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Should you be investing in secondary markets?

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Since 2008 the global gateway real estate markets have been the "flight to quality" investment strategy of many investors. Because of this increased demand, stable fundamentals relative to other markets, and "pretend and extend" loan workouts, most core markets did not see steep declines in commercial real estate values as was expected after 2008. As the U.S. economy started to bottom out these core markets saw a dramatic increase in activity and prices increased due to cap rate compression. Now, with cap rates at historically low levels and interest rates finally creeping upward, it is time to reconsider this strategy.

Consider a current gateway city investment versus a secondary and tertiary market investment.

For the gateway market example the following assumptions have been made: The asset purchased is a $5 million N.Y.C. multifamily walk-up property; the average going-in cap rate for this property type and market is 4%; the asset is purchased based on in-place net operating income (NOI); and not on projected NOI (which many investors are being forced to do by lack of supply.)

So if the cap rate for this property stays at 4% and NOI grows then the property will appreciate in value. However, let's look at what might happen if we see rising interest rates that force cap rates to expand and not contract, as they have over the last three years or so.

A 200bps expansion in cap rates, from 4% to 6% will represent a 33.33% loss in value. However the plan is to grow NOI, not keep it the same, as assumed above. So how much does NOI need to grow simply to keep the value of this property the same with the assumed expanding cap rate? To keep the same $5 million value of the building one would need NOI growth of 50%1 over the period of time that this cap rate expansion occurs.

For the secondary/tertiary market example the following assumptions have been made: The asset purchased is $5 million Columbus, OH multifamily property; the market average going-in cap rate for this type of building is 8%; the asset is bought based on the current in-place NOI; and the business plan is to raise NOI through renovating the property and raising rents to catch up with market increases.

1. In the past 12 months we have seen increasing competition in these secondary and tertiary markets and expect this to increase as others come to the same conclusions.

Part two to be continued in the October 29th, 2013 New York City Financial Digest edition of the New York Real Estate Journal.

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