BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT POPULATION MOBILITY SUMMER 2020

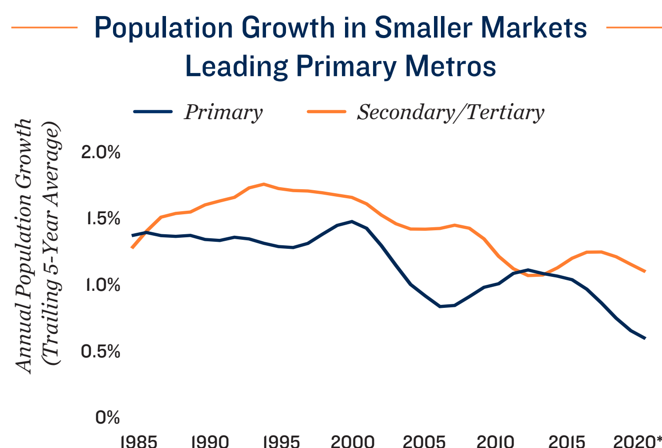
Health Crisis Shines New Light on Market Migration, Signaling Potential Changes for Commercial Real Estate

Businesses and consumers find benefits outside gateway cities. Over the past 20 years population growth among secondary and tertiary markets has outpaced that of the country's large primary metros. This trend may accelerate going forward as the global health crisis prompts residents of densely packed, high-cost urban hubs to consider the financial and lifestyle advantages of moving to smaller cities. Many companies are doing the same, seeking to diversify their workforces and reduce overhead by entering new areas. The economic downturn instigated by the pandemic may motivate more firms to shift a greater share of operations to lower-cost markets that provide flexibility in how space is utilized. These dynamics have the potential to substantially influence commercial real estate demand, from both tenants and investors, in the years ahead.

Relocations bring concrete benefit to property performance. Greater in-migration to secondary and tertiary metros has increased the demand for housing. Companies in search of new talent and ways to reduce their overhead and tax exposure were also looking for office space in smaller cities before the pandemic. These operational advantages are still in place despite the health crisis, benefiting non-primary markets, especially those with additional resources such as well-regarded universities. As more residential and office space fills, other types of local real estate will benefit, from retail shopping centers to industrial facilities and even self-storage buildings. At a high level, assets in secondary and tertiary markets have recorded tighter vacancy and stronger rent growth than comparable properties in gateway metros, drawing investor attention.

Health crisis sparks investors to consider smaller metros. Since 2000, the number of properties changing hands in non-primary markets has grown from about a third of all trades to around two-thirds in 2019. There are multiple motivating factors behind this shift. Properties in smaller cities tend to have a higher yield profile and private investors usually face less competition from institutional buyers. While COVID-19 has temporarily slowed sales activity, investors positioning for the new post-coronavirus normal are increasingly focused on smaller cities. Lower entry costs and higher cap rates offer advantages to investors today, with notable long-term upside potential supported by the increasing number of people moving to smaller cities.

Population Growth in Smaller Markets Leading Primary Metros

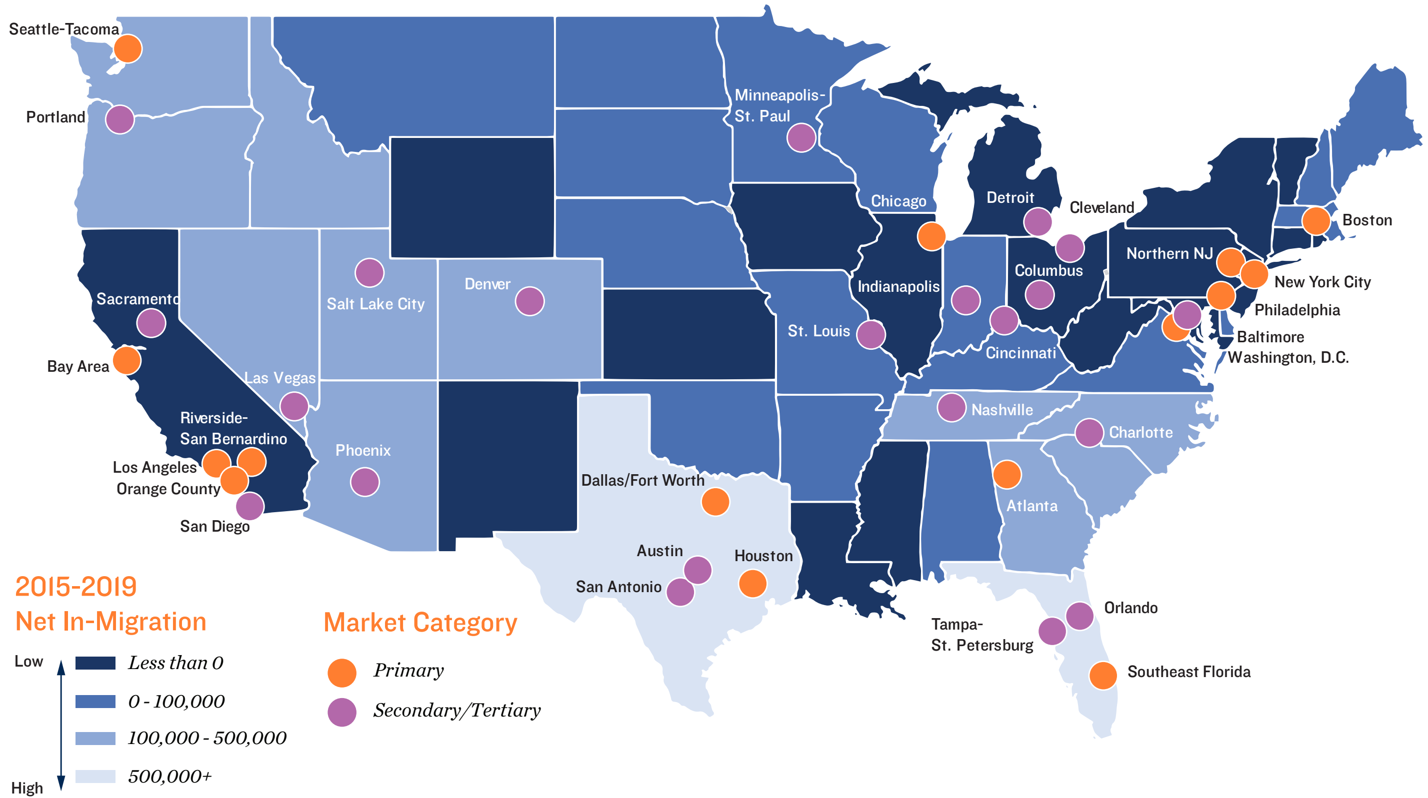


Top 15 Markets by Five-Year Population Growth: Smaller Metros Outperform Gateway Cities

Market	Category	2015-2019 Population Growth
Austin	Secondary	13.5%
Orlando	Secondary	11.7%
Las Vegas	Secondary	10.8%
Phoenix	Secondary	10.2%
Nashville	Secondary	9.6%
Charlotte	Secondary	9.6%
Dallas/Fort Worth	Primary	9.6%
Salt Lake City	Tertiary	9.3%
San Antonio	Tertiary	8.9%
Jacksonville	Tertiary	8.7%
Houston	Primary	8.4%
Seattle-Tacoma	Primary	8.2%
Tampa-St. Petersburg	Secondary	8.2%
Atlanta	Primary	7.7%
West Palm Beach	Primary	7.4%
United States		**3.0%**

* *Pre-COVID-19 forecast*
Source: U.S. Census Bureau

Health Crisis May Accelerate Migration to Smaller Markets Already Driven By Lower Living Expenses and Numerous Job Opportunities



Migration patterns favor non-primary markets. Over the past two decades total net migration was 70 percent higher in secondary and tertiary metros than in gateway cities. Since 2014 that ratio has climbed to over 200 percent. Changing household compositions and quality of life goals are major factors behind this trend. Individuals and families looking for a larger apartment or to own a home are moving to metros with a lower cost of living, which includes taxes. The 2017 Tax Cut and Jobs Act imposed a cap on state and local tax deductions, prompting an exodus of personal and corporate taxpayers to states with lower rates. Employment options also play a role. Following the Great Recession, job creation was initially concentrated in primary markets, but in recent years companies have been investing more in smaller metros. Prominent firms such as Apple, Amazon and Deloitte have all announced new offices in Austin, Nashville and Phoenix. Such a relocation or expansion can help diversify a firm's workforce and reduce operating expenses, opening up more professional opportunities for those looking to move. Metros in the Sunbelt and Mountain states have benefited the most from these trends. By contrast, at a net level, about 600,000 people have migrated out of New York City and Chicago since 2014.

The health crisis and adoption of remote working to accelerate relocations. Months of sequestration have emphasized the importance of comfortable living spaces, especially for urban dwellers who traded larger rooms for now-closed amenities. Mail-forwarding requests in densely populated New York City spiked this spring, and if this behavior extends to other markets and becomes more permanent, it could have a substantial impact on primary metros. Urban cores raise infection risk by virtue of clustered quarters and more frequent public transportation. Moving to the suburbs or to a less dense secondary or tertiary metro can lower some of these risks. The pandemic has also prompted the widespread adoption of remote working, potentially removing another barrier to market migration. Many companies are eager to have employees return to the office, but some firms such as Facebook and Square have announced plans to allow significant portions of their staffs to work from home indefinitely. Employees in costly housing markets such as San Francisco may move to smaller cities where homeownership is more obtainable. These and other changes to how and where people choose to live could extend well beyond the current concern of coronavirus infection.

Source: U.S. Census Bureau

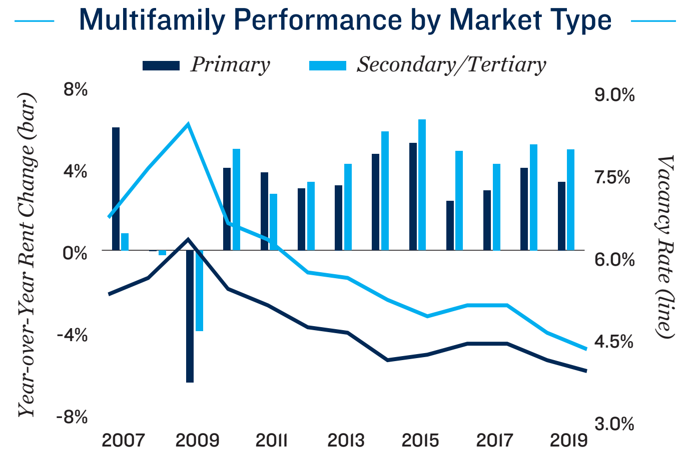
Market Migration Having a Structural Impact on Real Estate Demand

Relocations influencing property fundamentals. The migration of people and businesses to secondary and tertiary markets has notably impacted commercial real estate performance. Despite some concerns of overbuilding since the last recession, apartment, office and industrial availability have all fallen more dramatically in smaller cities than larger ones. Multifamily vacancy in particular dropped 240 basis points to 4.3 percent across non-primary metros between 2007 and 2019. By comparison, vacancy in major gateway hubs fell 100 basis points to 3.9 percent. This steeper decline also supported stronger rent growth. The average effective rent for secondary/tertiary markets improved 51 percent between 2007 and 2019, versus a still notable 34 percent gain in primary cities. Offices have shown less differentiation in rent gains, but availability in smaller metros continues to outperform larger cities as businesses increasingly look to move into new areas. Corporate and residential growth in non-gateway markets has also increased the demand for industrial space, as exemplified by a similar decrease in vacancy.

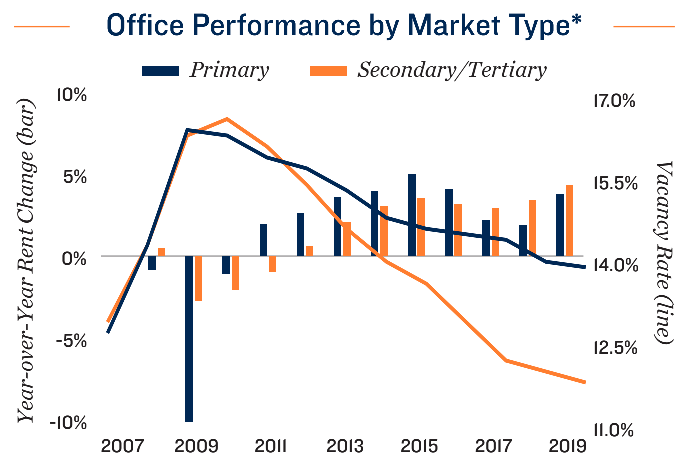
New health threats may further increase space demand in smaller metros. How human behavior is responding to COVID-19 may have a substantial impact on commercial real estate demand beyond population migration. This is especially true of the office sector. Since the 2008 financial crisis, office development has trended toward increasingly dense buildings located close to public transit. Tenants of these high-rise offices in prominent downtowns now face notable hurdles to bringing employees back. As physical distancing requirements and infection control take top priority, some companies' focus has shifted to lower-density space in smaller markets or suburban locations accessible by car. Less costly rents and more land availability also grant flexibility in how firms utilize space. As more companies consider a relocation or expansion into a secondary or tertiary metro, other support businesses may follow.

Economic disruption may also push employers to non-primary markets that meet specific criteria. While current health dilemmas may be temporary, other economic factors could last longer. Firms seeking to reduce overhead may look to smaller markets as long as they meet other conditions. Companies will want to relocate operations to metros with growing populations that already meet a certain minimum size threshold. Connectivity to larger economic hubs via highways and airports is important as well. Firms also prefer cities with established universities that provide a high quality of life via leisure and recreational opportunities for staff. Business-friendly environments, including lower tax burdens, will also be a motivating factor. Cities building relationships with prominent national employers may in turn see even more people moving in.

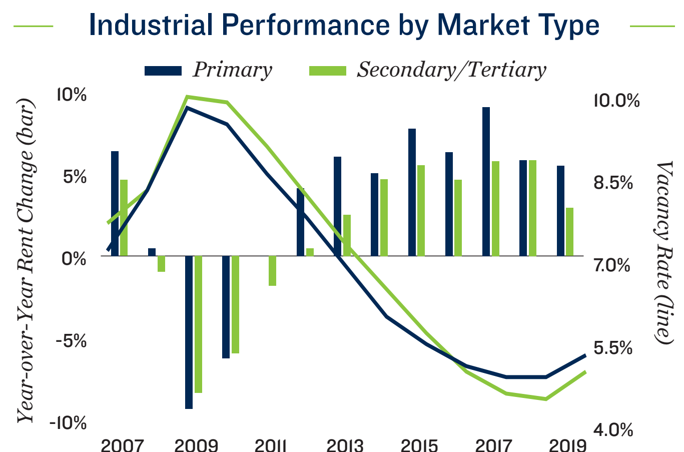
Multifamily Performance by Market Type



Office Performance by Market Type*



Industrial Performance by Market Type



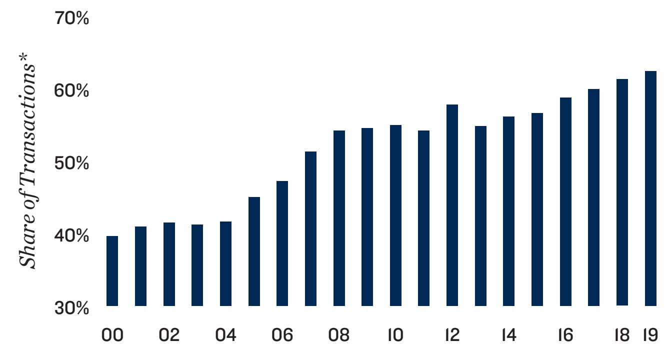
* *Office data excludes 2007 rent change*
Sources: CoStar Group, Inc.; RealPage, Inc.

Pandemic Adds New Motivations for Secondary and Tertiary Market Investors

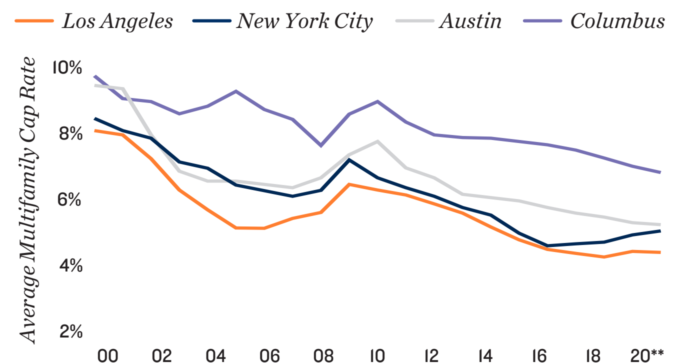
More than half of major trades now taking place outside primary metros. The shift toward more individuals and companies moving to secondary and tertiary markets has already influenced capital flows. In 2000, approximately 40 percent of transactions priced over $1 million occurred in non-primary markets. As of last year, that ratio had expanded to roughly 60 percent. Stronger property fundamentals, less competition from larger buyers, and value-add potential are drawing investors to these areas. Lower entry costs and higher yields than typically found in larger gateway cities also appeal to new as well as established buyers seeking to diversify their holdings. The unprecedented social and economic disruptions caused by COVID-19 are prompting investors to adjust their risk exposure, with future implications for real estate demand in secondary and tertiary metros.

Health crisis may shift more interest to secondary and tertiary markets, influencing long-term outlook. A recent survey reported that more than half of investors listed secondary and tertiary metros as places of interest, indicating that the pandemic has not reversed the sentiment on smaller cities. While rental income may be disrupted in the near future, longer-term performance trends are favorable. Sales price and cap rate arbitrage in secondary and tertiary markets also aid capital-constrained investors seeking higher first-year returns. This dynamic may change more over time, however. Greater competition among buyers from a renewed focus on smaller cities may drive price appreciation over the next several years, compressing cap rates and narrowing the margin relative to primary markets. This shift could be advantageous further down the line when these assets are placed back on the market.

Share of Transactions Occurring in Secondary/ Tertiary Markets Continues to Climb



Multifamily Cap Rates Illustrate Changing Relationship With Yield Among Market Types



* Multifamily, office, retail and industrial sales priced $1 million and above across all major markets
** Trailing 12 months through first quarter
Sources: CoStar Group, Inc.; Real Capital Analytics

National Multi Housing Division
John Sebree
Senior Vice President, National Director | Multi Housing Division
Tel: (312) 327-5400 | john.sebree@marcusmillichap.com

National Office and Industrial Division
Al Pontius
Senior Vice President, National Director | Office and Industrial Division
Tel: (415) 963-3000 | al.pontius@marcusmillichap.com

Prepared and edited by
Cody Young
Research Analyst | Research Services

For information on national commercial real estate trends, contact:
John Chang
Senior Vice President, National Director | Research Services Division
Tel: (602) 707-9700 | john.chang@marcusmillichap.com

Price: $1,000

The information contained in this report was obtained from sources deemed to be reliable. Average rent figures for multifamily properties are reflective of average effective rent, while representing average asking rent metrics for office and industrial assets. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guaranty, express or implied, may be made as to the accuracy or reliability of the information contained herein. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; New York Times; Real Capital Analytics; RealPage, Inc.; SEI; U.S. Bureau of Labor Statistics; U.S. Census Bureau

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