Devote Time to Emerging Markets

Investors should understand how "18-hour cities" impact the bottom line

By Clark Briner

In search of higher yields, commercial investors are betting on the concept of "18-hour cities," places where people live, work and play in large numbers. These cities are not only business centers with major technological influences, but also entertainment centers with vibrant lifestyle choices.

With rental rates mostly flat in the top 50 U.S. markets through the first quarter of 2017, markets like Austin, Texas; Nashville, Tennessee; and Raleigh-Durham, North Carolina, are offering Gen Xers, millennials and even baby boomers a chance to shuck their suburban dwellings for a downtown lifestyle. And they're helping investors push further afield to make money.

Before delving into current property-market conditions — and to understand them better at the midway point of the year — let's take a look back at what has happened recently with the nationwide investment climate.

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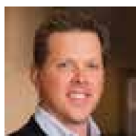

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The year 2015 is widely considered to have been an outlier for commercial-property financing. Led largely by foreign-capital institutions, investors poured record amounts of money into the market. They were almost exclusively interested in "gateway cities" like New York, Chicago, Miami, San Francisco and Washington, D.C. Houston, with its new Panamax-friendly port that offered more space for ships heading through the Panama Canal, also joined the gateway ranks.

Two years later, brokers should consider the reasons why some historically overlooked real estate markets, the so-called 18-hour cities, are now thriving, so they can help borrowers lock up prime projects in these midsize metros.

18-hour cities

The Urban Land Institute and professional-services company, PwC, partnered on the 2017 Emerging Trends in Real Estate report, which concluded that strategy and quality are now trumping location. In the report, seven of the top 10 "U.S. Markets to Watch" for overall real estate prospects are up-and-coming metro areas that qualify as 18-hour cities.

The term refers to a strong secondary real estate market that offers services, amenities and job opportunities on a similar scale as the six primary markets — Boston, Chicago, Los Angeles, New York, San Francisco and Washington, D.C. — but does not operate on a 24-hour basis. Eighteen-hour cities typically feature a thriving urban core that has undergone substantial redevelopment over the last decade, a solid public transportation infrastructure, a strong economy and moderately priced housing in comparison to larger competitors.

The seven markets — Austin; Dallas; Portland, Oregon; Seattle; Nashville; Raleigh-Durham; and Charlotte, North Carolina. — are outpacing national averages, either partially or across the board, in terms of overall population growth, millennial population growth, employment rates and gross metropolitan product. In addition, all offer a quality of life that is deemed attractive, relative to the exorbitant cost of living and congestion that increasingly defines the six primary real estate markets.

Market	2016-17 population growth	Five-year millennial growth	Gross metropolitan product per capita projected growth	2016-17 employment growth
U.S.	0.8%	2.6%	1.4%	1.5%
Austin, Tex.	2.9%	18.0%	1.7%	2.3%
Dallas	2.0%	12.2%	1.1%	2.6%
Portland, Ore.	1.1%	10.5%	2.6%	1.7%
Seattle	1.4%	13.9%	1.3%	1.8%
Nashville, Tenn.	1.4%	3.7%	0.9%	2.2%
Raleigh-Durham, N.C.	2.5%	14.6%	1.0%	4.1%
Charlotte, N.C.	2.2%	14.8%	2.1%	1.9%

Source: Urban Land Institute/PwC 2017 Emerging Trends in Real Estate

The Emerging Trends Report notes continued interest from developers, investors and lenders alike in "next-tier" cities, the markets that are first in line to be added to the primary markets. General consensus categorizes the next-tier cities as Seattle, Dallas, Houston, Atlanta, Miami, Philadelphia and Phoenix. These markets have always been popular with domestic investors, but are now seeing rising interest from international investors. And there is plenty of capital in position to buy commercial properties.

Emerging Trends delved into private equity and cited Preqin, a data firm specializing in the private-funds arena. As of June 2016, Preqin estimated a worldwide total of $238 billion in "dry powder," or highly liquid funds, queued up for investment. More than half those funds are focused on North America, and the majority of that on the U.S.

The Emerging Trends study also determined that private investors are willing to take on greater perceived risk in order to generate higher yields. Almost 70 percent of their funds are focused on value-add and opportunistic investments.

Foreign infusions

There are a few standout examples of foreign-cash infusions in 2015, including Singapore's sovereign wealth fund's purchases of Industrial Income Trust ($4.6 billion) and IndCor Properties ($8.1 billion). The latter purchase relied on commercial mortgage-backed securities (CMBS) for financing. There was also a $5.9 billion venture for 322 industrial properties involving Norges Bank Investment Management of Norway and San Francisco-based Prologis Inc.

One reason investing in secondary and tertiary real estate markets remains attractive is that it is still cheaper to buy than to build. The cost to build a new office property in Atlanta, for example, is $425 per square foot, according to Real Capital Analytics (RCA). The Atlanta market's top price for an existing property last year was $366 a foot, however.

Patterson Real Estate Advisory Group, an Atlanta-based boutique investment banking group, said that particular deal involved the acquisition of a 411,000 square-foot property by a German fund manager. The office building was 91 percent occupied at the point of sale, Patterson said.

RCA reported nationwide commercial real estate sales volumes in excess of $530 billion in 2015, which would appear to be the peak of the current cycle and, frankly, somewhat at odds with underlying fundamentals such as rental income. Two years ago, secondary and tertiary property markets were, for the most part, playing rent catch-up from the Great Recession. In terms of both real and inflation-adjusted figures, the record sales year occurred while commercial office, retail, multifamily and industrial rental income numbers were com-

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parable to 2007 and 2008.

For example, the average asking rent for Class A office space in the central business district of Milwaukee during the fourth quarter of 2015 was $18.03 per square foot, according to Colliers International. That was about the same cost as in 2007. In Detroit, Colliers reported, quoted rental rates for the overall office market averaged $19.92 per square foot at the end of 2006. They dipped as low as $17.55 in 2012, then climbed back to $18.77 at the end of 2015.

Nationally, the top 50 markets saw nominal rental-price increases during 2016 and the first quarter of 2017, research firm JLL reported. The exceptions included the aforementioned emerging markets: Austin, Nashville, Raleigh-Durham, Dallas, Denver, Seattle, Portland and Charlotte.

Investment sales started sluggishly in 2016. JLL reported a first-quarter decrease of nearly 30 percent in CMBS issuances and a 27 percent drop in closed-end real estate deals. But overall numbers rebounded well, RCA reported, finishing the year down only 11 percent from 2015, with $489 billion in total sales volume.

Yet a look at the details indicated the shift toward secondary and tertiary property-market investments began in 2016. RCA noted searches for higher yields from core properties in nonmajor markets increased 2 percent last year, while they declined 9 percent in the six major U.S. markets.

The investment shift also was recognizable in capitalization rates, RCA said. Although cap rates declined across the board in 2016, they declined more in nonmajor markets — 80 basis points, to 6.8 percent. Properties in the six major markets saw a 25 point reduction to 5.3 percent.

With such a large amount of investment funds concentrated in opportunistic investments, more capital will continue pouring into secondary and tertiary U.S. real estate markets, and to noncore property types. Consequently, there will be fairly creative and flexible capital availability for 2017, filling niches that core and core-plus investors are passing over at this point. Expect this trend to carry on well into 2018. ■

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