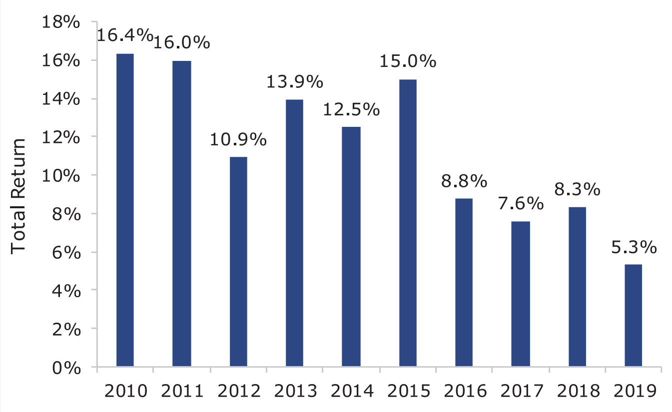
ODCE

ODCE: MAJOR SHIFTS IN SECTOR ALLOCATION UNDERWAY

Ten years into the current real estate cycle, overall demand and supply fundamentals remain strong in most property sectors and markets. Healthy job growth and household formation have led to strong demand for commercial space. At the same time, relatively conservative underwriting and rising construction costs have constrained new supply.

The ODCE Index continued to deliver positive but more moderate returns. In 2019, ODCE achieved 5.3% in total return, 301 bps lower than in 2018 and the lowest annual total return this cycle (Figure 1). Despite leverage of 21.5%, ODCE also underperformed the NCREIF Property Index (NPI) by 108 bps over the past year. One reason is that most ODCE funds have a mark-to-market debt policy. In a declining interest rate environment, outstanding debt should be written down. In 2019, the Federal Reserve reversed its monetary policy and reduced the target fund rate three times. The U.S. 10-year Treasury yield fell by 77 bps, from 2.7% to 1.9%. In our estimation, this interest rate decline might have resulted in a mark-to-market debt value loss of approximately 40 bps for the ODCE Index. Another reason is the depreciation of retail, which currently accounts for 16.1% of the ODCE Index. Several funds are writing down retail values to reflect the changing omnichannel consumer landscape. In our opinion, ODCE managers are ahead of the rest of the industry in adjusting values of their retail assets

Figure 1: ODCE Annual Total Returns By Year

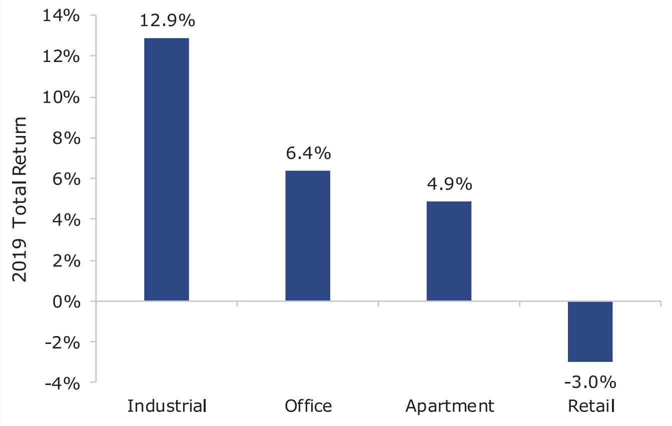


Source: NCREIF, Q4 2019.

On a positive note, the ongoing e-commerce boom has benefited the industrial sector. In the U.S., e-commerce has been growing at an approximately 15% CAGR over the past fifteen years, continuing to gain market share of retail sales. Today, e-commerce sales account for about 13% of core retail sales, and are forecast to grow to a 30% share by 2030. Online sales growth is the primary driver of the industrial sector's significant outperformance and the retail sector's substantial underperformance. According to CBRE, every $1 billion increase in e-commerce sales effectively requires an additional 1.25 million square feet of new warehouse space. On the other hand, store closures accelerated in 2019, with more than 9,300 announced. Such closures disproportionately hurt mall and power centers. Rising cap rates may be inevitable as same-store NOI growth plummets and CAPEX requirements for re-leasing and re-development spike.

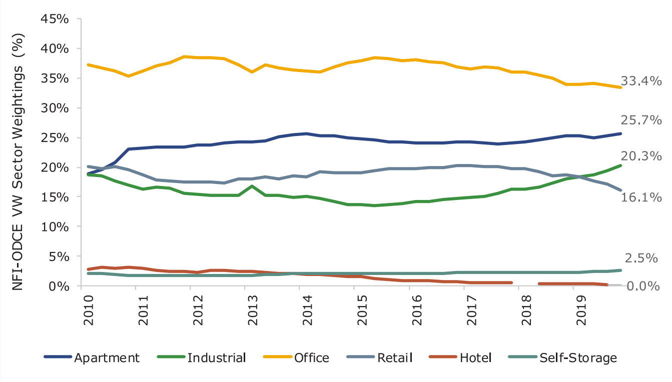
The diverging performance between industrial and retail is arguably the most stunning development in the NCREIF 42-year history. In 2019, the ODCE Index industrial return was 12.9% while retail was -3.0% (Figure 2). The e-commerce boom is a transformative secular investment theme, which is only halfway through likely with several more years to go. Having recognized this dramatic change, many investors are reducing retail sector exposure and increasing industrial sector exposure (Figure 3). As a result, over the past three years, the ODCE weighting in retail declined from 20.2% to 16.1%, while industrial weighting increased from 14.7% to 20.3%. Interestingly, ODCE weighting to office also declined during this three-year period from 36.9% to 33.4%, reflecting portfolio de-risking as the market enters the mature stage of the cycle. It is little surprise that ODCE weighting to apartment increased over the past three years from 24.3% to 25.7%, given strong demographic tailwinds. This makes sense because housing is a necessity, and apartment has historically demonstrated better risk-adjusted returns. ODCE hotel weighting has been reduced to zero. Hotel tends to be highly volatile during economic downturns, and investors are uncertain whether hotel should be considered a core investment at all.

Figure 2: 2019 ODCE Property Total Returns By Sector



Source: NCREIF, Q4 2019.

Figure 3: ODCE Sector Allocation By Year



Source: NCREIF, Q4 2019.

As total returns for core property sectors continue to moderate, there is stronger interest in alternative property types. Self-storage is already 2.5% of the ODCE Index. More investors are pursuing medical office (MOB), life science, senior housing, student housing, and data centers. Some of these property types exhibit core-like investment characteristics, including relatively stable cash flow, high occupancy, and good liquidity. It is likely that the ODCE allocation to alternative property types will continue to increase in years ahead.

Looking forward, we expect ODCE to continue to perform well, driven by solid fundamentals (excluding retail). As sector performance continue to diverge, ODCE fund managers are taking notice. We believe that ODCE industrial weighting will continue to increase quickly, while retail weighting will resume its slide. Investors will gain increasing confidence in alternative property sectors.

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