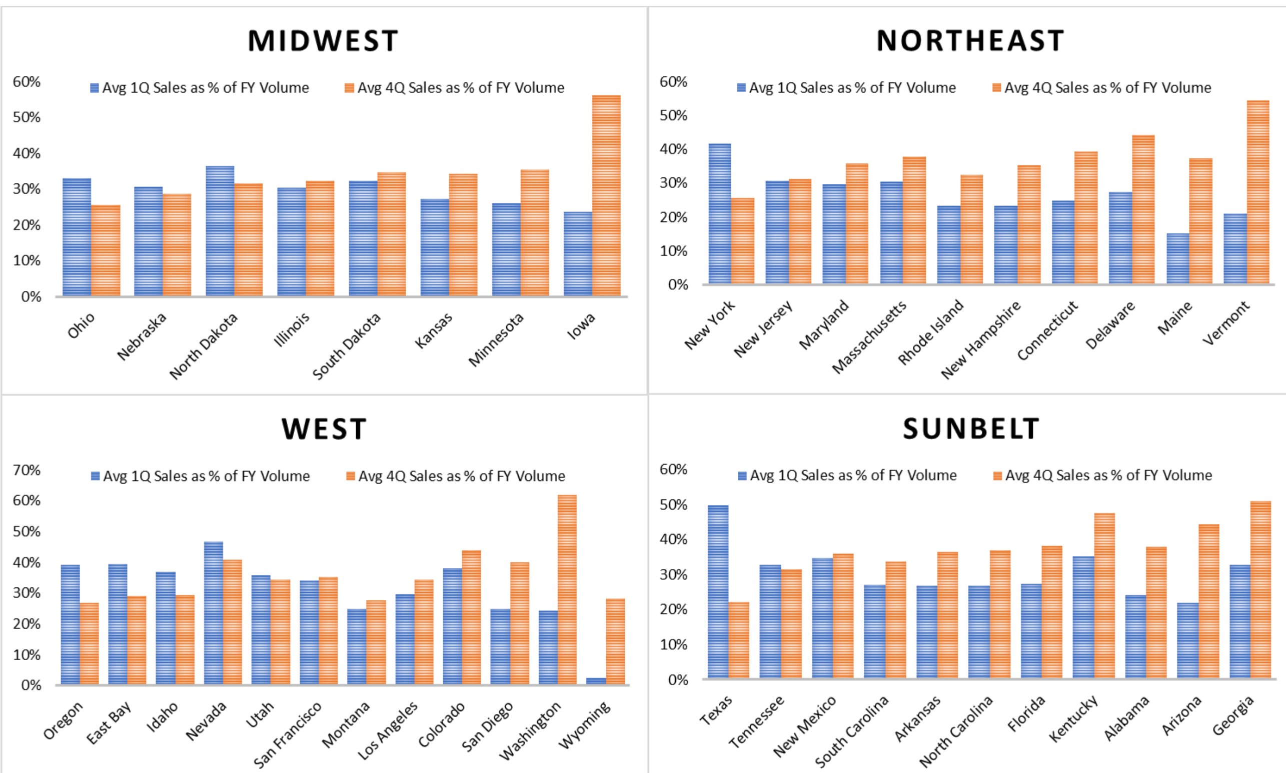
INVESTORS ARE SHIFTING TO SMALLER MARKETS

Which Markets Are Benefitting from the Relocations?

While the COVID-19 pandemic continues to suppress short-term sentiment, the Consumer Confidence Index rose for the third straight month in March as people expect jobs and businesses to improve. Low interest rates and little recessionary impact on high-income earners kept home sales robust in 2020. Nine million people have relocated since the beginning of the pandemic (per NAR). Will the relocations be short-term or long-term? How will residential relocations resulting from new work-from-anywhere flexibility impact commercial real estate assets?

To understand how relocations are influencing commercial development, we compared Q1 sales activity before the impact of the outbreak with the average of the remaining three quarters in 2020. We found that investors are following the migration patterns. While big cities still hold the top spots for total commercial real estate volume, reflecting the high value assets in those markets, investors shifted new money into smaller markets throughout New England, the Mountain and Sunbelt states.

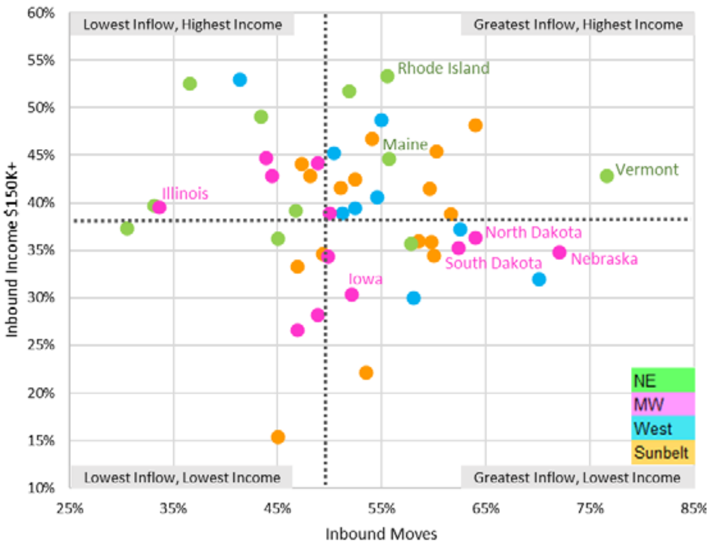
Exhibit 1. Shift in 2020 Commercial Real Estate Sales Volume by Region



Source: CBC Research, Costar data (includes Multifamily, Retail, Industrial, Office, Land).

How is migration making markets more desirable for investors? Smaller markets that are attracting new residents are generally more affordable and spacious with the least disruption from the lockdowns. While the pandemic will eventually end, the trends it accelerated likely won't as the flexibility of remote working has led many people to move wherever they want. As a result, less expensive markets are seeing sharp increases in housing demand and, as anticipated, commercial real estate assets that have occupiers servicing the expanded population are also benefitting. Vacancy rates are at record-lows across much of the South and in metros that border the biggest cities. Apartment rents are up significantly year-over-year in places like Durham, NC; Nashville, TN; Scottsdale, AZ; Lincoln, NE; Madison, WI; Billings, MT; Cheyenne, WY; Boise, ID; and Portland, ME (according to Apartment Guide). At the same time rents have fallen more than 10% in high-density cities like New York, San Francisco, Los Angeles, Boston, Chicago and Dallas-Fort Worth.

Exhibit 2. Inbound Migration and Income Trends in 2020 by Region



Source: United Van Lines data, CBC Research

Investment shifts. After a 60% drop in second and third quarter multifamily property sales, investors returned with a vengeance in Q4. Year-end deals were driven by pent-up demand in a few big Sunbelt markets, including several $125M+ luxury high-rises in Fort Lauderdale and West Palm Beach; workforce housing and single-family build-to-rent communities in fast-growing Arizona suburbs; and $100M luxury complexes in downtown Durham and Charlotte. While cap rates in the Sunbelt have compressed slightly to just below the national average, they still offer higher yields than many coastal markets.

For suburbs across the Midwest and Mountain states, investors favored rentals in the form of townhouses, stacked flats, and garden apartments with courtyards, including $29M for a 200-unit Central Pointe property in Boise, Idaho; $17M for a 192-unit Cambridge Court community in West Des Moines; and $26M for 120 garden units and a luxury clubhouse in Bozeman, Montana. Despite the investment in these markets, cap rates still sit 50-100 bps above the national average, presenting further opportunities.

Despite record growth in Montana's multifamily market in 2020, we believe it will continue to attract interest from out-of-state buyers in 2021 as the trend of renters staying in their rentals and high-income earners leaving pricey coastal cities to work remotely continues.

Strong rent growth and an appealing lifestyle has set Idaho up for sales growth in 2021. Even with increasing supply, vacancy rates should stay low as inbound migration continues and few buyers are able to quality for a single-family home at any one time.

Businesses are also migrating. While the impact of the pandemic varied widely across property types, markets that are seeing a housing boom are also attracting new businesses with lower office and retail rents. Together, these different segments have been reviving local economies. While some sectors were hard-hit, like office and restaurants, essential businesses and those that support the digital economy fared very well.

Industrial assets stayed strong throughout 2020 as $70 billion worth of properties changed hands. This was the only sector to post a full recovery in Q4 from the mid-year drop, driven by a surge of build-to-suit projects and corporate expansions.

To meet increased demand for storage space created by the online boom, companies like Amazon, Google, Facebook and Apple have been adding new data storage buildings around the country, especially in

Virginia, South Carolina, Iowa, Missouri, Nevada and Ohio (according to company press releases).

Tech is not the only driver. A variety of retailers, including home improvement stores, discounters and food manufacturers, are investing heavily in logistics and distribution to meet expectations for immediate delivery of online orders. Though states with smaller metros like Kansas, Montana, Maine, and New Hampshire are not major distribution hubs, a rapidly growing consumer base and high occupancy rates in these markets have brought on a surge of investments in 2020 with deals like PepsiCo's 1M SF distribution center at Logistics Park in Kansas City; Amazon's 2M SF warehouse at the Hudson Logistics Center in New Hampshire; and Brockway-Smith's $13M warehouse purchase in Portland, Maine to expand operations.

After pulling back at the onset of the pandemic, investors returned to the life science and logistics hubs of L.A., Boston, New Jersey and Chicago in Q4, setting record quarterly sales. Notable deals include the 550K SF Van Nuys Airport Industrial Center in L.A.; a fully leased 2M SF Class A complex in Phillipsburg, NJ; Alexandria Real Estate's $169M purchase of several acres on E Street in South Boston; and a $74M business park near O'Hare International Airport.

"To keep up with strong population growth in the smaller markets, local developers have been scooping up land with industrial, recreational and residential users in mind."

- CBC professionals across the country

While cap rates in gateway cities are among the lowest for industrial properties, they may compress further as more investors deploy capital in 2021.

Retail is not dead. While many large retail metros had big volume drops in 2020, such as New York City, Miami and Dallas-Fort Worth, the year also saw a steady string of expansion announcements from big-name tenants like Amazon, Dollar General, Ross Stores, Ikea, FedEx and Bank of America as they look to capitalize on lower lease rates and cheaper land values being offered in smaller markets.

"Interest in grocery-anchored and open-air shopping centers increased significantly for both developers and tenants." - CBC Atlantic

Major brands like Chipotle, Chick-fil-A and Starbucks have shifted their business strategies to open more drive-thrus. Retail giants and banks are following consumers to lower-cost metros. Coldwell Banker Commercial professionals in secondary and tertiary markets are seeing private investors not only purchasing homes to live in, but also starting and buying businesses at the same rate.

Retail property investors followed the new concentrations of high-income earners and job growth spurred by corporate relocations to the South, pushing Q4 retail property sales back up to pre-pandemic levels in the Carolinas, Tennessee, Alabama and Florida. Notable deals include a $90M mixed-used Metropolitan Midtown complex in Charlotte; $141M for The Avenue Murfreesboro open-air shopping center outside of Nashville; and $47M for the 60K SF Whole Foods-anchored retail space in Coral Gables.

Investment activity returned to the West Coast in Q4 as people relocated to Los Angeles, San Francisco and Oregon for work. Expect these trends to continue in 2021.

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Office property is the hardest-hit sector in our study. A strong Q1 was followed by a 57% drop in the last three quarters of 2020 as tenants sat on the sidelines evaluating how to return to the office, which brought into question the future of rental income streams for property owners. Most major metros saw steep cuts in sales volume after the stay-at-home orders went into effect, with average quarterly sales in Dallas-Fort Worth down 80% from its Q1 volume, New York City down 73%, San Francisco down 53% and Boston down 42%. Office vacancy rates in 2021 are still well above year-ago levels, with San Francisco +560bps; NYC +275bps; Boston +235bps; and Dallas-Fort Worth +225bps.

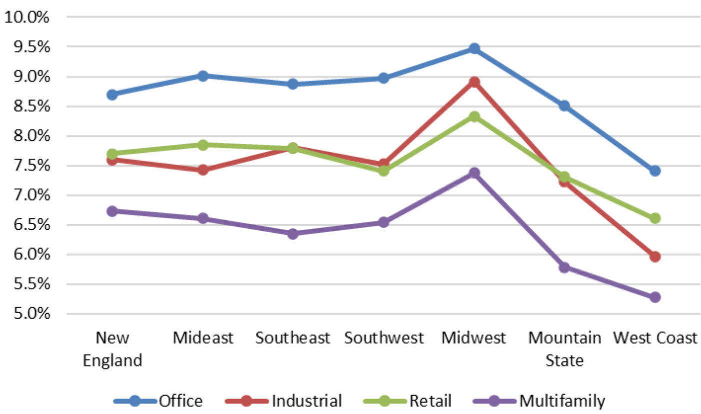
Investors strategically shifted capital to the markets seeing significant population and job growth as well as steady occupancy rates. Majority of deals in tertiary markets (like Maine, Vermont, Montana, North Dakota, Wyoming) consisted of 3,000-10,000 SF single-story flex buildings and mixed-use offices purchased by medical professionals, credit unions and local restaurants.

Secondary markets (like South Carolina, Arizona, Arkansas, Florida) saw a majority deal flow of medical office and high-quality single tenant buildings. Notable deals include a $35M purchase of a Class A headquarter building leased to RoundPoint Mortgage in Fort Mill, SC; Arkansas Urology's $32M sale-leaseback of three medical office buildings in Little Rock; and $24M sale of OrthoArizona surgery center in Phoenix.

Life science and biotech companies were key drivers in bringing markets like Boston, San Diego, Los Angeles and Tennessee back to life in Q4. As vaccinations widen and restrictions loosen more broadly, we expect New Jersey, Connecticut and Florida to benefit from the urban exodus as they gained over 75% of the people who left New York (according to NAR). Continued momentum in early 2021 suggests that buyers believe companies will return in some form to centralized offices over the next year.

Conclusion. Significant movement out of the country's biggest cities last year fueled an increase in demand for land, housing, jobs, goods & services, and leisure in secondary markets much earlier than naturally would have occurred. This in turn has caused investors to look to the smaller markets for investment returns. Despite a robust December, we expect cap rates to compress further as more investors come back to the market in 2021.

Exhibit 3. Cap Rates in 2021 By Region



Source: CBC Research, CoStar data

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