May 2014
Chicago Lawyer®
Volume 37 Number 05 • chicagolawyermagazine.com

Bust. Now boom?

Photo by Lisa Predko

By Roy Strom

Whether you drive into work on Interstate 90, walk along Wacker Drive near Clark Street or ride the El down Lake Street, you must have noticed it: Chicago is once again feeling like the city that works.

And that bodes well for Windy City real estate lawyers.

Visible from a traffic jam on the Kennedy Expressway, the rising office building at 1000 W. Fulton Market will house more than 500 Google employees in 250,000 square feet.

A concrete-and-steel shell at 111 W. Wacker Drive has turned from an eyesore — and a reminder of how quickly the recession took hold — to a 60-story reflection of resiliency. Residents will begin moving into the luxury apartment tower this year.

Just to the north of Lake Street's El tracks near the Chicago River, the footing is being laid for the first post-recession office tower to rise downtown. Groundbreaking at the 52-story River Point building will likely be followed by earthmoving for a 60-story tower at 150 N. Riverside Plaza, just across the tracks. A third West Loop office tower — 32 floors high — is planned by developer John Buck.

And if all that wasn't enough to prove that developers are at long last bullish on Chicago's growth prospects, there is even a deal in place to unthaw from its six-year freeze the 76-by-100-foot hole at 400 N. Lake Shore Drive. New owners at the site of The Spire have said they intend to build the curling 2,000-foot residential tower that would again make Chicago the home of the nation's tallest building.

To long-tenured real estate lawyers, today's ramp-up is a familiar plot line in the practice's age-old boom-and-bust story. The city has made it through the bust; psychological and financial wounds are healing, often through bankruptcies, and money is finally beginning to go to work. Lawyers don't believe it's quite boom times — despite some warnings of an upcoming apartment glut — but the volatile practice group is back in the black for law firms.

"Exciting things are happening here again. It's not crazy, but it's positive," said Alex Cole, a partner at Perkins Coie who has been a real estate lawyer in Chicago since the 1980s. "I think that people are still wary. And how can they not be, given recent history?"

The health of the Chicago real estate market only goes so far in assessing the strength of practices at the largest firms — Perkins, DLA Piper, Dentons, Latham & Watkins and others. They are insulated by geographic breadth as well as by the international reach of the real estate players based in Chicago they call clients. But the

animal spirits still make it a complicated practice to manage for large firms.

Meanwhile, the state of the Chicago market is a strong indicator for the health of more local practices, which often weathered the recession by pivoting from putting deals together to taking them apart. Lawyers at these firms are starting to feel like things have come full circle.

The state of the markets

Supply and demand goes a long way toward predicting developers' activity and, in turn, lawyers' billable hours. There are a few caveats, as is perhaps all too well-known in a practice where enticing prospects can outpace realistic expectations.

Chicago is America's second-largest skyline based on office space square footage, according to real estate firm Jones Lang LaSalle, which recently changed its name to JLL.

At just more than 60 million square feet of office space, it is two-thirds the size of New York but twice as large as its next closest competitor, Boston.

With 14.3 percent of its square footage available for lease at the end of 2013, Chicago's supply of premier office space was slightly above the nation's biggest markets, which were only 12.3 percent vacant on average, JLL says. Only Los Angeles, at 17.8 percent vacant, had more unused space among the nine skylines JLL calls "primary" (Bellevue, Wash., Boston, Chicago, Houston, Los Angeles, New York, San Francisco, Seattle and Washington, D.C.).

A significant factor, JLL says, in extending the depth and duration of Chicago's real estate recession is a fundamental shift by tenants to use space more efficiently. That trend has kept Chicago's vacancy rate elevated, JLL says.

But real estate professionals and attorneys say it has also driven demand for new buildings. The cost savings and prestige associated with the latest office spaces counteracts and, to an extent, overcomes the challenge posed by the city's vacancy rates.

"The Chicago market has done a great job of absorbing trophy, Class-A space," said Bill Rogers, who leads JLL's tenant representation group in Chicago. "There's a demand for that and, historically, it has proven to be very good for the developers."

Rogers points out that even buildings that came online in 2009 — the pit of the recession — were roughly 90 percent leased when they opened. That includes 155 N. Wacker Drive and 300 N. LaSalle St., which are leased, respectively, at 97.6 percent and 99.5 percent — among the fullest houses in any city.

If it's true that tenants increasingly choose buildings based on efficiency, then the city's older buildings appear less efficient. They are losing ground to newer, glass-covered competitors. Of Chicago's 54 most prominent buildings, the 10 oldest are an average 81 percent leased. The 10 newest — all opened since 2003 — average 95 percent leased, according to JLL data.

"When people say, 'Why do we need another building downtown?' … That's why," said Drew Nieman, an executive vice president at U.S. Equities Realty. "They lease up. Everybody likes to move to the new and better product."

While the demand curve for office buildings may make supplying them both a good business venture for developers and a source of income for lawyers, some in the industry are concerned the same cannot be said for residential developments.

Murmurs of an apartment glut have surfaced in the absence of any kind of condominium development.

Appraisal Research Counselors, a Chicago-based consultancy, predicts that 3,000 rental units will be added to the downtown market in 2015. That comes on top of a boom last year and this year that will put roughly 5,300 rental units in the market.

If those predictions come true, the nearly 2,700 units expected to come online on average this year and next would outpace the current rate at which new apartments are being occupied, a metric known as absorption. Over the last three years, downtown absorption has averaged 1,348 units, according to Appraisal Research Counselors.

Rich Klawiter, chair of DLA Piper's Chicago real estate practice, expects a condominium project will likely kick off soon, partly as a result of the rental market reaching equilibrium.

"Just as two years ago it was speculated that there would be one or more new downtown office buildings constructed in the near future, in my view the same is true of a condominium building in either River North, Streeterville, downtown or the Gold Coast," Klawiter said, adding that he expects such a project would break ground this year or next.

"The laws of supply and demand seem always to prevail, and now that the balance is being achieved between the demand for high-end rental housing and the number of apartment buildings now or soon to be under construction … I expect the opportunities to develop (and) finance high-end new construction condo development to be present soon, if they are not already."

"The Chicago market has done a great job of absorbing trophy, Class-A space. There's a demand for that and, historically, it has proven to be very good for the developers."

The pendulum swings, local lawyers react

To Harold Dembo, co-chair of 100-lawyer Much Shelist's 15-lawyer real estate practice, the ups and downs that dominate the real estate industry don't have to take a lawyer's billable hours along for the ride.

The key is being nimble. That's what Much Shelist and many other firms learned in the real estate freeze's lurch.

"Up until 2007, 2008, we were transaction attorneys — extremely busy," Dembo said. "Deals were happening everywhere and all over the country. Then the market went down the toilet, upside down — whatever you want to call it."

But the firm's real estate practice only let one lawyer go as a result of the recession. It has since hired attorneys.

"As their lawyers, including lawyers for the lender, we had to then educate ourselves in the nuances of foreclosures and workouts," Dembo said. "Because deals

were collapsing. And clients were running the risk of losing their properties. Some of them did."

The firm also benefited from clients that took seriously the investment theory of "buy low, sell high." That's a polite way of describing what some call real estate "vultures," which Much Shelist represented in purchases of distressed property or debt.

One local example of such a transaction was a California investor, Colony Capital, that purchased from MB Financial a $384 million portfolio of mostly distressed commercial real estate loans for 50 cents on the dollar.

Those transactions came with a slew of legal work: Working out mechanic's liens, negotiating with creditors, sometimes going through a bankruptcy process.

And the vulture investor client may be the gift that keeps on giving. Once the market rebounds, they typically sell their assets, creating another wave of legal work.

In one example of how the market has turned and lawyers are going back to the type of work they did before 2008, Dembo said a client of his is currently hoping to build a boutique hotel in Lincoln Park. That comes after the company purchased a parking

garage in 2007 that it planned to renovate. Those plans stalled with the market, but the developer now thinks the time is right.

"That's a perfect example of guys that bought something to reposition it, to add value to the property, and they had the good fortune to be able to hold onto that property and not lose it," Dembo said of the proposed hotel, a Starwood brand owned by Sheraton.

"The marketplace has come full circle, where they believe they can put the financing and equity together to build a hotel."

Could things flip again? While it hasn't happened yet, Dembo said he could foresee downtown apartments falling prey to familiar irrational exuberance.

"It's human nature," Dembo said. "We don't really learn from our past mistakes. And I'm afraid that at some point there will be some related issues to all that. The lenders want to make loans. The developers want to develop. And you just hope you're not the last one in before the economy tanks."

Managing the ups and downs

Such volatility is a good thing in years like 2014, when real estate lawyers are benefiting from both the wind-down of litigation and the pickup of new transactions.

But the boom-and-bust cycle is difficult for firms to manage.

Perkins Coie's Cole, who started her career in the real estate practice at Altheimer & Gray, said large firms should limit the size of their real estate groups to between 7 and 10 percent of the firm's overall revenue.

That's because real estate legal work is a bit of a paradox: Clients are extremely price-sensitive in some situations while cost couldn't be less of a consideration in others.

"For big REIT (real estate investment trust) acquisitions, portfolios of large size, public deals, they're not really price-sensitive, and they'll use the most expensive" lawyers, Cole said. "But ask that same client that is asking you to do that big merger if you can do their leasing all across the country and they become immediately, extremely price-sensitive."

That diverging sensitivity creates a particular problem for large firms that focus on high-profile matters that command a billable-hour rate supporting their profits per partner metric, Cole said. The big firms want to take the pricey matters, but they may have priced themselves out of, say, leasing deals that can be handled by other firms at lower rates.

"That's a conundrum for large firms," Cole said. "To meet the profits required to compensate their most well-producing lawyers, it gets really tough when the market tanks, which it always does every eight or 10 years. And so you have to have enough (lawyers in your practice), but you can't have too many. So it's very hard for really large firms to stay in real estate consistently."

DLA Piper's Klawiter agreed head count is an important metric to consider in the real estate practice. The firm's Chicago office, where the Rudnick & Wolfe and Piper Rudnick firms laid a legacy in real estate, is 25 percent real estate lawyers. The firm as a whole has 8 percent real estate attorneys, which is an important number, Klawiter said, because it protects against the "vicissitudes and cyclical nature of the real estate market."

While national firms' cost structure can hinder them in the real estate practice, their geographic diversity can bolster their bills.

Cole, for instance, recently worked on a real estate transaction that featured properties

in Texas, California, Nevada and Chicago. Perkins has lawyers licensed in all those states, so they acted as Cole's local counsel in all of those transactions. That is the benefit firms such as DLA Piper, Dentons, Perkins and many others have received from expanding nationally — as well as internationally.

Even firms that only have offices in Chicago can still have a national practice, thanks to the large contingent of major real estate firms based here that they call clients.

The list of Chicago's influential real estate companies is impressive: General Growth Properties, Hyatt, Sam Zell's Equity International and JLL, just to name a few.

"We've been fortunate that our clients have historically made really good, strong relationships with lawyers in Chicago firms and have taken those lawyers with them wherever they're doing business," Cole said.

Lately, that's been a short trip: Real estate lawyers are finding work in Chicago. For now. ■

rstrom@lbpc.com

© 2014 Law Bulletin Publishing Company. Reprinted with permission from Law Bulletin Publishing Company.