COVID-19 Accelerates Population Migration Trends in the U.S.

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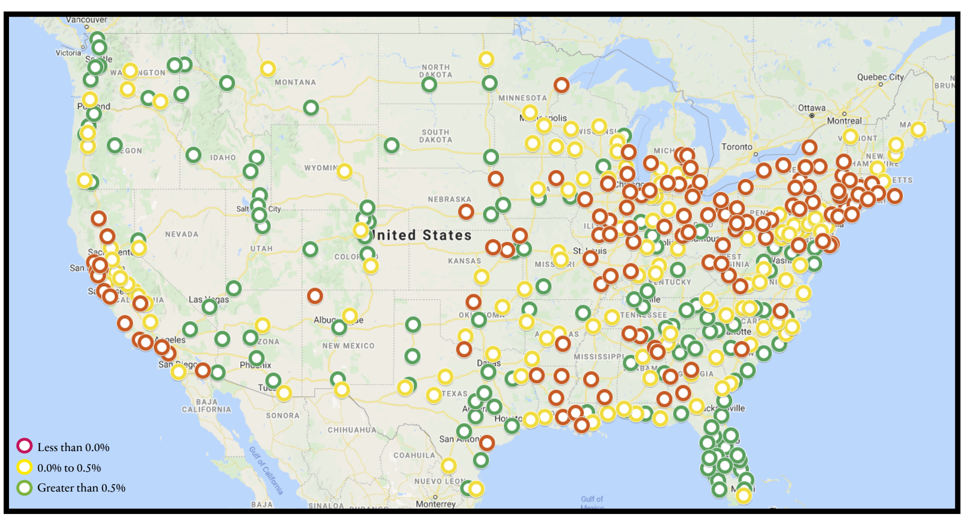
Introduction

Over the past year, the pandemic has accelerated the ongoing trend of population migration from gateway cities to growing primary and secondary markets. Driven by lower costs of living and the increased adoption of remote work, many Americans left large metropolitan areas and migrated toward mid-sized cities. Corporations have mirrored this trend and have begun moving operations to primary and secondary markets due to lower labor costs and more favorable business environments.

As the graphic below demonstrates, the populations of large cities located on the East and West Coasts declined in 2020. Over the same time period, primary and secondary markets in the Mountain West and Sun Belt regions experienced above-average population growth (> 0.5%). We believe this population growth is a result of the increased ability to work remotely, combined with lower costs of living and housing availability in these markets relative to gateway markets. While more millennials were choosing to live outside of densely populated urban markets leading up to the pandemic, we believe that the COVID-19 pandemic accelerated the trend of migration toward growing primary and secondary markets. We believe these population changes will positively affect real estate fundamentals in these growing markets.

Exhibit 1: Population Changes by Market



Source: CoStar.

Factors Driving Population Migration

Lower Cost of Living

The cost of living is significantly higher in gateway markets such as New York, San Francisco and Los Angeles relative to primary and secondary markets. For example, according to the C2ER's Cost of Living Index, the cost of living in Manhattan is approximately 150% higher than the national average.(1) While day-to-day living expenses are generally higher overall in these markets, housing costs are a primary factor contributing to the significantly higher cost of living figures in gateway markets. The higher housing costs are due to the densely populated nature of these markets, which results in limited housing supply. Prior to the pandemic, many urban office employees viewed these higher housing costs as worthwhile given they allowed them to live close to their offices in order to reduce daily commute times. Thus, markets with dense central business districts exhibited high levels of housing demand. However, at the onset of the pandemic, many office employees were given the opportunity to work remotely, and some have been told that this shift to remote work would likely remain in place over the long term. Without having to factor in a daily commute to an urban office building, many employees chose to move out of gateway markets and into primary and secondary markets that offered lower costs of living.

High state tax rates in densely populated states like New York and California are another factor causing residents to move out of gateway markets. New York state's highest income tax bracket is currently 8.82% and may increase. California's highest income tax bracket is 13.30%. On the contrary, states such as Florida and Texas do not have a state income tax. Thus, residents moving out of gateway markets and into growing markets such as Austin and Orlando, not only benefit from lowering their cost of living expenses, they can also increase their after-tax income through more favorable state tax rates. This trend increased with the limitations imposed on the state and local tax deduction for federal income taxes in 2017.

Increased Adoption of Remote Work

At the beginning of the coronavirus pandemic, many companies were forced to pivot their operations and have employees work remotely. The shift to remote work seemed temporary, but as more of the U.S. population became vaccinated, many employers have continued to provide workers with the option to work remotely. A study conducted by Growmotely found that 74% of professionals expect remote work to become more standard, and 97% of employees don't want to return to the office on a full time basis.(2) According to a survey of over 3,000 tech employees, 64% of respondents would rather work remotely full-time versus receiving a $30,000 annual raise with the requirement that they work full-time in the office.(3) The ability to work from home provides employees with the flexibility to locate in growing primary and secondary markets that offer a lower cost of living, while still allowing them to hold sought after jobs that were previously restricted to residents of gateway markets such as New York and Los Angeles.

1) The Council for Community and Economic Research—Q3 2020
2) Growmotely—The Future of Work is Remote & Aligned
3) Blind Workplace Insights

Factors Driving Population Migration

Corporations Moving Operations

Similar to the population trends present primary and secondary markets, large corporations have begun moving operations from coastal cities to primary and secondary markets located throughout the Mountain West and Sun Belt regions. These regions have continued to attract new businesses due to their lower occupancy and labor costs, educated labor forces, more business friendly regulatory environments and business incentive programs. For example, over the last year, banks such as Citigroup, Goldman Sachs, Morgan Stanley, Barclays, Moelis, and Credit Suisse elected to move significant portions of their operations out of New York to southern states. In regards to the move out of New York, Ken Moelis, CEO of Moelis said "We're a talent business. I want to attract, I want to motivate and I want to retain the greatest talent in the world. And if that talent wants to do it in Florida, that's where we'll support them".

States in the Southwest such as Texas, Arizona, New Mexico, and Oklahoma have benefited from multiple relocations from notable corporations. For example, two major technology companies have recently relocated to Texas from California. Oracle Corp. recently announced the relocation of its Redwood City California headquarters to Austin due to the state's lower taxes and lower cost of living for employees. Prior to Oracle's announcement, Hewlett Packard Enterprise Co. announced that it is building its new headquarters campus in Houston. Similarly, several technology companies have announced major new facilities located in Arizona. Lucid Motors Inc., an electric-vehicle startup, plans to open a $700 million vehicle factory this year in Arizona. The company had looked at more than 60 sites in 13 states before settling on the site in Pinal County, Arizona due to the market's growing labor pool and low cost of living. Chip maker Taiwan Semiconductor Manufacturing Co. selected Arizona for a new $12 billion factory near Phoenix that will employ 1,600 people and Intel Corp. announced it would invest ~$20 billion to expand its current manufacturing operations in Arizona, a project that is estimated to create 3,000 jobs.

The competitive labor environment has also served as a primary driver of corporate relocations. According to Area Development, a corporate site selection and facility planning resource, for nearly all strategic location decisions today, the most important factor for a company to evaluate is workforce. Most growing primary and secondary markets are located near major universities, which allow companies to access skilled labor pools with more favorable labor costs than gateway markets. A number of primary and secondary markets located throughout the Southeast exhibit these characteristics, which has driven significant growth in the region. For example, the Raleigh-Durham-Chapel Hill area of North Carolina (the research triangle) features proximity to three major research universities: Duke, the University of North Carolina, and North Carolina State University. As a result, the region is well known as being a hub for technology and biotech companies. Given the attractive labor pool, corporations including Cisco, IBM, Google, and Microsoft have well established offices in the area. Apple plans to invest $1 billion in North Carolina over the next 10 years, including $552 million to create a campus within the Research Triangle Park, creating over 3,000 jobs.

Industrial Demand

We believe industrial real estate fundamentals in growing primary and secondary markets have been positively affected by the ongoing population migration away from gateway markets. In Exhibit 2 below, we analyzed the approximately 390 industrial markets covered by CoStar, and the average rental growth for industrial properties over the last twelve months ending March 2021 was approximately 4%. The green circles in the map indicate markets with above average industrial rental growth (i.e., above 4%), while the red circles indicate markets with below average rental growth.

The exhibit showcases a noticeable concentration of above-average rental growth for industrial properties in the Southeast region of the U.S. We believe this concentration of rental growth in the region is a result of population growth spurred by the factors discussed above. Corporations are following this consumer shift and expanding their industrial footprints in these markets to better serve them. This trend, along with significant growth in e-commerce sales, has resulted in a supply and demand imbalance for industrial product in these markets, which has caused the noticeable increase in industrial rents.

Looking forward, we expect to continue to see strong industrial rental growth in growing Southeast markets like Charlotte and Orlando, along with growing Western markets like Phoenix and Salt Lake City. We believe the population migration away from gateway markets to these growing primary and secondary markets is not a one-time occurrence but rather an ongoing long-term population trend that will continue for the foreseeable future. As a result, we expect tenant demand to continue to remain elevated in these markets, which should continue to drive strong leasing dynamics over a long-term horizon.

Exhibit 2: Trailing Twelve Month Industrial Rental Growth by Markets

Source: CoStar. Data as of Q1 2021.

Impact on Real Estate Fundamentals – Tenant Demand

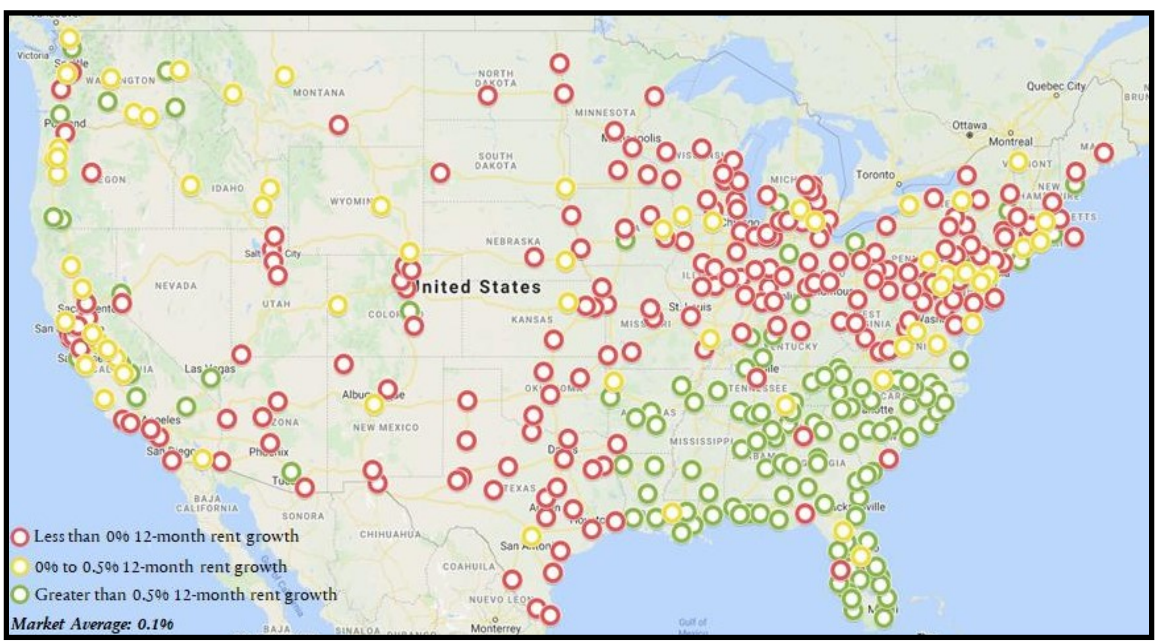
Office Demand

Although the fundamentals of the office market are not as strong as the industrial market, the concentration of markets with above average rental growth mirrored the markets with growing industrial rents. Like industrial rents, the Southeast region experienced strong growth in rents for office space as shown in Exhibit 3 below. We believe the office market more directly highlights the impact of the ongoing population migration trends on the commercial real estate market. The growth in office rents in the Southeast market illustrates this trend.

We believe the strong rental growth figures in the Southeast are a function of two major trends. First, as previously discussed, consumers who previously resided in gateway markets with a higher cost of living are choosing to live in these markets to lower their cost of living. Second, more college graduates are choosing to live in the primary and secondary markets where their colleges are located. The Southeast region features a number of top tier educational institutions. Previously, students in the area were motivated to move to gateway markets upon graduation to obtain the most sought after jobs in the U.S. However, as a result of the increasing adoption of remote work and more corporations realizing they can find strong talent in these markets, students are now more likely to stay in these markets upon graduation because of the new job opportunities in these areas.

Looking forward, we expect office fundamentals to continue to remain bifurcated by region. We believe markets that feature positive demographic trends, favorable business environments and proximity to universities will perform well, and we believe these markets are primarily concentrated in the Southeast region. However, gateway markets witnessing an ongoing population outflux will likely continue to experience negative fundamentals.

Exhibit 3: Trailing Twelve Month Office Rental Growth by Markets



Source: CoStar. Data as of Q1 2021.

Conclusion

We believe the COVID-19 pandemic created an environment that accelerated the already-present trend of population migration from densely populated gateway markets to primary and secondary markets. The pandemic forced many companies to adopt remote work policies, which spurred employee migration out of high cost areas toward markets with lower costs of living and lower taxes. We believe that many employees will continue to seek jobs that allow them to work remotely, which will lead to continued population growth in primary and secondary markets that offer more business friendly environments and a lower costs of living. Similarly, we expect corporations will continue to capitalize on this trend by choosing to locate more facilities in these markets. These markets allow corporations to access growing, talented labor pools while potentially decreasing their labor and occupancy costs.

For the industrial market in particular, we believe growing e-commerce sales and the need to build out supply chains will result in positive fundamentals for most regions in the U.S. However, we believe leasing trends for industrial properties in growing markets in the Southeast and Southwest regions will continue to outperform the national average given the ongoing population migration towards these markets will further exacerbate the supply and demand imbalance occurring in the industrial market. We believe corporations will continue to build and lease new industrial product in these markets to better serve the growing population bases.

For the office sector, we believe the impact of the current population trends will be even more direct as we generally expect office fundamentals to remain bifurcated by region. Markets in the Southeast that feature positive demographic trends, more favorable business environments, lower income taxes and proximity to universities are expected to see stronger leasing trends while coastal gateway markets witnessing an ongoing population outflux will likely continue to experience negative fundamentals over a mid-term horizon.

Disclaimer

About ElmTree Funds

ElmTree Funds, LLC, headquartered in St. Louis, Missouri, is a real estate private equity firm that manages capital on behalf of institutional and private investors. ElmTree's investment philosophy focuses on creating attractive risk-adjusted returns for its investors in the commercial real estate net lease and build-to-suit sectors with a focus on industrial and office properties. Since its founding in 2011, ElmTree Funds has acquired, developed, or financed an extensive portfolio of commercial real estate. ElmTree Funds targets commercial real estate investments in primary and secondary markets across the United States that are net-leased to investment grade tenants on a long-term basis.