FALL
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MIGRATION PATTERNS AND ECONOMIC OPPORTUNITY

Migration patterns have long favored the South and Southwest, fueling a multicycle debate about the merits of investing in gateway versus Sunbelt growth markets.

Before the pandemic, the debate on whether to follow population growth into secondary and tertiary markets largely focused on soaring costs of living and affordability issues in gateway markets. The debate intensified and took on simple blue and red color coding after state and local tax deductions were capped in 2018. Those looking ahead cite municipal finances as a concern that living costs (and property taxes) will rise in gateway markets, further exacerbating affordability issues. During the pandemic, the debate has deepened, with a spotlight on work-from-home policies that largely emptied downtown offices and city streets, most famously in New York City. If the debate were simply about where people are moving and, in turn, where populations are growing the fastest, this article could end here: average annual population gains in metros with high net in-migration trends were three times higher on average over the past two decades than other large metros with more limited or even negative net in-migration trends (Exhibit 1).

The debate goes on, however, because population growth alone does not drive real estate performance or investment decisions. The depth and breadth of economic activity, supply constraints, liquidity, and relative risk are also key considerations, and here the stats tend to favor gateway markets despite their slower population growth. Indeed, population growth is not necessarily commensurate with rising earnings, which over time may better correlate with how much rent can be charged in commercial space. GDP per capita gains in low, not high, net in-migration markets suggest that the volume of people migrating to the South and Southwest is not lifting the productivity of these places, likely making it harder for commercial real estate owners to push rents.

Supply constraints are especially important in qualifying migration flows because commercial real estate owners benefit more over time when growth is geographically concentrated. Local home prices can be used to estimate how population and economic growth translate through the constraints of the built environment into price appreciation; home price growth in gateway and low net in-migration markets has bested that in higher-growth markets by about 100 basis points per year over the past two cycles.[1] In the past five years, however, home price appreciation between the

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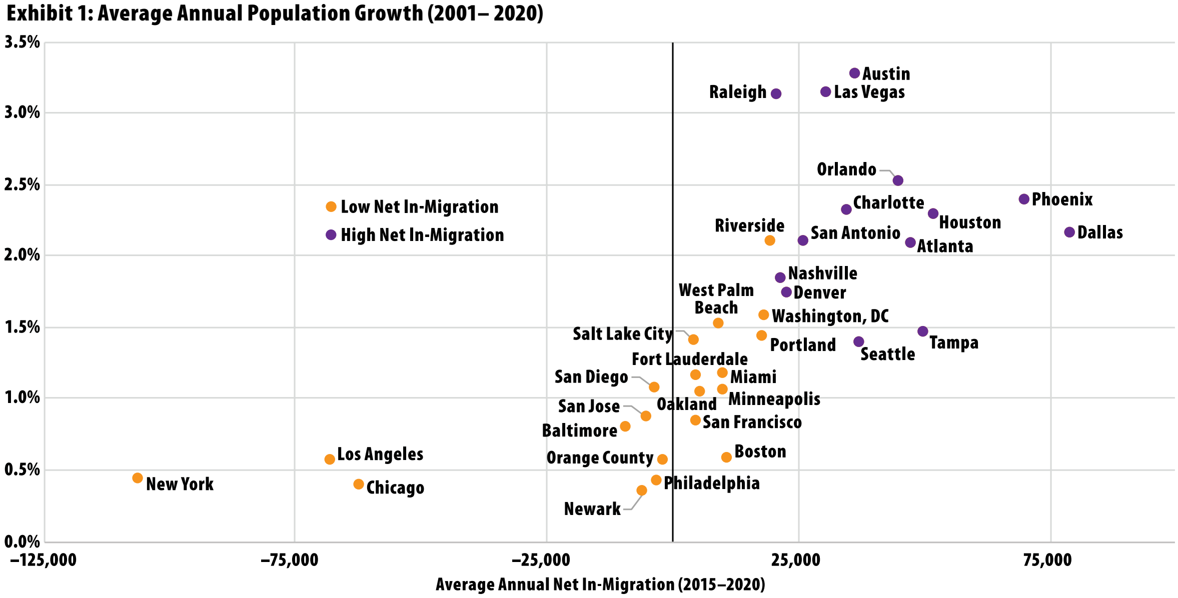
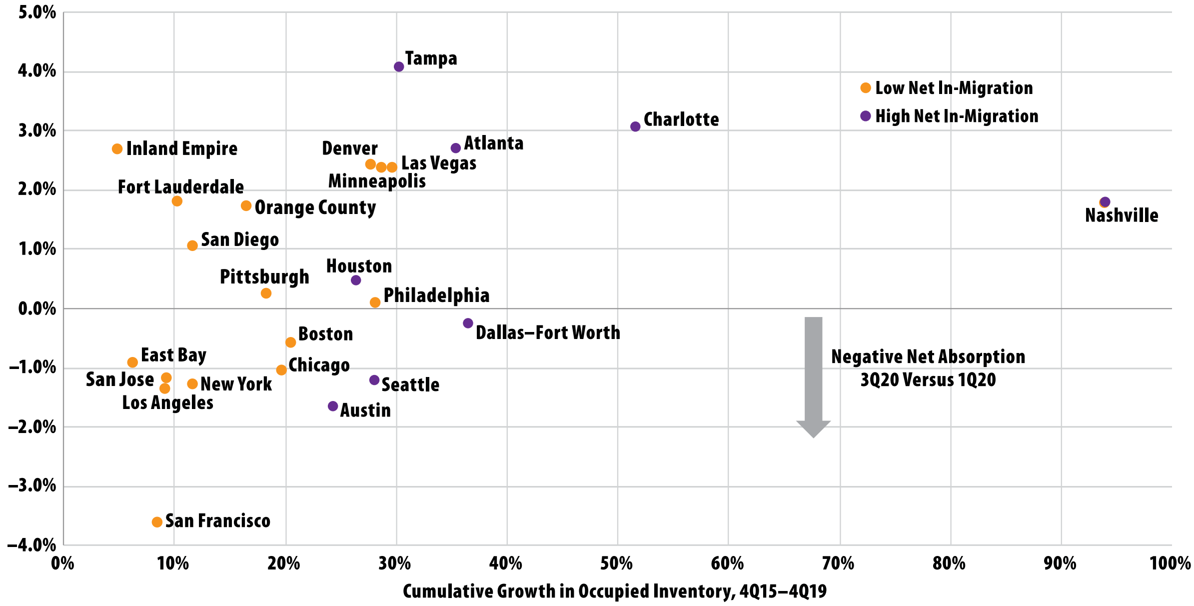
1. Oxford Economics and GID calculations based on population weighted average annual home price change 4Q01–2Q20.

Exhibit 1: Average Annual Population Growth (2001– 2020)



Sources: Oxford Economics, GID
Notes: High net in-migration markets were defined as major markets with average positive net inflows of more than 20,000 annually from 2015–2020.

Exhibit 2: Change in Occupied Units in Prime Urban Submarkets, 1Q20–3Q20



Source: CoStar Advisory Services; preliminary data as of 3Q20

two groups of markets has been more evenly matched. Perhaps the key question is this: are we now at a tipping point; will the confluence of affordability issues, tax advantages, and work-from-home polices accelerate migration patterns to the detriment of gateway markets?

Current Evidence Is Stoking the Debate

Unfortunately, apartment demand trends in the second quarter showed that some urban hubs were soft (Exhibit 2). The percentage of occupied units, which isolates the demand trend from the impact of new supply, fell by about 0.7%, or 7,000 units, between the first and third quarters in the prime urban hubs.[2] This marginal negative absorption marks a sharp reversal from average annual demand growth of 3.6% per year since 2015. Lower-rent properties accounted for most of the decline in occupied stock, dropping by 1.5% cumulatively in the second and third quarters, which is commensurate with the outsized job losses endured by low-income households. Meanwhile, Class A properties, on average, squeezed out a 0.9% cumulative gain.

The drop in occupied stock in the densest cities has been more acute, with San Francisco a clear outlier, suffering a 3.6% quarterly decline. Some smaller cities, including Austin and Phoenix, have experienced urban demand slip, which is exacerbating the impact of peak supply on rents. In almost all cases, the demand in the suburbs has offset the urban pullback.

The Bay Area is the biggest exception to the trend of offsetting suburban demand. Here, total market demand, both urban and suburban, fell in the second and third quarters. This was also the case during the last recession, but the shock to market rents has been more severe this cycle because of new supply hitting the market. Of course, in an area famous for its lack of affordability, lower-income households cannot hang on long when earnings become impaired. At the same time, the renter-by-choice resident, at least on the margin, is choosing to be elsewhere. Tech companies located in the Bay Area were quick to institute work-from-home policies and early to extend that policy into 2021 (some

2. CoStar Advisory Services. Preliminary 2020Q3 data. Prime urban submarkets are defined according to rent level, population, and commercial real estate density relative to other areas within the MSA and across the US. For this analysis, only prime urban submarkets with at least 20,000 units of inventory were included.

have made the policy indefinite). This may have enabled some employees to move to different places to hunker down during the pandemic. The Northern California fires may be another catalyst for marginal outflows.

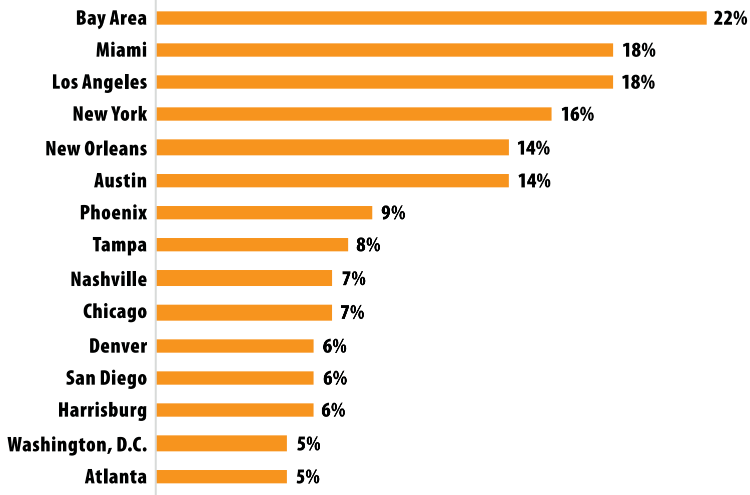
Leveraging the multifamily universe for early insights into shifting migration trends makes sense; the resident base tends to be inherently more transient, and unlike homeowners, renters do not face significant transaction costs in moving. But more consideration must be given as to whether this shift is simply a temporary reaction to the pandemic or the establishment of a longer-term trend. Can markets in the South and Southwest offer competitive lifestyle and earnings potential compared with denser markets to the north?

Migration Is Only Half the Equation

Net migration is the difference between in-migrants and out-migrants, or simply people moving in versus people moving out. For example, New York, which suffers chronic negative net migration, still experienced an inflow of 245,000 people per year from 2013 to 2017; in San Francisco, inflows during the same period were 169,000.[3] Perhaps even more important is who is coming in contrast to who is leaving. A 2018 study found the earning power of inflowing residents in many gateway markets was much stronger than that of those moving out (Exhibit 3). In the Bay Area, for example, the advantage of people moving in over those moving out was 22%.[4]

This earnings advantage is generally consistent with longer-term growth in real gross metropolitan product per capita, which has averaged 1.2% per year since 2001 for slower-growth markets (more than double the .5% pace in high-growth markets).[5] The trends likely reflect the inflow of knowledge workers who look to gateway markets for lifestyle as well as economic opportunities. In contrast, those moving out are on average older and more likely cashing out home equity. The study of out-migrants versus in-migrants notes a higher proclivity to own for those leaving than for those moving in, and a time series of outflows notes a pickup when local home prices are high. When conflated with where out-migrants are moving (the primary destination from New York is Florida), a significant number of out-migrants are likely retirees, who are more sensitive to the cost of living and ready to liquidate home equity. The pandemic may be accelerating these trends; older workers who have opted to take early retirement or have been laid off might be more prone to relocate to lower-cost metros.

Exhibit 3: Change in Earnings of In- Versus Out-Migrants



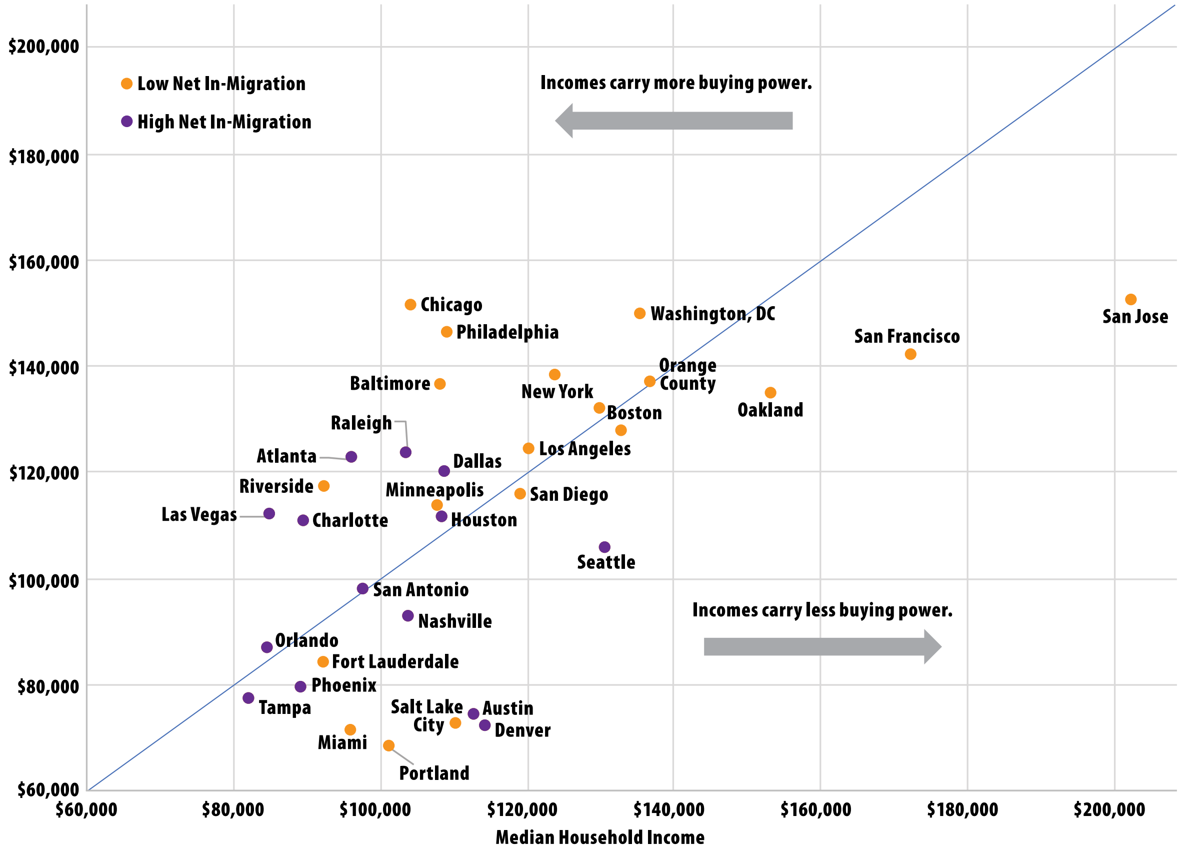
Sources: US Census Bureau: American Community Survey; BuildZoom

Permanent Anchors

Arguably the size of a local economy, including the depth and density of commerce and labor pools, acts as an anchor to growth in gateway markets. Replicating the vibrancy of these urban hubs in the suburbs is impossible, and few places in the South and Southwest can offer workers the depth of opportunity and earnings potential seen in larger, more concentrated economies. Firms, too, are anchored by the depth of commerce and services available in urban hubs, especially the labor pool. Indeed, companies still face a severe skills mismatch in the labor market that makes attracting and retaining talent difficult. As a result, businesses have been forced to follow knowledge workers to urban hubs, including into gateway markets, where skilled labor pools are deepest.

3. US Census Bureau: American Community Survey.
4. Issi Romem, "Characteristics of Domestic Cross-Metropolitan Migrants," BuildZoom blog, April 3, 2018.
5. Oxford Economics.

Exhibit 4: Cost-of-Living-Adjusted Household Incomes*



Sources: Oxford Economics, GID
*Incomes are adjusted using an index of local median home prices relative to the national average.

The recession has done little so far to correct the skills mismatch for knowledge workers and may have even worsened it, with the supply of foreign talent cut off. Over the longer term, slower working-age population growth will likely make this issue more acute: "As economic growth downshifts to pace slower gains in working age population, areas with deep pools of human capital will thrive, while those without will not. This has set up a demand supercycle: employers will locate in areas rich in knowledge workers, driving up wages, and attracting more workers, which in turn leads to greater densification, and attracts more companies. In these knowledge hubs, the result will be faster growing economies and better commercial real estate performance, all else equal. This makes the curation of industry and geographic exposures even more important."[6]

Lifestyle Choices

Of course, knowledge hubs could be unseated if workers choose to locate elsewhere. Austin has been a fantastic case study in the growth possible when knowledge workers move en masse. Austin, like Dallas and Atlanta before it, now boasts a critical mass of both knowledge workers and businesses that attract firms and job seekers. The renewed preference for urban lifestyles over the past two decades may help accelerate the emergence of other hubs by creating an organic anchor to growth. This could reverse the historical trend in which population gains in many high-growth markets was diffused across ever-expanding submarkets. A decentralized and suburban pattern of growth could gradually shift the center of

6. GID Outlook, November 2019.

commerce and leave existing building owners suddenly outside the path of growth. Such a pattern can be avoided through investment in transportation that funnels workers into centralized hubs, as well as through the location of industries, hospitals, and universities, which act as anchors. Nashville and Charlotte, which ranked first and second for growth of renters in the prime urban submarkets, may serve as the next real-world examples.[7]

Meanwhile, the pandemic has accelerated the adoption of technology and made connections to home offices possible from almost anywhere. With many of the amenities that make cities attractive closed or handicapped in their operations, some workers may opt to work remotely in second homes. Whether this is sustainable once the health risks have passed is debatable. Anecdotal evidence to date is mixed. And of course, lifestyle amenities are only half the value of urban hubs; networking with those outside a company is highly valuable. So far, Zoom calls have been a poor replacement for in-person networking.

Taxes and Affordability

The argument for the tax advantage of Sunbelt markets is predicated on one assumption: that income can be replicated in a lower-tax state. The data suggest otherwise. The Tax Foundation found that the top four states for share of income taxes paid (New York, Connecticut, New Jersey, and California) were also the states with the highest per capita incomes (ranking third, first, fourth, and sixth, respectively). In fact, median household income, an after-tax figure, is 22% higher in low net-migration markets than in high.

Affordability, therefore, might be a better argument in favor of the Sunbelt. Home prices have climbed aggressively in many gateway markets, and the delta with markets in the South and Southwest is large. This is pivotal in driving the migration patterns from high-cost cities in the North to lower-cost cities in the South (Exhibit 4). Retirees especially will take advantage of the relative differential in home prices to liquidate equity and reduce living expenses. But for a household with ongoing recurring incomes, the math is less clear. For example, after adjusting median incomes by a simple cost-of-living factor (in this case, relative home prices), San Jose's average $202,000 income spends more like $150,000. This is still top among major markets, so there is little cause for the median earner to move from San Jose, at least by this measure. Meanwhile, Chicago's median income of $104,000 spends like the equivalent of $150,000 because of the relatively cheap housing costs. Perhaps it's the weather that prevents more migrants from availing themselves of this value.

Meanwhile, the pandemic may be re-sorting relative affordability, at least for the renter pool. Sharp rent declines in San Francisco and New York may make these markets more affordable for those needing or wanting to be in those cities.

The decision framework is different for a business looking to pay lower taxes and, perhaps more important, reduce salaries. For companies that can replicate operations in lower-cost markets, a move seems like an easy decision. But again, labor may prove to be a constraint: is the lower-cost market home to the talent a given firm needs? The answer may vary widely by market.

Summary

The net flow of people will likely continue to the South and Southwest. For real estate investors targeting assets for long-term holds, it is paramount that the growth is anchored rather than diffused across ever-expanding suburbs. The renewed preference for urban lifestyles should make this more likely. But building a critical mass of businesses and knowledge workers to create a self-sustaining growth paradigm will take time. With future long-term growth likely to be at a premium, especially among knowledge workers, not every market is expected to break through. Pricing these divergent future growth paths is an even bigger challenge. ■

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7. CoStar Advisory Services; growth rates calculated from 4Q15–1Q20.