

Can you still call secondary markets secondary?

Investors target secondary cities as primary real estate investment locations

Recently, **Chase McWhorter**, Institutional Real Estate, Inc.'s managing director, Americas, spoke with **Jim Raisides**, managing partner of TA Realty, about the demographic shift from primary markets to secondary cities, and what that means for institutional investors. Following is an excerpt of that conversation.

How would you describe the investment opportunity in secondary markets?

Secondary markets that are getting a push from investors reflect the new realities of where people want to live, work or shop. Factors influencing people to second-tier cities include lower cost of living, warmer climates, lower taxes and a better quality of life. These markets are midsized real estate markets. They are generally not as dense as large cities, but they still have all the amenities associated with the larger primary markets, and secondary markets often also offer business-friendly environments, fewer barriers to entry and more favorable tax structures. As a result, many of these markets have benefited from outsized job growth in the last decade. As more and more investors are focusing the majority of their capital on industrial and multifamily property types, this market cycle is going to open up the opportunity for investors to arbitrage geographic regions — basically high-growth secondary markets against low-growth primary markets.

What makes a secondary market a target for real estate investment?

Secondary markets have become targets for investment because they have seen job or population growth at an above-average rate, so there is a strong case for employers to expand or relocate to these midsized cities, as their talent pools are growing very quickly. In recent years, secondary Sun Belt markets, in particular, have benefited from population migration, while the coastal and northern markets have seen the opposite. Markets such as Austin, Nashville, Raleigh, Charlotte, Tampa, Denver and Phoenix are opportunities for real estate investors, as employers have followed that talent. Austin, for example, has attracted corporate relocations and expansion for large companies, such as Tesla, Apple, Oracle, Amazon and Facebook. Another example is Nashville, where AllianceBernstein announced it is going to move the company's headquarters from New York City, bringing more than 1,000 jobs to the area. We think this trend is in its early stages, and there is going to be an increase in higher-quality, better-paying

jobs in secondary markets. This activity will create new opportunity for real estate investment.

How has the pandemic shifted demographics and affected these smaller markets?

The pandemic accelerated the demographic shifts that were already under way. Even before the pandemic hit, people were leaving major metropolitan areas with high rent and high costs, such as San Francisco and New York City, in favor of some of the less dense areas. During the pandemic, a warmer climate and greater affordability in a lot of the suburban or secondary — or even tertiary markets — made these areas really attractive destinations, and that has contributed to the slowing population growth in some of the largest U.S. cities. COVID-19 job disruption and the Great Resignation have made this shift even easier. Employment growth and net migration were strong trends before COVID-19 hit for markets such as Austin, Nashville, Raleigh and Charlotte. Our forecast for growth in these markets continues to be higher than what we anticipate to see in major gateway markets, such as New York City, Chicago and San Francisco.

Has real estate investment increased in these markets? Has it changed as a result of the pandemic?

Yes, the second-tier markets are on the rise coming out of the pandemic. They are attracting more investment. Pre-pandemic investment volume was led by cities, such as Los Angeles and Manhattan, but during the first three quarters of the year, Dallas was at the top of the list and Atlanta was second, and now Phoenix ranks fifth in total deal volume. The important point here is that these markets are reaching a scale that helps to mitigate the volatility of investing in smaller markets. By attracting institutional investment, these smaller markets have increased liquidity, availability of debt and market stability. It is not just the growth that is making these markets attractive; rather, they are reaching a scale that allows for institutional investments. Liquidity is one of those key metrics.

COVID-19 prompted a bit of a shift when assessing market tiers, but the demographics still drive the demand for real estate. We are following markets where we see the major population- and employment-growth trends. The pandemic has caused headwinds in some of the larger urban areas that are less favorable right now, so we are focused on the growing secondary markets with relatively low cost of living

and favorable tax environments. We are targeting Sun Belt cities with strong population growth and job growth. That growth creates high demand in rent growth, which directly leads to higher returns. The key is that some of the pre-pandemic trends for these secondary markets are quickly accelerating with regard to the growth, while the same trends are slowing in the primary markets.

How do you evaluate the investment potential of each second-tier market?

We favor different secondary markets for a variety of reasons, considering metrics such as rent growth, occupancy, investment activity, availability of debt and being confident of a successful exit strategy. Each secondary market has its own unique set of real estate demand drivers. For example, Austin and Raleigh are growing technology hubs with very strong pipelines of talent, while Phoenix is growing significantly due to a lower cost of living relative to neighboring California.

What challenges do you see for investing in these fast-growing secondary markets?

Of course, we are keeping a close eye on development pipelines, as supply response can shift the demand balance quickly. Other factors we monitor amid this migration shift include the natural growing pains as these midsized cities expand. Adequate levels of infrastructure investments are required to keep up with the high level of growth and, in some of these secondary markets, proper city planning is

required. There are some socioeconomic implications to consider, as well, given that living costs are likely to rise in these markets amid the growth of higher-paying jobs. It becomes a challenge for a lot of these cities, as their success breeds some of the similar difficulties you may see in some of the more mainstream primary markets.

How far do you think the rise of secondary markets will go?

We believe the demographic demand accelerated by the pandemic for second-tier markets, particularly in the Sun Belt, will continue to fuel outperformance for these markets, and we do expect this trend to continue. As long as healthy market fundamentals remain in place, investors with exposure to these secondary markets are likely to continue to benefit from this long-term trend. Unless there is a reversal of growth in the secondary markets or a reacceleration of growth in the primaries in excess of what we are seeing in the secondary markets, the thesis for additional secondary-market exposure in investors' portfolios should hold for the foreseeable future.

There is a massive geographic arbitrage occurring as people shift away from high-tech, high-cost markets — the population is shifting from California to Austin, Dallas or Phoenix, or from New England and New Jersey to the Carolinas and Florida. Some of these second-tier cities have grown in population and liquidity to a point where investors start to ask: Is this truly a secondary city anymore?

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Jim Raisides is a managing partner of TA Realty and leads the firm's portfolio-management team. He is responsible for strategic management of the firm and oversees the achievement of the goals and objectives for its investment vehicles. During his nearly 30 years of industry experience, Raisides has served in a variety of roles that encompass portfolio management, dispositions, capital raising and asset management. He has been with TA Realty since 1996 and a member of the firm's Investment Committee since 2004. Raisides also serves on the firm's Management Committee and Acquisitions Committee, and sits on the Board of Managers.

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CORPORATE OVERVIEW

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