators) are anxious to be the first to pick up what they consider the bargain units. After opening, stoking the flame of demand is critical. In several instances, sales stalled after the first month. No developer (or lender) wants to risk the possibility that early speculators and the first few owner/occupants may not go to closing.

There has been a general shift in product type, with fewer loft conversions and more new construction. While demand is still very strong for adaptive use products, the remaining shell buildings are harder to locate and adapt to residential use. The best-selling product in the market continues to be the one-bedroom unit; units with dens also are strong sellers. According to Appraisal Research Counselors, Ltd., this category may be underrepresented in the market, based on its strong appeal and the lack of inventory. Unit sizes are still tending downward, due to increasing construction and acquisition costs.

Due to increased land prices, which limit the economic feasibility of low-density projects, new construction has evolved from mid-rise buildings to predominantly high rises. While condominium prices also have increased and can support the increased costs of high-rise construction, high-density projects increase risk. Zoning is harder to obtain; the inability to "buy today, build tomorrow" creates a timing risk; and longer construction cycles require huge cash outlays, gambling on solid sales in a distant and uncertain future market.

While land values are escalating, site acquisition costs as a percentage of gross sellout are diminishing. For each dollar of revenue, more pennies are going to hard costs. If sales stall, soft costs will increase, eroding profit margins.

Adding Fuel to the Fire

$400+ per square foot: This is the next new thing. During fourth-quarter 1999, only the Bristol (57 East Delaware Street) and the upper floors of the Fordham (25 East Superior Street) were above this plateau. During first-quarter 2000, 840 North Lake Shore Drive, the Pearson (250 East Pearson Street), 65 East Goethe Street, and Elm Tower at Dearborn and Elm streets have joined these projects. Equity buildup, stock market gains, empty-nester relocations, and an aging stock of luxury resale products are key factors moving the market.

$300 to $400 per square foot: This market is dominated by riverfront projects—the Residences at River Bend and River View at River East. Developers are eyeing this price level, with much of the proposed activity at the lower end of the range, as the former $250- to $275-per-square-foot product now is being projected to sell at prices of $300 per square foot. While the product in this price point is growing, this segment may be more susceptible to stock market swings than the entry-level or the ultra-luxury market.

$250 to $300 per square foot: Inventory increases dramatically below $300 per square foot, with the $250-

to $300-per-square-foot units being in the upper-middle, not the luxury, market. This segment grew from 19 percent to 47 percent of the market between 1999 and 2000 and has attracted broad speculator interest, particularly in the recent River North projects.

Projects announced during 2000 include the Museum Park high rise in the South Loop and 330 West Grand Avenue, Huron Pointe (421 West Huron Street), and Park Place (600 North Kingsbury Street) in the River North area. All experienced brisk absorption, with 50 to 70 percent of the units under contract or reserved within first-quarter 2000.

$200 to $250 per square foot: This is the second-largest segment, with a 24 percent market share. New mid-rise and adaptive use/loft developments typically sell in this price range. The product targets first-time buyers purchasing entry-level new construction housing. However, after prices increased from $150 to more than $200 per square foot, many first-time buyers were priced out of the market.

New construction units generally are found in the South and the West Loop markets. The Gold Coast and South Streeterville offerings at this level are condominium conversion buildings—well located but lacking full amenities. Recent market additions include the Madison Club at 1115 West Madison Street, 1260 West Washington Street, and 950 West Huron Street. All are small West Loop/River West mid rises.

Townhouses: Most townhouses range between $175 and $200 per square foot, with some recent luxury projects at upward of $225 per square foot. While per-square-foot prices are lower than those for condominium units, the "chunk prices" (i.e., total prices) are higher. Units are larger and generally include the parking garage in the square footage. Developments that exceed $200 per square foot typically are better located, and they may offer a riverfront setting.

The major difference between the townhouse market and the condominium market is not price but absorption rate. While condominium projects are able to achieve some rather remarkable absorption rates (i.e., one-day sellouts of 170 units), townhouse units tend to sell much more slowly. However, an increase in townhouse absorption has occurred most recently at Museum Park (1301 South Indiana Avenue), the Commonwealth on Prairie (1918 South Prairie Avenue), and St. John's Park (850 North Ogden Avenue). The speculator market does not appear attracted to townhouses. Only a few brokers have reported interest.

Loft/adaptive use: Minimal loft redevelopments are proposed for second-quarter 2000. Enterprise Development is buying the south Montgomery Ward building and converting it to condominiums, while Centrum Properties is retaining the north building for loft redevelopment. The only other development is University Village, near the University of Illinois campus.

Demand far exceeds the number of units being brought to market. Loft units continue to be strong sellers. In buildings that contain both adaptive use and new roof units, the adaptive use component shows a faster sales rate; this is primarily due to the lower price points, but also to the perceived desirability of loft units.

Appraisal Research Counselors, Ltd.'s database of loft acquisitions totals 104 buildings purchased for $285 million for conversion into 9,321 condominium and rental units. The median raw loft acquisition price in 1993 was $15.51 per square foot; by 1998, it increased to $25.78 per square foot. Pending deals are at $38.65 per square foot. Some sales exceed $50 per square foot, with a few likely to approach $75 per square foot. The dramatic price increases are due to rising retail prices; diminishing inventory; competition from office, Internet-related, and self-storage developers; and increasing underlying land values.

Apartment development: In terms of additional announcements by developers, the rental market is ready to explode, due to the leasing success of One Superior Place and the projected success of Chestnut Tower. Five projects have been recently completed or are under construction, totaling 2,159 units. One proposal has an estimated 75 percent probability of moving forward, while 16 more deals have an estimated 25 to 50 percent probability—totaling 6,857 potential units and 2,087 probable units in the 17 projects. By the end of 2000, there may be as many as five to seven more rental announcements, totaling 2,500 additional units. New construction predominates; only 5 percent of the announcements will occur in the redevelopment rental segment of the market.

The following factors are affecting rental development:

- Developers are booking land at $20,000 and even $30,000 per unit—up from $15,000.
- Total development costs appear to have stabilized, at roughly $240 to $250 per rentable square foot (without profit).
- Feasibility remains tight, but the numbers are looking better.
- Rents, while escalating well above the CPI, are substantially below the increases seen in the for-sale market.
- While rents may be a "bargain" in the market, the question is whether renters can afford to "pay to stay." With a strong economy and continued influx of workers, the answer thus far is "yes."
- Because announcements do not equal new projects, there may not yet be a risk of overbuilding in the rental market.
- Reassessments are catching up to market value; this may stall pending deals and offerings as buyers reconsider.

Room for More

Unlike Naperville and Aurora, downtown Chicago cannot expand its borders. But that does not mean the market is mature. Large-scale developments are responding to the demand:

- US Equities and Cattiatore JV opened a 62-acre site at Roosevelt and Clark in the South Loop.
- LaSalle Park has the potential to develop 2,750 units.
- Enterprise Development has proposed more than 800 units at Museum Park at Central Station.
- Illinois Center, with a 25-acre site, could accommodate 6,000 units.
- Wolf Point, adjacent to the Apparel Mart, could accommodate several hundred units.
- The redevelopment of Cabrini Green will include a market-rate component.
- The Montgomery Ward campus at Chicago Avenue and the Chicago River is under redevelopment.
- Kinzie Station's additional phases will total almost 1,000 units.

Chicago is a city that continues to reinvent itself. As Mayor Richard M. Daley said at City Home Expo 2000 in June, "No other city has done as much to improve neighborhood quality of life in the last ten years. The city of Chicago and its sister agencies have invested more than $6 billion in new schools, parks, playgrounds, libraries, streets, sidewalks, sewers, and water mains." The investment by the city of Chicago is paying off: the fire has been stoked in Chicago's downtown residential market—once again an emerging market.

Eugene W. Stunard *is president of Appraisal Research Counselors, Ltd.* ***William H. Miller****,* ***John R. Jaeger****, and* ***Gail Lissner*** *are vice presidents at the firm, responsible for research, multifamily housing, and residential development, respectively*.