THE ACQUIRED TASTE OF SECONDARY CITIES

By John Salustri

There's been much in the press of late about investors, squeezed by pricing and ramped-up competition in gateway cities, exploring secondary markets. The numbers speak to the trend, as *Emerging Trends* in Real Estate 2015, attests:

"The secondary markets have seen a fairly impressive level of activity as well, totaling $140 billion. This represents nearly 72 percent of the previous peak for this group of markets."

But what is the dynamic within these markets, and what should investors expect when they set their sights beyond the big gateway cities? We asked Tom Farrelly, SIOR, an executive director of Cushman and Wakefield of New England, located in Manchester, N.H., what his market segment is seeing. Farrelly, who is also Northeast regional director for SIOR, works on a C&W team that handles Southern New Hampshire and Northern Massachusetts.

"People are starting to wake up and pay more attention to the secondary markets," he says. But it's clearly an acquired taste. "Larger institutions have trouble getting comfortable with secondary markets because there's just not as much depth or velocity." In Maine, he points out, the focus is on Greater Portland, in Vermont, it's Burlington, but in New Hampshire, that volume and activity is spread around multiple markets—"Concord, Manchester, Bedford, Nashua, Salem, and Portsmouth. Not only is the market on the thin side but it's also geographically dispersed and so not as efficient."

By way of example, Farrelly says that International Place in Boston paces out to nearly 1.8 million square feet. There's just over 1.7 million feet of inventory in all of Nashua.

As a result, outside investors are challenged to find clear definitions of market performance. While Burlington might have three shopping centers that sold in the past year, in New Hampshire you might need to canvas multiple, geographically different markets to find three. "It's harder to come up with more like-kind data points on value," he says.

It takes a certain spirit to venture beyond the big-city limits, and not only in terms of market data. Farrelly says his shop is seeing "more regional opportunity funds and high-net worth people and investors who aren't as challenged by operating in a market that's not only new to them but also doesn't behave quite as predictably or rationally as markets they're used to playing in."

For example, while Boston rents are fast approaching their pre-recession peak, "in cities like Manchester, Bedford, Nashua, Concord, and to some extent Salem, a lot of the rents are actually below what they were when I opened this office 30 years ago." Farrelly reports that the average direct office rent in Boston is $53.44, but it's $17.98 in Manchester and Bedford, $16.88 in Nashua, $20.85 in Concord, and $19.34 in Salem.

But in other ways, they behave very much like major markets, and Farrelly tracks a trend toward re-urbanization in most of the above cities, along with a millennial push toward the CBD, and the redevelopment of the inner core around the new live-work-play phenomenon. Post-recession, "fundamentals are starting to shore up."

SIOR regional director Tom Farrelly says first-time investors in secondary markets must "make sure you're buying in a market based on the reality of that market's fundamentals."

And they're shoring up to the point where spec development is coming back. In Portsmouth, Farrelly tracks 100 Arboretum, which just entered Phase 2 construction with a 70,000-square-foot spec build, and 249 Corporate, a 37,000-square-foot spec development that just broke ground. "You're seeing owners putting properties through the approvals process."

But while fundamentals are tightening, they aren't close to approaching major-market heights, and one of the draws traditionally attributed to secondary markets remains true: "We're seeing people buy because the relative price per square foot is so low," Farrelly says.

Farrelly points to two Q4 2014 sales: one in Boston, the other in Manchester. Boston's 132,983-square-foot Windsor building sold for $39.5 million (just over $297 a foot). The cap rate was 3.5 percent. By comparison, in Manchester, the

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In the City for instance, availability, by both the number of floors and the overall volume of space marketed, has fallen sharply over the last two years. During the first quarter of 2015 there were only 374 floors (2.9 million sq. ft.) of floor space on the market in the core City postcodes. Supply fell due to strong levels of occupier interest in EC2, particularly due to the considerable number of small to medium sized floors which were put under offer during the first quarter. This almost halved the number of floors on the market between 10 to 20 thousand sq. ft. in size in the space of one quarter and made this sub-sector of particular interest.

It is a similar story in the West-End; demand for the best space is extremely strong and there is considerable upward pressure on prime headline rents. Average prime rents in the West-End currently stand at around £117.50 per sq. ft. ($180.64 USD), although exceptional deals on the best space are being agreed upon at much higher rates. There are markets, such as the office market in Victoria, which has very low levels of availability, but is one of the more popular locations listed in occupier requirements. Whilst there are developments underway to try to match this demand, with the Nova North and Nova South schemes and the Zig Zag building expected to help fill the supply gap, there is still considerable room for short-term rental growth in such a market.

As the U.K. commercial property market continues into the second phase of its recovery and becomes increasingly reliant on income return and rental growth, London is expected to lead the way. The medium term supply shortage will create increased levels of rental growth, but not all sub-markets are expected to be equal. Understanding the occupier market dynamics, which often vary from sub-market to sub-market, or even between building size categories, is crucial for those looking to identify the potential hotspots.

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216,910-square-foot City Hall Plaza went for $19.75 million ($91.50 a foot) on a 6.97 percent cap rate; and in addition to lower prices, investors will find the field is nowhere as crowded with competitors.

So what should out-of-towners expect venturing for the first time into a secondary market? Unlike Boston, where "people are willing to sign on for historically low cap rates because of the trending uptick in rents, in New Hampshire, it's more about current cash flow, not future yield and IRR," says the regional director.

In short, "don't bring major-market expectations to a secondary market," he warns. "There's nothing worse than a developer or investor buying a property, ignoring what you told them, and thinking along the lines of how similar buildings perform in other markets. If you're telling them lease-up will take nine months and they think, 'sure, but we can do it in half the time,' there's a chance they'll end up disappointed. I've seen it happen."

Also, stick with what you know. "If you understand office, pick office," he says. "It's the same with industrial, retail, or apartment complexes."

Farrelly advises first-timers to "make sure you're buying in a market based on the reality of that market's fundamentals and not based just on the appearance of a building and its location."

And probably most important, remember that you can't "just parachute in. You can get your head handed to you. You need local market expertise, and boots on the ground." ■