Today’s industry news headlines are often dominated by trophy real estate assets trading for record high prices and all-time low capitalization rates. These headlines have led some investors to conclude that the market has returned to 2007 euphoria and that limited investment opportunities exist across the entire core real estate universe.

This perception of a narrow investment opportunity set should be separated from the reality that certain trophy assets still offer investment opportunity. It should also be separated from the reality that some core real estate properties are trading below (in some cases well below) record levels. Failure to understand these realities can cause missed opportunities.

Record high prices and all-time low capitalization rates create an anxiety that prices are moving away from fundamentals just as they did in 2006–2007. In a simplified discounted cash flow model, a current 6 percent to 7 percent expected return assumes a 4 percent to 5 percent initial yield plus a fairly modest 2 percent growth in net operating income during a 10-year hold period. Compellingly, the 2 percent projected NOI growth could prove conservative due to factors such as stronger than expected economic growth or choosing the “right” real estate assets.

Core reality

The perception that there is no upside left for core investors runs afoul of statistical reality

by Melissa Reagen
Under these assumptions, it is difficult to argue that, in the aggregate, core real estate prices are disconnected from fundamentals.

Current trophy asset pricing can be explained by reasons other than the excess liquidity and the ubiquitous mispricing of risk experienced in 2006–2007. The U.S. real estate market has a variety of long-term hold investors (20-plus years). These investors may need to match assets with liabilities or they may be very focused on receiving a consistent cash flow. Near-term cyclical and volatility is not a primary concern. From a relative value perspective, the spread between the 10-year U.S. Treasury note yield (~3 percent) and the current underwritten total return on core real estate for a 10-year hold period (6 percent to 7 percent) is 300–400 basis points. This same spread was 50–100 basis points in 2006–2007. Relative to 2006 and 2007, the influx of global capital into the U.S. real estate market is unmistakably higher. For global investors, U.S. trophy properties tend to offer better value compared to those in major non-U.S. markets. Finally, certain investors may believe that trophy assets offer income or appreciation growth potential that other market participants do not see and thereby cannot value.

**Defining the core investment universe**

Trophy property pricing is an important topic, but it is no more important than how and where to invest in core real estate assets beyond trophy properties. Across the top six U.S. markets — Boston, Chicago, Los Angeles, New York City, San Francisco and Washington, D.C. — CBD office and apartment properties have exceeded 2007 peak prices (see chart on this page). These data points contribute to the conclusion that core real estate has limited investment opportunity. However, in these same six markets, industrial, retail and suburban office prices remain 13 percent to 20 percent below their 2007 peak levels. In the markets beyond these six, prices remain 20 percent to 35 percent below their 2007 peak levels, depending upon the property type. Core real estate investment opportunities do not look so limited in this context.

Prices could be below their 2007 peak for reasons such as weak current and future net absorption, which would preclude them from being investment opportunities. Alternatively, prices could be below their 2007 peak for reasons other than poor fundamentals, implying that more value could be realized in these markets and property types. Although not conclusive, the data does provoke a couple key questions:

1. For investors seeking opportunities beyond trophy assets, where in the top six markets can these opportunities be found?
2. In markets beyond the top six, there is a wide diversity of economies and real estate markets. Which of these additional markets should be targeted for real estate investing?

**In the top six markets**

To answer the first question, individual property trades that occurred in 2013 were analyzed to understand the dispersion of capitalization rates. Not all properties are trading for extremely low capitalization rates. In fact, across the top six markets there is a 135 basis point spread between the lowest capitalization rate and the next lowest capitalization rate tier. The core real estate universe extends beyond the absolute highest trophy quality assets in the best locations. Core real estate investments can also include high-quality but less-than-trophy-quality real estate assets in the top six markets.

The industry headlines suggest that few investment opportunities exist in the top six markets. The reality is that attractive core investment opportunities may exist in the next lowest capitalization rate tier (25th percentile). The core real estate universe extends beyond the absolute highest trophy quality assets in the best locations. Core real estate investments can also include high-quality but less-than-trophy-quality real estate assets in the top six markets.

Our recommendation that investors expand the definition of core is not to suggest that investors engage in style drift, in which higher-risk real estate opportunities are misleadingly labeled as core opportunities.

An expanded core real estate universe includes “emerging” submarkets in the top six markets. These submarkets can offer significant income growth (and potentially appreciation growth) during a hold period of 10 or more years. In the apartment and

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Current prices vs. 2007 peak prices

![Graph showing current prices vs. 2007 peak prices for various market segments.](chart)

*Note: The top six markets, defined using RCA’s definition, are Boston, Chicago, Los Angeles, New York City, San Francisco and Washington, D.C.*

*Data as of December 2013

*Source: Real Capital Analytics*
retail property types, these submarkets, or neighborhoods, could include, but are not limited to, the Arts District in downtown Los Angeles; Williamsburg in Brooklyn; the Pearl District in Portland, Ore.; Northern Liberties in Philadelphia; the Mission District in San Francisco; Ballard in Seattle; or H Street in Washington, D.C. Many of these submarkets would currently be considered “emerging” by institutional investors. Over time, however, these neighborhoods can and already have created very strong demand for retail and apartment properties.

The “emerging” submarket theme can also be found in the office sector. Office submarkets such as Chelsea in Manhattan, South of Market (SoMa) in San Francisco and Seaport in Boston had weak market fundamentals throughout the 1990s and into the mid-2000s. As of fourth quarter 2013, these submarkets had office vacancy rates below 7 percent versus 13 percent nationally, largely due to strong occupier demand from technology tenants.

With historically little demand from traditional office tenants, class B office space dominates these “emerging” office submarkets. Well-located class B office space can be a part of an expanded core real estate universe. The same applies to well-located class B apartments. With apartment construction set to reach 2006 levels, well-located class B assets are often more insulated from that new construction that competes more directly with existing class A apartments.

**The next nine major markets**
The top six markets could be joined by a handful of other markets based on factors such as the level of capital flows from both foreign and domestic investors, the size of the investable real estate universe, and the general health of the real estate market and economy. From our analysis, the next nine major markets that have these characteristics are Atlanta, Austin, Dallas, Denver, Houston, Miami, Minneapolis, San Diego and Seattle. In particular, most of these markets have a higher concentration of science, technology, engineering and mathematics occupations than the U.S. average. It is our view that these highly skilled occupations will drive significant demand and NOI growth for office, apartments and retail during the long term.

The capitalization rate across these nine markets, as shown by the chart on this page, is 90 basis points higher than that across the top six markets — the largest spread seen since this data was first collected in 2002. We are not suggesting that investors seek real estate opportunities exclusively in these next nine major markets. We are suggesting that investors give these next nine major markets equal consideration as the top six markets.

The spread between the capitalization rate of the top six markets and the next nine major markets is just one component of our investment analysis. Average annualized NOI growth across these nine major markets from first quarter 2010 through third quarter 2013 was 3.7 percent versus 2.9 percent across the top six markets. The nine major markets are proving themselves, and we believe they will continue to do so going forward.

**Conclusion**
Trophy real estate asset pricing is creating the perception that limited investment opportunities exist across the entire core real estate universe and that the U.S. real estate market could be entering 2007 euphoria. But excess liquidity and the ubiquitous mispricing of risk are not pervasive as they were in 2006–2007, and thus cannot fully explain current trophy property pricing. Varying investment objectives, differing growth expectations, and the growing presence of long-term hold and global investors provide better explanations for trophy asset pricing.

**Capitalization rates by market**

![Chart showing capitalization rates by market]

*Note: The top six markets, defined using RCA’s definition, are Boston, Chicago, Los Angeles, New York City, San Francisco and Washington, D.C.*  
*Data as of December 2013*  
*Source: Real Capital Analytics*

Of equal importance, a wide variety of investment opportunities exist in the core real estate universe beyond trophy properties. These opportunities can be found in the next nine major markets and in the “emerging” submarkets in the top six markets. Understanding these realities grants investors the ability to see and seek a variety of core real estate investments. ❖

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