

As featured in Wealth Management Real Estate's 2024 Midyear Outlook Report

How Secondary Market Investments Can Strengthen Your Portfolio

While primary markets such as New York and Los Angeles attract significant interest from institutional real estate investors, some of the most favorable markets in the country to invest in are secondary markets. Even before the COVID-19 pandemic accelerated inbound migration to smaller cities in the Sunbelt and other parts of the U.S., astute investors were already enjoying the benefits of acquiring assets in these markets. Here, we explore some of the principal attributes of secondary markets and the reasons why investors should consider them.



Less Competition

In order to deploy capital efficiently, institutional fund managers regularly focus on acquiring larger assets in primary markets. This phenomena lessens competition for secondary market assets and can lead to lower prices and better acquisition terms for these properties. There may also be fewer regulatory hurdles for buyers in secondary markets where local governments welcome investment capital to stimulate growth and development. The price differential between properties in secondary and primary markets is reflected in Real Capital Analytics' data indicating an average long-term cap rate spread of approximately 90 bps between middle-market properties that trade for \$35 million or less and are often located in secondary markets, and more expensive properties located in primary markets.

Meaningful Growth Potential

Less buyer competition for secondary market assets can also lead to them being mispriced. When purchased at an attractive basis, these properties possess strong growth potential. For example, a mispriced or undervalued asset that has been acquired at a low basis and is subsequently upgraded through better management, capital improvements, or another strategy can generate enhanced cash flows through its holding period and meaningful capital appreciation at exit by being returned to the market as a core asset that generates greater interest from a broader pool of buyers. Value creation from property improvements can also be augmented by increased interest in the market itself, further contributing to attractive returns at exit. This is reflected in Real Capital Analytics' data indicating that price growth in various secondary markets has recently exceeded price growth in primary markets.

From 2010 to 2019, the average price growth for properties that were traded in strong secondary markets such as Columbus, Nashville, Tampa, Denver, Salt Lake City, and Seattle exceeded the average price growth for properties in primary markets. As migration to secondary markets accelerated during the pandemic, the average price growth in several secondary markets continued to surpass price growth in primary markets.

The benefits of lower acquisition costs, current income, generous capital appreciation, risk mitigation and attractive risk adjusted returns are particularly important in today's elevated interest rate environment. Real estate assets in growing secondary markets have demonstrated these attributes through different economic cycles and investors who value these benefits should consider placing capital in select secondary markets to strengthen their portfolios.

Risk/Return

In addition to mitigating risk, judicious secondary market investments may offer the added benefit of comparatively strong returns. Preqin data used to calculate risk adjusted returns based on Sharpe ratios indicates that funds that focus on middle-market properties, which are primarily located in secondary markets, have recorded higher risk adjusted returns than equivalent sized funds that focus on higher-priced properties, which are often found in primary markets. It is critical, however, that investors select attractive secondary markets supported by robust population and employment growth, and healthy supply and demand fundamentals.

ABR Capital Partners, LLC

ABR Capital Partners (ABR) is an independent real estate investment manager specializing in core-plus, value-add and opportunistic investments. Visit abrcapital.com for more information.

Debo Ayeni

Director of Research and Data Analytics
debo.ayeni@abrcapital.com

Thomas Burton

Senior Managing Director/Chief Investment Officer
tom.burton@abrcapital.com