Beyond Core Markets

INVESTORS SEEK HIGHER YIELDS IN NON-CORE MARKETS

As the commercial real estate sector continues to recover from the "Great Recession," investors across the nation are ramping up their acquisition and development activity. While core, coastal markets such as New York, Washington, D.C., Southern California and San Francisco continue to be the most desirable locales for most larger, institutional investors, non-core and alternative markets are increasingly attractive. These alternative markets offer an attractive option to core markets, particularly for entrepreneurial and non-institutional investors.

"Smart money is looking at alternative markets due to better returns, higher upside and less competition," says Fred Schmidt, president & COO of Coldwell Banker Commercial Affiliates. "Secondary and tertiary markets allow investors to achieve a higher yield, along with diversification of assets and geography. They offer an opportunity to generate real wealth and returns."

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> **FRED SCHMIDT, PRESIDENT & COO OF COLDWELL BANKER COMMERCIAL AFFILIATES**

A recent survey conducted exclusively for National Real Estate Investor (NREI), Retail Traffic and Coldwell Banker Commercial found that 44% of respondents expect to make additional investments in non-core markets in 2011; 41% of respondents say these markets offer the best development opportunities today.

"Everyone wants to invest in major markets, but as cap rates are driven down, investors are willing to accept more risk and move into secondary and tertiary markets," says H. Michael Schwartz, CEO of Strategic Storage Trust Inc., the first and only public, non-traded REIT that specializes in the self-storage industry. Today, SSTI's portfolio includes approximately 48,000 self-storage units, 6 million rentable square feet of storage space and 76 properties located in 17 states and Canada.

Key Findings

- A recent survey conducted exclusively for National Real Estate Investor (NREI), Retail Traffic and Coldwell Banker Commercial® found that 44% of respondents expect to make additional investments in non-core markets in 2011; also, 41% of respondents say those markets offer the best development opportunities today.
- Owners expect to continue to invest in their properties in secondary and tertiary markets. In fact, nearly half of respondents plan to upgrade their properties. Meanwhile, 40% plan to increase rents in 2011.
- 46% of respondents say the vacancy rate for their smaller market portfolio is less than 10%. Nearly four out of 10 respondents expect the vacancy rate to decrease somewhat or greatly in 2011. Another 40% say the vacancy rate will stay the same; 45% of respondents expect rents to increase in 2011.
- Respondents have seen average cap rates of 8% to 12.5% in non-core markets.
- Strength of economy and availability of financing were the two most important factors when considering an investment in a secondary and tertiary market.

SURVEY METHODOLOGY

Between May 12 and June 5, 2011, NREI and RT surveyed commercial real estate owner, manager and developer subscribers using an email invitation containing a link to the online questionnaire. The findings presented in this report are based on the 194 qualified responses that were received.

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The NREI/Retail Traffic/Coldwell Banker Commercial survey collected data from 194 developers, owners and managers from May 12 to June 6, 2011. Respondents own and/or manage an average 1.4 million square feet of commercial real estate in secondary and tertiary markets.

Additional key findings:

Investment:

- Owners expect to continue to invest in their properties in secondary and tertiary markets. In fact, nearly half of respondents plan to upgrade their properties. Meanwhile, 40% plan to increase rents in 2011.

Vacancy:

- 46% of respondents say the vacancy rate for their smaller market portfolio is less than 10%.
- Nearly four out of 10 respondents expect the vacancy rate to decrease somewhat or greatly in 2011.
- Another 40% say the vacancy rate will stay the same.
- 45% of respondents expect rents to increase in 2011.

Returns:

- Strength of economy and availability of financing were the two most important factors when considering an investment in a secondary and tertiary market.

REWARDED FOR RISK

During the most recent market boom, the risk premium for assets in secondary and tertiary markets eroded as competition for real estate intensified. The yield spread between properties in core markets such as Washington, D.C., and smaller, non-core markets such as Minneapolis narrowed to the point where it was almost non-existent.

Simply put, investors were not being rewarded for risk, explains Robert Dietrich, managing director in FMV Opinions' real estate valuation services division. Throughout market ups and downs, those risks have not changed – concerns about exit strategy and worries that smaller markets are more vulnerable to shifts in demand and supply because markets are not as deep as larger, core markets.

Since the financial crisis and the onset of the recession, however, investors have eschewed risk and focused predominantly on the best properties in the best markets. This "flight to quality" has limited the interest in secondary and tertiary markets. Yet, investor appetite for risk – or perhaps acceptance is a more accurate description – is slowly returning as property valuations stabilize.

"We're back to a more normalized market where investors are compensated for risk," Dietrich says. "As a result, we're seeing investors being less cautious and looking at properties and markets they wouldn't have looked at last year."

Yet, secondary and tertiary markets often are overlooked or misunderstood, especially by larger, institutional investors. "In general, people think that larger markets are deeper – that they have greater demand to capture, but they're missing out," says Dan Bernstein, chief investment officer and executive vice president at Campus Apartments, the largest privately held student housing company in the United States.

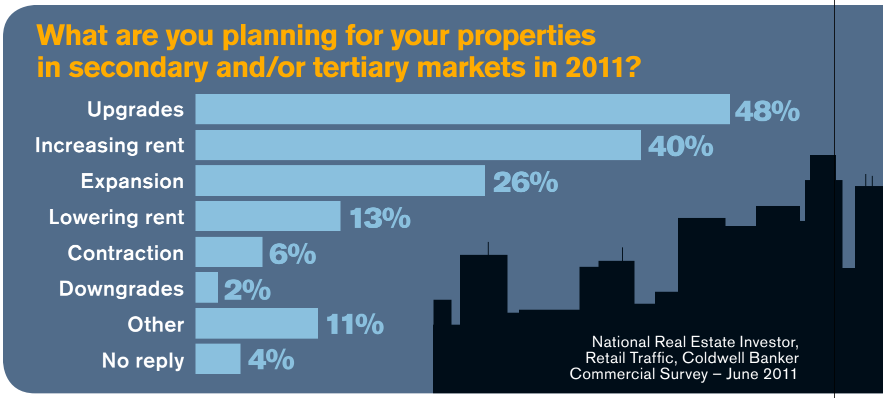
Mark Stapp, a real estate developer and executive director of the Master of Real Estate Development program at the W.P. Carey School of Business at Arizona State University, says perception often plays a greater role than reality when it comes to investing in smaller markets. "They haven't studied the markets enough to know the real risk, so it's easier to say 'no,'" he explains. "Sometimes the reasons why an investor won't look at a particular place have nothing to do with market fundamentals."

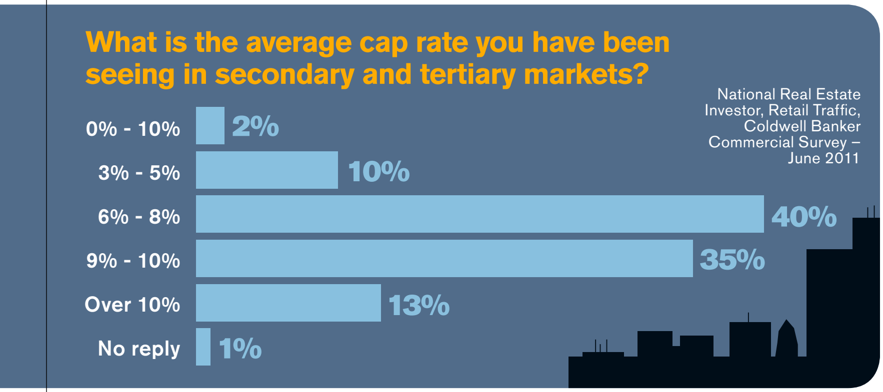
VIBRANT MICRO-ECONOMIES

In fact, many smaller markets not only have vibrant, growing economies, but population growth as well. An annual ranking of the top economic growth markets in the United States conducted by POLICOM found that only one of the top 10 markets was considered "core" or "primary" markets for most commercial real estate investors: Washington, D.C.

The Palm City, Fla.-based economic consulting firm measures 23 economic factors over a 20-year period to identify the top performing markets in the nation. "The rankings do not reflect the latest 'hotspot' or boom town, but the areas that have the best economic foundation," says William Fruth, president of POLICOM. "While most communities have slowed or declined during this recession, the strongest areas have been able to weather the storm."

"The cities that have no economic drivers – where industries have departed – it's very difficult to think about why one should invest in them," says Alan Feldman, CEO





at Philadelphia-based Resource Real Estate, which manages roughly $1.5 billion in assets. "But smaller towns that have something to offer – sustainable industries and growing regional economies – those can offer outsized returns because fewer people are interested in investing in them."

Consider Shreveport, La. – a tertiary market by anyone's measure with a population of 398,694, according to the 2010 U.S. Census. This southern city currently is enjoying an economic boom, driven primarily by the natural gas sector. It is experiencing in-migration as people seek jobs created by the Haynesville Shale, one of the largest natural gas deposits on the planet.

Admittedly, Shreveport is not a market that most investors seek out. Given the opportunity and knowledge of the market, however, smart investors jump at the chance to invest there.

For example, earlier this year, Inland Diversified Real Estate Trust Inc. invested $43.5 million in the market to acquire Regal Court Shopping Centre, a 363,167-square-foot power center anchored by Kohl's, J.C. Penney and Dicks Sporting Goods. The Oak Brook, Ill.-based REIT expects to realize an 8.1% cap rate on the property.

Likewise, Raleigh-Durham, N.C., has seen its star rise, according to Billie Redmond, president of locally-based Coldwell Banker Commercial Trademark Properties. She points to the recent trend in which sizeable organizations are choosing to move from large metropolitan markets to smaller cities.

"Because of our region's affordability and projected growth, we've seen a number of large national institutions and industries transfer from their existing metro locations to our market," Redmond adds. "We have even seen financial service companies relocate to Raleigh-Durham from Manhattan."

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> **DAN BERNSTEIN, CHIEF INVESTMENT OFFICER AND EXECUTIVE VICE PRESIDENT AT CAMPUS APARTMENTS**

"With corporate clients, we've noticed that many of them willingly bypass larger markets in favor of secondary or tertiary markets when it comes to setting up back-office, call center or data operations," according to Vik Bangia, a senior vice president with Realogy's Global Client Solutions group. "Many smaller cities are willing to provide significant financial and tax incentives that aren't available in major markets."

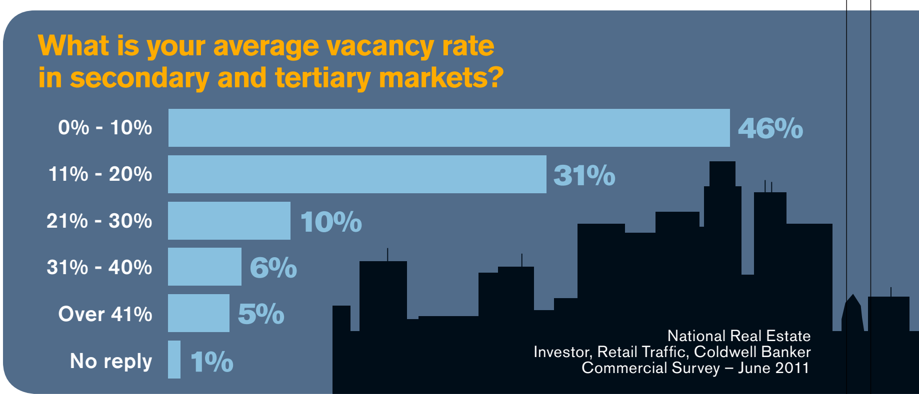
CHASING YIELD

Investors interested in secondary and tertiary markets are chasing yield and focused on markets with strong economic drivers and dominant properties in the market.

"Part of the beauty of investing in secondary and tertiary markets is that there's less of a herd mentality," Bernstein says. "People flood larger markets and suddenly there's greater competition – prices are driven up and cap rates are driven down."

Bernstein recalls a recent opportunity to acquire a student housing asset in New York City. The property was priced to trade at a 2% cap rate. "I'd rather make additional investments in the markets in which we've seen higher yields – markets like Lancaster, Pa., or Richmond, Va., where we have a 23-building portfolio – than invest in a core market and get a 2% return," he says.

Better yields are one of the reasons why Phoenix-based Cole Real Estate Investments is open to investing in smaller markets, according to Scott Holmes, vice president of acquisitions and team leader for multi-tenant retail acquisitions. He notes that secondary and tertiary markets can provide yields premiums – anywhere from 50 to 150 basis points higher than primary markets.



Capital Flows to Smaller Markets

Availability of capital is a key determining factor when it comes to investing in secondary and tertiary markets, according to a survey conducted exclusively for National Real Estate Investor (NREI), Retail Traffic and Coldwell Banker Commercial.

And, after a long dry spell, it seems that financing is finally available for investors who are making bets on smaller markets. Both local and regional banks are lending again, albeit sparingly, and as pension funds and life insurance company lenders focus on core and primary markets, conduit lenders have been forced to head to smaller markets to meet their origination objectives.

For example, Stonegate Real Estate Investments LLC refinanced two trophy office properties, one in Birmingham, Ala., and one in Oklahoma City, for a total of $70 million. Wells Fargo provided two 10-year, fixed-rate mortgages for the four-building Urban Center in Birmingham and Quail Springs Parkway Plaza in Oklahoma City.

Similarly, Parmenter Realty Partners was able to obtain two CMBS loans totaling $85 million for its two Class A office buildings, Warren Place I & II. JP Morgan Chase originated the loans for the properties, which total 959,928 square feet.

"Most secondary and tertiary markets tend to avoid overbuilding during development cycles, and one could argue that, because they lack the volatility often seen in markets that investors really like, they actually are less risky," says Norm Nichols, executive vice president and manager of income property finance for KeyBank Real Estate Capital, the segment of the bank's business that is focused on private commercial real estate owners, investors and developers.

The non-traded REIT recently invested nearly $33 million in the tertiary markets of San Marcos, Texas, a college town located about 45 minutes south of Austin, and Bismarck, N.D., which has a population of 108,779, according to the 2010 U.S. Census.

In San Marcos, Cole acquired Red Oak Village, a 176,000-square-foot, 96% leased power center for about $22 million. In Bismarck, it bought Pinehurst Square West, a 69,000-square-foot power center that is shadow anchored by Lowe's and Kohl's, for $10.25 million.

Moreover, rental rate growth in secondary and tertiary markets still can be rewarding to owners, albeit not as extreme or volatile as core or coastal markets. For example, Parmenter Realty Partners COO Andrew Weiss says its trophy office buildings, known as Warren Place I & II in Tulsa, Okla., performed well throughout the recession: occupancy has stayed well above 90% and rents continue to increase.

Tulsa, with a population of 391,906, has a diversified economy that continues to create jobs, Weiss says. As of May 2011, the unemployment rate in that market was just 5.8%, roughly 3.5% lower than the national unemployment rate, according to the U.S. Bureau of Labor Statistics.

Tulsa's strong economy has compelled Encore Multi-Family LLC to enter the market. The Dallas-based apartment developer has broken ground on a new project in Bixby, one of Tulsa's suburbs.

"When we look at a market like Bixby, which is the fastest growing city in Oklahoma, we don't think it's a risky market, even if it isn't a core market," explains Brad Miller, president of Encore Multi-Family, which has projects under development in other secondary and tertiary markets throughout Texas, including Texarkana and Temple, for a total of more than $33 million in project costs.

Likewise, in El Paso, Texas, demand for apartments has outstripped supply as the city absorbs thousands of new residents from the expansion of Fort Bliss. The army base has benefitted from the Base Realignment and Closure (BRAC) program – its population has increased from 17,000 troops to 24,000, with 40,000 troops expected by 2013. An additional 36,800 family members are arriving – more than 15,800 of whom are working-age spouses.

El Paso's apartment market occupancy is hovering at 98%, setting the stage for rent growth. In fact, a recent report by MPF Research calculated that the nation's strongest rent growth during the past year has occurred in El Paso.

Resource Realty hasn't overlooked the opportunities El Paso offers, Feldman says. "We've made a lot of investments in El Paso because we like smaller markets that have good economic drivers like Fort Bliss," he explains. "Sometimes bigger isn't necessarily better."