From sea to shining sea: Investment opportunities in US markets beyond the major coastal cities

by Stephen L. Rabinowitz, Greenberg Traurig

Foreign investors consider US real estate among the most stable and secure investments, if not the most stable and secure, of the world's real estate markets. In the current cycle, foreign investors, chasing consistent and plentiful returns have flooded the US real estate market with capital. Most of this capital has been sent to the largest and most expensive markets in the country, like New York and San Francisco, cities that international investors have the most personal exposure to and where they like to visit and live. In this process international investors have bypassed enormous opportunities in smaller cities throughout the country, many of which have experienced both short and long term gains in property values which exceed those found in New York and other marquis markets. Coupled with favourable demography, and legal and regulatory environments found in these smaller urban areas and these secondary real estate markets represent enormous untapped opportunity for the innovative and intrepid foreign real estate investor.

Foreign real estate investment in the US has been steadily growing for over three decades. After a short period of retrenchment after the Great Recession, foreign direct investment in US real estate is on track to exceed its pre-Great Recession peak within the next couple of years. Foreign investors are again flocking back to the perceived stability and security of investing in real property in the US. Surveys have consistently shown that investors in commercial and multifamily real estate investment consider New York, San Francisco and Los Angeles as the most desirable markets to invest in.

In February 2013, for example, foreign investment in these three cities alone represented 37% of total US foreign commercial real estate investment, according to Jones Lang LaSalle. By February 2014, investment in just New York and Los Angeles alone constituted 36% of total foreign investment. The Consequences of this large aggregation of capital are the perception that foreign investors are solely interested in these primary markets, and the outsized attention paid to these markets in industry media.

While these primary markets command an enormous influence, they should not be considered the only markets that present attractive US investment opportunities for foreign interests. In fact, many foreign investors have already begun to move their capital into secondary markets. In 2014, secondary markets like Houston, Dallas and Seattle are seeing substantial increases in capital flows, and there are other attractive markets out there still waiting to be discovered by foreign investors. Several secondary US markets are strong candidates for foreign investment because of a number of prevailing factors and trends. These include favourable tax and regulatory environments outside of the primary markets, demographic changes, and a trend towards re-urbanisation.

Innovative foreign investors have already identified opportunities in US real estate outside of the over-reported primary markets. This article will explore what these innovative investors are seeking and doing, the factors and trends that make these secondary US real estate markets attractive investment opportunities, and other features of the current US real estate market that may result in broadening geographic scope of foreign capital being received by US real estate markets.

Why foreign real estate investment is growing: A favourable legal and economic environment

The amount of foreign direct investment (FDI) in the US real estate market has grown steadily over the last three decades. According to the US Bureau of Economic Analysis, FDI in the US real estate industry was US$22bn. At its peak in 2007 FDI in US real estate was US$56.4bn. Despite the pop of the housing bubble and the FDI retreat that followed, 2012 FDI in US real estate was back up to a substantial US$50.5bn, with a rapid upward trend from 2010, when FDI was US$44.6bn. As of 2012, FDI in US real estate had grown by a substantial 156% over the course of 25 years. The reason for this growth is not a mystery.

The US real estate market has traditionally been understood by foreign investors as a place to harbour capital in a secure environment while reaping both

short-term returns and long-term growth. Foreign investors can always be assured that their assets in the US, a robust liberal democracy, are not subject to politically motivated seizure or unchecked corruption and that their businesses and assets in the US are subject to a constitutionally based system of consistently applied common law. Further, the US has no federal laws that prohibit foreign investment in US real estate, with the exception of the Exon-Florio law, which applies where a business investment could be deemed a threat to national security – for example, investment from a hostile country in military or surveillance technology. In those cases transactions are subject to review by the Committee on Foreign Investment in the US. Historically, less than 10% of foreign investments have been investigated under this law, and to our knowledge, no real estate transactions have been rejected on the basis of this statute.

Furthermore, the US common law system has consistently honored and respected private property rights in real estate as nearly sacrosanct. Government appropriation of land via the governmental power of eminent domain (also known as condemnation) has been rare, can be exercised only after a judicial process, and requires fair compensation to the owner of appropriated land.

US real estate law also provides land owners with numerous remedies against the devaluation of their property caused by private nuisance and trespasses. Land owners who are subject to a devaluation of their land because of the activities of neighboring land owners have recourse to an open judicial system to seek compensation for their losses. The US system is often in sharp contrast to the home environments of many foreign investors, where governments may have the power to arbitrarily seize assets, where industrial and development activity can wipe out the value of one's land, and where there is maybe independent judiciary to sort out claims among private owners or between the government and private owners.

US real estate assets also have a history of steady appreciation over the long term. Residential and commercial rents have consistently followed the same positive trend line, creating a national real estate market that has been profitable for both owners and landlords across sectors. Together, steady appreciation and exemplary legal stability have made US real estate assets a very suitable investment to safely and productively harbour foreign capital.

While US real estate has remained a steady and stable environment for the past 25 years and for long before that, this has not been the case elsewhere in a changing world. The fall of the Soviet Union, the transformation of the Chinese and Indian economies and the development of the internet, have contributed to rapid economic growth and capital creation in a wide variety of previously poor markets. Yet many of these growing economies do not yet have the long positive track record of US real estate or the foundational protections of private property rights of the US legal system. Further, the open knowledge in, and interconnectedness of, global capital markets allows more and more foreign investors to understand the relative stability of US real estate as an investment. The result has been an extraordinary outflow over the past 25 years of investment capital from fast growing global economies into the US real estate market.

Demography as destiny: America's re-urbanisation

No factor is better correlated with the success of a real estate market than demography. Cities that are growing jobs and attracting people will experience property values, rising rents, and provide, at the outset at least, more value per investment dollar than stagnant cities. The common wisdom that the primary markets are a smart investment is borne out by demographic data. All of the primary markets in the US, with the exception of San Francisco which has a heavily constrained housing stock, have experienced substantial population growth for the last decade. These cities are all well-known preferred destinations for ambitious, skilled and well-credentialed graduates and young professionals, ready to start their lives.

The demographic influx of job seeking graduates and young professionals creates a virtuous cycle of growth as rising incomes breed a greater demand for housing, leading to increasing rental rates and property values. The prime markets have shown resilience in a changing economy. For example, at the same time that New York has shed high paying financial services jobs it has replaced many of those jobs with technology jobs. Yet it is not in the primary markets where this virtuous cycle has been most clearly demonstrated in recent years.

America's fastest growing cities are all secondary markets. In 2013 the five cities with the highest rates of population growth were:

1. Austin, Texas;
2. Raleigh, North Carolina;
3. Phoenix, Arizona;
4. Dallas, Texas; and
5. Salt Lake City, Utah.

While even casual readers of the news may have predicted high rates of growth in Texas due to the reemerging dominance of the US energy industry, the other three cities on that list might surprise many foreign investors. The next three cities on the list:

6. Denver, Colorado;
7. Ogden, Utah; and
8. Charlotte, North Carolina

should be even more surprising. Of the top eight growth markets six of them are outside of the states which are most often viewed as the primary targets by foreign investors in US real estate: New York, California, Florida and Texas. The questions to ask are: what is driving the population growth of these cities, will it create a favourable investment environment for commercial real estate developers and investors and what other markets in the US might present similar opportunities?

All of the cities listed are experiencing rates of unemployment well below the US median. Job opportunities are naturally one of the primary factors of city demography, and excellent job opportunities are a necessary condition for the growth of a city. But the quality of the jobs being offered is just as important as their availability. Highly paid positions in desirable fields create the urban professional class so vital to the virtuous cycle of growth identified above.

A look at the technology sector, now America's fastest growing industry, perfectly complements the list of quickly growing cities. The top two cities for technology job growth from 2001-13 were Austin, Texas and Raleigh, North Carolina, the two cities that also were the highest growth cities in America last year. Number six on the technology jobs list was Salt Lake City, Utah. Other secondary market cities worth mentioning that have experienced high rates of technology job growth are Nashville, Tennessee at number four and Indianapolis, Indiana at number nine. San Francisco, one of the primary markets, makes it onto the technology list at number five, none of the other primary markets do.

More broadly, an analysis of employment data based on individual income from new jobs in cities across the country shows that middle income employment has grown the most in the Texas metropolitan areas (numbers (1) – (4) on the list of cities creating the most middle class jobs), but also has grown substantially in:

(5) Oklahoma City, Oklahoma;
(7) Nashville, Tennessee;
(8) Salt Lake City, Utah; and
(9) Denver Colorado.

New York has seen technology jobs growth as well, however, in New York much of the employment growth has been in low wage jobs, a situation that on its own, without the inflows of capital from places like the Middle East, China and Russia, would be unable to sustain the sky-high for-sale and rental residential real estate market that exists in the city today. A study of the jobs data in the US clearly shows that the cities with most potential for steep growth and returns are well outside of the primary coastal cities. Many graduates and young professionals are heading to other regions, and that demographic trend is likely to sustain and accelerate in short and medium terms.

Demographic data, by itself, only tells us about the markets that will experience jobs and population growth relative to other US markets. Perhaps equally or even more important is the re-urbanisation trend the US is experiencing, which may revolutionise the way American's work, live and commute. If the return to urban centres plays out, as many sociologists expect, real estate opportunities in centre cities will be extraordinary on a national level. The opportunities will be especially attractive in the many secondary US cities that saw their downtowns deteriorate into ghost towns over the second half of the 20th century. As urban centres are reenergised there will be a demand for modern living and working space, in both new and re-purposed buildings, as well as a need for retail, restaurants and other amenities, creating great demand for investment.

Cities in this category broadly include many cities in the Midwest, such as Cleveland, Ohio, with more US$1.3bn invested in projects in the downtown area that are currently in construction or planning stages, and southwest like Denver, Colorado, with over US$1bn in public development in its downtown area that went live in 2013 and 2014. Many of these cities have already begun this urbanisation process and are starting to yield impressive returns to investors.

An in depth deep analysis of the rise and fall of US urban centres is beyond the scope of this article. However, to understand the significance and impact of the current rebirth of urban centres requires a brief overview of the dramatic arc of US cities in the twentieth century. The US, after the Second World War, began to develop new cities and living spaces based on a suburban model of living.

This model emphasised the automobile, which achieved extremely widespread ownership in the US by the 1950s. In the suburban model of development, people of means and many in the middle class would live outside of the cities they worked in, in relatively large personal residences, and commute by car or public transportation to their jobs.

Large highways were built to facilitate the heavy traffic this model of living would create in cities. Downtowns and culturally distinct aggregations of buildings, such as restaurant and shopping districts, were eschewed in newer American cities, in favour of a more uniform distribution of commercial spaces throughout the suburban ring. Multi-family buildings were given lower priority under the assumption that only an underclass would seek to live in urban centres. Cities previously mentioned in this article which were first developed under this model of

development include Phoenix, Arizona and Charlotte, North Carolina. Other, more established cities like Los Angeles and a myriad of Midwestern cities were functionally retrofitted into the urban-work/suburban-live model.

This developmental model of living was followed faithfully in the US post-war period. Urban centre populations throughout the US peaked between 1950 and 1960, and then started on a steady decline. In many metropolitan areas, the workplace moved out to the suburbs along with the living space and many centre cities became isolated desolate places. Around 1980, the trend started reversing. Even as developers continued to concentrate on suburban development, urban centre populations began to rise. The rate of urban population growth in city centres grew steadily from 1990-2000. By 2000, population was growing in nearly every major city centre in the US.

There are both tangible and intangible factors that are assumed to have contributed to the re-urbanisation of the US. Some factors are sociological, including the emergence of non-traditional family structures, a trend towards later in life marriages, and the maturing of a suburban raised population seeking a more vibrant cultural life than suburbs could provide. Other factors are economic, such as a change in employment patterns of Americans: the phenomenon of job hopping among younger generations and thus a greater desire to be near a concentration of employers where new and varied job opportunities are more plentiful. Whatever the precise explanations may be, surveys of young Americans show an unprecedented appetite for urban living, and the facts on the ground lead us to the conclusion that urban centres in the US are expected to grow substantially in the future.

Cities built on a suburban model, lacking city centres, culture and nightlife have been left at a competitive disadvantage as the trend towards urbanisation continues. Corporations and government have taken notice. For example, Motorola, a major employer in the Phoenix metropolitan area during the post war years began to transfer the jobs from Phoenix to Austin in the 1980s, and had pulled out of the Phoenix area nearly completely by the early 2000s. Its reason for leaving: Phoenix's anemic urban centre as compared to Austin's bustling downtown and 24/7 cultural scene.

In response to this economically destructive divestment, Phoenix's leadership authorised urban development on a massive scale so they could regain equal footing in the race to attract jobs. A tremendous amount of real estate development was authorised in Phoenix starting in the 1980s and continuing to the present to try to create a vibrant downtown. Some of these developments failed, notably Arizona Centre (150,000 square feet of retail space) and 400 condominium units at 44 Monroe and Summit. Other developments, however, saw great success, such as an expansion of Arizona State University into Phoenix's downtown area, and the construction of medium density housing such as Artisan Village. Another city that sought to re-energise its downtown in the last few decades was Charlotte, North Carolina. That city successfully developed downtown housing that led to a revitalisation of the area.

Whatever the failures and successes of past urban revitalisation efforts, it is clear that for metropolitan areas planned largely on an suburban car-based lifestyle to attract employers and population there will need to be a continuing drive towards real estate development in the urban core. Foreign real estate investors should keep an interest in these kinds of markets as they are likely to be able to find attractive investment opportunities that can be developed with the support and partnership of municipalities.

The prevailing demographic trends in the US support an optimistic outlook for commercial real estate development around the country as many US cities continue to grow. A close look suggests that the places where many of the most attractive growth and investment opportunities are the secondary markets, not exclusively the primary ones. A look at the cities where rental rates have increased the most in 2013 already bears out this conclusion. While San Francisco and its neighbor San Jose top the list of cities with highest growing rents due the housing stock constraints inherent in the area, none of the other primary markets make the list, instead secondary markets abound in the top ten like:

(3) Seattle, Washington;
(6) Denver, Colorado; and
(10) Austin, Texas.

However, as places like these cities above mature, it would be advisable to look to less well known secondary cities, and even tertiary cities to find opportunities for outsized returns and appreciation

.

Taxes and the costs of doing business

All foreign real estate investors are subject to federal taxes, and without sound counsel they may end up paying substantial rates on income and return on their US real estate investments. Nonetheless, the US is still generally considered a favourable tax environment for real estate investment at the federal level, as a well-structured real estate investment will pay substantially fewer taxes in the US than investments in many other

nations. But foreign real estate investors should also be aware that they are subject to state and local taxes on their real estate investments in addition to federal taxes. The state and local tax environments in many secondary markets can be much more favourable to investment than in primary markets.

New York and California, the states with the three most prominent primary markets also have some of the most onerous state tax burdens in the US. Think Tank Tax Foundation rated New York and California as having the 49th and 48th worst overall tax climates in the US respectively. This analysis incorporated corporate taxes, individual taxes, sales taxes, unemployment insurance taxes and property taxes.

Even if a foreign real estate investor only needs to worry about property taxes, many economists feel that the higher tax states will lose jobs and population due to a competitive disadvantage against states with better tax climates. Texas, the state with the ninth best tax climate, shows the kind of impact tax environment can have on demography, which then further impacts property values and investors bottom lines. From a pure cost perspective, real estate taxes in New York are the 45th worst in the country. California does substantially better from a purely real estate tax perspective and in fact has the 17th best real estate tax environment in the country. Almost all of the growing secondary real estate markets are in states with favourable tax environments, including:

(7) Washington;
(10) Utah; and
(16) Colorado.

The competitive advantage provided by low tax environments will not, however, always lead to a favourable real estate investment environment in the long term. States with low tax burdens will generally be spending less on the public improvements that are required to support new real estate development and the revival of city centres. Foreign investors looking at secondary markets should be mindful of whether there are adequate state and local resources necessary to implement public projects that will make a state's city infrastructure competitive. Also while sophisticated foreign real estate investors are aware that public-private partnership (P3) opportunities in the US can step in where public funds are not available for public works, in fact it has been high tax states where most P3 opportunities have been spawned. New York, New Jersey and Maryland lead the way in P3 formation. Overall, compared to the rest of the world P3 development in the US has been undercapitalised, with municipalities continuing to rely mostly on traditional public finance to meet their infrastructure needs.

Opportunities outside the cities

A review of the current prospects of the US real estate market generally points to cities as the prime locations for investment in the long term. Still there are other areas of unique real investment opportunity which exist in the US that should not be ignored. The discovery and exploitation of natural gas and oil fields throughout the US presents one of those opportunities. The hydraulic fracturing boom of the past five years is likely to remain a feature of the US economy for the next few decades. The amounts of natural resources which have become feasibly extractable are enormous, with the Bakken shale formation in North Dakota being comparable to Saudi Arabia in the amount of oil and natural gas it holds. Other significant shale formations are located in Appalachia (Pennsylvania and West Virginia) and Texas. These sites are going to be centres of extensive industrial extraction for the foreseeable future. The employees that work at these sites, most of whom are highly paid, need amenities, and development on these sites is likely to expand business in the future.

As it stands, energy boom areas are grossly underserved. Rents near the Bakken field in North Dakota are reaching rates similar to those in major cities. Retail and entertainment space in these areas is nearly nonexistent. Developers have only recently begun to enter this space, and while development in a resource boom town area is risky, the yields on these investments have been commensurate with the risk involved. Foreign investors, who are willing to take on some risk, may be able to find returns on investment in the shale fields that are well above any other market.

Conclusion

The US is a vast country, encompassing numerous regions each supported by different industries and providing a variety of employment opportunities. Foreign investors in US real estate have, however, concentrated their investments in marquis markets like New York, Los Angeles and San Francisco. With more and more foreign capital moving to the US, competition has increased for the most desirable properties.

As a result, investments in the top markets may not provide attractive yields and appreciation. Other markets in the US, while not offering the marquis appeal of the primary markets do offer the same political and legal protections as the primary US markets. A number of these secondary markets have demand for real estate investment as a result of job and population growth and the shift to urban living. These secondary markets may also have tax

environments that can further improve returns on real estate investments. Foreign investors looking for secure and stable real estate investments in the US owe it to themselves to look outside of the primary coastal cities and to explore the opportunity presented in secondary markets.

Research assistance provided by Greenberg Traurig Associate Robert Katsnelson.

Author:
Stephen L. Rabinowitz
New York Co-Managing Shareholder
Greenberg Traurig
MetLife Building
200 Park Avenue
New York, NY 10166, US
Tel: +1 212.801.9295
Email: RabinowitzS@GTLaw.com
Website: www.gtlaw.com