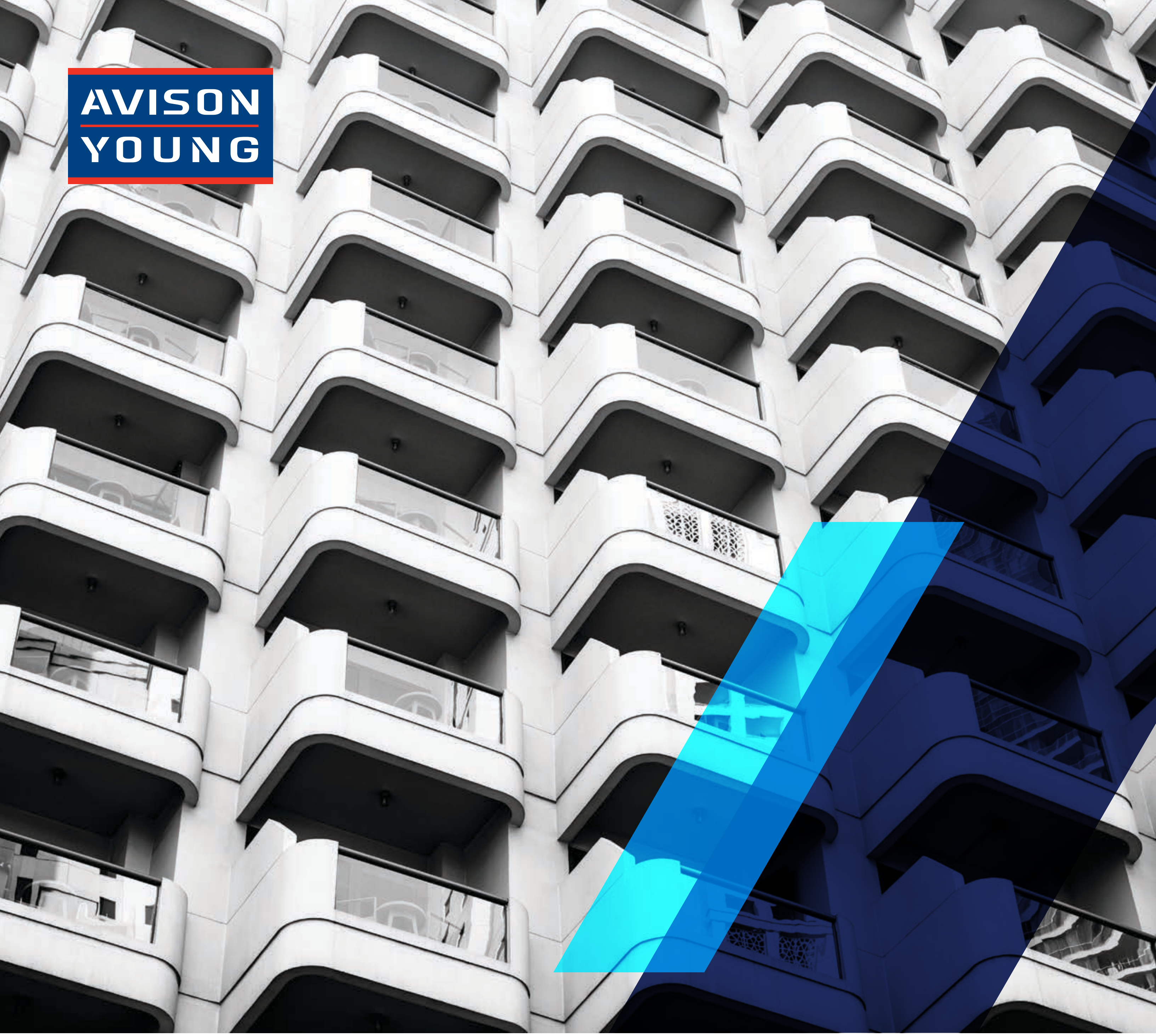

Mid-Year 2018: Chicago Market Snapshot

Condominium Deconversions: A Creative Structure for Unlocking Value

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Section 15 Condominium Deconversion Overview

Demographics, Economics and Rental Trends Fueling Condo Deconversions in Chicago Market

Introduction

The multi-family rental market has soared in Chicago and nationally since the Great Recession, as home ownership rates dropped and the coveted Millennial population demonstrated a strong preference for renting. This shift has led to a development cycle that added approximately 72,000 apartment units in the Chicago area since 2006.

At Mid-Year 2018, a new trend has emerged amidst this development backdrop. Chicago is seeing a wave of condo deconversions as investors look to add supply in a tight rental market. Investors are finding that buying an older condominium building and converting it to rental units is a viable avenue for gaining entry into some of Chicago's most coveted neighborhoods. New development is prohibitive in many instances, due to the high cost of land and construction; the shortage of suitable land sites in desirable neighborhoods; and, in some cases, community resistance to large new developments.

Over the past 24 months, ending July 15, 2018, there have been more than 20 deconversions—also known as Section 15 deconversions—announced in Chicago. These include buildings ranging from fewer than 10 units to over 300 units, mostly in popular city neighborhoods such as Old Town, Lincoln Park, and the Gold Coast. These city properties targeted for deconversion are generally older buildings constructed from the 1960s through the 1980s.

Understanding the Economics

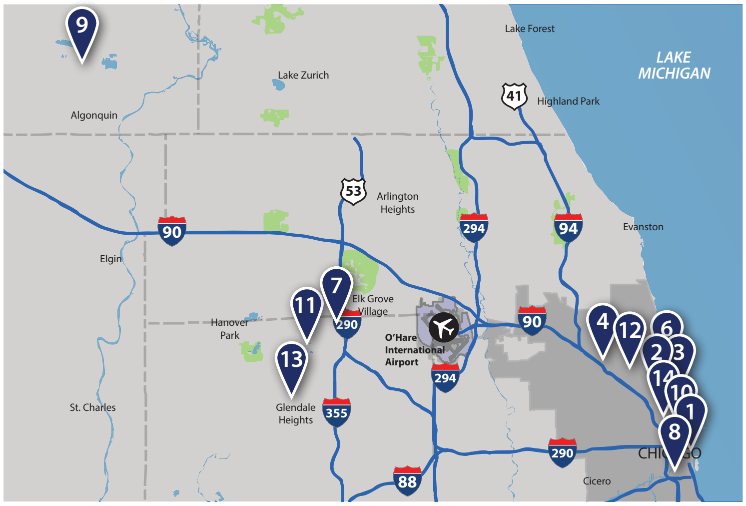
With home ownership rates hovering around 64%, the remaining 36% of the population translates to approximately 115 million renters in the United States. That reinforces the fact that there remains considerable demand for rental housing nationally and in Chicago.

In addition, apartment units in Chicago can be much more valuable than individual condominium units of a comparable age and quality. This allows a professional apartment investor to create value under certain circumstances.

The economics that make the deconversion attractive to investors also make the transaction attractive to condominium unit owners. In order to encourage condominium owners to sell through a deconversion process, the investor shares some of the deconversion value premium with the sellers. Investors often pay more for an individual condominium unit in a deconversion than it is worth on the market as a single unit. That benefit typically translates to a 25 to 40 percent premium in per unit pricing. And, as many of these older buildings are facing significant capital investments for repairs and upgrades, the owner also may avoid the financial burden of a special assessment.

Select Section 15 Sales in the Greater Chicago Area

1. 227 E. Walton Pl.
2. 3244 N. Clifton Ave.
3. 445 W. Wellington Ave.
4. 4954 N. Ridgeway Ave.
5. 625 Wrightwood Ave.
6. 732 Bittersweet Pl.
7. Burton Grove Apts
8. Century Tower
9. Darlington Court Apts.
10. Kennelly Square
11. Spring Hill Apts.
12. Sunnyside Lane Apts.
13. The Flats at Gladstone
14. The Kent



Source: CoStar and Avison Young

When examining condominium deconversions, it is important to consider these factors:

Location, Location, Location

Condo deconversions are ideally suited for markets and neighborhoods where demand is high and available land for development is scarce. In the Chicago market, many established neighborhoods from Old Town to Lakeview are ideal for deconversions.

Benefits for Investors

Investors are drawn to condo deconversions due to several factors:

- **Strong demand for rental housing**
- **Availability of older condominium developments in coveted in-fill locations**
- **New construction hurdles -- land prices are high and there is a limited supply of land sites that can support developments large enough to generate desired return.**

The economics that make the deconversion attractive to investors also make the transaction attractive to condominium unit owners.

Condo Owners/Associations -- Is it the Right Move?

As older properties face expensive renovations—from new windows to resurfaced façades to significant mechanical overhauls—some unit owners are rethinking their commitment to ownership. Can they afford the special assessment, which can sometimes reach beyond $50,000 per unit? If they try to sell, will the looming assessment scare away buyers, deflating the value of their unit?

Other Economic Details

Apartment rents have escalated rapidly in most areas of the country, resulting in a sharp increase in values as well. Conversely, condominium values in Chicago have struggled to recover from the recession, according to data prepared by the National Association of REALTORS. The trade association notes that Chicago's recovery has been the 35th weakest among the 66 major metropolitan areas in terms of year-over-year growth in median sales tracked in the index.

The weakness in values is particularly pronounced for smaller studio and one bedroom units, which have traditionally been considered as housing for more transient owners. Whether first time homeowners seeking to grow their equity in anticipation of a future upgrade to a larger home or a transitory worker with a short-term ownership horizon, these smaller units tended to trade more frequently. In the current housing market, these temporary residents have a strong desire for rental housing, which depresses values in the condominium sector.

Over the past 24 months, ending July 15, 2018, there have been more than 20 Section 15 sales in Chicago.

Real Capital Analytics

Strategic Approach for Investors

Avoiding the pitfalls of a Section 15 transaction

As the condo deconversion trend continues, it is important to note that not all properties are well suited for conversion. The process is lengthy, complex, and filled with potential breakdowns. Investors should take a strategic approach that involves collaborating with trusted real estate capital markets and construction specialists who understand the market dynamics and the nuances of the process.

Among the potential pitfalls to avoid are properties with extensive structural issues or buildings which lack a clear commitment from unit owners to pursue a Section 15 transaction. Because 75% of the members of the condominium association need to approve a deconversion in order for the transaction to proceed, strong owner support is critical.

What’s Ahead

As demand for rental units continues, the Avison Young team expects deconversion activity to:

- **Proceed at a steady pace as new investors enter the market and drive favorable transaction pricing;**
- **Expand the stock of class B apartment units available in Chicago;**
- **Add significant rental units in desirable submarkets where new development is not feasible;**
- **Come full circle as some of the original deconversions, which have successfully leased as apartments, are sold as core multi-family assets.**

Summary

The Illinois Condominium Property Act, passed in 1963, allows for this unique investment opportunity, in certain circumstances, but also leaves some issues open for debate. The Act requires that more than 75 percent of unit owners, in buildings with four or more units, vote to approve a sale.

Questions for investors, homeowners and their attorneys:

Market Centric – Which neighborhoods are more suited to the demand for these deconversions? What type (general characteristics) of condominium associations are most likely to benefit from deconversion? Which ones should an investor avoid?

Economics – How do the economics work and when are deconversions feasible for the investor and the home owner?

Timing – Deconversions are not for the faint of heart, and can take anywhere from 12 to 18 months simply to complete a transaction. Do investors have the patience and wherewithal to wait things out before the conversion actually begins?

Due Diligence – What are the potential pitfalls that residents and investors need to consider and how can they be avoided?

Legal – How does a Section 15 deconversion work and what are the restrictions?

Recent Case Study

In Q2 2018, The Avison Young team completed the sale of Kennelly Square, a 268-unit condominium building located in the Old Town neighborhood of Chicago. The team completed a national marketing effort that generated 125 potential buyers that reviewed offering materials; 50 property tours with investors; and 17 offers. There were multiple rounds of bidding in order to secure optimal price and terms for the unit owners.

Kennelly Square
1749 N. Wells Street, Chicago, IL

268 UNITS

Kennelly Square
1749 N. Wells Street, Chicago, IL

About the Author

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James Hanson joined Avison Young's Chicago office in 2014 as a Senior Capital Markets and Structured Finance Executive. He brings 28 years of Capital Markets experience to Avison Young, including over $5 billion of closed investment sale, financing, sale-leaseback, development capitalization and strategic advisory assignments.

Jim began his career at Jones Lang LaSalle, where he completed his tenure as a Managing Director in the Capital Markets Group. Based in the firm's Chicago headquarters, he oversaw all Capital Markets Group activities in the Central Region of the US. These activities included asset dispositions and financings, structured corporate finance transactions and other financial advisory assignments on behalf of clients that included domestic and foreign corporations, developers, REITs, real estate fund operators and institutions.

After leaving JLL, Jim was a principal at Chicago-based real estate developer Mesa Development. At Mesa, Jim was responsible for all capital structuring activities related to almost $1 billion of urban, mixed-use, residential development completed during his tenure. Jim identified and structured approximately $700 million of senior construction financing, $125 million of mezzanine financing and $80 million of institutional co-investment equity capital.

Jim's extensive real estate experience, including deep relationships with capital sources representing the full spectrum of the capital stack, allows him to provide valuable insights into the execution of transactions for clients of Avison Young.

Certain legal information in this document was provided by Jeff Richman of Bancroft, Richman & Goldberg, LLC | 312.252.4380

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