VIEWPOINT

Exploring the Shift:

Institutional Investors Turn to Smaller Markets

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In a perfectly efficient market, institutional capital for commercial real estate would seek metro areas experiencing the greatest increases in population and job growth. Many institutional investors with a built-in preference for large core assets in gateway markets may benefit from a reassessment of post-COVID market trends. Larger gateway markets are historically believed to provide greater liquidity and more stability in financial returns. More recent post-COVID trends in population and employment growth, along with technological and information advances, may warrant revisiting previously disproportionate allocations to the largest urban markets.

Population and Employment Dynamics

Since 2020, growth trends have favored smaller metro areas over larger metro areas. The top 25 Metropolitan Statistical Areas (MSAs) house 42% of the U.S. population and 44% of total national employment. The top 50 MSAs make up 55% of the U.S. population and 56% of total national employment. Since 2020, 70% of total population gains have occurred outside the top 25 metro areas, with a top 25 market population growth rate of 1.5% compared to 2.4% for all other markets.

Drilling down further, population trends within most major metro areas are favoring the suburbs over traditional urban CBD locations. From 2021 to 2023, U.S. inner suburban counties grew by a total of 3.2 million and outer suburban counties grew by nearly 1 million, while urban counties lost approximately 800,000 people.

For employment gains since 2020, 65% of total new jobs have been created outside the top 25 MSAs. These new jobs represent a 2020-2024 growth rate for the top 25 markets of 1.3% compared to 1.9% for all other markets. It's notable that in the next tier, the metro areas ranked 25 to 50 have been significantly outperforming the top 25 in population and employment growth.

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Investing in Emerging Secondary Markets

Within commercial real estate, the top 25 largest MSAs account for nearly 64% of the combined value of the four primary product types (multifamily, office, retail and industrial), and the top 50 MSAs contain 77.5% of the total value. Despite this top-heavy concentration, within the four main sectors alone, the market still offers a nearly $5.5 trillion investable universe outside many investors' current allocations to the top 25 metro areas ($3.4 trillion accessible outside top 50). In some cases, secondary investment markets may allow for an overall yield premium and individual property pricing inefficiencies. The overall average cap rate across the four main sectors of multifamily, office, retail and industrial is 160 basis points higher for all markets outside the top 25 MSAs. At current interest rates, the top 25 markets are barely able to achieve positive leverage, whereas the broader expanse of additional markets may generally benefit from varying spread premiums to enhance cash flow.

Although a large cap market investing strategy provides needed CRE beta, it's also important to note that concentration and correlation risks do exist for investors who limit allocations to the largest markets and largest funds. Potential alpha and reduced concentration/correlation may be produced by strategic investments made in expanding suburban areas of major metros and in select emerging secondary markets. Because individual transactions won't allow the larger and efficient ticket sizes needed for institutional investors, accessing secondary markets efficiently at scale requires identifying operators and fund sponsors who have the resources and reach to source, underwrite, acquire and manage diversified portfolios in less dense locations. Nimble allocators best positioned to take advantage of these opportunities will have access to discretionary capital and can identify transactions and close in a timely fashion. Such investors may find themselves faced with less institutional competition, in theory providing potential yield premiums over similar investments located in gateway markets.

Over the longer term, increased institutional capital deployments into suburban and secondary markets could improve market liquidity, thereby reducing return volatility and opening additional frontiers for diversified portfolios. Added capital resources in these emerging markets in turn benefit developers, owners and sellers, helping to fuel ongoing growth and expansion.

Sources: CoStar, U.S. Census Bureau

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