REAL ESTATE

Gateway Markets and Core Property Types: Not What They Used to Be

February 20, 2024

Key Takeaways

- To our surprise, we found there has never been an authoritative methodology behind the commonly used real estate categorization of "gateway markets" or "core property types." We believe both definitions should be based on high transparency and high stability of expected returns and outline our recommendation in this report.
- Despite there not being a consensus on the methodology, "core property types" has been synonymous with office, retail, industrial and apartment investments. Within the U.S., gateway markets have meant New York City, Boston, Washington D.C., Chicago, San Francisco and Los Angeles.
- Based on our proposed methodology, as well as changes in market conditions in the last 40 years, Atlanta, Dallas and Seattle rank highly as gateway markets, while once "niche" alternative sectors like manufactured housing and single family rentals may exhibit traits of core property types.
- We believe gateway markets and core property types should be reevaluated every five to ten years.

MetLife Investment Management

Two commonly used categorizations of commercial real estate investing that emerged or became formalized in the late 1980s and early 1990s include “gateway markets” and “core property types.” They largely help institutional investors like pensions and sovereign wealth funds to understand the types of investments that could have the best liquidity, transparency and expected stable returns. These terms were never intended to mean the best returns, in our view, and indeed, investors can target higher returns in markets that are less liquid and less transparent. The “core” property type nomenclature was partially an extension of more established investment strategies where core referred to low risk/return strategies—and opportunistic to higher risk/return strategies.

During the 1980s, core property types included office, industrial and malls, and in the early 1990s, the definition was expanded to include apartments. Gateway markets have included New York, Boston, Washington D.C., Chicago, San Francisco and Los Angeles. Although these property types and markets arguably had the largest available investment pools, there wasn’t enough information at the time for investors to understand if they were necessarily the lowest risk. (Or, perhaps put another way, because the markets and property types were so large, they were the only ones that had a semblance of transparency, which made the risk profile at least seem more understandable).

Today, the commercial real estate world is very different, with organizations like the National Council of Real Estate Investment Fiduciaries (NCREIF), the Commercial Real Estate Finance Council (CREFC) and the National Association of Real Estate Investment Trusts (NAREIT) offering decades of standardized performance information across many segments of commercial real estate. This has given investors the power to better evaluate and rank what the lowest risk and most transparent property types and markets are—which we will attempt to do in this report. Going forward, as transparency into commercial real estate performance continues to improve, we believe these definitions should be refreshed every five to ten years.

Defining and Ranking “Gateway Markets”

Although there is a consensus on what the gateway markets are, to our knowledge, there has never been an authoritative definition of what a gateway market should be. One often cited characteristic includes the size of the market, as measured by population or real estate transaction volume, and we believe this may have been the primary characteristic as the terminology was formalized 30 years ago. Another is a location where international investors tend to visit when traveling to another country—to the benefit of locations like San Francisco but to the detriment of other large markets like Houston. Another may include the historical stability of the local economy.

Despite the lack of a consensus methodology, there are generally accepted U.S. gateway markets, which include Boston, New York, Washington D.C., Los Angeles, San Francisco and Chicago.[1]

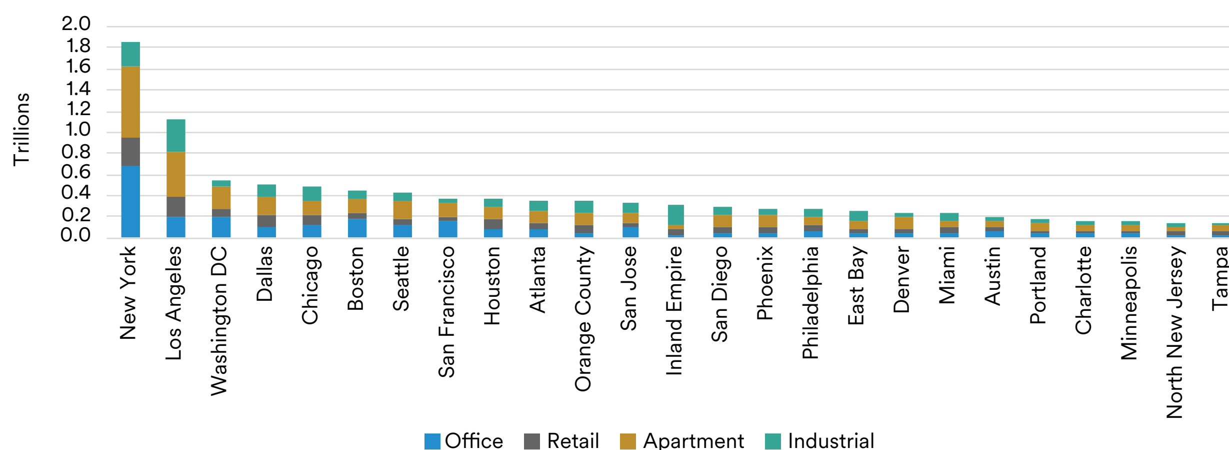
Detailed assessments of each market by property type might point in different directions on the same gateway market. For example, Houston office has historically had high price volatility and generally would not be considered a “gateway office market.” However, given the size and magnitude of Houston’s industrial real estate, Houston could be justified as a “gateway industrial market.” Nonetheless, we believe gateway market-sorting at the market level, as opposed to—the market-property-type level—is still a useful categorization tool.

We believe gateway markets should be defined as the markets that are the most transparent, have a history of stable returns and offer the most liquidity. Transparency and liquidity are probably aligned with existing notions of what a gateway market should be, while the addition of stability may or may not be. We believe stability is important, however, as it helps to capture where new global investors may want to target or set a benchmark to, when entering a new country.

To help identify the markets with the highest transparency, return stability and liquidity, we thought the available information could be best explained and ranked in five subcategories, which are outlined below. Although we believe transparency, return stability and liquidity should always be the hallmarks of gateway markets, we think the five measures below should be periodically revisited to reflect changing risks in the market, to be replaced as newer datasets or information become available, or to be completely changed as different factors may be more relevant in non-U.S. countries. We acknowledge the concept of gateway markets is international, but we only focus on U.S. markets in this report.

1. **Market size.** To support the goal of transparency, we start by examining commercial real estate asset value estimates for each of the top 25 markets in the United States, which is shown in Exhibit 1. Although this is just a single measure, we believe it is an effective proxy for other factors that could be relevant such as an MSAs population, economic size or transaction volume. We considered using transaction volume directly, but found it did not add value along with the asset value measurement. Using equities as an analogy, the S&P 500® Index is comprised of the largest 500 publicly traded stocks in the United States, and this exercise ranks the top 25 commercial real estate markets in the United States.

Exhibit 1 | Market Value of Top 25 Markets in the United States ($Tn)



Source: CoStar. As of January 2024.

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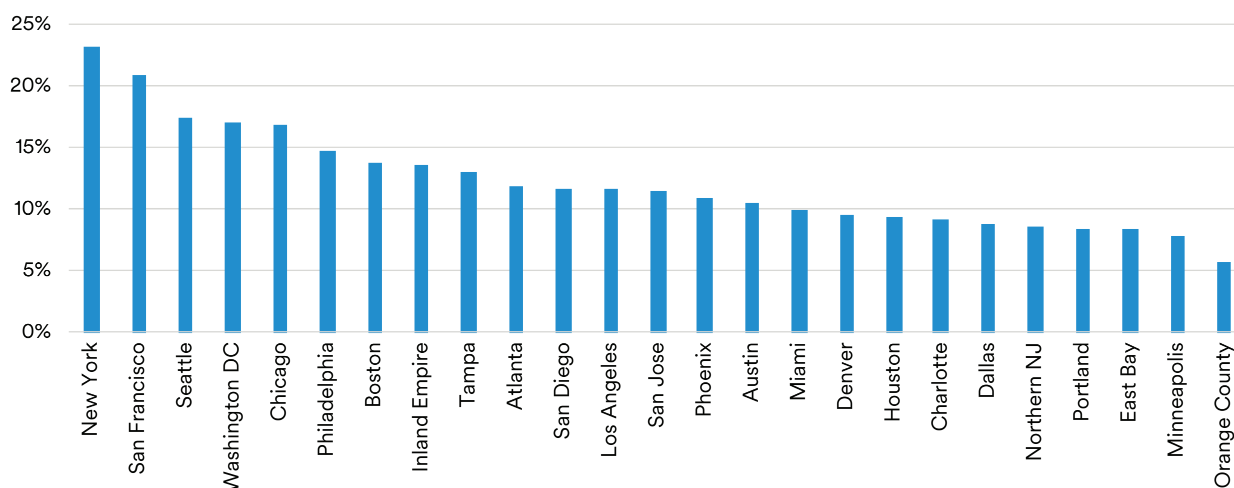
2. **International capital** is an indication of the global stature of a city and can help to define a gateway market. Also, the presence of international capital indicates more depth of buyers and sellers and enhanced liquidity. In Exhibit 2, we rank the top 25 markets based on the amount of international capital as a percentage of total transaction volume since Real Capital Analytic estimates were first available 21 years ago. In addition to markets like New York and San Francisco that are generally known to have large international capital flows, markets such as Tampa, Seattle and the Inland Empire stick out with this analysis.

Exhibit 2 | Top 25 Markets by Cumulative International Capital Flows as a Percentage of Total Transaction Volume Into Commercial Real Estate Over the Past 20 Years



Source: RCA. As of January 2024.

3. **Total rate of return stability** is another key element of this analysis. Gateway markets are typically thought to be more stable with lower cap rates. However, lower cap rates do not always accurately reflect the size or stability of the market at present. We used NCREIF NPI[2] total return data over the past 20 years to stratify markets by price stability (lowest standard deviations of returns). While larger markets are considered to be more stable, our analysis doesn't conclude this. For example, Minneapolis and Chicago rank as the two markets with the lowest standard deviation of return, and both differ on the spectrum in terms of market size. As a result, we believe that 10-year expected population growth rates are positively correlated with TROR stability and encapsulate demographic shifts in each market, and incorporate these forecasts into our market stability ranking. Additionally, we believe that 10-year expected population growth rates are a forward looking measure of return stability and have also incorporated these forecasts into our market stability ranking.

4. **Climate change** is making future commercial real estate returns less predictable in some markets. Real estate owners face risks from climate change in the form of physical risk as well as the transition to a low-carbon economy. Transition risk includes federal and local legislation and regulations. Several cities, counties and states have already established various types of carbon or energy laws.[3] Rising physical risks, such as storms, wildfires, drought, flooding and storm surge can all have impacts on the viability of commercial real estate investments, even if the impact is only to the surrounding community and not to the actual asset.

To integrate climate change factors into our gateway market framework, we utilized the FEMA National Risk Index (NRI), which estimates the average annual loss from natural hazards and measures each location's unique vulnerability and resilience to such events.[4]

Although we believe investors are generally considering climate change when making new investments, this factor is meant to capture the possible "error margin" of higher underwriting in markets with more climate risk, in our view. We think this factor is not meant to capture which markets are better investments, or which markets may be mispriced because of too much fear or not enough fear from climate change.

5. **Fiscal health** could be important for U.S. markets today, with many markets reaching stress levels as a result of expanding debt and limited or negative population growth. Markets with strong fiscal health likely have a better ability to respond to climate risks, grow needed infrastructure and keep property taxes stable. Similar to climate change, in our view, this factor is not meant to capture which markets are better investments, or which markets may be mispriced. Instead, we think it is meant to capture which markets have more predictable underwriting, which we believe are those with a healthier fiscal situation.

These five factors and subsequent scores are outlined in Exhibit 3. The weights are 25% Market Volatility, 25% International Capital, 30% Market Size, 10% Climate Change, 10% Fiscal Health.

Exhibit 3 | Gateway Market Ranking[5]

	Market Size (30%)	International Capital (25%)	TROR Stability (25%)	Climate Change (10%)	Fiscal Health (10%)	Overall Rank
Washington DC	3	4	10	1	1	1
Seattle	7	3	8	12	6	2
Atlanta	10	10	3	2	9	3
Dallas	4	20	1	19	19	4
New York	1	1	24	15	24	5
San Francisco	8	2	18	14	17	6
Los Angeles	2	12	16	25	5	7
Boston	6	7	20	6	15	8
Chicago	5	5	15	21	23	9
Denver	18	17	2	9	12	10
Houston	9	18	6	24	18	11
Austin	20	15	5	7	13	12
San Diego	14	11	13	20	10	13
Phoenix	15	14	13	10	11	14
San Jose	12	13	18	8	16	15
Inland Empire	13	8	22	22	2	16
Tampa	25	9	12	11	3	17
Minneapolis	23	24	3	3	7	18
Charlotte	22	19	11	4	4	19
Miami	19	16	7	23	20	20
Philadelphia	16	6	22	18	22	21
Portland	21	22	8	13	21	22
Orange County	11	25	25	16	8	23
East Bay	17	23	21	17	14	24
Northern NJ	24	21	17	5	24	25

Source: MIM, RCA, NCREIF, CoStar. As of January 2024.

As a final point of clarification on gateway markets, MIM does not always recommend overweighting gateway markets. Indeed, investors with a greater risk tolerance, and investors who view market selection as a way to add alpha, may want to actively avoid the lower and more stable returns generally offered in gateway market real estate. Gateway markets should therefore not be thought of as a proxy for where the best relative value resides. Gateway markets serve as a useful benchmark or consideration for portfolio management but do not replace the analysis needed to develop informed market allocation strategies.

Defining Core Property Types

Similar to gateway markets, we do not believe that what was true 30 years ago is necessarily true today. Due to the maturation of the commercial real estate sector, we think that there should be more than just four core property types. We believe core property types should generally be those that offer the most transparency and that have the most stable returns. We used six measurements to help evaluate the new core property types. Weights for each variable are as follows: 40% unlevered return targets, 15% income stability, 15% liquidity, 15% institutional acceptance, 15% data availability.

Unlevered return targets is one of our criteria. MIM has internally tracked unlevered 10-year return targets (Exhibit 4) that most brokers are offering, or investors are requiring. In our view, lower-return targets are partially a function of how investors view the outlook for risk across the various property types, with lower-return targets indicating less of a risk premium. Since at least 2016, sectors like manufactured housing, industrial, apartments and data centers have traded at lower discount rates than sectors like hotels or office buildings. Pre-pandemic unlevered IRRs and current market IRRs were each given a 50/50 rating. Unlevered return targets hold the most weight (40%) in our ranking, as we believe this is the most comprehensive variable for ranking core property types.

Income stability is a key factor in our core property type ranking. Over the past 10 years, core investors have gravitated to high income/low capital expenditure sectors, such as manufactured housing, self-storage and single-family rentals, and away from low income/high capital expenditure sectors like office and malls. We estimated NOI stability utilizing historical Green Street NOI data. For sectors that are not tracked by Green Street, we estimated volatility using REIT share volatility and MIM experience, as well as consideration of average operating expense loads. In addition to NOI volatility, we estimated historical capital expenditures by property type using NCREIF and MIM experience.

Liquidity is another component in our core property type ranking. We try to rank each sector based on the ability to buy and sell $250 million. We estimated liquidity using transaction volume as reported by Real Capital Analytics (RCA) between 2018–present. We also consider the days on the market for a property to sell, as measured by CoStar. For sectors that are not covered by RCA, we estimated transaction volume by using the size of the market as a proxy, as well as JLL data on alternative property type transaction volume. While the office sector currently has its liquidity issues, it still ranks fifth due to historically high transaction volumes.

Exhibit 4 | Unlevered Core Real Estate IRRs by Sector

Property Type	2018-2023 Average Underwritten IRR	
Hotels	7.92%	Less Core
Malls	7.83%	
Office	7.53%	
Strip Centers	7.08%	
Life Sciences	6.78%	
Senior Housing	6.63%	
Single Family Rentals	6.47%	
Self Storage	6.40%	More Core
Manu. Housing	6.33%	
Student Housing	6.30%	
Cold Storage	6.23%	
Apartments	6.23%	
Industrial	6.05%	
Data Centers	6.05%	

Source: MIM. As of January 2024.

Institutional acceptance is based on the historical role that institutions have played in each of the sectors. To calculate this factor, we applied a 50% weight to historical ownership by institutions and a 50% weight to what institutional investors have been targeting according to institutional surveys and observations from MIM's institutional real estate clients, including many of the largest pension funds, sovereign wealth funds, insurance companies and others. Multifamily, office and industrial markets have been dominated by institutions for decades, but smaller sectors like manufactured housing and single-family rentals are also accepted by most institutional investors. Office has historically been one of the most institutionally accepted sectors but in recent years has been shunned, with large institutional investors looking to diversify away from the sector. Since our rankings are not just a reflection of the market today, office ranks seventh in this institutional acceptance category.

Data availability was evaluated using data vendors including Green Street, CoStar, Moody's, MSCI, CompStak and CBRE-EA. Additionally, NCREIF's NPI+ proposed property types, CMBS reporting, Yardi Matrix reporting and single-sector REIT performance were also considered. Finally, MIM applied professional judgement to evaluate what types of datasets and industry organizations still need to emerge in order to give similar levels of confidence across each sector.

In Exhibit 5, we show the results of our core property type ranking.

Exhibit 5: Core Real Estate Property Type Ranking

	Unlevered Return Targets (40%)	Income Stability (15%)	Liquidity (15%)	Institutional Acceptance (15%)	Data Availability (15%)	Overall Rank
Industrial	1	2	2	1	2	1
Apartments	4	6	1	3	5	2
Single Family Rentals	8	3	8	6	9	3
Manu. Housing	5	1	12	9	12	4
Student Housing	6	5	6	14	8	5
Self Storage	7	3	9	10	11	6
Strip Centers	11	12	3	5	3	7
Life Sciences	10	8	10	2	7	8
Data Centers	2	10	10	12	14	9
Cold Storage	3	6	13	13	15	10
Office	12	12	6	7	1	11
Senior Housing	9	9	5	11	12	12
Hotels	14	14	4	4	6	13
Malls	13	11	14	8	4	14

Source: MIM, CBRE, RCA, Green Street, CoStar, CompStak. As of January 2024.S

Conclusion

Despite the seemingly slow-moving nature of real estate, the investment universe is ever evolving and can do so rapidly. We believe that many of the markets and property types that have long been considered gateway or core should evolve too. These labels should not be confused with appropriate market strategies, however. Indeed, MIM has often recommended property types and markets that are outside of both the old and new definitions, but we believe the core and gateway classifications remain important identifiers to help investors frame portfolio compositions and risk levels. While this paper proposes a useful guide, investors should consider the fact that core investments can exist in cities and property types that fall further down the list, such as a newly constructed and well-leased market-dominant mall, or a LEED platinum office building with more than 10 years of term remaining on leases, to growing investment-grade tenants. As with all real estate analyses, property-level evaluations trump all.

Endnotes

[1] The Risk and Reward of Investing in Secondary Markets - Urban Land Magazine (uli.org)
[2] The NCREIF Property Index (NPI) measures the performance of real estate investments on a quarterly basis.
[3] The regulations are often referred to as Building Performance Standards (BPS) that can result in significant annual penalties for properties that perform below a stated metric. At least 38 cities (Top Stories of the National Building Performance Standards Coalition - IMT) have announced plans to implement BPS laws, and we believe that most primary and secondary markets will implement BPS laws within the next ten years.
[4] We recognize that this index (or any index) cannot encapsulate all of the climate change risk factors present in a given market, but we believe it is the best available at the present time. As with all of the factors used to determine gateway markets, all assets within a market are not similarly impacted. For instance, Miami's score is influenced by the vulnerability of Miami Beach.
[5] Weights for each variable are as follows: 25% Market Volatility, 25% International Capital, 30% Market Size, 10% Climate Change, 10% Fiscal Health. Market volatility is 50% based on the standard deviation of returns as tracked by NPI from 2000-2022, and 50% based on 10-year projected population growth as tracked by Moody's. International Capital is based on transaction volume averages non-U.S. investors between 2000 and 2021 as tracked by MSCI's RCA divided by the total transaction volume. Market Size is based on CoStar's total commercial real estate market value.

Authors

WILLIAM PATTISON
Head of Real Estate Research

MICHAEL STEINBERG
Director

DEREK TONG
Associate Director

JACOB KUROSAKI
Associate

Kiel Deitrich
Senior Analyst

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