Investors Pour into Small Markets, Drive Price Momentum

By: CoStar News Staff

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Commercial real estate investors priced out of major U.S. markets have expanded their scope to secondary and tertiary markets to find properties yielding more generous returns, a trend typical of late-inning property cycles. But the robust demand for real estate and the current cycle's longevity set this growth period apart from past ones and suggest that smaller markets will continue to reap investment for some time.

According to the CoStar Commercial Repeat Sales Indices (CCRSI) in September, property price momentum in smaller markets increased an average of 16.5% over the 12 months ended Aug. 31 of this year, far outpacing the average growth of 3.5% in major cities. Additionally, a 19.8% average increase in the pricing of smaller, lower-priced assets over the same period further indicate that more investors are targeting a wider range of properties across more markets, according to CoStar.

"The dynamics associated with the pursuit of assets in secondary and tertiary markets have to do with the fact that a tremendous amount of equity and debt is looking for yield," said David Blatt, CEO of CapStack Partners, a New York-based investment bank and advisor focused on real estate and other asset classes. "While price in primary markets is a factor in terms of getting value for your dollars, yield is a stronger driver for many of these buyers."
Blatt and other observers suggest that investors are avoiding more speculative cities that tend to suffer most at the onset of a downturn. Instead, they favor markets enjoying increasing population and jobs and that have the diversified economies, infrastructure and other underpinnings that support more growth.

"As the economy has been gaining momentum, we've seen a lot of smaller metros really gaining momentum, too," said John Chang, first vice president of research services for Calabasas,CA-based Marcus & Millichap. "We've seen the performance of metrics for apartments, office and retail centers all improving, which has created a compelling case for investment. Setting aside a 'black swan' event, it appears that this growth cycle still has momentum."

Metros on the radar span the nation's regions and include Denver, Nashville, Portland, Dallas and Pittsburgh, observers say. Buyers are interested in all property types, from industrial properties in the Midwest to facilitate ecommerce distribution, to creative office and mixed-use redevelopment opportunities in old industrial areas experiencing gentrification, they explain.

What's more, many investors remain enamored with multifamily properties, particularly Class B and C assets that are rehab candidates or that have been recently renovated. Among other markets, that strategy is accounting for about 70% of apartment transactions in Jacksonville, FL, where sales volume is expected to exceed $1 billion this year, said Brian Moulder, a managing director with Walker & Dunlop Investment Sales.

Moulder was part of a Walker & Dunlop team that represented Atlanta-based Cortland Partners in its $74.5 million sale of the 616-unit Aqua Deerwood complex to Investcorp International in July. The sale price represented a capitalization rate of 5.25%. Cortland Partners acquired the 31-year-old property about six years ago and overhauled it, he said.

"The asset is in a great location and submarket, and it will probably be a long-term hold," added Moulder, who is in Walker & Dunlop's Orlando office. "We've really seen institutions that have not come to Jacksonville in the past entering the market, and they are getting better returns than they would in bigger Southeast markets like Miami or Atlanta."

In another recent Jacksonville deal, Fairfield Residential sold the Harbortown Apartments (pictured above) at 14030 Atlantic Blvd, to Praedium Group for $57.3 million in July.

Similarly, in Charlotte, NC earlier this year, New York-based developer Gamma Real Estate paid $43.2 million for Stone Ridge apartments, a 314-unit complex built in 2000. The acquisition exemplifies a strategy that many investors are pursuing in the market: targeting properties with nine-foot ceilings and up-to-date floor plans for extensive renovations, said Jordan McCarley, executive managing director with Cushman & Wakefield's multifamily advisory group in Charlotte. He along with Marc Robinson, vice chair in the brokerage's office, represented the local seller in the deal.

"Over the last 12 to 18 months, we've seen a changing landscape in terms of a new buyer pool that really wasn't here previously," McCarley said. "It's not all institutional, but they are bringing a lot of investment demand and interest to the market."

CapStack Partners, through its recently created investment advisory platform, also has entered the Southeast with a mandate to partner with local operators and acquire value-add and opportunistic apartment assets. The firm is targeting Nashville and Atlanta, Blatt said, and expects to close its first couple of acquisitions by the end of the year. "We certainly like the drivers in the region and the fact that we're seeing growth on a macro level," he explained.

Indeed, employment in metro Nashville grew at annual rate of 4.2% last year and 3.4% in 2015, for example, well above the national average of 1.7% and 2.1% for the years, respectively, according to the Bureau of Labor Statistics. Moulder and McCarley also credit job growth for increased investment activity in their markets: In 2016, employment grew 2.7% in Jacksonville and 4.2% in Charlotte, according to the BLS.

Although job creation is tapering in Denver, it is still outperforming the nation, and along with population growth, continues to attract new investors. Employment grew 2.6% last year, a dip from each of the previous two years by about 130 basis points, according to the BLS. To capitalize on the healthy investment interest, Chicago-based JLL recently launched a new office sales initiative covering the Denver and Texas regions.

Among other efforts, the brokerage is quietly marketing a $200 million suburban office portfolio in Denver that features several major credit tenants, and many well-known institutional investors are showing interest, says Michael Zietsman, an international director with JLL who is leading the new endeavor. The assets should sell at a capitalization rate of around 6.75%, some 100 basis points higher than a similar property in a major market, he said. "We're definitely seeing big institutional funds and offshore tenants looking at what we consider to be non-gateway markets," Zietsman added. "Not only are buyers finding better yields, but the growth dynamics in these markets are pretty strong."

For lenders like Los Angeles-based Thorofare Capital, funding deals in Denver has become a primary strategy, said Felix Gutnikov, a principal with the firm. In September, Thorofare provided $30.3 million in short-term bridge financing to Mass Equities to acquire industrial buildings on 7.8 acres in Denver's booming River North Art District (RiNo) neighborhood near downtown.

Based in Santa Monica, CA, Mass Equities is planning a $200 million mixed-use redevelopment on the site, and Thorofare's loan replaced a financing commitment that fell apart last year.

The RiNo loan followed Thorofare's first investment in the market last fall, a roughly $20 million senior loan to fund the purchase of an office building, Gutnikov said. The company also is bullish on Portland and is funding senior housing, self-storage and student housing deals in other small markets, he said.

"We're not averse to going into secondary and even tertiary markets, but it depends on the building's location - we get much more granular in smaller markets," he said. "We want to know what street the property is on, what the visibility is, and whether it's on the right side of the street."

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