

## CAPITAL MARKETS

Plenty of Daylight Left in the  
Secondary Sunbelt Markets

October 20, 2017

## Office-Using Jobs and Net Migration Point to Continued Strength

### Key Takeaways

- Secondary Sunbelt office markets are priced to offer attractive, risk-adjusted returns relative to the Gateway<sup>2</sup> markets.
- Strong net migration and office-using employment growth will drive net absorption over the next two years in these markets.
- Rent growth has already accelerated in many markets and will continue to outperform as the construction pipeline remains muted.
- While investor interest has begun to shift towards these markets, turnover rates in this cycle suggest opportunities remain, particularly in suburban locations.

### Growing Investor Interest Supported by Strong Real Estate Fundamentals

Secondary Sunbelt markets have been absorbing space at a rapid rate—3.3% percent of average inventory over the last eight quarters compared to 1.7% in the Gateway markets. As a result, secondary Sunbelt vacancy has fallen while vacancy in the six Gateway markets has risen 72 basis points (BP) since bottoming out in December 2015. In fact, the spread between Gateway and secondary Sunbelt market vacancies has shrunk to 240 BP—the lowest level seen this century.

Despite converging vacancies, rent spreads between Gateway and secondary Sunbelt markets remain near record highs at \$21.90 per square foot (psf), well above the long-term average of \$15.94 psf. Rent spreads have begun to narrow, however, as rent growth in the secondary Sunbelt markets is now outpacing the Gateways. In the secondary Sunbelt markets, the fastest rent growth occurred in Nashville (9.9%), Austin (8.7%), Baltimore (8.3%), Miami (6.5%), and Phoenix (5.8%).

Reflecting these strong fundamentals, capital is shifting to secondary markets. Gateway market office volumes peaked in 2015 and are now declining, while secondary Sunbelt office market volumes continue to rise.

## Sunbelt vs. Gateway: Real Estate Fundamentals

	Secondary Sunbelt Markets	Gateway Markets
Vacancy	14.2%	11.8%
Volumes (H1 '17, YoY)	21%	-24%
Rent Growth (Q2 '17, YoY)	4.5%	3.2% (1.8% excluding Los Angeles)

### Forecast Net Migration and Office-Using Jobs Strong Indicator of Continued Strong Absorption

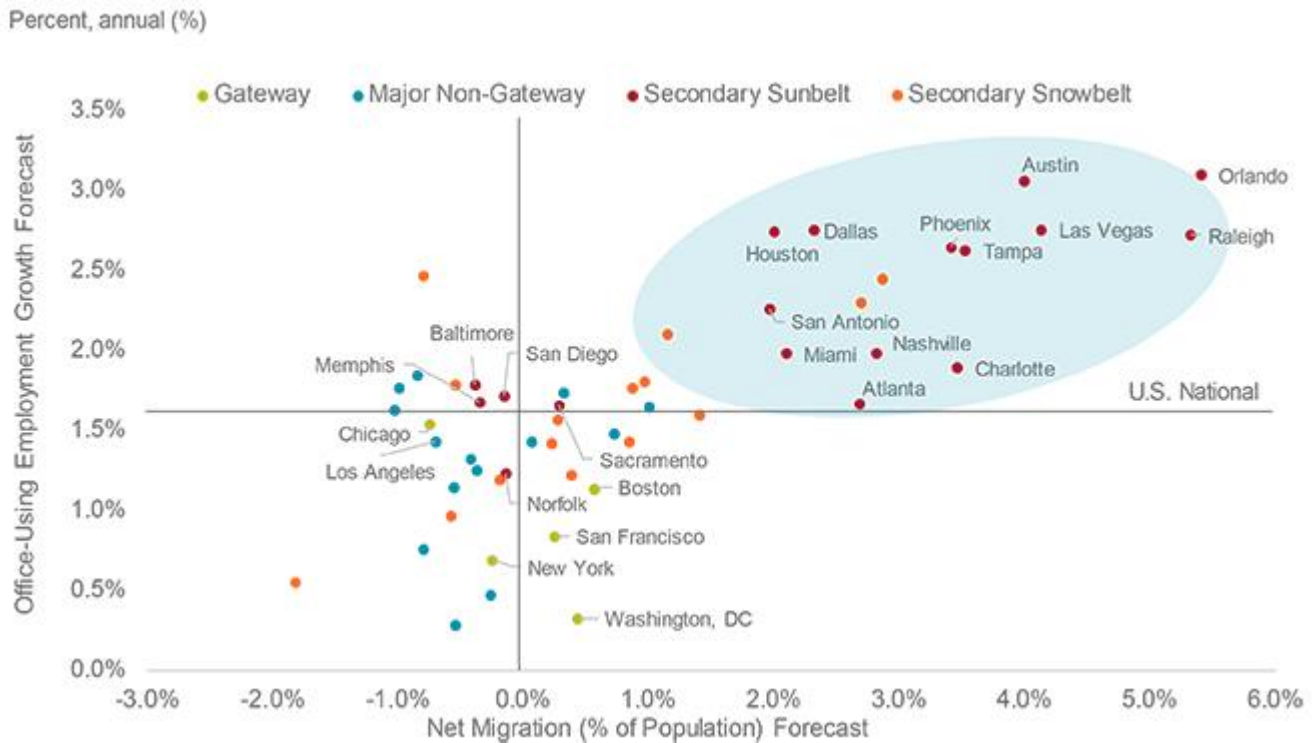
While overall employment growth rates typically slow as a cycle continues, Sunbelt markets are forecasted to experience a combination of high population (measured by net migration) and office-using employment growth. Net migration, which following a dip during the recession and early years of the recovery, has returned to its pre-crisis trend—600,000 in 2016. Over the next two years, secondary Sunbelt net migration and office-using jobs growth is forecast to outpace those of Gateway markets.

In the secondary Sunbelt markets Cushman & Wakefield tracks, office-using job growth and net migration are highly correlated with net absorption<sup>3</sup>, which in turn supports forward rent growth. Accordingly, Cushman & Wakefield forecasts higher average rent growth in the secondary Sunbelt markets compared to in the Gateway markets.

## Sunbelt vs. Gateway: Projections

	Secondary Sunbelt Markets	Gateway Markets
Net Migration	674,000 (-37,000 average per city)	-52,000 (-8,000 average per city)
'18-'19 Office-Using Job CAGR	2.3%	1.1%
'18-'19 Asking Rent CAGR	2.6%	1.3%

## Forecast Office Employment vs. Net Migration (Q2 2017 to Q2 2019)



Sources: Bureau of Labor Statistics, Bureau of Census, Moody's Analytics, Cushman & Wakefield Research

### Construction Activity Remains Constrained Relative to Demand

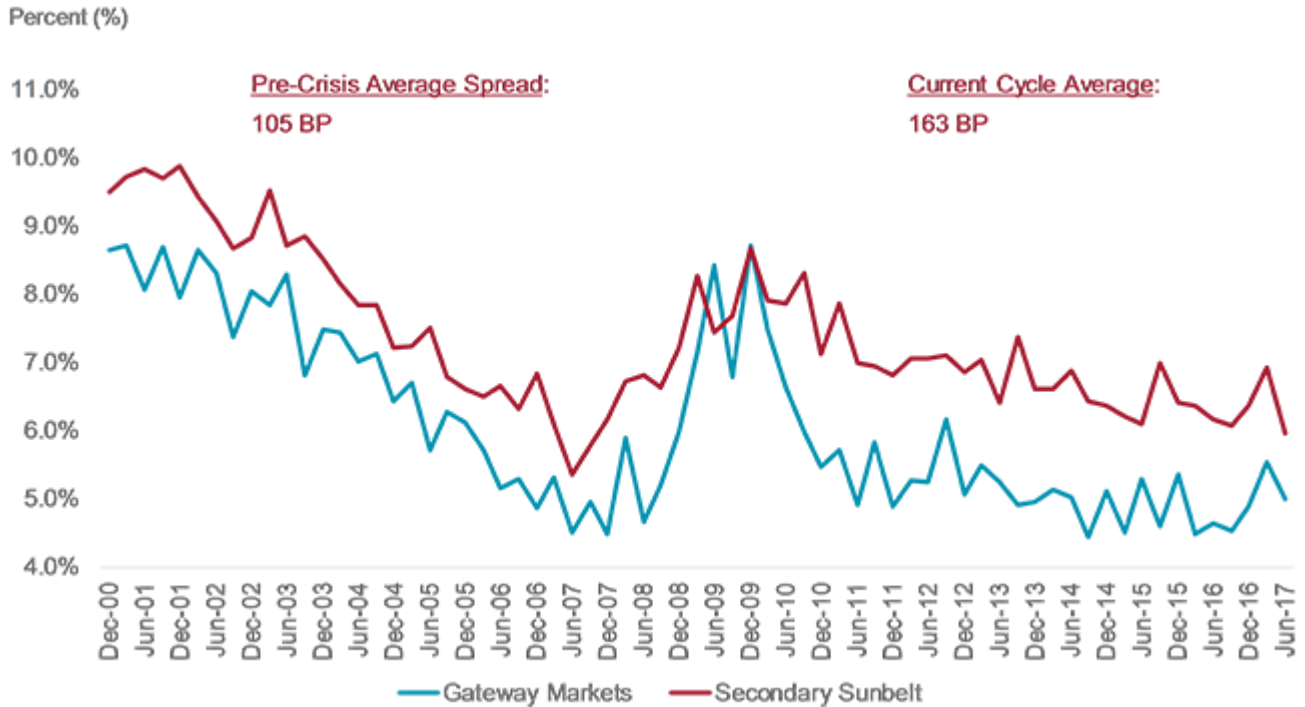
Supply dynamics further support a relatively more favorable outlook for secondary market vacancies and rents. The Gateway markets currently have a construction pipeline equal to 3.3 times the annual average absorption over the last two years (4.0x excluding Los Angeles) as compared to only 1.3 times for the secondary Sunbelt markets. The pattern persists when looked at relative to inventory: office product under construction in the Gateway markets amounts to 2.7% of inventory as opposed to 2.1% in the secondary Sunbelt markets.

### Pricing, Yields Still Underpriced Relative to Alternatives, Fundamentals

Secondary markets look set to outperform on fundamentals at a time when they are significantly undervalued relative to Gateway markets. According to the RCA Commercial Property Price Index, Gateway office prices were 70% above their previous cyclical peak as of June 2017. Secondary market office prices are only 8% above their previous peak.

Undervaluation can also be seen in capitalization rates. In the previous cycle, the spread between Gateway and secondary Sunbelt office market cap rates averaged 105 BP, but it has since expanded to 163 BP on average. In recent quarters, the spread has begun to compress. This reflects some rise in secondary asset valuations, but it has mostly been driven by a shift in the asset mix away from large trophy assets with the lowest cap rates in the Gateway markets. Accordingly, secondary Sunbelt markets continue to offer highly attractive yields on a risk-adjusted basis, with upside from further cap rate compression at a time when many asset classes and in particular Gateway market office are fully valued.

## Volume-Weighted Quarterly Office Cap Rates: Q2 2000 to Q2 2017



Sources: RCA, Cushman & Wakefield Research  
Deals over \$5 million

### Markets Not Yet Overtraded with Plenty of Opportunity in Suburban Locations

Despite rising volumes in the last two years, only 23% of the inventory in secondary Sunbelt markets has traded, alleviating concern that opportunities have been picked over. Within secondary Sunbelt markets, suburban submarkets have stronger momentum across fundamentals and have been less picked over by investors so far this cycle. Since 2010, 72% of CBD office inventory has traded as compared to 65% in the suburbs.

The largest, most liquid Sunbelt markets are Dallas, Houston, Charlotte, Atlanta, Miami, and Phoenix, each with transaction volumes of more than \$1 billion in the first half (H1) of 2017. Of these, Houston (+293%), Charlotte (+79%), and Phoenix (+68%) have seen the greatest growth in volumes compared to H1 2016.

With these dynamics in mind, we have developed a model to identify the top markets (out of the 87 markets we track) positioned for material improvement in fundamentals and which remain attractively priced over the next two years. We scored markets across the following metrics:

- Forecasted office-using employment growth over the next two years
- YoY percent change in overall office vacancy
- Overall asking rent (rewarding higher scores to markets with lower rents as a value indicator)
- Overall asking rent growth momentum
- Net absorption momentum
- Supply pipeline relative to absorption
- Inventory turnover
- Weighted average transaction cap rate over the last eight quarters

We have focused the results on major and secondary markets to account for many investors' need for liquidity. **Seven of the top ten markets are secondary Sunbelt markets.**

## Top 20 Major and Secondary Office Markets Positioned for Future Growth at a Reasonable Price

Market	Office Empl.	YoY Δ	Rent		Net Abs.	Supply	Inventory	Current	Composite
	Forecast <sup>1</sup>	Vacancy	Level	Momentum <sup>2</sup>	Momentum <sup>3</sup>	Pipeline <sup>4</sup>	Turnover	Yield	Z-Score <sup>5</sup>
1 Cleveland, OH*	2.5%	-4.3%	\$17.29	0.5%	0.4%	0.6	5%	9.6%	1.6
2 Las Vegas, NV	2.8%	-12.9%	\$21.60	3.9%	0.7%	0.3	8%	6.7%	1.4 ✓-
3 Baltimore, MD	1.8%	-12.1%	\$23.36	6.7%	2.6%	0.7	16%	7.2%	1.1 ✓-
4 Sacramento, CA	1.7%	-20.6%	\$21.60	0.2%	0.5%	0.4	14%	6.9%	0.9
5 Orlando, FL	3.1%	-10.5%	\$21.11	0.8%	-0.7%	0.3	30%	6.7%	0.8 ✓-
6 Detroit, MI	0.6%	-18.2%	\$19.32	-7.2%	0.0%	0.1	11%	8.0%	0.7
7 San Antonio, TX	2.3%	-21.2%	\$20.77	-0.8%	2.3%	1.0	16%	6.6%	0.7 ✓+
8 Phoenix, AZ	2.6%	-2.5%	\$24.87	0.3%	0.8%	0.3	26%	6.5%	0.6 ✓
9 Inland Empire, CA	1.6%	-17.1%	\$21.68	-0.1%	0.2%	0.0	15%	7.0%	0.6
10 Norfolk, VA	1.2%	-1.9%	\$17.29	2.0%	0.3%	0.4	9%	7.0%	0.6 ✓
11 Kansas City, MO	1.4%	-2.9%	\$19.79	0.7%	0.5%	0.6	17%	7.8%	0.5 ✓
12 Milwaukee, WI	1.8%	-8.3%	\$19.00	-0.6%	0.9%	3.3	17%	7.4%	0.5
13 Raleigh/Durham, NC	2.7%	-6.5%	\$23.12	0.9%	-0.9%	1.7	22%	6.4%	0.6 ✓
14 SF North Bay, CA	1.6%	-3.7%	\$27.95	-1.2%	-0.4%	0.0	8%	5.6%	0.3
15 Westchester, NY	0.5%	-13.4%	\$29.15	-1.4%	1.3%	0.0	22%	8.5%	0.3
16 Long Island, NY	1.3%	-8.9%	\$29.93	0.3%	0.3%	0.5	21%	7.2%	0.3
17 Cincinnati, OH	1.6%	2.9%	\$18.17	-0.1%	-1.1%	0.5	21%	6.9%	0.2
18 Memphis, TN	1.7%	-1.0%	\$17.76	-2.4%	0.4%	3.9	14%	7.4%	0.2 ✓+
19 Tampa, FL	2.6%	2.1%	\$24.14	1.3%	-0.8%	0.2	42%	6.7%	0.1 ✓-
20 Philadelphia, PA	1.0%	-8.4%	\$25.98	0.5%	0.7%	0.7	25%	6.8%	0.1

Secondary Sunbelt Markets



Below Average Tax Burden

**Sources:** RCA (deals over \$5 million), Bureau of Labor Statistics, Moody's Analytics, Cushman & Wakefield Research  
 (1) Two-year growth forecast (2) One-year minus three-year average asking rent growth (3) Change in trailing 8-quarter net absorption divided by average inventory over the period versus two years ago (4) Square footage under construction divided by trailing two-year average annual net absorption (5) Sum of 8 variable z-scores renormalized across entire set of major, secondary and tertiary markets

**Footnote:**

<sup>1</sup>Secondary Sunbelt markets include Atlanta, Austin, Baltimore, Charlotte, Dallas/Fort Worth, Norfolk, Houston, Las Vegas, Memphis, Miami, Nashville, Orlando, Phoenix, Raleigh/Durham, Sacramento, San Antonio, San Diego and Tampa.

<sup>2</sup>Gateway markets include San Francisco, Manhattan, Boston, Chicago, Los Angeles and Washington DC.

<sup>3</sup>For the statistically inclined, the correlation with net absorption was 0.65 and 0.62 for office-using employment and net migration, respectively.

**Research Contact:**



DAVID BITNER  
 Senior Director,  
 Head of Americas Capital Markets Research  
[david.bitner@cushwake.com](mailto:david.bitner@cushwake.com)