ALEX. BROWN REALTY
SPECIAL REPORT

AN EXAMINATION OF THE MIDDLE MARKET SEGMENT OF COMMERCIAL REAL ESTATE

Q2 2022

TABLE OF CONTENTS

EXECUTIVE SUMMARY

After being severely curtailed by the COVID-19 global pandemic in 2020, U.S. commercial real estate activity rebounded sharply in 2021, setting a record with $809 billion in transaction volume. In addition, of the nearly 40,000 properties that were traded in the major real estate asset classes (i.e., office, industrial, retail, multifamily and hotels), 81% were for middle market assets. This report describes the middle market, it analyzes the performance of middle market properties and it examines the benefits middle market assets can provide investors.

INTRODUCTION

While there is no single definition for middle market commercial real estate properties, they are generally considered to be properties valued at or below $50 million. They can be further stratified into the following segments:

$2.5 million to $15 million: **LOWER MIDDLE MARKET**

$15 million to $35 million: **CENTRAL MIDDLE MARKET**

$35 million to $50 million: **UPPER MIDDLE MARKET**

Assets priced above $50 million are generally considered too large to be classified as middle market and are often owned by larger institutional platforms. Alex. Brown Realty, a Baltimore-based real estate investment manager, defines middle market properties as those priced between $2.5 million and $35 million. Assets priced in this range represent the vast majority of properties traded and this report will focus primarily on this segment of the market. According to Real Capital Analytics (RCA), between 2011 and 2021, 87% of the properties that were traded were priced between $2.5 million and $35 million.

The high trade volume for middle market properties evidences strong interest in this section of the market and while trades for larger assets tend to receive most of the headlines, significant value can also be found in middle market assets.

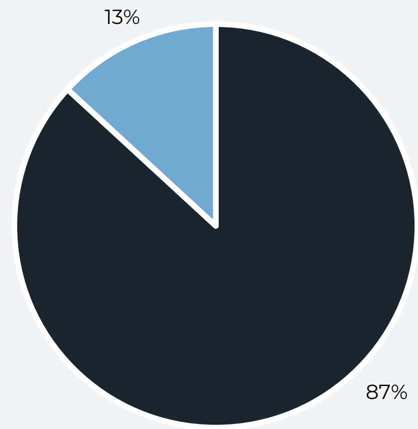
U.S. Commercial Real Estate Trades by Number of Properties 2011 – 2021

■ Between $2.5M and $35M
■ Greater than $35M

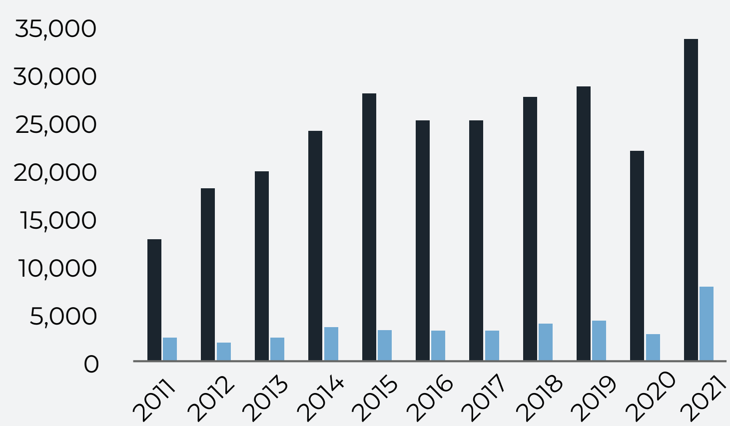
Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors

Aggregate Percentages



Trade Volumes by Year



While trades for larger assets tend to receive most of the headlines, significant value can also be found in middle market assets.

THE BENEFITS OF INVESTING IN THE MIDDLE MARKET

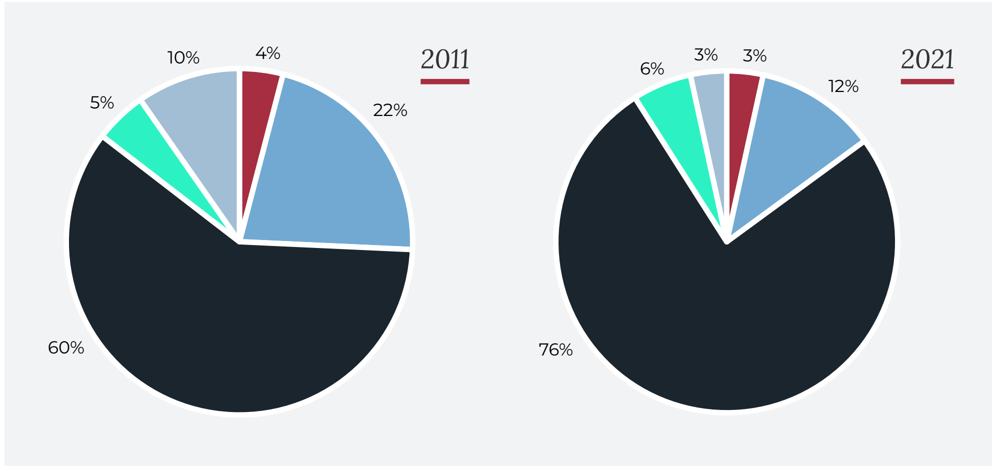
With 87% of the properties traded between 2011 and 2021, the middle market is large, broad, and fragmented. It is also subject to less competition from institutional capital because the large amount of capital institutional funds need to deploy makes it inefficient for them to pursue middle market properties. This is reflected in data from RCA revealing that while the amount of private capital pursuing middle market assets has increased substantially since 2011, the amount of institutional capital pursuing middle market assets has decreased substantially since then.[1] In 2011, institutional capital accounted for 22%, 40% and 42% of investor capital in the lower, central and upper middle market segments, respectively. However, by 2021, institutional capital accounted for only 12%, 21% and 25% of investor capital in the lower, central and upper middle markets, respectively.

Buyer Composition CRE Valued Between $2.5M and $15M

- Cross-Border
- Institutional
- Public
- Private
- User/Other

Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors

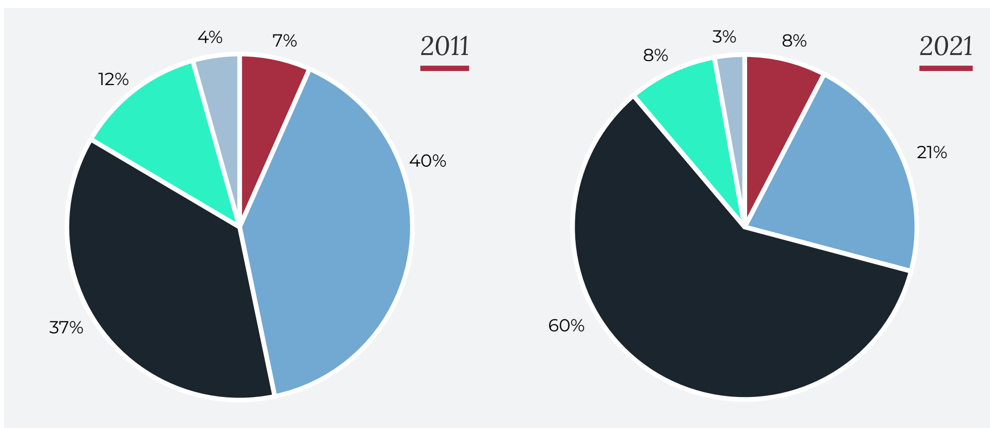


Buyer Composition CRE Valued Between $15M and $35M

- Cross-Border
- Institutional
- Public
- Private
- User/Other

Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors

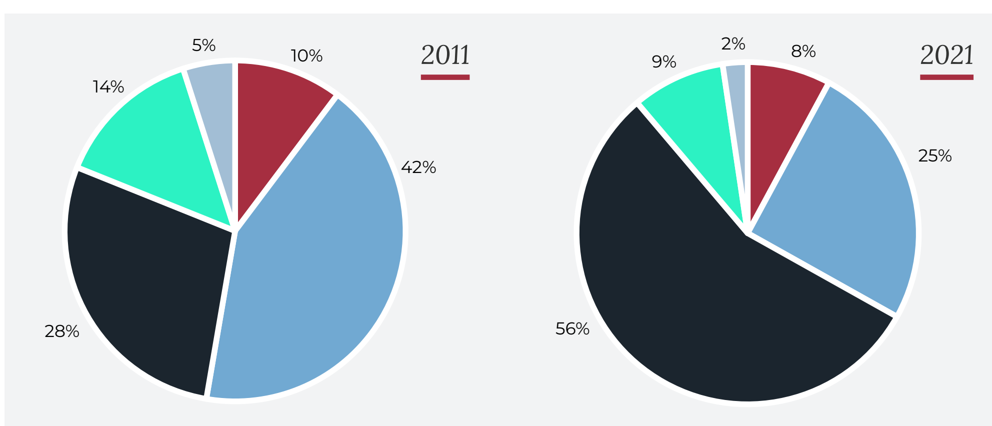


Buyer Composition CRE Valued Between $35M and $50M

- Cross-Border
- Institutional
- Public
- Private
- User/Other

Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors



Instead of being owned primarily by institutional funds, middle market property owners tend to be non-institutional and varied. They include smaller funds, partnerships formed by friends and family, family offices, other entities and individuals. Accordingly, while there is plenty of capital in the middle market, it is not as well organized, sophisticated or professional as the capital targeting larger assets. In addition, because middle market properties can be found across the country, the middle market's vast size and scope arguably make it the most inefficient and fragmented segment of the broader commercial real estate market. The combination of these factors can generate several benefits for middle market investors.

First, a lack of sophisticated capital in the middle market can lead to quality assets being mispriced and thus, potentially acquired at an attractive basis. There is currently a significant disconnect between where lower and central middle market properties are trading compared to where upper middle market and larger properties are trading. This is demonstrated by recent cap rate spreads between properties valued between $2.5 million and $35 million, and properties valued above $35 million. From 2011 to 2019 the average cap rate spread between these segments was 87 bps. However, in 2020 it grew to 99 bps as capital flowed to the perceived safety of institutional assets after COVID-19 emerged. The spread continued to grow in 2021, ultimately finishing the year at 102 bps.[2]

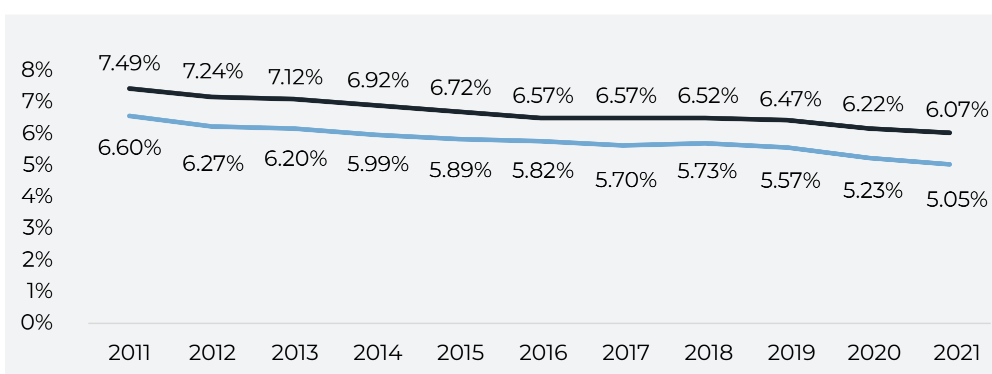
U.S. Commercial Real Estate Average Cap Rates 2011 – 2021

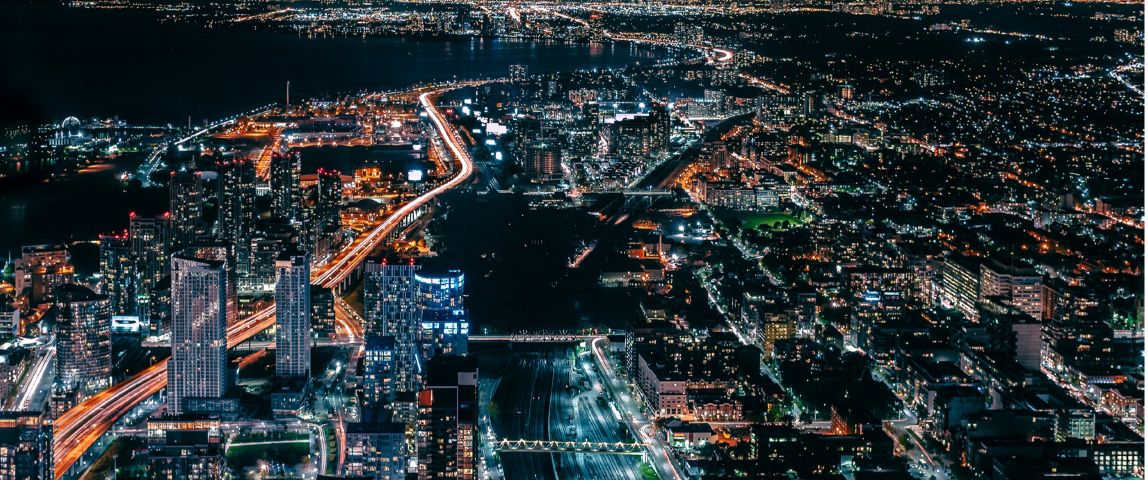
Between $2.5M and $35M

Greater than $35M

Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors





Contributing to recent high cap rate spreads between middle market and higher priced properties is the acquisition strategy of large institutional funds. In recent years, these funds have raised large sums of capital from domestic and foreign sources, and they need to invest it efficiently and on a timely basis. This dynamic demands that these fund managers focus on acquiring larger properties or portfolios in lieu of investing in middle market properties because it is not efficient for them to allocate capital to this segment of the market. This reduces the number of sophisticated buyers for middle market assets and leads to quality middle market assets being mispriced. This in turn, allows for astute investors to acquire these assets at an attractive basis and earn higher yields relative to their larger peers. For example, a diligent investor with strong sourcing and underwriting capabilities can acquire a mispriced or undervalued middle market asset at an attractive basis and implement a business plan that improves the property's performance. The business plan may include interior or exterior capital improvements, a redevelopment or recapitalization of the asset, improved management and/or marketing from a new operator, or some other value-add mechanism. If the business plan is successfully executed, it can result in additional cash flows throughout the holding period and a significant return at exit by placing the asset back on the market as a core asset (often at a price above $35 million that produces greater institutional fund interest). Thus, in addition to generating current income on investor capital, well-executed middle market investments can also provide substantial returns through capital appreciation.

the middle market is large, broad, and fragmented

Second, even though middle market deal sizes are smaller, there are several financing sources available for them. These include large lenders, major banks, community banks, insurance companies, debt funds, government agencies, crowdfunding platforms, and others. This broad access to leverage reduces the cost of debt for middle market acquisitions to a point that compares favorably with institutional assets.

Third, in addition to potential pricing premiums from mispriced properties, because of the number of financing sources that are available, middle market investors may also receive a structural financing premium in the form of better covenants from lenders.

MIDDLE MARKET PROPERTIES' RECENT PERFORMANCE

PRICING TRENDS

A detailed analysis of pricing trends demonstrates middle market properties' upside. For example, an examination of price PSF growth for properties valued between $2.5 million and $35 million, and properties valued above $35 million, reveals that lower priced assets outperformed their higher priced peers significantly between 2011 and 2021. During this period the price PSF for properties valued between $2.5 million and $35 million increased by 58%, versus a 26% increase for properties valued above $35 million.

In addition, a property-level comparison of pricing growth in the six major primary markets that are home to many larger assets, versus the pricing growth of properties in the non-primary markets that are home to the majority of middle market properties, reveals that in recent years pricing growth for assets outside the primary markets has generally outperformed pricing growth for assets inside the primary markets.[3] Furthermore, when analyzed over four different periods, the data also indicates that rent growth for larger assets began to peak around 2015, motivating investors to look to secondary markets for yield. The periods that are analyzed are the following:

I. **2011 to 2015**
   2015 is approximately the time rent growth for larger assets began to peak.

II. **2015 to 2019**
   2019 is the year before COVID-19 emerged.

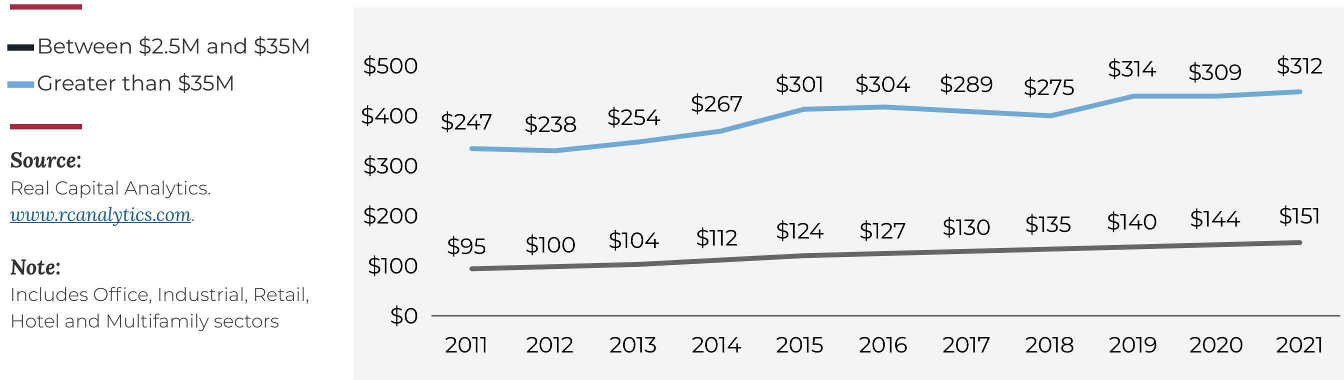
III. **2019 to 2020**
   2020 is the year COVID-19 emerged, severely disrupting the economy and dramatically curtailing commercial real estate transaction activity.

IV. **2020 to 2021**
   This period includes the year COVID-19 emerged and the following year, when economic growth and commercial real estate trades accelerated.

The data reveals that from 2011 to 2015, with the exception of multifamily assets, pricing growth for assets in the primary markets exceeded pricing growth for assets outside the primary markets across the major real estate asset classes.[4] However, this trend shifted in 2015 and since then, with the exception of 2019 to 2020, a period that was heavily influenced by COVID-19, pricing growth outside the primary markets has outperformed pricing growth inside the primary markets. Specifically, from 2015 to 2019 pricing growth outside the primary markets exceeded pricing growth inside the primary markets for all of the major real estate asset classes. From 2019 to 2020 pricing growth outside the primary markets exceeded the pricing growth that took place inside the primary markets in two out of the five major real estate asset classes (i.e., office and multifamily). Lastly, from 2020 to 2021, repeating what occurred from 2015 to 2019, pricing growth outside the primary markets again exceeded pricing growth inside the primary markets for all of the major real estate asset classes.

A detailed analysis of pricing trends demonstrates middle market properties' upside.

Commercial Pricing Trends ($PSF): 2011 – 2021



Source:
Real Capital Analytics.
www.rcanalytics.com.

Note:
Includes Office, Industrial, Retail, Hotel and Multifamily sectors

OFFICE PROPERTIES

From 2011 to 2015 the price PSF for office properties increased by 24% in primary markets, versus 18% outside the primary markets. However, from 2015 to 2019 this dynamic shifted and prices increased by only 18% in primary markets, versus 27% outside the primary markets. Since then, office assets outside the primary markets have continued to outperform their primary market peers. From 2019 to 2020 office prices decreased by 3.42% in primary markets, versus a 3.22% decline outside the primary markets; and from 2020 to 2021 prices decreased by 1% in primary markets, versus a 9% increase outside the primary markets. The substantial pricing growth for assets outside the primary markets during this final period is likely due to concerns about the future of office properties in higher density urban settings now that hybrid and remote work arrangements have become more prevalent due to COVID-19.

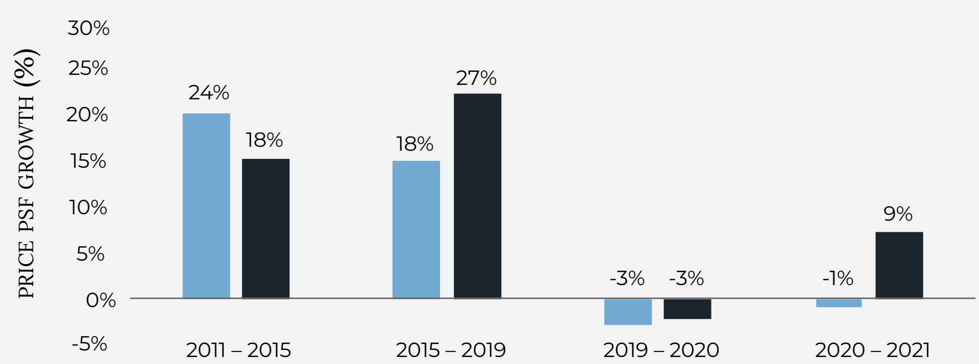
Major Metros vs Non-Major Metros: 2011 – 2021

OFFICE

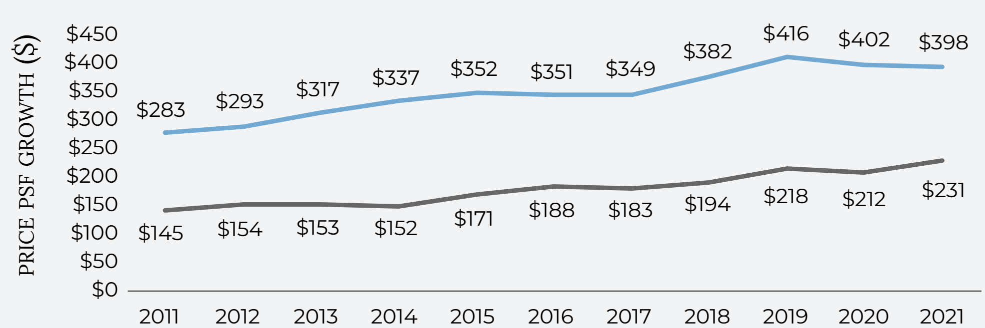
- Primary Markets
- Non-Primary Markets
- Primary Markets
- Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.

Price Growth PSF (%)



Price Growth PSF ($)



INDUSTRIAL PROPERTIES

From 2011 to 2015 the price PSF for industrial properties increased by 54% in primary markets, versus 28% outside the primary markets. However, from 2015 to 2019 this dynamic shifted as prices increased by 33% in primary markets, versus 34% outside the primary markets. From 2019 to 2020 another shift occurred as primary markets experienced 6% pricing growth, overtaking the non-primary markets which experienced 5% pricing growth. This trend then reversed again and from 2020 to 2021 industrial real estate prices increased by 9% in primary markets, versus an 11% increase outside the primary markets. The pricing growth outside the primary markets from 2020 to 2021 was partially driven by rapid e-commerce growth during this period. E-commerce activity had been growing consistently for years, but it accelerated in 2020 largely because of stay-at-home orders and other COVID-19 related measures that restricted the ability of people to shop at stores, malls, and other retail outlets in-person. Furthermore, because COVID-19 related restrictions occurred across the U.S., e-commerce growth also occurred in markets across the country. This geographically dispersed growth increased the importance of warehouses, distribution centers and other industrial properties in secondary markets located outside of city centers and contributed to strong pricing growth outside the primary markets.

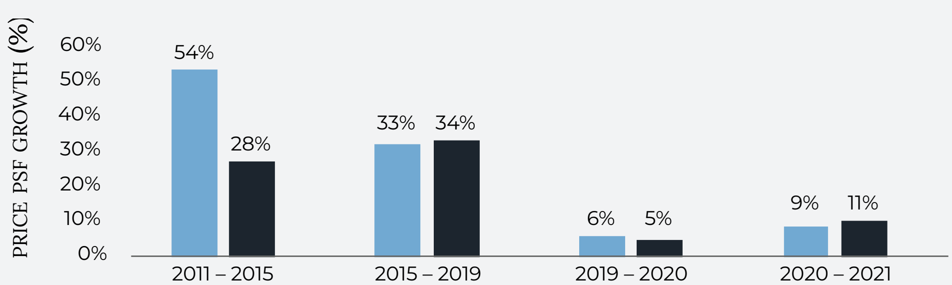
Major Metros vs Non-Major Metros: 2011 – 2021

INDUSTRIAL

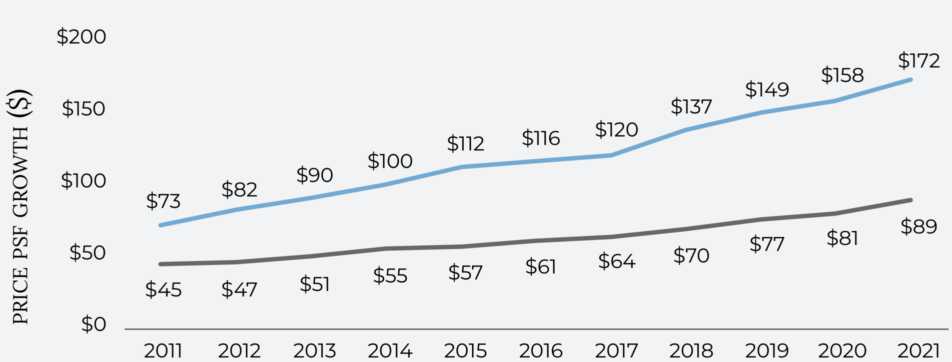
- Primary Markets
- Non-Primary Markets
- Primary Markets
- Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.

Price Growth PSF (%)



Price Growth PSF ($)



RETAIL PROPERTIES

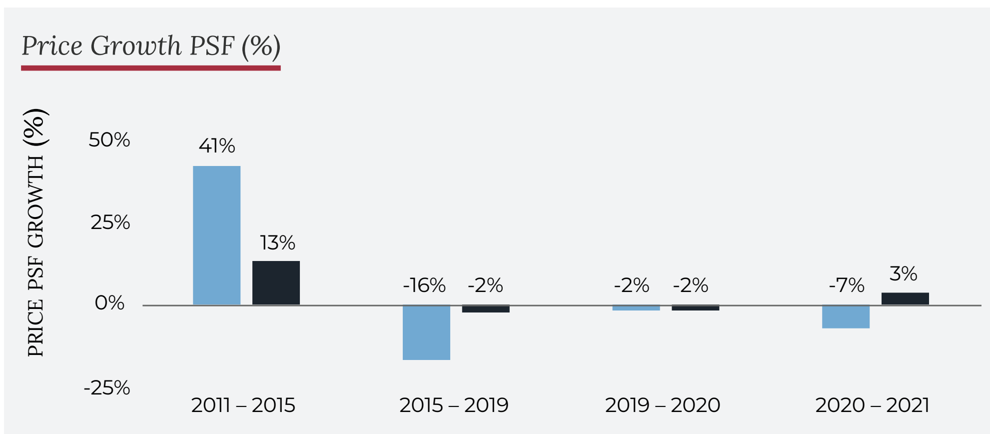
From 2011 to 2015 the price PSF for retail properties increased by 41% in primary markets, versus 13% outside the primary markets. From 2015 to 2019 this trend reversed as prices declined by 16% in primary markets, versus a smaller decline of 2% outside the primary markets. From 2019 to 2020 another shift occurred as retail prices decreased by 1.68% in primary markets, versus a slightly larger decrease of 2% outside the primary markets. Then, from 2020 to 2021 retail pricing trends reversed again with prices decreasing by 7% in primary markets, while increasing by 3% outside the primary markets. During this period investors appeared hesitant to acquire retail properties in crowded city centers as COVID-19 disrupted shopping patterns in urban locations.

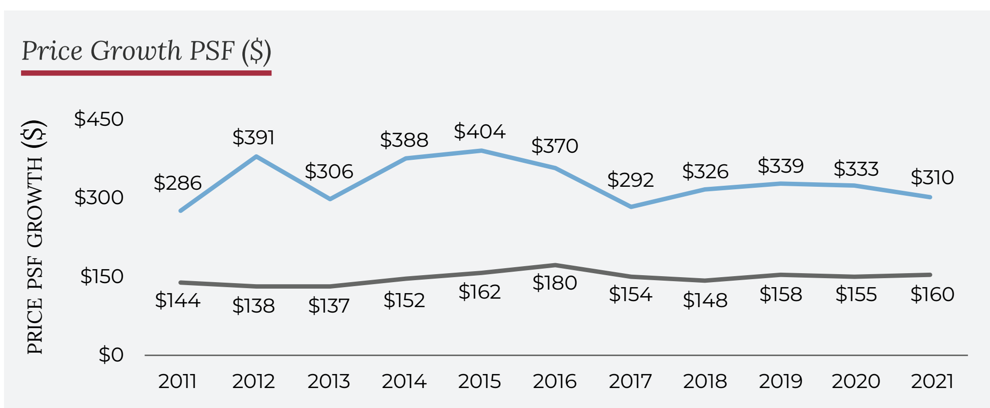
Major Metros vs Non-Major Metros: 2011 – 2021

RETAIL

Primary Markets
Non-Primary Markets
Primary Markets
Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.





HOTEL PROPERTIES

From 2011 to 2015 the price per key (PPK) for hotel properties (note the change from price PSF), increased by 47% in primary markets, versus 17% outside the primary markets. A shift then occurred and from 2015 to 2019 prices declined by 24% in primary markets, but increased by 6% outside the primary markets. Another shift then took place and from 2019 to 2020 prices declined by 16% in primary markets and by a much larger 31% outside the primary markets as investors grew cautious about acquiring hotel properties in less populated secondary markets. However, this thinking changed once it became apparent that leisure travel would recover from the COVID-19 pandemic much quicker than business travel. This trend favors limited-service and select-service hotels in secondary markets and this contributed to hotel prices increasing by 7% in primary markets from 2020 to 2021, while they increased by 39% outside the primary markets.

This trend favors limited-service and select-service hotels in secondary markets.

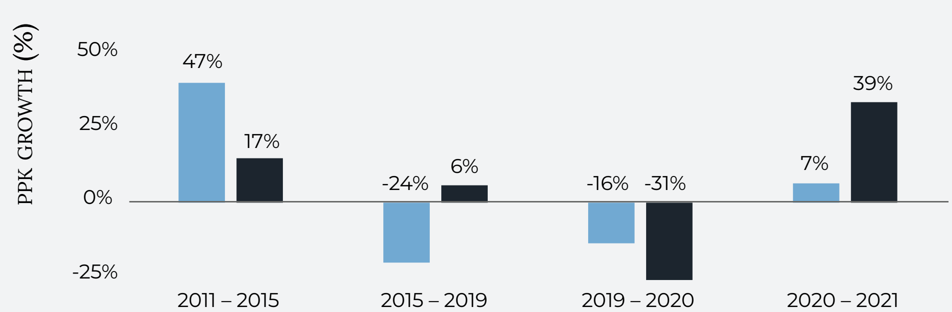
Major Metros vs Non-Major Metros: 2011 – 2021

HOTELS

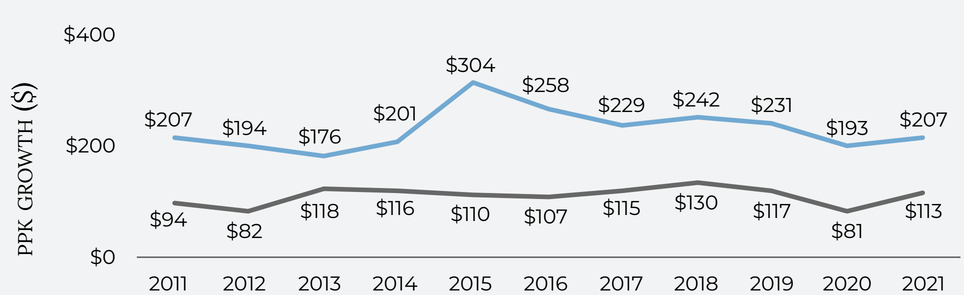
- Primary Markets
- Non-Primary Markets
- Primary Markets
- Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.

Price Growth PPK (%)



Price Growth PPK ($)



MULTIFAMILY PROPERTIES

For multifamily properties, pricing growth outside the primary markets has consistently exceeded pricing growth inside the primary markets. From 2011 to 2015 the price per unit (PPU) for multifamily properties in the six primary markets increased by 43%, versus a larger 48% increase outside the primary markets. From 2015 to 2019 prices increased by 13% in primary markets, versus 39% outside the primary markets. From 2019 to 2020 prices declined by 2% in primary markets, but increased by 5% outside the primary markets. And, from 2020 to 2021 prices declined by 4% in primary markets, but increased by 4% outside the primary markets.

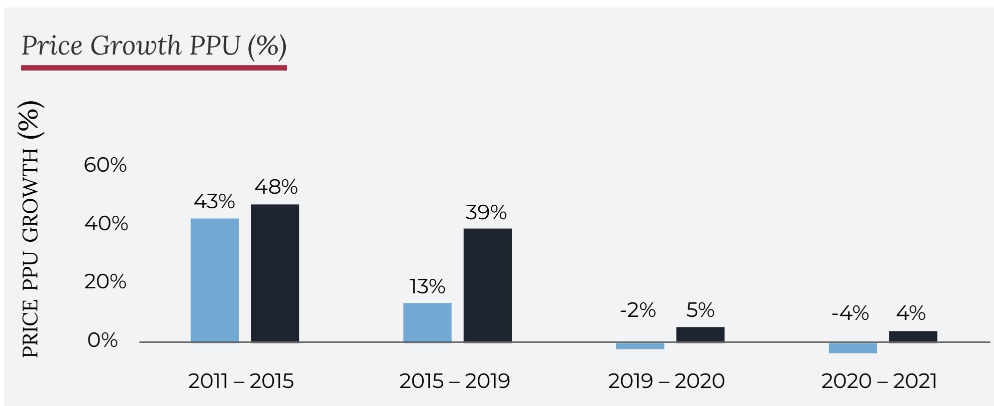
The strong pricing growth of real estate assets in the non-primary markets where most middle market properties are located reflects their upside potential. Additional data on capital flows and cap rates also indicates that investors are taking steps to realize the value attractive middle market assets hold.

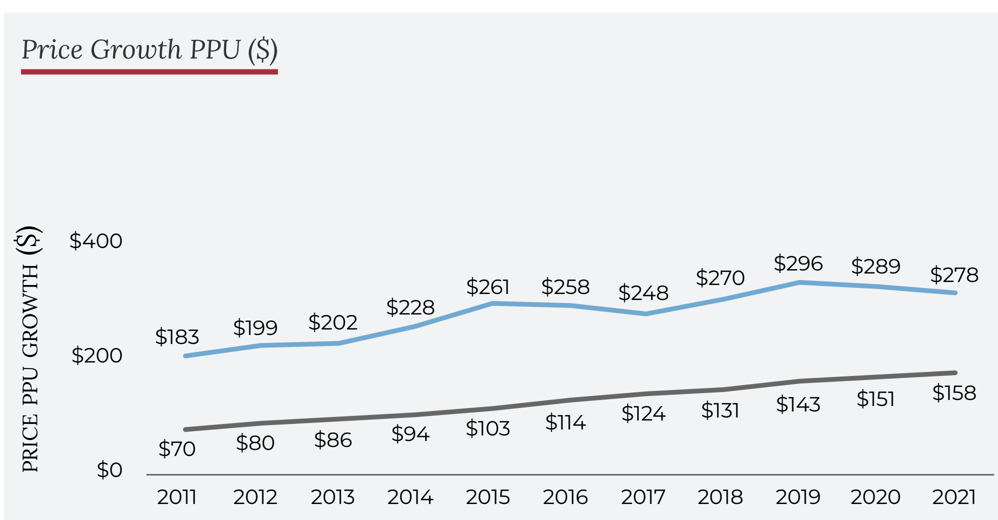
Major Metros vs Non-Major Metros: 2011 – 2021

MULTIFAMILY

- Primary Markets
- Non-Primary Markets
- Primary Markets
- Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.





INVESTOR INTEREST IN MIDDLE MARKET PROPERTIES

An examination of capital flows indicates that investors are increasingly looking outside the primary markets for yield. For example, of the nearly $200 billion in domestic capital that was invested in the major real estate classes in 2011, only 54% of it found its way to secondary and tertiary markets. However, by 2021 this figure had grown to 71%.

The amount of foreign capital being invested in secondary and tertiary markets has also increased in recent years. From 2011 to 2017 foreign capital invested in primary markets exceeded the amount invested in secondary and tertiary markets. However, this changed in 2018 and since then foreign capital invested in secondary and tertiary markets has exceeded the amount invested in primary markets.

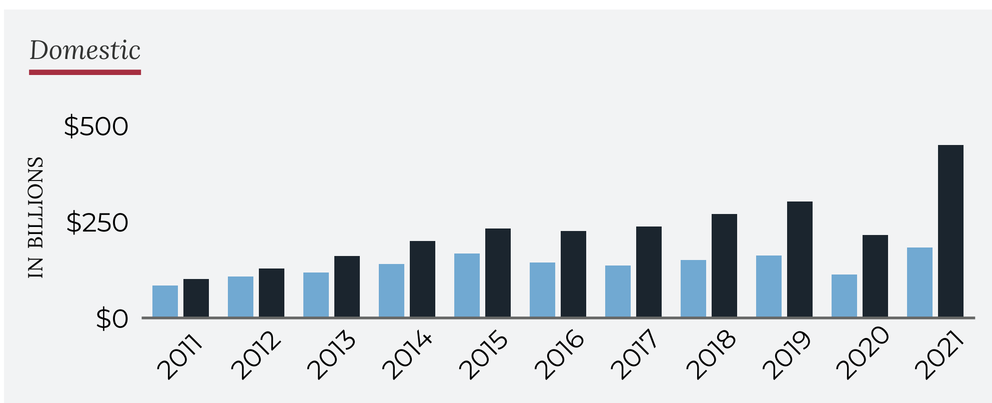
investors are increasingly looking outside the primary markets for yield

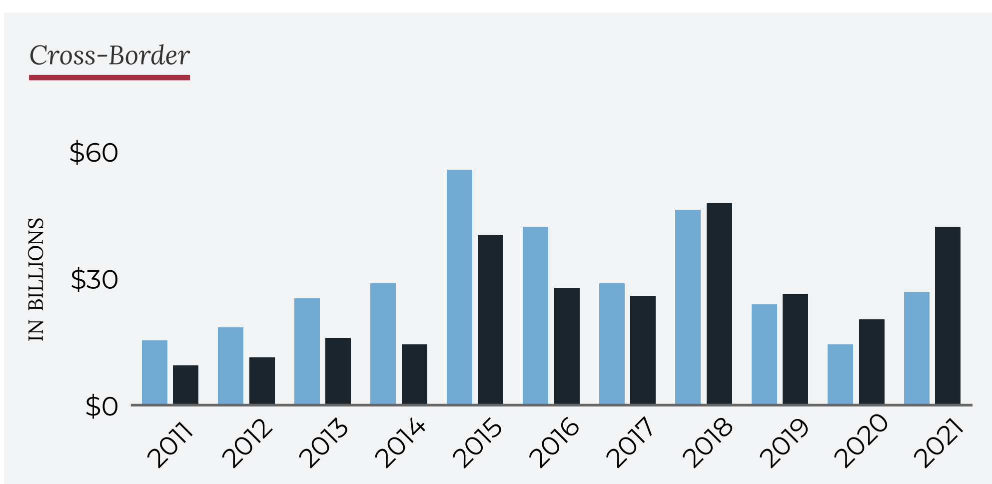
While capital is flowing into middle market properties, it is also important to note that these properties can hold investment risks that are different than those associated with larger assets in primary markets.

Capital Invested in Major Metro and Non-Major Metro Markets: 2011 – 2021

- Primary Markets
- Non-Primary Markets

Source:
Real Capital Analytics.
www.rcanalytics.com.





MITIGATING MIDDLE MARKET INVESTMENT RISK

Generally, primary markets, where most larger assets are found, enjoy a broadly diversified job base and typically have higher barriers to new supply. And, in the case of office and industrial assets, larger properties typically have high credit leases. This contrasts with secondary and tertiary markets, and middle market assets in general. Instead, with middle market assets, local fundamentals, particularly supply, demand and locational considerations, have a greater impact on property performance and valuations and can substantially impact an asset's performance. Mitigating the unique risks associated with middle market sized assets can be accomplished through various strategies.

Preqin data indicates that mid-sized funds that focus on central middle market assets record higher risk adjusted returns than their peer funds that invest in higher priced properties.

First, underwriting risk can be moderated through strategic partnerships with experienced local operators who know their markets well. These operators typically have intimate knowledge of locational and building advantages in their communities, and often an understanding of the history of both. They are typically the first to learn of events that can help create or impair value, such as new road construction; changing demand catalysts, such as new company relocations or expansions; and potential new supply. A comprehensive understanding of the information provided by these parties produces more accurate underwriting, which helps lessen investment risk.

Second, leveraging relationships with knowledgeable partners who can effectively source deals and identify mispriced properties can lead to acquiring assets at less than intrinsic value. Acquisitions of this kind create a cushion for cash flows, operational issues and performance challenges. This further moderates investment risk.

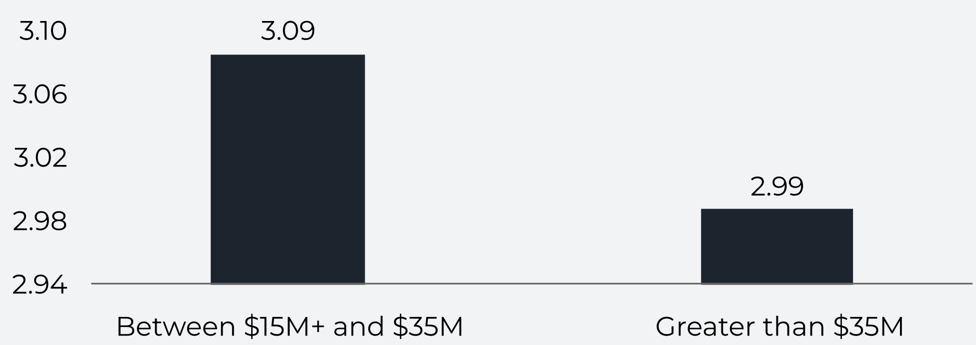
Third, by utilizing strategic partners an investor can successfully gain access to multiple property types and different geographic regions. This provides portfolio diversification and mitigates nonsystemic risks associated with a particular market such as adverse weather events, excess supply being delivered, material increases in local property taxes or employment loss in large local industry. Portfolio diversification also helps protect investors against risks experienced in a particular property sector, such as that experienced by the hotel industry when travel declined due to COVID-19.

Lastly, while some level of risk is inherent with all investments, Preqin data indicates that mid-sized funds that focus on central middle market assets record higher risk adjusted returns than their peer funds that invest in higher priced properties. Specifically, an analysis of core, value-add and opportunistic fund returns provided by Preqin reveals that funds sized between $200 million and $1 billion that invest in assets priced between $15 million and $35 million return higher Sharpe ratios than equivalent-sized funds that invest in assets priced above $35 million.[5]

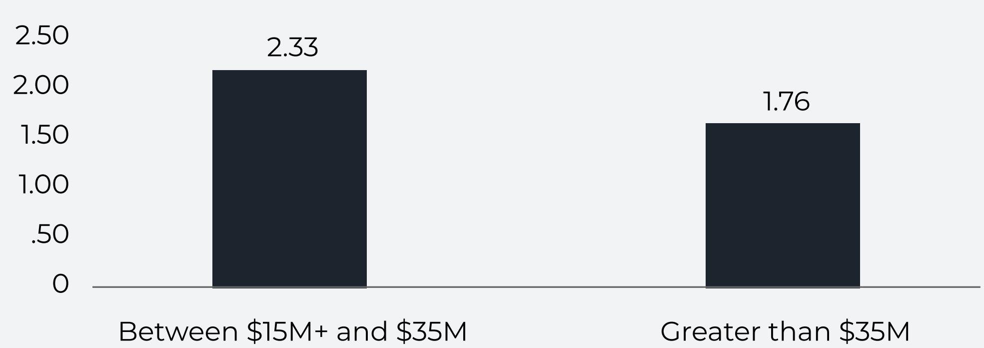
Sharpe Ratios for Fund Sizes Between $200M and $1B

Source:
Preqin

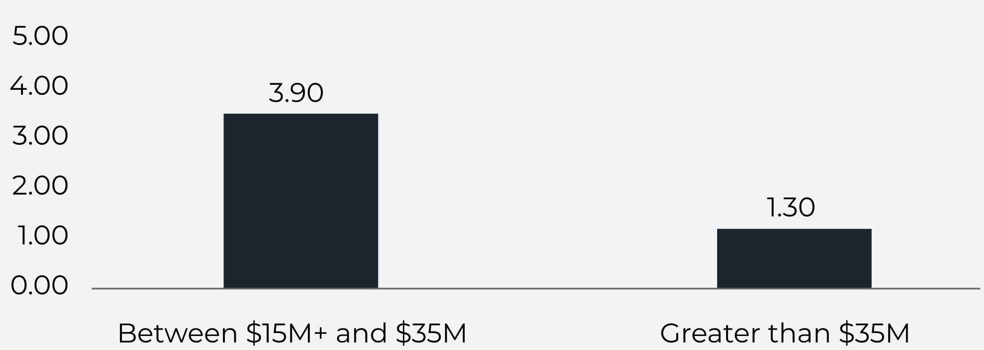
Core/Core Plus Funds



Value-Add Funds



Opportunistic Funds



CONCLUSION

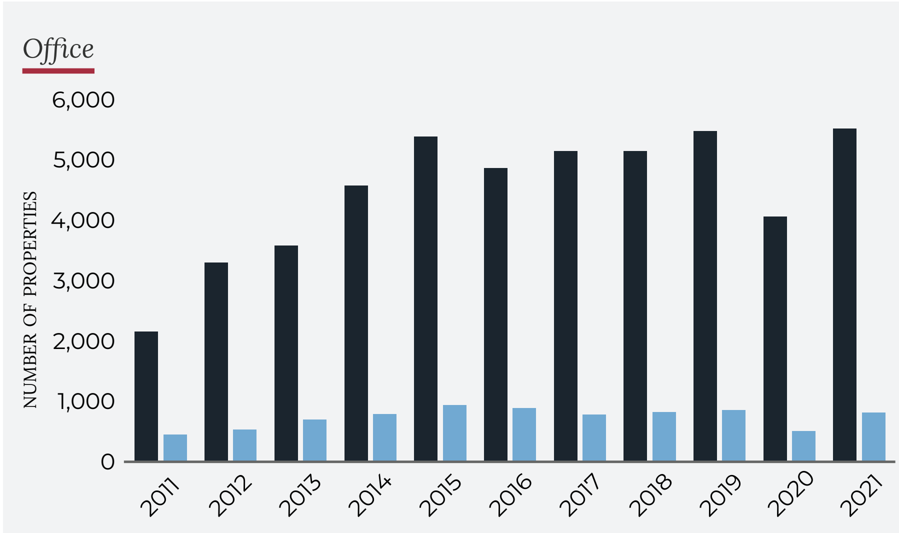
The middle market for commercial real estate is distinguished from other market segments by its large size, fragmented nature, and limited competition from institutional capital. These characteristics combine to create a market that offers several benefits to investors, including the potential to generate strong yields from selective investments in growing regions across the country. Generous cap rate spreads between middle market properties and their higher priced peers indicates strong upside potential for these assets, and transaction volumes and capital flows into the secondary markets where most middle market properties are located suggests that investors are increasingly taking note of the yield potential they possess. With a disciplined approach, effective underwriting and appropriate risk mitigation practices, knowledgeable investors who can source, acquire and manage middle market assets effectively will be well-positioned to earn attractive returns from these investments.

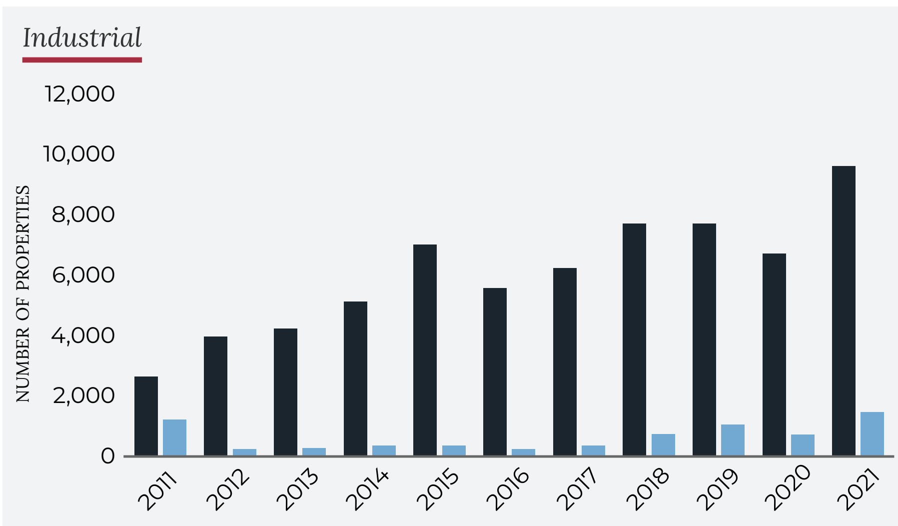
APPENDIX

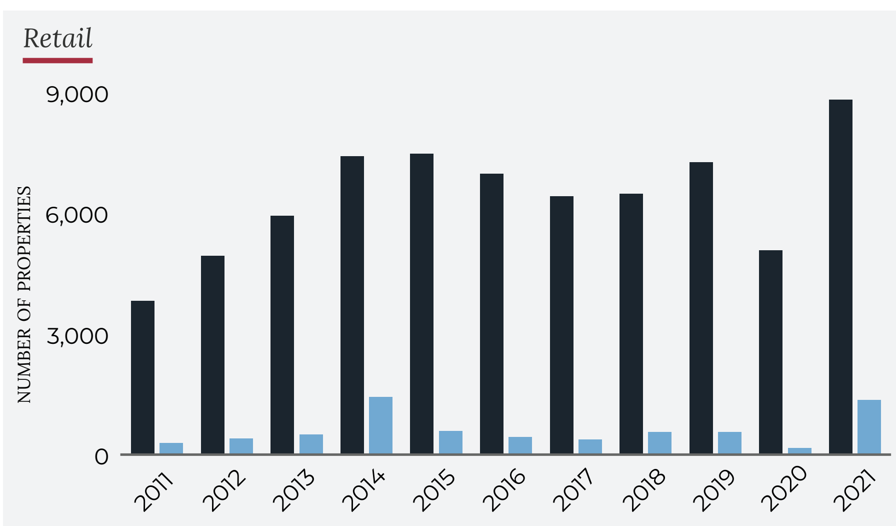
HISTORICAL TRANSACTION VOLUMES BY ASSET CLASS: 2011 – 2021

■ Between $2.5M and $35M
■ Greater than $35M

Source:
Real Capital Analytics.
www.rcanalytics.com.







HISTORICAL TRANSACTION VOLUMES BY ASSET CLASS: 2011 – 2021

■ Between $2.5M and $35M
■ Greater than $35M

Source:
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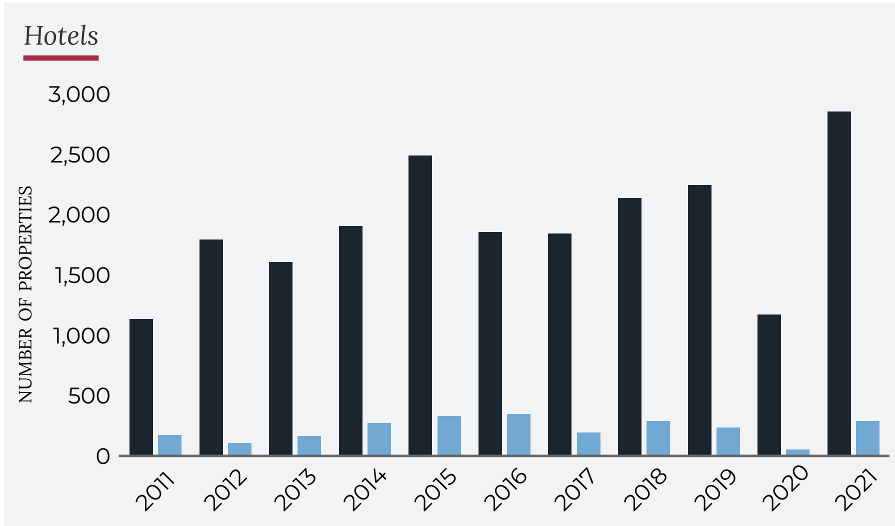
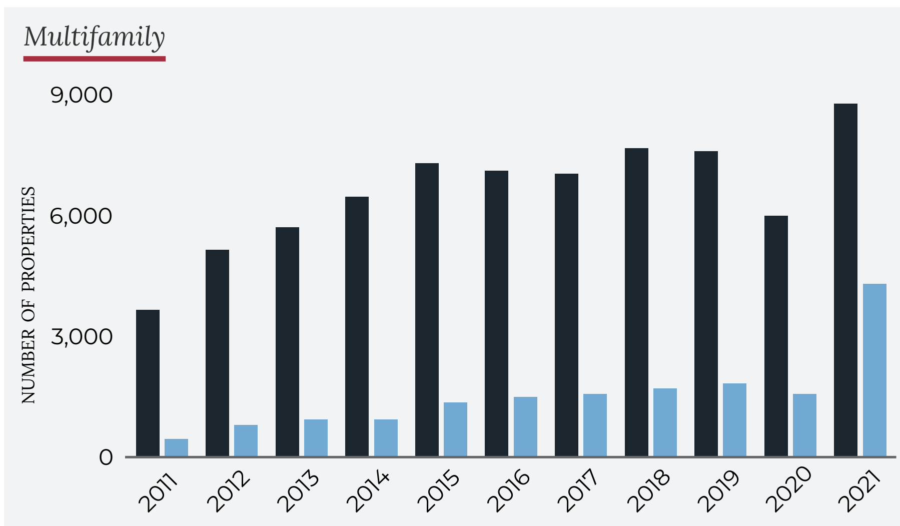
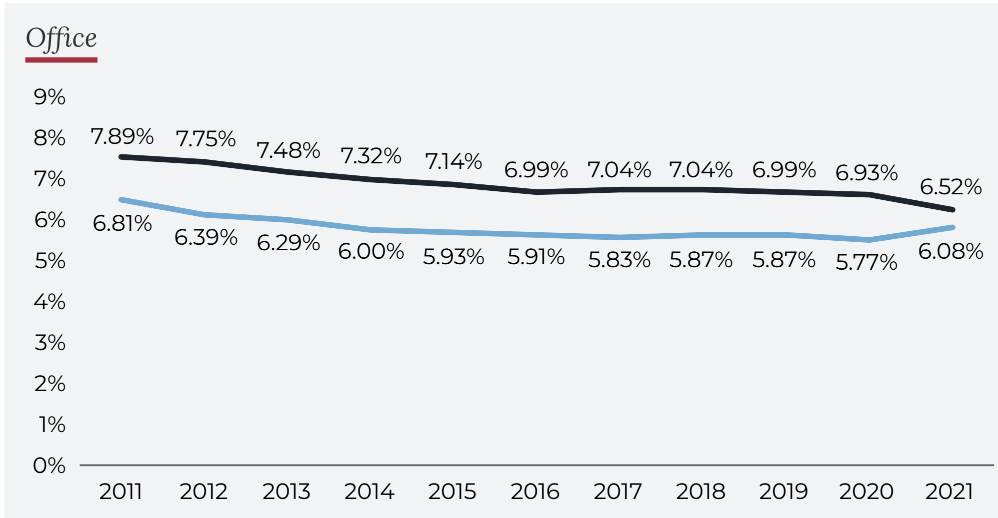


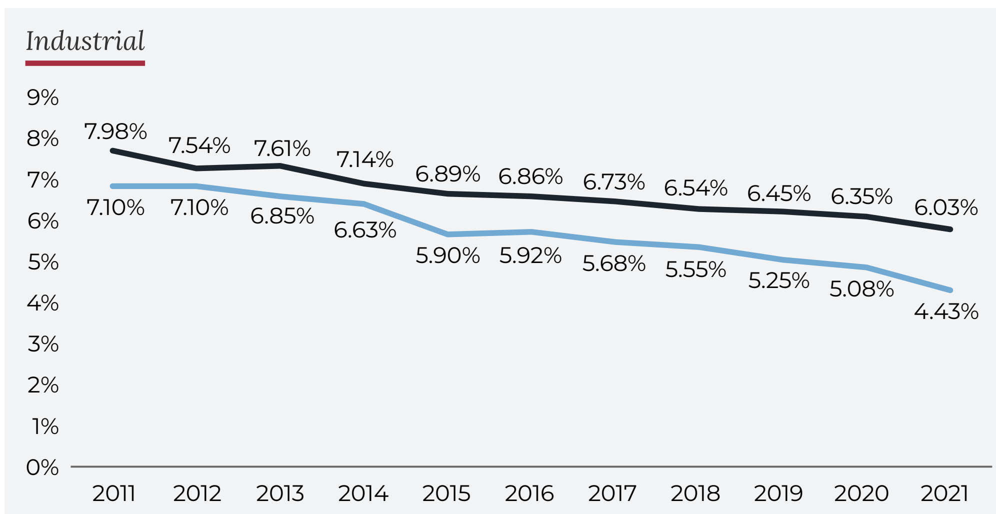


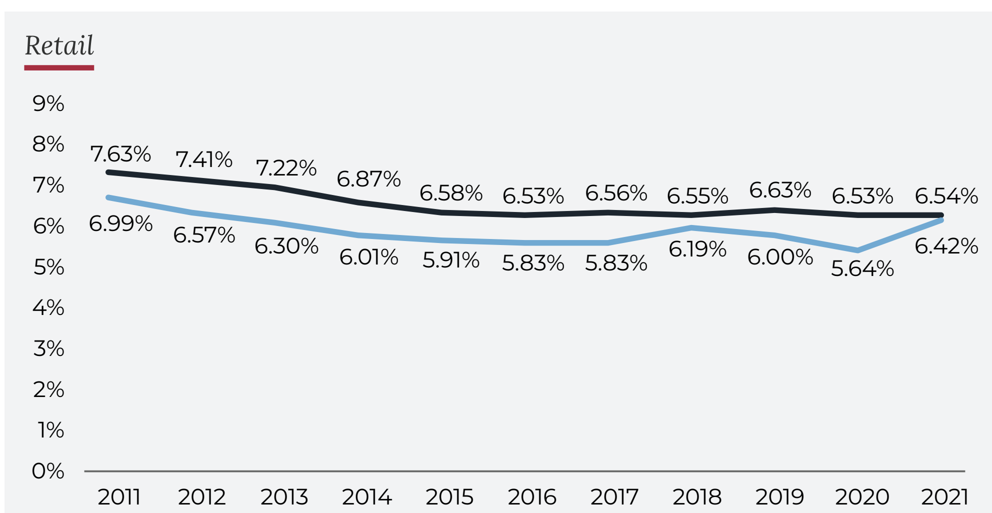
HISTORICAL CAP RATES BY ASSET CLASS: 2011 – 2021

Between $2.5M and $35M
Greater than $35M

Source:
Real Capital Analytics.
www.rcanalytics.com.



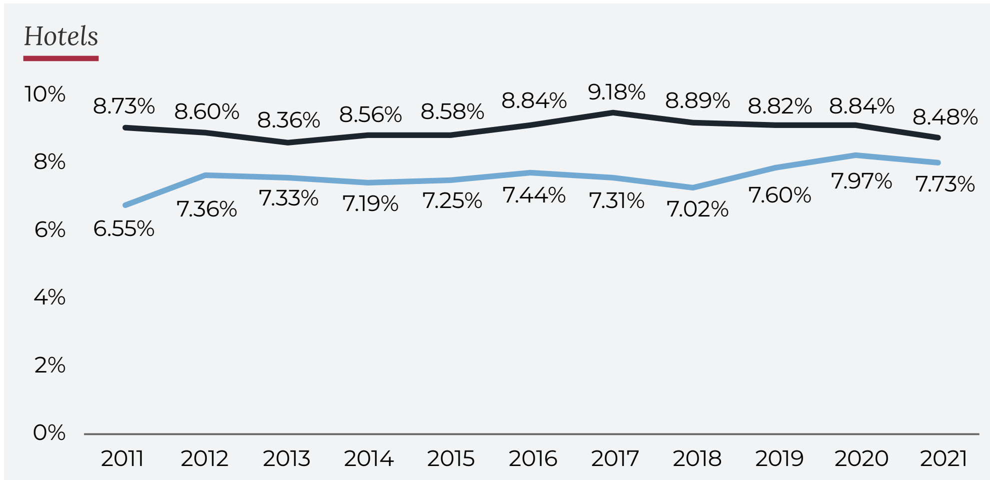


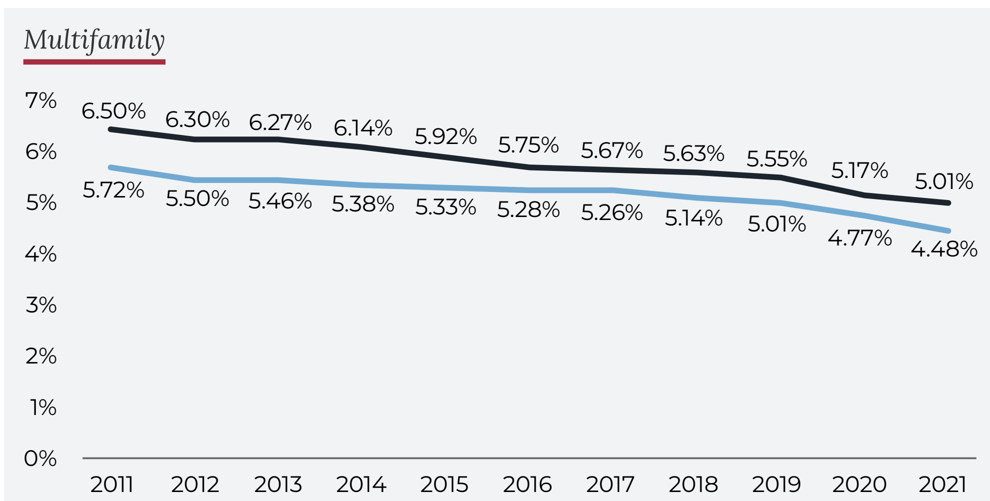


HISTORICAL CAP RATES BY ASSET CLASS: 2011 – 2021

Between $2.5M and $35M
Greater than $35M

Source:
Real Capital Analytics.
www.rcanalytics.com.





ENDNOTES

1 Real Capital Analytics defines institutional investors as the following: An investor, such as a bank, insurance company, retirement fund, hedge fund or mutual fund, which is financially sophisticated and makes large investments, often held in large portfolios of investments. Real Capital Analytics defines private investors as the following: Private family wealth invested directly, non-traded Real Estate Investment Trusts (including public non-listed REITs), and non-traded privately held developers, property managers, owners, and operators.

2 The exact cap rate spread for the 2011 to 2019 period is 87.15 bps, it is 98.56 bps for the 2020 period, and it is 102.15 for 2021.

3 The six major primary markets are New York, Los Angeles, San Francisco, Chicago, Boston, and Washington D.C. The non-primary markets are also referred to as secondary and tertiary markets.

4 The major real estate asset classes are office, industrial, retail, hotels, and multifamily.

5 Sharpe ratios were calculated using data from closed-end funds with North America as their Primary Region Focus, vintage years between 2011 and 2018, and that reported at least two trades, trade pricing, and fund net IRRs to Preqin. A total of 79 funds met the eligibility criteria and were used in the analysis. 8 funds were analyzed in the Core/Core Plus group, 46 funds were analyzed in the Value-Add group, and 25 funds were analyzed in the Opportunistic group. The Sharpe ratio was calculated based on fund data reported through August 17, 2021 and is subject to change as fund returns change. ABR does not attest to the accuracy or completeness of the data that individual funds reported to Preqin.

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