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THE SHIFTING LANDS O

SCAPE

F BIG CITIES

What is taking place in urban areas is more than people moving addresses; the working landscape is greatly changing, and that is impacting the future of real estate investing strategy.

Two things can be true at once:

1) People have left (and are continuing to leave) big cities across North America, and
2) more people are flocking to these markets because there is an essence about them that cannot be replicated elsewhere.

It is a story of cause and effect. Certain people are leaving big cities, and this is leading to people entering to replace them, while being welcomed with lower relative costs. It comes down to supply and demand. There are few housing options in congested cities, and there is less desire to live in these expensive areas. But the real kicker is that supply dropped initially more so than demand. This shift will continue to result in demand rising and catching up to the relative supply rate. So, people outside the Bay Area will see discounted rates and view now as the time to move to that market.

THE FUTURE OF WORK IN THE SHORT-TERM

A year ago, we forecasted the future of work and the five main aspects of this trend in *Canadian Property Valuation (Volume 64, Book 3, 2020)*. First, the rise of secondary markets (which was the gateway into our following report detailing the outpost economy, which I will describe later). With vast amounts of employees still working from home, secondary cities – such as Sacramento, Nashville, and Salt Lake City – will witness continued population growth. These secondary markets were already growing prior to the pandemic, but the decentralization of office space and the increase in jobs that allow for remote work are exacerbating the trend. Secondly, employers will continue to weigh the pros and cons of their office spaces — they will be far more intentional, potentially downsizing or moving to a newer, more open area or embracing more flexible models. This prioritization of a hybrid model led to the foothold secondary markets dug into in late 2020 and still are experiencing today.

Third, the shared office space (or, WeWork model) is primed for a resurgence in an era of increased flexible work. The year 2020 was turbulent to say the least, which forced people and employers to be flexible. Fourth, with downtown real estate being 'undervalued' by previous standards, smaller businesses will invest in these locations to move up the corporate food chain. Part of this will lead to a revitalization in primary markets, some of which we are experiencing now and have seen for the past few months. Lastly, microbusinesses will find more opportunities and mobility as smaller businesses gain their traction.

THE INCREASING VALUE OF SECONDARY MARKETS

In a report that we released this past winter, we further examined secondary markets as some began to exhibit signs of becoming an outpost to more populated metropolises. This effect led to us coining the phrase the "outpost economy" to describe secondary markets that could act alongside their nearby primary market. We explained the rationale behind this as the "hub and spoke" model. For example, a city in California's Central Valley such as Modesto would have a growing workforce connected by a metaphorical spoke to the symbolic hub: San Francisco.

We took this a step further by stating that primary market offices would have satellite locations in these smaller cities to diversify and follow the trail of employees leaving for these secondary markets. In the report, we projected that office demand would not decrease, and even in some markets, it will rise due to the appeal of the hub and spoke model. With this in mind, we noted that the value of downtown high-rises would decline by 10-15% over the next few years because of dissemination outwards and into secondary markets. In addition, we anticipated a decrease in employer costs, including real estate expenses. This trend as a whole led us to believe that a Renaissance in traditional working-class cities could occur with the right circumstances and interest.

WHY PRIMARY MARKETS WILL NOT FALL OFF THE FACE OF THE EARTH

There was a popular but misguided notion that big cities would see a long-term drop off in residents a few months into the start of the pandemic, when people began to recognize the concern of living in close quarters as well as the severity of what the pandemic lockdowns were doing to people's desires to move. However, while areas witnessed short-term decreases in the average population, this fact does not quite paint the whole picture: People are opportunistic and what is considered an 'opportunity' can swing demand like a pendulum in a matter of months.

There will be a resurgence of entrepreneurship in primary markets, leading to young professionals and savvy entrepreneurs moving into these areas. We wrote about this in our recent report, *Rebirth of a City: Why Primary Markets are Primed for Revitalization*. These new entrants will replace people who left for secondary markets or elsewhere. Because of this natural cycle, comparable amounts of people will pour into markets like Chicago and San Francisco as others who are able to leave flock to more affordable markets. The infrastructure, both literal roadways connecting buildings and intellectual networks of people, already exist in primary markets, and recreating that is costly – if not impossible – in the monetary sense and logistically.

Working professionals in large cities can almost always follow the ebb and flow of demand to the place where they will reap the most reward. They are the types of people who take more calculated risks; they try to learn the best skills and apply them in the best places. These are the type of people who view big life decisions like this as if it were a stock: the 'shares' of living in New York City are lower, so young professionals in, say Rochester, looking to shake things up and capitalize on the softer-than-usual market value in the Big Apple will strike while they still can. It will be more expensive to rent in New York City than other parts upstate, but comparatively less than if they had made such a life transition in 2017, for example.

SHORTCOMINGS FOR SOME CITIES, OPPORTUNITIES FOR OTHERS

Despite the well-warranted optimism of the last section, it will not be smooth sailing for every big city. Cities with low employment or housing opportunities will stagnate. Suppose businesses choose not to invest in cheaper-than-average office space and/or do not make new hires in these markets (i.e., there are no remote workers in these given cities). In that case, there will be no incentive for young professionals – or any working professionals for that matter – to migrate into these metropolitan areas. A 20% reduction in rent is irrelevant if a person has no job to pay for it. Additionally, cities that do not find ways to entice people to move will be hurt the most. If there are no enjoyable entertainment or fun attractions to keep people wanting to stay, they will leave. However, cities with lower rent prices that attract remote workers or entice businesses to open up satellite offices stand to benefit.

This should be obvious given that most people who left big cities will not be returning. They knew the advantages of big cities: great restaurants, lots of fun and diverse people, notable segments of art from music to paintings to theatre – and yet they still chose to leave. Granted, some may come to regret their decision, especially given the fact that many points of interest closed during the pandemic, but, for the most part, those who took the initiative to leave will not be keen on packing up shop and moving back.

Therefore, it is on cities and employers to generate ways to encourage new people to call their primary market their home. As investors in commercial real estate, it may be valuable to look at initiatives taken by local governments and business owners in their communities. If both groups are not stepping up to the challenge or going about the solution passively, that is a big red flag.

KNOWING THE HOW/WHEN/WHAT ABOUT PROPERTY VALUES IN THE POST-PANDEMIC ERA

I touched on this slightly in the last section regarding the investment quality of commercial real estate in primary markets and what would increase its value. The same standard could be applied to Canadian cities like Montreal and Toronto. Suppose leaders in those major markets find ways to entice people to come (or return if they left during the pandemic) to the big city. In that case, business employers will likely do the rest of the work to bring people into these cities.

Part of the equation also dips into residential real estate, which should remain residential and are converted to commercial space. Apartment owners that create workspaces out of their residential buildings will literally be creating new offices for remote workers. Additionally, with rent prices dropping in many primary markets, it could be highly advantageous to convert certain buildings over to commercial properties if local ordinances and zoning laws permit such a transition. In short, apartment owners that create these workspaces will thrive in the long run.

Companies that embrace intentional office work will be the real winners. However, we know that in-person collaboration cannot be substituted to the same degree. Yes, video conferencing is a great alternative when clients are halfway across the country (and especially internationally), yet there comes the point where getting everyone in the same room to hash out a plan or a report is the ideal option.

The pandemic will inevitably fade away, which means that property values will increase with population and inflation. Keeping in mind telltale signs is the best way to predict the future, but like with anything, there is no certainty even if all the indicators are pointing towards something that ends up not happening. However, having more components in your analysis before investing in property will better your chances of securing a worthwhile investment. Even in strange times, it is good to go back to the basics rather than reactively buying up properties that are simply selling for lower than market value.

THE FUTURE OF REAL ESTATE RISK CALCULATIONS

Post-pandemic life will give a glimmer of light to historically strong primary markets. Young professionals chasing their dreams will embrace that light and chase their dreams. They will capitalize on the opportunities inherent in these economic hubs. This will accelerate the rise in value in primary markets as they rebound from the market recession of 2020. Despite the outflux of big-city residents, people moving in to replace them will outweigh the exodus.

Tracking population movement in primary markets may offer a glimpse into the potential value of real estate property. As population growth starts swinging upward in major markets, that bodes well for commercial (not to mention residential) real estate. That said, it is crucial to keep an eye on potential self-fulfilling prophecies. If investors do not invest in a market, shying away from investing will actually continue a downward trend in that market. It is the contrarian investors who swoop in during those moments that find real value.

If it becomes evident that employers want to have their employees in the office because they think it will give them an advantage, this could turn the gears of business expansion which would lead to local economic growth. Essentially, it could create business opportunities that would not have occurred if employers did not jump on the trend, and might not have happened otherwise had the potential trend not been predicted in the first place.

However, watch out for over-saturation in the market. If every commercial real estate investor is jumping into the ring at the same time because there is a projected property boom in the community, the ROI may decrease. I like to call this an anti-self-fulfilling prophecy. Investors all think the market is about to grow substantially, they all invest in it to feed that outcome, and yet all that energy has the opposite effect, or no effect whatsoever. It is worth noting that perceptions of reality (where investors think property prices will rise) should not outweigh the reality itself (where property prices go as a matter of fact).

Wading through the waters of commercial investment will always have its risks, but analyzing as many contributing factors and trends occurring will paint the best holistic picture possible, and allow you to make the most educated and calculated investment decision available. Those who take advantage of the rebirth of primary markets – where there is an emphasis on higher quality of life and economic incentives – will reap the rewards from these types of properties. Such communities will become hotspots of success and prosperity in the years to come, which generates more overall value.