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Vintage Year Returns Higher in Gateway Markets Over Past Decade

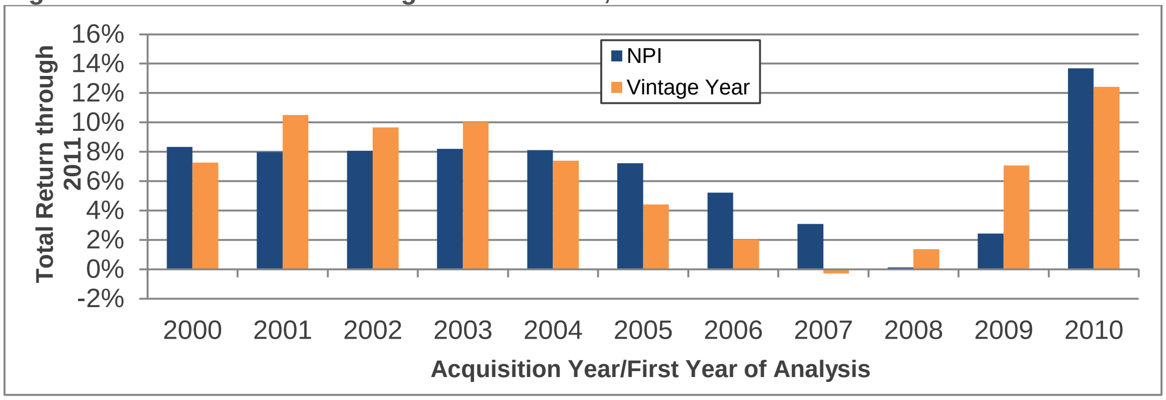
Years Leading up to the Global Financial Crisis Were the Exception

Key Messages

- Since 2000, returns for NPI properties in gateway markets[1] have outperformed those bought in the same year in non-gateway markets by an average of 1.5%. They have outperformed in eight out of eleven years.
- A big driver of gateway market out-performance was better net operating income (NOI) growth. Same property NOI growth in gateway markets has averaged 1.4% over the past decade, 0.8% higher than in non-gateway markets.
- Vintage year returns for properties bought between 2006 and 2008 were lower in gateway markets than other markets, because of the high prices paid for them and because of the sharp decline in NOI and expected NOI growth.
- Pricing has increased significantly in gateway markets over the past two years, causing the income yield to fall much lower than yields in non-gateway markets.

Comparing asset-level returns to an appraisal-based benchmark such as the NCREIF Property Index (NPI) may not always be a good measure of performance due to the lag between index values and prices for new acquisitions. This "appraisal lag" results from a delay in incorporating transaction market conditions so that index property values are not directly comparable to newly purchased similar properties. One way to minimize this effect is to compare asset returns to other properties bought in the same year, or vintage. Figure 1 below compares annualized since-inception total returns for vintage year investments to the NPI returns during the same period. Between 2000 and 2011, the NPI annualized total return was 8.3%, while the total return through 2011 for properties bought in 2000 was 7.3%. A property bought in 2000 that had an 8.0% return through 2011 would have underperformed the NPI, but still outperformed other properties bought in the same year. In a rising market, transaction prices are usually higher than NPI values. As a result, returns for those properties will be lower (assuming other factors are equal). NPI returns for each period are less sensitive to cyclical factors than returns for properties bought in the first year of the period.

Figure 1: NPI Returns vs. Vintage Year Returns, 2000-11

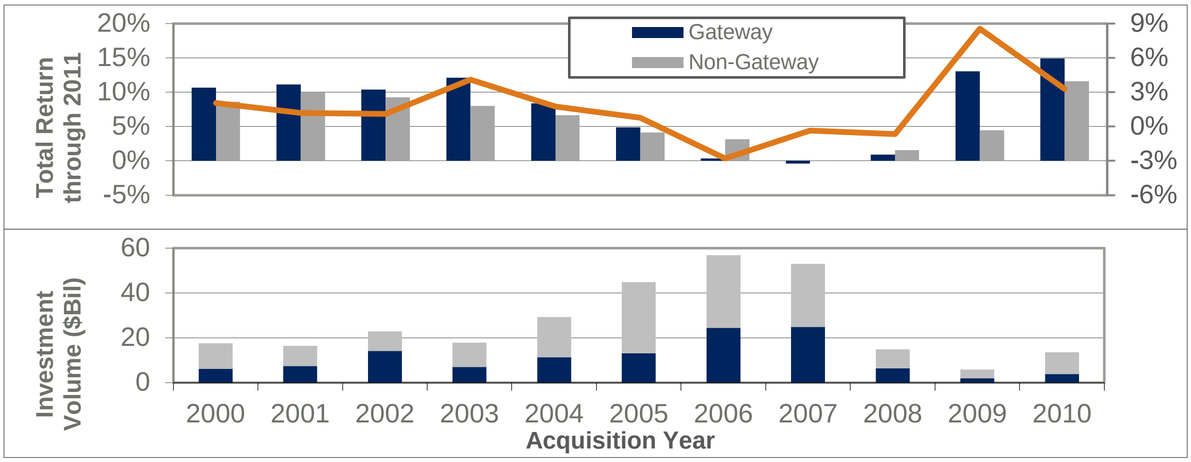


Source: NCREIF, LaSalle Investment Management

[1] The six gateway markets used in this analysis include New York, Washington, DC (including Bethesda), Los Angeles, Chicago, San Francisco and Boston (including Cambridge).

This paper compares vintage year returns for core properties between the six "gateway markets" and the rest of the NCREIF universe between 2000[2] and 2011. Gateway markets are important because they comprised 41% of the NPI market value as of the end of 2011. The gateway markets outperformed other markets in eight of the vintage years since 2000 and by an average of 1.5% over the entire period. This outperformance is the result of better property fundamentals and compressing yields. The graph below shows vintage year returns through 2011 for each year since 2000, and the accompanying investment volume for that year. Three distinct phases are evident: strong returns in 2000-05, weak returns in 2006-08, and a recovery in 2009-10. These phases are discussed below.

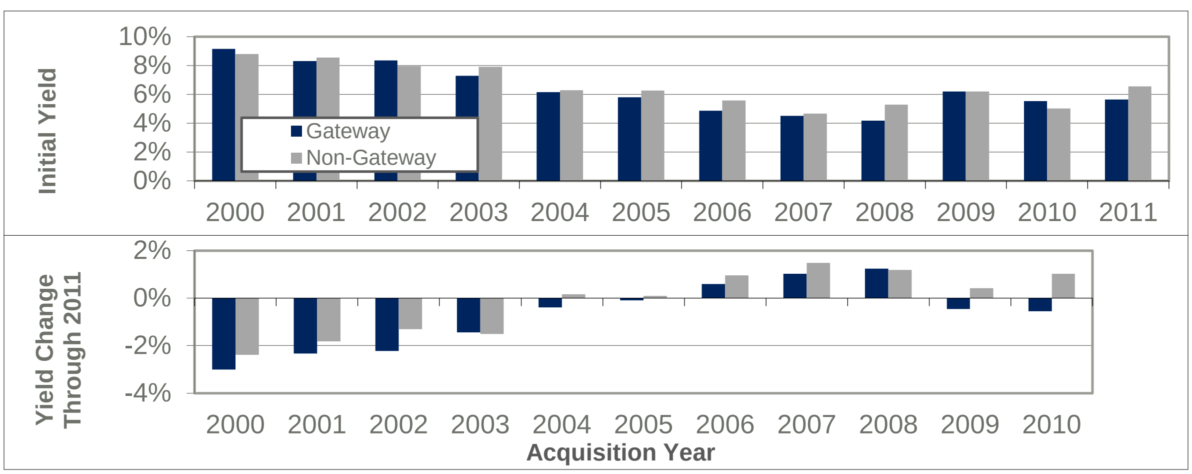
Figure 2: Gateway Markets Outperform for Most Vintage Years



Source: NCREIF, LaSalle Investment Management

For each vintage year between 2000 and 2005, acquisitions in gateway markets outperformed those in the other markets (see figure 2, above) because of stronger real estate fundamentals and more yield compression. Net operating income (NOI) for these properties increased by 1.6% annually through 2011, compared to 1.1% in non-gateway markets. The lower graph in figure 3, below, shows yields for properties bought in these years falling between the year they were bought and 2011. For example, the 2000 gateway markets initial yield of 9.1% fell 300 basis points, while the non-gateway market yield fell only 240 basis points.

Figure 3: More Yield Compression in Gateway Markets in 2000-2005 and 2009-2010 Vintage Years



Source: NCREIF, LaSalle Investment Management

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[2] Prior to 2000, there were too few acquisitions in some metropolitan areas to enable meaningful analysis.

Gateway market acquisitions made in 2006 through 2008 underperformed non-gateway markets due to accelerating prices during that time. According to NCREIF data, gateway market prices increased 47%, compared to 34% in non-gateway markets, between 2005 and 2007. The low initial yields at which these properties were purchased have since expanded in all markets. Yields for properties bought between 2006 and 2008 have risen through 2011 in the both gateway markets and non-gateway markets, though the increases were greater in the non-gateway markets. For example, in the 2007 vintage year, yields in gateway markets increased 100 basis points through 2011, but by 150 basis points in non-gateway markets. The high prices paid for properties in gateway markets assumed strong NOI growth that never materialized. Annual NOI growth for these properties has averaged 0.2%, compared to 0.4% in non-gateway markets. Consequently, there was less yield expansion in the gateway markets.

Gateway markets have outperformed non-gateway markets starting in 2009, as capital started to return to real estate. NCREIF-reported transaction prices fell similarly for gateway and non-gateway markets, declining 32% from their peak in 1Q2008 through 4Q2009. Properties bought in gateway markets in 2009 and 2010 have materially outperformed with returns of 13.0% and 14.5%, respectively, through 2011, compared to 4.5% and 11.6% in non-gateway markets. Higher returns in gateway markets are the result of improved NOI growth assumptions and yield compression fueled by the better availability of cheap debt in these markets. Since 2009, gateway market yields for properties bought in 2009 fell 50 basis points (see figure 3) through 2011, while they increased by 40 basis points in non-gateway markets.

Property Type/Geography Trends

Within gateway markets, vintage year returns for most property types deviated little from the overall average of 7.9% over the entire period. Apartment returns were 20 basis points higher than this average, the strongest outperformance of any property type. Office returns were nearly identical to the average. However, CBD office returns were 50 basis points higher on average, while suburban office vintage year returns were 30 basis points lower. Retail and industrial returns were both around 10 basis points lower than the all property average.

Among the gateway markets, New York was generally the best performing market for each vintage year (see figure 4, below). Vintage year returns there averaged 4.2% higher than the average of all gateway markets since 2000. Washington, DC and San Francisco returns were also above average. Washington, DC's outperformance was second only to New York. One reason for this higher stability is that returns for properties bought there between 2006 and 2008 were much stronger than returns in New York and San Francisco. Values in Washington, DC did not fall because stable federal employment and strong stimulus spending boosted the local market. Returns in Boston were the lowest among the gateway markets because it was hit hard by both the tech bust after 2000 and the global financial crisis after 2007. Both office and industrial properties there experienced sharply negative returns during both downturns.

Figure 4: New York Vintage Year Returns were Strongest, but Most Volatile

Market (all property types)	Average VY Return (2000-2010)	Standard Deviation (2000-2010)
New York	12.1%	14.9%
Washington, DC	10.5%	7.0%
San Francisco	9.0%	8.3%
Chicago	7.0%	4.9%
Los Angeles	6.8%	3.8%
Boston	5.6%	8.0%
Gateway Total	**7.9%**	**5.5%**
Non-Gateway Total	**6.1%**	**3.7%**
US Total	**7.2%**	**4.5%**

Source: NCREIF, LaSalle Investment Management

One caveat to this analysis is that the vintage year returns are time weighted. That is, they ignore the impact that properties sold before 2011 had on the level of investment. A vintage year IRR, or dollar-weighted return, would account for the sold properties, but data for individual properties are not available from the NCREIF database. Moreover, an IRR may not be the most appropriate calculation to measure investor performance for these properties. While investment managers decide when and where to place capital, they do not always have discretion over when those gains should be harvested. Still, a composite vintage year IRR may be an interesting topic for future study.

The lesson to investors of these vintage year returns is that with few exceptions since 2000, investments in gateway markets have had higher returns than in non-gateway markets. The strong returns in gateway markets since the global financial crisis show the importance of the “buy low” principle. However, the lack of transaction volume in this time shows the difficulty in acting upon this principle.

Another important takeaway from this analysis may be found in the exception to this trend. Investments in gateway markets made between 2006 and 2008 have materially *under*performed investments in non-gateway markets through 2011. Because they were bought at very high prices, investments in gateway markets were more exposed to a downturn in both capital markets and property markets. Investors’ pro forma assumptions did not materialize (at least in the near term). Still, the Global Financial Crisis was a once in a lifetime event, so this risk is probably small, going forward.

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