The Gateway Market Investment Paradox

Following the Global Financial Crisis (GFC), the majority of commercial real estate investment flooded into Gateway markets. These investments have provided significant NOI growth and price appreciation as demand recovered, and major Gateway markets thrived. However, eight years later, we see a number of forces that may challenge Gateway markets going forward.

As a result of the unprecedented capital inflows to Gateway markets, particularly from foreign capital, several years ago rents and values reached levels at which new development became economical. It is a paradox of this cycle that, as we show in this paper, the “hard to build” markets are those with the most new supply. It is also important to note that this supply is being delivered at a time when cap rates are at all-time lows and properties in Gateway markets must be purchased at extremely high bases.

We believe that Gateway markets no longer present a compelling investment opportunity, and see potential risk if flattening demand meets with new supply, resulting in higher vacancy rates and corrections to rental rates and valuations. Instead, we believe that investors would benefit from the allocation of the marginal dollar to high-quality assets in CenterSquare Preferred Major Markets, where we see attractive pricing and risk-adjusted return potential.

Given the current pricing and strong recent performance of Gateway markets, we believe it is time that investors look beyond the Gateway.

Gateway Underwriting Requires Unprecedented Assumptions

Real estate returns are derived from a combination of cash flow and asset appreciation. Traditionally, investors in core, Gateway markets expect a significant portion of their overall return from cash flow; however, current cap rates in the 3-4% range for Gateway markets such as San Francisco and New York severely limit an investor’s ability to produce meaningful current income.

The Gateway Market Investment Paradox

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Executive Summary

Following the Global Financial Crisis, real estate capital flows focused on core properties in Gateway markets. These investments have provided significant NOI growth and price appreciation as demand recovered, and major Gateway markets thrived. However, today we believe that the marginal investment dollar is better served outside of these markets. Gateway markets are priced at an historically high premium with potentially greater than average risk given all-time high rental rates, above average supply, elevated capital flows and all-time low cap rates. We believe that investors should embrace the broader opportunity to invest in specific major markets outside of Gateway cities – in this paper we identify them as CenterSquare Preferred Major Markets – in order to achieve higher returns with lower relative fundamental and pricing risk.

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Therefore, to achieve targeted returns, prospective investors in Gateway markets are forced to make aggressive rent growth assumptions. Since the GFC, rent levels in Gateway markets have climbed steadily and in many cases have reached historical highs. In fact, replacement cost rental rates—or the rent levels needed to justify new development—have been achieved in Gateway markets for the first time in nearly a decade. Replacement cost rental rates enable both equity and debt to justify new development, necessitating exit pricing in excess of replacement cost, another barrier to overall returns.

The table in Figure 1 presents a summary of the relative conditions in Gateway and CenterSquare Preferred Major Markets.

The Opportunity in CenterSquare Preferred Major Markets

CenterSquare’s investment thesis is that in this market, higher risk-adjusted returns can be achieved by seeking prime quality, cash-flowing assets in select major markets that exhibit specific characteristics such as diversified employment growth, pricing below replacement cost, and a limited supply pipeline. Figure 2 presents both Gateway and CenterSquare Preferred Major Markets, including current CBD (Central Business District) office cap rates. While each market is unique, real estate conditions in these Major markets reflect strong employment and population growth, and are priced more attractively than Gateway markets. Below, we examine the conditions of fundamentals, liquidity, and valuations that lead us to believe that CenterSquare Preferred Major Markets are the more attractive investment choice.

Fundamentals: Supply and Demand

Due to strong demand growth over the years since the GFC, rents in Gateway markets have climbed steadily and driven vacancy rates to all-time lows. Using data compiled from several sources and CenterSquare’s own estimates of development yield requirements, CenterSquare compiled
Figure 3, a summary of Class A office rents relative to the replacement cost rents needed to make development attractive. In San Francisco, rental rates on Class A office buildings have even exceeded replacement cost rents. This portends increasing speculative building, which will likely increase vacancy and put pressure on rents. Meanwhile, in CenterSquare Preferred Major Markets such as Dallas, Philadelphia, and Atlanta, Class A rents are approximately 40% below replacement cost rents.

There was a significant slowdown in deliveries following the GFC, and for much of the recovery total new supply was muted. However, in the past two to three years development has increased, concentrated in the Gateway markets. When examining supply, it is important to consider preleased versus speculative development. According to a Q2 2016 JLL report, approximately 47.5 million SF of office is under construction in Gateway markets in comparison to 36.9 million SF in CenterSquare Preferred Major Markets. Importantly, almost 60% of the space under construction in the CenterSquare Preferred Major Markets is preleased.

Office Spotlight: Phoenix

The Phoenix office market is poised for growth, with strong employment and demographic drivers and attractive fundamentals.

Highlights
- The nation's 6th most populous city¹
- Competitive operating cost advantages (i.e. no corporate franchise tax, transfer tax or business inventory tax)
- Strong, diversified employment base
- Arizona has the highest projected job growth in the U.S. through 2019²
- Limited new office supply

The Phoenix real estate market was relatively late to recover following the GFC, however it is now demonstrating strong growth with significant runway remaining. We are attracted to office in particular in this market, as Phoenix provides an already diversified base of industries, features an educated workforce and affordable cost of living, and offers a friendly business environment. There are numerous recent examples of companies seeking to establish or expand in the market - Apple chose to establish its global operations command center in nearby Mesa, Intel recently built a $5 billion semiconductor fabrication facility in the Phoenix area, and GM is hiring 1,000 new employees for its Information Technology Innovation Center nearby as well. The office market in Phoenix also features below average supply and asking rents and occupancy figures well below peak levels.

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while in Gateway markets, 57% of the new supply under construction is speculative development (see Figure 4), which is significantly above trend. In fact, the speculative development alone in Gateway markets represents nearly double the 10 year annual average of total office deliveries for Gateway markets.3

Retail Spotlight: Denver
Denver’s strong demographics and diverse economy create a sweet spot for retail real estate.

Highlights:
• Population growth at 2x the national average3
• Real retail sales per capita nearly 2x the U.S. average3
• Median salary 20% higher than national average3
• 40% of Denver citizens have a bachelor’s degree (compared to 35% of major metro aggregate)3
• Large presence of biotech, energy, tech, and defense industries to add more high-paying jobs

Denver has seen enormous population growth in recent years, and that growth has been concentrated in the demographics most central to the success of retail real estate. In the five years ending in 2015, Denver’s population grew by a cumulative 11%, and the population with a bachelor’s degree or higher increased by 15%—both growth rates ranked in the top five out of the country’s largest metro areas. In the same timeframe, median incomes increased by 12%, the seventh-best growth rate in the nation.3 These trends are not lost on national retailers, who remain attracted to Denver’s strong demographics and diverse economy, with Walmart, H&M, and Cabela’s all making major expansions in the region recently.

Multifamily Spotlight: Atlanta
The multifamily market in Atlanta is supported by solid employment growth and attractive cost and lifestyle characteristics for the millennial demographic.

Highlights:
• 9th largest labor force among U.S. metros3
• Top 10 in college graduates3
• Household and employment growth projected to outpace U.S. through 20203
• Attractive business costs
• Metro rent growth remains above the long run average as 60% of new supply is concentrated in two major submarkets3

In addition to household and employment growth projected to outpace the U.S. through 2020, and a cost of living 20% lower than the average for top 12 U.S. metros3, the city also offers a balance of city living and affordable housing, a large and central airport, and warm weather with snowless winters. The market offers business costs around 10% below the national average3, and has recently seen major companies like Mercedes relocate to within its borders. The Atlanta market also stands to benefit from larger demographic trends - Money magazine recently ranked Atlanta the 2nd best U.S. city for millennials.

Liquidity
We consider liquidity in two segments: debt and equity that is available to invest.

Nearly all lenders today are eager to finance assets in Gateway markets. Additionally, institutional borrowers, the most likely to invest in Gateway markets, typically use lower leverage levels, making lending an even easier

2 Source: CoStar Portfolio Strategy, Q2 2016
exercise. In other major markets, we see significant levels of interest but not the same euphoria as in Gateway markets. This can be viewed as positive, as capital market restraint can prevent a ubiquitous run up in asset values. It also creates the opportunity for well-capitalized sponsors to be compensated for taking risk.

On the equity side of the equation, demand from foreign buyers in U.S. commercial real estate is growing at an accelerating rate. In a single transaction, Chinese insurance companies are buying the equivalent of what might be owned by an entire U.S. REIT. In addition, we expect the PATH Act passed by Congress in December 2015, which exempts certain foreign capital from taxation under FIRPTA (Foreign Investment in Real Property Tax Act of 1980), to accelerate capital flows from foreign buyers. Foreign investment in U.S. Real Estate was up 125% in 2015 relative to 2014, prior to FIRPTA changes being announced. Notwithstanding foreign investors’ rationale for investing in the U.S.—expectations that local currency will devalue, certainty of owning hard assets, store of value theory—foreign capital has focused almost exclusively on Gateway markets and has had a meaningful impact on inflated pricing. In fact, 70% of Chinese investment in U.S. commercial real estate from 2010 to 2015 was in New York, San Francisco, and Los Angeles, and that figure jumps to over 75% if you include Silicon Valley and Orange County. Flush with non-economic buyers with indefinite holding periods, prices in Gateway markets continue to deviate further from intrinsic value, making it less appealing for an institutional investor to compete for those properties.

**Industrial Spotlight: Philadelphia**

Philadelphia’s potential for growth in the industrial space is supported by both its strong transportation infrastructure and its geography.

**Highlights:**

- 5th most populous city in U.S.
- Excellent roadway, rail, and airport infrastructure
- Attractive geography for distribution to the U.S. and Canada
- Lower cost of living than other major Northeast cities
- Limited new light industrial supply

Greater Philadelphia is served by over 2,500 miles of interstate, state, and local highways and roads, and over 50% of the U.S. population and more than 60% of Canada’s population lies within a 500 mile radius of the region. E-commerce is growing exponentially in the market, and third party logistics companies are growing in order to fulfill distribution and transportation needs. Since 2013, leasing volume from third party logistics companies has grown 15.5% annually, with FedEx Ground, UPS, and OHL growing in the region. Additionally, vacancies remain at an all-time low, and current rents for industrial properties are below long-term averages.

It’s a common misconception that during a downturn, the Gateway and Non-Gateway markets meaningfully diverge, with the Gateway markets providing more liquidity for investors. However, when we examine liquidity in Gateway versus Non-Gateway markets based on transaction volume, the liquidity differential between these markets seems overstated (see Figure 5). Both Gateway and Non-Gateway markets do experience declines in liquidity during market downturns.
Examining Employment Growth in Non-Gateway Markets

Employment growth is a major driver of real estate demand and a factor closely analyzed by investors. Over the past 5 years, 19 of the top 20 employment growth markets in the U.S. were Non-Gateway markets, and on average, these markets produced 51% greater employment growth relative to the Gateway markets over the same period.

It is important, however, to delve into the specific drivers of each market to ascertain the long-term potential. For example, Houston is a top 5 employment growth market, but this growth is driven by the energy sector, and the corresponding supply build up is concerning. At CenterSquare, we work to examine the existing data to understand trends and their drivers, and conclude if that change is permanent and sustainable. With a careful examination, a complete picture of the fundamentals, valuation and liquidity potential of each market can be constructed and individual properties examined within that framework.

A common belief among investors is that cap rates in Gateway markets cannot compress any further. However, it cap rates are at all-time lows, as seen in Figure 6.

Valuations

Across the board, commercial real estate values grew exponentially from 2004 to their peak in 2007. Forensically, it is clear that this was fueled mainly by the debt capital markets and the increasingly acceptable application of leverage, as traditional whole loans were repackaged as CMBS and CDOs, driving asset pricing to levels untethered from underlying intrinsic value. While caused by different underlying drivers, the distortion we are currently seeing in the Gateway markets is strikingly similar. Across all major asset classes in Gateway markets the data show valuations have meaningfully surpassed previous peak-levels, and related
is important to note that the impact of an increasing cap rate is not linear—recall that asset value is equal to NOI divided by the cap rate—so the lower the initial starting cap rate, the greater the impact on value. For example, as shown in Figure 6, during the GFC cap rates in Gateway markets increased from 5.9% to 7.2%, representing an overall loss of 18% in asset value holding NOI constant. Non-Gateway markets experienced an increase from 7.1% to 8.1% which represented a loss of 12% in value holding NOI constant. Another important factor to consider in Figure 6 is the current cap rate spread between Gateway and Non-Gateway markets, which is at 165 bps as of Q1 2016, 41% above its 10-year average of 117 bps. Overall, values at current levels lead us to believe that while traditionally considered “safe”, many Gateway markets potentially face the most near-term risk. On the other hand, we see attractive risk-adjusted return potential in certain high-demand, low-supply major markets as a viable alternative for marginal investment at this point in the cycle.

Conclusion

In spite of the traditional association between Gateway markets and safety, our thesis is that Gateway markets are experiencing unsustainable conditions, increasing the probability of a correction, while certain major markets are exhibiting more defensive characteristics and more attractive risk-adjusted returns.

We believe that investors would be remiss to overlook opportunities available in major markets that display the following characteristics: real employment growth, pricing below replacement cost, and a limited supply pipeline. Investors seeking core-like investments that provide cash flow and asset appreciation do not need to look to inferior assets—they just have to look beyond the Gateway to find their opportunity.

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Mr. Burkhardt serves as a Senior Vice President in the Acquisition Group of CenterSquare Investment Management. He is responsible for the sourcing, underwriting and closing of acquisitions in the eastern region of the United States. Prior to joining CenterSquare, he served as a Director of Blackpoint Partners, where he led evaluation, underwriting, and execution of prospective acquisitions. Previously, Mr. Burkhardt was a Vice President at D.E. Shaw & Co., a multi-strategy hedge fund based in New York. Mr. Burkhardt oversaw commercial real estate acquisitions, which included the purchase of senior and subordinate debt positions, as well as CMBS and REIT bonds. In addition, he was responsible for portfolio management and the disposition of select real estate assets. Prior to D.E. Shaw, Mr. Burkhardt worked at Merrill Lynch & Co. as a Vice President in Global Principal Investments, the group responsible for investing the firm’s balance sheet in commercial real estate debt and equity, with a focus on the Americas. Mr. Burkhardt graduated from Cornell University with a B.S. in Hotel Administration with a concentration in Real Estate Finance and Management. Mr. Burkhardt is a member of the Commercial Mortgage Securities Association and on the board of directors of NYPEN Real Estate. He serves as a member of the Investment Committee for CenterSquare’s Private Real Estate Group.

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