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Rising U.S. Cities

The real estate investment opportunity beyond America's gateway cities

Featuring expert commentary from

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Rising U.S. Cities

The U.S. real estate market has boomed in the post-Great Recession era, with the lion's share of investment capital flowing into the big "gateway" cities like New York and San Francisco. But at the same time a second tier of cities has steadily been transformed by job creation in largely tech and healthcare industries, cities like Nashville and Austin.

As you will learn from this report, there is indeed smart money flowing into the real estate of these rising cities, but careful analysis and underwriting are still required. Privcap gathered a group of real estate experts recently—all of them very active in second tier cities—to learn what the best strategies are for growing and protecting capital invested in properties there.

Key Takeaways

1. A second tier of U.S. cities is prospering in a growing new economy, offering real estate investment opportunities
2. The safety of U.S. gateway cities is often overestimated; likewise, the risks of secondary cities are often overestimated
3. Next-generation physical retail is here to stay in rising cities
4. Asset flexibility is crucial when investing in the real estate of changing cities

The Experts

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1 A second tier of U.S. cities is prospering in a growing new economy, offering real estate investment opportunities

Why bother with a secondary city when you can park your capital in a big one like New York? In short, because it is possible to find higher cap rates paired with very attractive economic tailwinds. These tailwinds come primarily in the form of job growth. According to Preston Sargent, executive vice president of San Francisco-based real estate investment firm Bailard, the secondary cities are all about relative value. "The common characteristics are good job growth, good population growth, a large percentage of college graduates," he says, adding that the top secondary cities are "magnets for smart, talented, energetic, creative workers and employees, so they attract employers that want to tap into that pool."

Like real estate investors, these young workers are attracted to cities where prices are lower but job growth in attractive industries is strong.

Sargent lists as examples of attractive secondary cities for investment Dallas, Charlotte, Raleigh, Durham, Salt Lake City, Phoenix, Houston, and Minneapolis. These cities "trade at a substantial discount" to the big coastal cities, he says.

Not surprisingly, the most attractive cities are seeing job growth in what are termed new-economy industries, says Laura Dietzel, a senior manager at RSM. "We're seeing a great urban divide—those economies that are anchored to technology in sciences, healthcare, and media are bustling," Dietzel says. "Those that are anchored to the old economy—manufacturing and agriculture—are struggling."

Dietzel gives the examples of Austin and Nashville, which have become "epicenters of healthcare technology. Those cities also have great talent pools, are anchored to universities, and serve as state capitals," all of which provide recession-resistant characteristics, she says.

2 The safety of U.S. gateway cities is often overestimated; likewise, the risks of secondary cities are often overestimated

Institutional investors with large allocations to real estate have traditionally taken the view that there is a natural trade-off when investing in the biggest gateway markets. While investor demand pushes prices up and cap rates down, that same demand keeps valuations steady and provides liquidity when it's time to monetize an asset.

Reverse Retail Apocalypse
Derrick McGavic
Newport Capital Partners

McGavic is skeptical that the cities currently being flooded by young workers will become e-commerce-only markets: "What I think is fascinating is that by the year 2028, still 85 percent of all purchases will have some form of bricks-and-mortar store tied to them. Which means it's just the opposite of what's happening to the department stores. The pure online only-retailer, they're not going to be able to survive. They're going to have to go to be an omnichannel retailer, which includes brick and mortar."

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By contrast, this thinking goes, prices may be lower in secondary markets, but when a crisis hits, you may find it harder to sell your asset, and its valuation may be more volatile.

Our assembled experts say this traditional view is not quite right.

"That's all true, until it's not," says Sargent, who cautions that sky-high prices in the central business districts do not make for sound long-term investments. "More and more investors are piling in, and people are paying historically low cap rates, historically high prices per square foot, and big premiums to replacement cost. For us, replacement cost is an extraordinarily important metric. If we can find properties as substantial discounts to replacement cost, and at cap rates that are two, three, four hundred basis points higher, that's a much better bet than some of the wonderful gateway markets."

Derrick McGavic, a managing principal at Newport Capital Partners, points to the vast supply of capital awash in gateway cities. "Let's say there's a $50 million property for sale in southern Florida and there are 30-plus funds chasing it. Well, that means $1.5 billion is trying to buy that property. Nobody's really any smarter than the other. In our world [secondary markets] I would rather compete against three bidders. It's still an active market, although it may not be as active as southern Florida."

Dietzel points out that the supply of capital targeting gateways is not just domestic. "You're also competing with global investors, who have very different risk profiles than traditional U.S. investors," she says. "So if I'm an investor and I'm just looking for a safe haven for my money, I don't care if I have a three cap. I may easily overpay for an asset just to park my money there safely."

As for liquidity risk, McGavic points out that a thinning out of bidders in a market downturn should not be the biggest worry of a real estate investor. The biggest worry should be whether or not tenants can continue paying rent, and that all comes down to the stability of the employment base in an area.

Nashville Beckons
Laura Dietzel
RSM US LLP

"A lot of millennials are favoring Nashville as a lower-cost city, a city where they can live, work, and play, which is something that's really high on their priority list versus a city where it's just work, work, work. We're also seeing that Fortune 1000 companies are moving a lot of back-office operations into cities like Nashville, where the relative cost of doing business is much lower, so they can have their corporate finance and accounting teams housed out of Nashville but maintain their headquarters on the coasts."

3 Next-generation physical retail is here to stay in rising cities

Rising U.S. cities are attracting young people in droves who come for the jobs and the lower cost of living. What is the retail investment play in these areas, particularly when young people are more likely to use e-commerce to shop?

McGavic, whose firm specializes in retail investing, says that successful retail investing means an intense focus on neighborhood characteristics and an understanding of which types of physical retail operations will survive. "We look at how

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many people are within one, two miles. In our portfolio, our average one-mile radius is about 40,000 people. That's the size of many small towns across America. The next thing we look at, of course, is the tenancy and how they react in today's world of e-commerce."

Dietzel notes that "a successful retail strategy is going to be omnichannel. Even e-commerce companies want to have a brick and mortar presence. They're looking to build the loyalty to their brand. Even Amazon has Amazon Go stores."

4 Asset flexibility is crucial when investing in the real estate of changing cities

When investing in changing neighborhoods – especially in rising U.S. cities to which young people are flocking – it is important to invest in "flexible" real estate, meaning real estate that can be repositioned for changing tastes and uses.

A city that was previously tethered to manufacturing, but which is now creating technology jobs, will need to transform its real estate assets to suit the new needs and tastes of tenants. Some real estate assets are more easily transformed than others. McGavic notes that his firm is attracted to real estate that is "designed in a flexible way so that as the economy changes and uses change, can it be reconfigured conveniently and relatively inexpensively."

Sargent gives a very specific example of inflexibility: "Let's say you have a suburban garden-style apartment complex—there's not a lot that you can do to that physically, other than upgrade the guts. And frankly, some of the older products with eight-foot ceilings, we won't touch any of those. Eight-foot ceilings feel confined and boxed in. You cannot raise the ceilings in a garden-style apartment. You can add pools, you can improve the fitness center, you can dress up the landscape, you can do all those things, but you're sort of stuck with that box with an eight-foot ceiling."

Given the fact that smaller markets tend to have a smaller volume of bidders in downturns, it is important that the structure of ownership is also flexible and durable. Dietzel cautions that real estate investors need to understand any factors that might change during the duration of their hold. "Can you weather the downturn? What will financial conditions be like five to 10 years from now? We don't have a crystal ball, so we're always advising our clients to really make sure that they understand if they can weather the storm if it comes. They may need to maintain that property for a longer hold period than maybe they originally assumed." ■

Money in Their Pockets
Preston Sargent
Bailard

Sargent is quick to point out that although salaries are, on average, higher in the gateway cities, many consumers in secondary cities have more disposable income: "The disposable income there is significantly higher than it is in some of the fancier cities that we've already talked about. It's because the housing costs are actually really reasonable. Consumers have a lot more in their pockets at the end of the day because they're not spending 40, 50, 60 percent of their take-home pay on housing costs."

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All About
Robotic Process Automation (RPA)

An Expert Q&A With Laura Dietzel of RSM

Laura Dietzel
Senior Manager
RSM US LLP

Privcap: What innovations in automation, analytics, or real-time reporting could influence data management for commercial real estate owners and the investors?

Laura Dietzel, RSM: We certainly find ourselves in an exceptionally tight labor market, so a lot of companies are looking for ways to invest in technology that will help them become more efficient through their back office, as well as front-office operations.

An area that is exceptionally helpful for real estate would be robotic process automation, so really the streamlining and standardization of these traditional, menial tasks that can be automated.

A firm that we have partnered with, Automation Anywhere, is one of the leading solutions for middle-market clients, and really allows for the automation and learning of these processes to automate the back-office reporting and drive efficiencies for back office operations.

What is an example of a menial task that could be automated?

Dietzel: Cash reconciliation every month—tying out your cash receipts, deposits, as well as your cash transactions from a bank statement. That is a tedious task and time-consuming and can easily be done through robotic process automation.

What parts of the asset management accounting and reporting processes are you seeing your clients automating?

Dietzel: Clients would really love to have data that speaks to them and lets them know how to better manage their business. They are looking for dashboarding of their budget to actuals, real-time information, and with the growth of the internet of things and further investment in technology and AI, we're really finding that pulling from various information sources, from a property or even from an operational standpoint, are helping drive more meaningful business decisions, especially across large portfolios.

How are real estate companies using AI to meet the demands of tenants and investors?

Dietzel: The rise of artificial intelligence is really benefiting real estate developers and investors. At no time before this could we have the ability to comb through tons and tons of data in a very efficient way and learn about the metrics that make an investment successful, or learn from our past projects to really help guide decisions in future projects.

Real estate investors can utilize AI and machine learning to help drive predictive analytics and really make better business decisions about underwriting and asset management.

What would be an example of a prediction that an algorithm could make that would be beneficial to an asset owner?

Dietzel: In underwriting for a specific tenant, you may find useful information about their past credit history that could indicate future default and give you that analysis ahead of time. This could give you signals about when they could potentially be in a default mode before you arrive at that, so that you can have a little bit more lead time in terms of re-leasing your property. ■

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