

## Institutional Buyers Taking Note of Nashville

Could Nashville become the next Austin — a hip capital city that punches above its weight in the office-sales arena?

Tennessee's "Music City" is attracting increasing attention from institutional investors. It has a growing population, rising employment and a surging local economy anchored in the healthcare and education sectors. What it hasn't had historically is an abundance of listings, as long-time local owners have tended to hold on to their properties.

But a fundamental shift could be under way. Market pros point to recent deals at record pricing that could entice more owners to sell, a construction boom that is expanding the city's institutional-quality supply, and growing demand from buyers seeking better yields than they can find in the biggest cities.

"We call Nashville 'Austin five years ago,'" said **Michael McDonald**, a senior managing director at **Eastdil Secured** who oversees investment sales in both cities. "There is a music scene. It's a foodie town. It's a cool place, and millennials want to be there. Investors buy into that."

McDonald added, "The problem is, it is a tough market to get into. It doesn't have the deal flow. But we've seen in these other markets, sometimes it takes one or two deals to tip the scales."

One recent trade and another in the works have raised eyebrows — both with prices above \$300 per square foot, a level never before seen in Nashville.

In recent weeks, bids topped \$330/sf, or \$28 million, for an 85,000-sf property on Charlotte Avenue, an emerging growth corridor within a mile of Vanderbilt University. **Holladay Properties** of South Bend, Ind., redeveloped an industrial site into a six-building complex featuring loft-style space catering to "creative" firms. Completed last year, it's fully leased, with just over half the space occupied by software contractor **L3 ForceX** — an example of a growing technology presence in Nashville. Indications are that multiple institutional investors put in bids, driving the aggressive pricing, and that an unidentified fund manager has been selected as the buyer. **Cushman & Wakefield** is advising Holladay.

A March deal set Nashville's current per-foot price record. **Zurich Alternative Asset Management** paid \$426/sf, or \$41 mil-



lion, for 35 Music Square East, a new, 96,000-sf building on Music Row, the heart of the country-music industry. The New York investment arm of Switzerland's biggest insurer edged out several other institutional investors for the acquisition, at an initial annual yield in the vicinity of 6%. Cushman advised the seller, **Panattoni Development** of Newport Beach, Calif. The Class-A property is fully leased, with a weighted average remaining lease term of 10.8 years. The **Country Music Association** occupies 28% of the building as its new headquarters.

**Sean Bannon**, head of U.S. real estate at Zurich, said the firm

Continued on Next Page

## Institutional Buyers Taking Note of Nashville

Continued From Previous Page ...

began chasing deals in Nashville last year as it expanded its list of targeted markets to 22 from 14. He noted that capitalization rates in Nashville can run 150 bp or more above similar trades in New York or San Francisco.

"The gateway markets have gotten super-competitive," Bannon said. "Everybody shows up for the same kinds of deals. We picked some of these secondary markets just so we don't have to stretch for the Nth deal in a more limited and concentrated set of markets to get money into the ground responsibly."

He noted the city's strong demographics and job growth, and the diversity of its economy. "You know it as the home of country music, and that is great. But look at the healthcare companies and white-collar job growth," Bannon said. "The occupancies have been great, the rents have been great. We'd be happy to grow in Nashville."

Institutional investment activity has increased in the past two years, according to an analysis of **JLL** data of office trades worth at least \$10 million. From 2010 to 2014, institutional investors accounted for an average of \$86.4 million, or just 24%, of Nashville's annual sales. But in 2015 and 2016, 44% of the total, or \$705 million, went to institutional buyers.

"It's the tightest office market in the country right now," said **Scott Homa**, JLL's director of U.S. office research. Nashville tops the 50 markets that the firm ranks by occupancy rate. Its 35.2 million sf of office space was 92.6% leased at the end of the first quarter, despite significant construction in recent years. Rents have jumped 25% in the past two years, to \$25.78/sf.

"You are seeing a movement in broad market fundamentals that attracts institutional investment," Homa said. "There may have been some reluctance among some of the more conservative institutional investors to be the first one in. But once it becomes mainstream or established, you start to see more product changing hands, more liquidity."

The Nashville metropolitan area's population has grown 12% since 2010 to nearly 1.9 million, according to **U.S. Census** estimates. Its unemployment rate has dropped seven times faster than the national rate during the recovery, according to JLL,

falling to 3.8% at the end of March.

The city's skyline is dotted with construction cranes. Some 2.4 million sf of office space is under development — 68% of which is pre-leased. Looking at that pipeline as a percentage of existing space, JLL ranks Nashville behind only San Francisco and Silicon Valley. Developers also are building 3,800 apartment units to accommodate the population growth and several hotels to tap into expanding tourism.

"It's a mutually reinforcing cycle," said Homa. "The development of all property types is coalescing to create a really appealing work environment that is boosting the office sector. Every tenant is looking for that vibrant, mixed-use environment."

Zurich's Bannon, while bullish on Nashville's long-term prospects, said the rate of development gives him some pause when it comes to underwriting rent growth.

"If you are looking out the rearview mirror, the numbers look good," he said. "But you have a lot of supply coming." If not for the long lease terms at 35 Music East, he added, "we might be concerned."

Nashville remains a small office market, ranking 36th nationally in terms of inventory, according to JLL. But some say it has potential for outsized investment sales, like Austin. The Texas capital ranks 24th in office inventory, according to JLL. But it has emerged as an institutional market in recent years, frequently cracking the top 15 in trades worth at least \$25 million, as tracked by **Real Estate Alert's** Deal Database. After averaging \$463 million per year in annual sales between 2001 and 2011, Austin posted over \$1 billion in each of the last five years, even approaching \$2 billion in 2015.

Until recently, Nashville barely registered in the tally of office sales worth at least \$25 million. From 2007 through 2011, there was a paltry total of \$230.7 million in such trades, an average of \$46 million per year. But over the past five years, annual sales have averaged \$428 million. Market pros believe Nashville has now reached a tipping point and momentum will build.

"I believe it is going to happen," said Eastdil's McDonald. "Perhaps not quite to the same level as Austin, but it will get better." ♦