Market Commentary

Suburban Markets:
Hidden Gems or Fool's Gold?

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Only a few years ago, investors avoided suburban real estate assets in favor of those in urban locations. Today, the industry is trumpeting the merits of suburban assets. What caused this dramatic reversal in how suburban markets are viewed and is the current view valid? Are these markets hidden gems or fool's gold?

This analysis is focused on traditional suburban locations, not close-in urban locations or secondary business nodes. Submarkets such as Buckhead in Atlanta, Kendall Square and Cambridge in Boston, Cherry Creek in Denver and Santa Monica in Los Angeles among other submarkets were excluded from the suburban analysis. These submarkets, although technically suburban, replicate urban characteristics and typically do not track the growth patterns of the more traditional suburban submarkets which were developed after World War II.

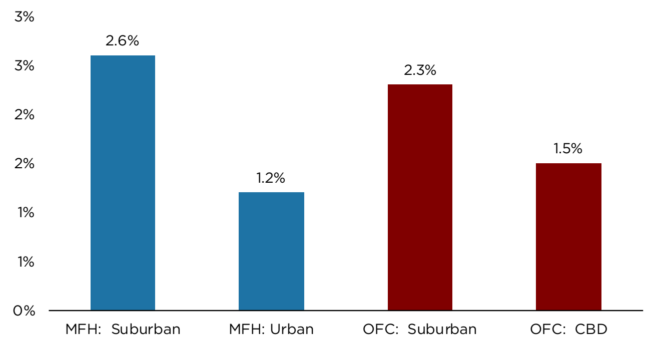
Argument 1: Property Fundamentals Are Compelling

Advocates for suburban investment believe that while urban locations currently face increasing supply headwinds and moderating rent growth, suburban assets are faring better offering stronger property fundamentals. But is this supported by the facts?

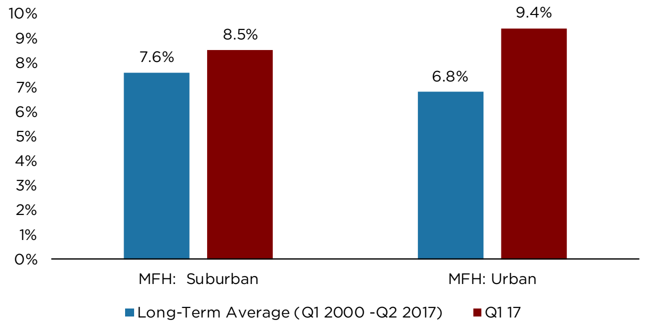
Current property fundamentals generally support this argument:

- both suburban multifamily and suburban office rent growth were greater in the second quarter than their urban counterparts
- suburban multifamily vacancy is less elevated relative to its long-term average than urban multifamily
- suburban office vacancy is below its long-term average while urban office vacancy is at its long-term average
- suburban multifamily and office rent growth is above its long-term average while their urban counterparts are below the long-term average.
- MFH suburban net completions are less than urban MFH net completions, but suburban OFC net completions are above urban OFC net completions.

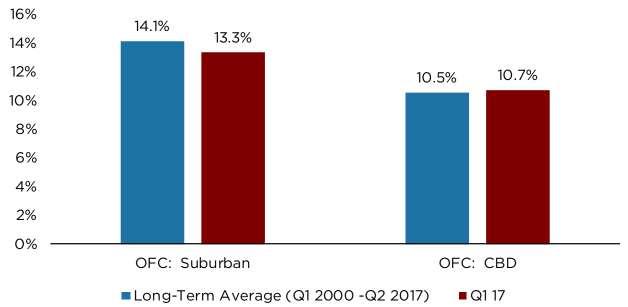
Year-Over-Year Rent Growth: 1Q17



Vacancy Rate - Multi-Family

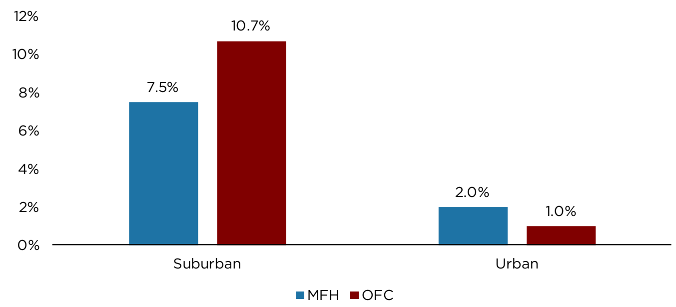


Vacancy Rate - Office



Source: CoStar

1 Year - Net Completion as a Percentage of Stock



Source: CoStar

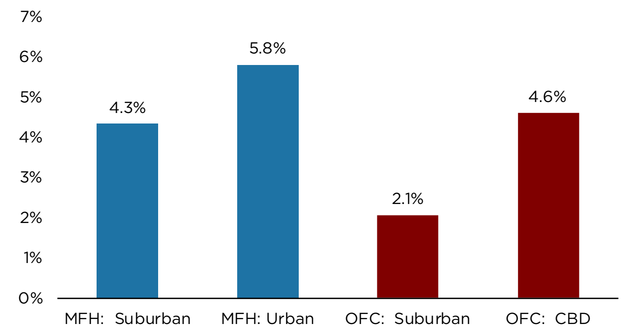
While this snapshot presents a more favorable picture of current suburban multifamily and office fundamentals, given the long-term nature of real estate investing a longer-term perspective also needs to be considered.

It is only recently that suburban office rent growth surpassed CBD rent growth, indicating that suburban office fundamentals have taken longer to recover, and should provide some guidance given the late stage of the current cycle. In addition, although multi-family rent growth in the suburbs is higher than urban rent growth, it is already decelerating and expected to see increasing supply. Conversely, urban supply is expected to plateau and then taper creating an eventual tailwind for future urban multifamily rent growth.

Second, while property fundamentals are generally more favorable in suburban markets today, will this remain the case over the long-term? Suburban office and multifamily rent growth have both materially lagged their urban counterparts over the long-term. Yet today investors seem to be assuming that today's more favorable suburban dynamics will continue in perpetuity. If property fundamentals were to continue to strengthen in suburban markets, at some point, similar to what happened in urban locations during the current cycle, suburban multifamily and office supply will increase, and as a result, also like urban locations, the rosy rent growth expectations investors may be using today as part of their basis for returning to the suburbs may not materialize.

If momentum investors are chasing short-term gains in suburban markets, that is understandable. However, the current suburban property fundamentals advantage is unlikely to last over the long-term. Additionally, suburban structural vacancy rates historically have been materially higher than their urban counterparts, which has resulted in greater negotiating power for urban landlords and stronger average NOI growth.

Average Annual NOI Growth Rate



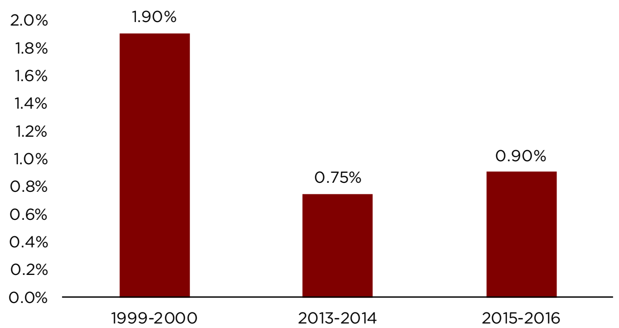
Source: NCREIF, 1Q00 - 1Q17

For suburban markets to outperform over the long term, there would need to be a significant increase in suburban supply constraints, unlikely given the lesser density levels combined with an increase in suburban demand.

Argument #2: Changing Millennial Migration Patterns

The second argument made for investing in suburban markets relates to where the Millennial generation is going. Are more millennials moving to the suburbs? Based on headlines one might think Millennials are moving from the city to the suburbs in droves. While this may be true on an absolute basis, the percentage in net migration among Millennials to the suburbs has declined dramatically. Net migration among Millennials to the suburbs has been cut in half.

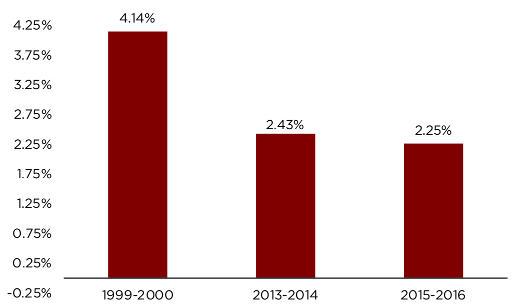
Net Migration City to Suburbs



Source: U.S. Census Bureau

Some might point to the slight uptick in the net migration from the city to the suburbs that occurred during the 2015/2016 period as a sign that Millennials are abandoning their urban environments, but that is not the case. As the graph below shows, as recently as the 2015/2016 period, the rate of migration from the city to the suburbs decreased slightly. It seems that urban based Millennials continue to delay the move from Gotham to Mayberry relative to their predecessors.

Millennial Migration: Urban to Suburban



Source: U.S. Census Bureau

While at some point, we expect urban-based Millennials to seek suburban locations, when they do, we project they will favor suburbs more proximate to the downtown cores than their parents did. This has significant implications for the office sector -- whereas Baby Boomers moved to distant suburbs in search of McMansions increasing demand for suburban office buildings, Millennials may prioritize a more manageable commute and proximity to the more vibrant and stimulating downtown environment.

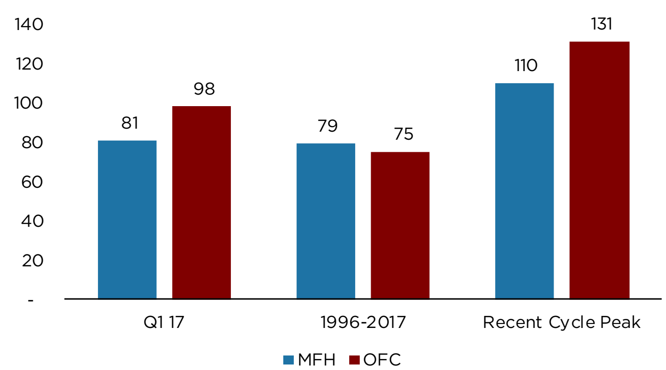
The property sector that is expected to be the most at risk in the event of increasing Millennial migration to suburban locations is the multifamily housing sector, and markets with greater housing affordability levels will likely feel the greatest impact. Millennials in these markets will have a greater ability to move from renting to homeownership, enabling them to move to the suburbs at a greater rate impacting multifamily housing demand in those markets.

Argument #3: Higher Yields

Given expectations of moderating appreciation, it is not surprising that investors would pursue higher yields currently available in suburban assets. However, is now the time to be taking on the risk accompanying those yield advantages? Suburban office rent growth has only recently overtaken the rate of urban rent growth and we are now later in the current recovery. Multifamily rent growth is decelerating, structural vacancy rates are higher, and NOI growth is weaker in suburban markets. Additionally, suburban multifamily and office returns historically have lagged their urban counterpart's average annual returns. We question whether investors are being adequately compensated for these factors, especially at this point in the recovery.

Currently, the spread between suburban and urban multifamily asset cap rates is 81 basis points, in line with the long-term median - there is no yield advantage versus historical norms. While the spread between suburban and urban office assets is somewhat elevated above the long-term average, the spread is now well below what was the current cycle's peak spread indicating that the best time for capturing disproportionate yield spreads in suburban office assets has passed.

Suburban to Urban Cap Rates (Bps)

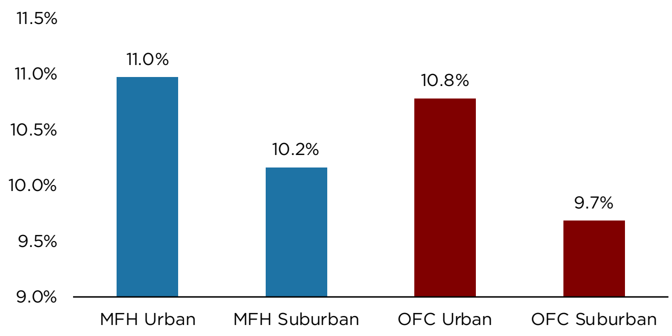


Source: NCREIF

Are today's spreads enough for investors to take the risk of late cycle investments in suburban multifamily and office assets? For that we turn to historical returns.

Over the 1996-2016 timeframe, suburban asset returns have materially underperformed urban asset returns in both the multifamily housing[1] and office sectors by 80 and 110 basis points, respectively.

Returns: 1996-2017



Source: NCREIF

Based on the late point in the current recovery, middle of the road yield spreads and historical underperformance of suburban multifamily and office assets, for investors with a long-term time horizon, we believe the current yield spread is insufficient to make a compelling case for a wholesale increase in suburban acquisition activity at this time.

Conclusion: A Question of Balance and Timing

Given the current buzz surrounding suburban markets and pricing in suburban markets it would be a stretch at this point to call assets in these markets "hidden gems". It would also be a mistake to broadly classify them as fool's gold. Like many things in life, this is not "either/or" but rather finding the right balance of suburban and urban assets for the long term. Given current yield differentials, historic underperformance and where we are in the cycle, we believe in many cases the risks associated with making a significant shift into traditional suburban markets outweigh the potential benefits and will remain the case absent select opportunities where we see exceptional pricing and sustainable property fundamentals.

[1] The Garden multi-family housing designation in NCREIF was used as a proxy for suburban MFH returns while the Mid and High Rise designations in NCREIF were used as proxies for urban MFH returns.

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