Gateway suburban office *outperforms* CBDs

Traditionally regarded as investment mainstays, CBD offices in gateway metros have underperformed their suburban counterparts. Investors have been slow to catch on and missed out on opportunities.

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Conventional wisdom has it that investing in office properties in central business districts (CBDs) of major US metros provides the best opportunity for steady income, capital appreciation and strong total returns. This thinking has resulted in major institutional investors, both domestic and international, allocating enormous amounts of capital to CBDs in hopes of achieving superior nominal and relative returns. Between 2001 and 2010, this was true as the NCREIF Property Index data shows that CBD office assets, notably in global gateways, had exceptional total returns.

The tables turned during the decade that followed (2011–2021). In the midst of the longest economic expansion in US history, suburban office property total returns (8.4%) outperformed CBDs (7.7%). However, not all suburban markets are equal — global gateway suburban office properties have been standouts. This article will provide some insights into why suburban office properties in the gateway markets had higher nominal and relative returns.

Market selection and grouping process

To perform its analysis, Bailard divided major metro areas into three groups of seven cities/metros, spread across the country (see Exhibit 1). These groups are based on recognized investor sentiment (as it pertains to office market nodes), office investment volumes, population size and demographic trends. The groupings are as follows:

1. *Global gateways* (colloquially known as the ‘sexy 7’) enjoy the status as top-tier real estate investment markets due to their myriad economic drivers, impressive cultural diversity and large population size. These markets have the highest barriers to entry.

[1] Debra Moritz, CBD vs Suburbs? The Millennial Effect, Cushman & Wakefield, October 16, 2018. Updated data through Q4 2020.

Exhibit 1: Markets in the three groupings

Group	Metro areas
Global gateways	Boston, Chicago, Los Angeles, New York, San Francisco Bay Area, Washington D.C., Seattle
Primary non-gateways	Philadelphia, San Diego, Denver, Miami, Portland, Atlanta, Austin
Other non-gateways	Phoenix, Orlando, Orange County, Dallas Fort-Worth, Salt Lake City, Minneapolis, Charlotte

2. *Primary non-gateways* have expanding economic diversity, large populations and favorable demographic trends. Most of these metro areas have modest barriers to entry.
3. *Other non-gateways* have similar attributes to the primary non-gateways, but they have a combination of traditional and alternative economic drivers. This grouping offers an array of value-add opportunities and the lowest barriers to entry of the three subgroups.

Performance components at a glance

Real estate returns are the product of two components: income and appreciation. The first is driven by cash flow performance at the asset level. Higher rents and higher occupancy levels, along with stable and/or lower expenses, contribute to increasing cash flow generation and higher income returns. The second is driven by the capital markets. Equity and debt investor demand drives pricing. When the demand for product exceeds the supply of product, prices will be driven up and yields will be pushed down. Conversely, if investors shun the asset class, values go down and yields go up. There are numerous reasons investors flock to, or retreat from, real estate including perceptions of risk, return expectations both nominally and vis-à-vis other assets, confidence in the economy and/or the asset class, tolerance for illiquidity, and concerns about inflation.

Suburban locations are proximate to a metropolitan area, which has driven many corporate users to these locations to ensure access to high quality labor while enjoying incentives such as lower rents, operating costs and property taxes. According to Cushman & Wakefield, suburb-to-suburb moves have represented over 40% of headquarters moves among Fortune 500 corporations in the past decade, more than relocations from the suburbs to CBDs. Of those moves, 38% of the new locations were in global gateway suburban markets.[1] Many of the suburbs that benefitted from those relocations have features touted by urban cores (i.e., dense but livable, an active live/work/shop/play landscape), a lower cost of living and easy access to CBDs via public transportation.

From an investment standpoint, suburban offices offer higher total return potential and good relative value when compared to CBD properties. High quality assets can often be found at or below replacement cost. Current yields are better, with cap rates in suburban markets generally 50 to 200 basis points (bps) higher than similar quality CBD properties. Deal sizes tend to be smaller, ranging from $25 million to $75 million. For these reasons, investing in suburban office assets may be the right strategy for institutional and high-net-worth investors.

Prior to 2011, office income returns across all tracking time periods showed no evident trend of favoring suburban nodes over CBDs, despite the

Exhibit 2: Income returns by market *Period ending June 30, 2021*

Income return	Global gateways (CBD)	Global gateways (Suburban)	Primary non-gateways (CBD)	Primary non-gateways (Suburban)	Other non-gateways (CBD)	Other non-gateways (Suburban)
1 year	4.0%	4.7%	5.0%	5.0%	4.2%	4.9%
3 year	3.9%	4.7%	4.9%	5.1%	4.5%	4.9%
5 year	3.9%	4.7%	5.0%	5.1%	4.7%	5.0%
10 year	4.3%	5.1%	5.3%	5.5%	5.6%	5.5%
20 year	5.3%	6.1%	5.9%	6.3%	6.4%	6.2%

Source: NCREIF Property Index, 2021.

Exhibit 3: Appreciation returns by market						*Period ending June 30, 2021*
Appreciation return	Global gateways (CBD)	Global gateways (Suburban)	Primary non-gateways (CBD)	Primary non-gateways (Suburban)	Other non-gateways (CBD)	Other non-gateways (Suburban)
1 year	-2.7%	**1.7%**	-2.6%	2.6%	-3.7%	-0.9%
3 year	-0.6%	**2.6%**	0.7%	1.3%	0.3%	-0.9%
5 year	0.2%	**2.8%**	1.2%	1.1%	1.3%	0.0%
10 year	3.2%	**4.1%**	3.9%	2.9%	1.5%	2.7%
20 year	2.9%	**1.7%**	1.9%	0.3%	-0.2%	0.4%

Source: NCREIF Property Index, 2021.

Exhibit 4: Total index returns by market						*Period ending June 30, 2021*
Total return	Global gateways (CBD)	Global gateways (Suburban)	Primary non-gateways (CBD)	Primary non-gateways (Suburban)	Other non-gateways (CBD)	Other non-gateways (Suburban)
1 year	1.2%	**6.5%**	2.3%	7.7%	0.5%	4.0%
3 year	3.3%	**7.4%**	5.7%	6.4%	4.9%	4.0%
5 year	4.2%	**7.6%**	6.3%	6.2%	6.1%	5.0%
10 year	8.1%	**9.3%**	9.3%	8.5%	7.1%	8.3%
20 year	8.3%	**7.9%**	7.9%	6.6%	6.3%	6.7%

Source: NCREIF Property Index, 2021.

dotcom/telecom crash (2001–2002) and Global Financial Crisis (2008–2010). Since 2011, income returns have favored suburban nodes due to better fundamentals (see Exhibit 2). Vacancy rates in the suburban subgroups (of the global gateways, primary gateways and other non-gateways) declined by 52 bps, 248 bps and 183 bps, respectively, while the vacancy rate increased by 352 bps, 249 bps and 92 bps in the CBD groups, according CBRE data. Rent growth followed a similar trend, albeit with less dramatic differences, as the suburban nodes of the global gateways, primary gateways and other non-gateways had average annual rent growth of 4.0%, 3.1% and 2.5%, respectively vs. 3.7%, 3.0% and 1.9% in the comparable CBD clusters.

What separates the global gateway suburbs from the other subgroups is capital appreciation. From 2001 to 2010, all suburban subgroups had weaker 10-year annualized appreciation compared to CBD office properties, but the trend reversed in the next decade. Since 2011, global gateway suburbs had a 10-year annualized rate of 4.1% vs 3.2% for CBDs (see Exhibit 3) due to increased income from filling vacancies, rent growth and cap rate compression. Growing investor confidence in the economy and office real estate fundamentals along with greater interest in suburban office assets from value-oriented investors increased the flow of capital into many suburban office nodes, and especially the global gateways. This, in turn, helped push values higher for those properties.

Strong performance

Between 2001 and 2010, CBD total return performance was stronger than in the suburbs. Since 2011, the global gateway suburban office properties yielded an average annualized return of 9.3%, 120 bps per year better than their CBD counterparts (8.1%) over the same period (see Exhibit 4). Even when looking at 5- and 3-year returns, the global gateway suburbs still offered superior returns. Conversely, other suburban subgroups did not consistently outperform their corresponding CBDs.

Despite favorable fundamentals and higher returns, institutional investors consistently shunned suburban assets in favor of their CBD counterpart. According to the CoStar Group, total sales volume in global gateway CBDs increased by 54.4%

Exhibit 5: Standard deviation of quarterly index returns for markets *Period ending June 30, 2021*

Standard deviation	Global gateways (CBD)	Global gateways (Suburban)	Primary non-gateways (CBD)	Primary non-gateways (Suburban)	Other non-gateways (CBD)	Other non-gateways (Suburban)
1 year	0.6%	**1.5%**	1.5%	2.1%	1.7%	1.2%
3 year	1.5%	**1.4%**	2.3%	1.6%	2.5%	1.2%
5 year	1.3%	**1.1%**	1.9%	1.3%	2.9%	1.2%
10 year	2.1%	**1.4%**	2.5%	1.8%	2.4%	2.1%
20 year	6.3%	**5.4%**	5.1%	4.6%	5.8%	4.9%

Source: NCREIF Property Index, 2021.

Exhibit 6: Sharpe ratios for markets *Period ending June 30, 2021*

Sharpe ratio	1 year	Rank	3 year	Rank	5 year	Rank	10 year	Rank	20 year	Rank
Global gateways (CBD)	1.7	4	1.4	6	2.4	5	3.4	5	1.1	4
Global gateways (Suburban)	**4.1**	**1**	**4.3**	**1**	**5.7**	**1**	**6.1**	**1**	**1.2**	**2**
Primary non-gateways (CBD)	1.4	5	1.9	4	2.7	4	3.6	4	1.3	1
Primary non-gateways (Suburban)	3.5	2	3.2	2	3.9	2	4.6	2	1.2	3
Other non-gateways (CBD)	0.2	6	1.5	5	1.7	6	2.7	6	0.9	6
Other non-gateways (Suburban)	3.3	3	2.2	3	3.3	3	3.7	3	1.1	5

Source: NCREIF Property Index, 2021..

over the prior decade (compared to a 34.0% increase in suburban global gateways); this was over four times the transaction volume of global gateway suburban offices. As a result, investors favoring CBDs over the suburbs have missed out on the arbitrage opportunity presented by suburban assets and their higher going-in yields.

A safe bet

Global gateway suburbs provided better risk-adjusted returns than any other subgroup over the 1-, 3-, 5- and 10-year time periods examined. Not only do they provide the highest returns, but global gateway suburban properties have demonstrated the lowest volatility, with a 10-year average annualized standard deviation of 1.4% (see Exhibit 5), among the six subgroups examined. The respective Sharpe ratios show the same trend (see Exhibit 6). Suburban nodes within the primary and other non-gateways also showed less volatility than their CBD counterparts, a strong indication that suburban nodes offered more favorable risk-adjusted returns over the last decade.

The missed opportunity

Despite higher returns, solid fundamentals and improved capital market dynamics, many large institutional investors have not invested in office properties in suburban markets. Why? Answers range from deal size to presumptions about future performance, perceptions about liquidity, concerns about management intensity and tenant turnover, and the idea that the suburbs are dying at the expense of ascendant and vigorous CBDs. Data from the last ten years proves that suburban markets, especially global gateways, are neither dead nor dying. Institutional investors that may have missed the boat on suburban investing in the past can yet benefit in the post-Covid-19 pandemic world as office-user dynamics have the potential to favor the suburbs over CBDs across the country. ◆

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