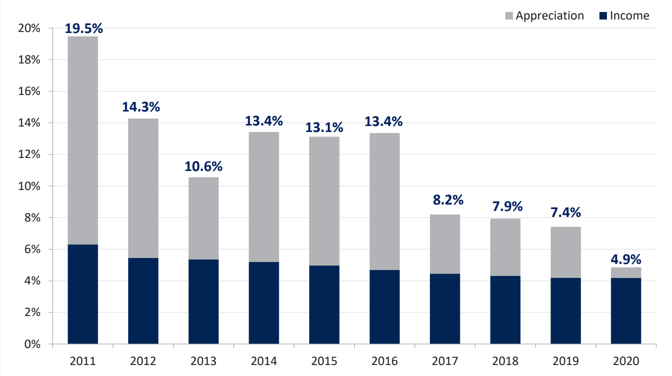
ODCE

ODCE: PERFORMANCE MODERATING AS CHALLENGES LIE AHEAD

What a difference a few months can make. The quarter began with the United States in the eleventh year of its longest economic expansion on record. However, the final weeks of the quarter ushered in dramatic change. A national state of emergency was declared in response to the Covid-19 outbreak, and many states went on lockdown in an attempt to limit the spread of the pandemic. Office buildings emptied as working from home became the norm for the time being. Malls became desolate as all retailers deemed "non-essential" were forced to temporarily close their doors. At the time of writing this piece, states are beginning to open up their economies, but the process will be gradual.

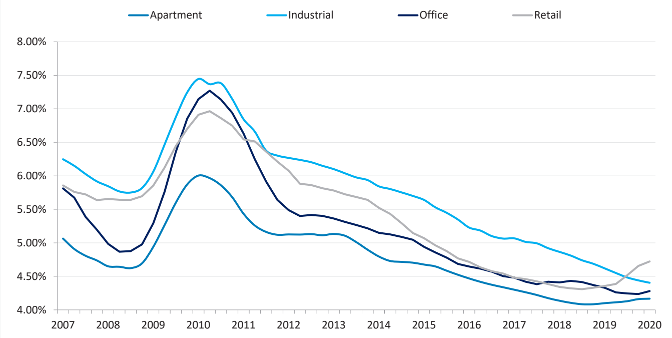
While the full brunt of the pandemic is yet to be determined, it is evident that the impact of the shutdown is already showing up in first quarter performance. The total return for ODCE was 0.98% in the first quarter, which was down 53 basis points (bps) from the previous quarter. This moderation was driven by a significant deceleration in the appreciation return to -0.04%, marking a drop of 51 bps from 4Q19. Meanwhile, the income return was down 2 bps to 1.02% for 1Q and is holding relatively in line with its two-year average. Overall, the trailing one-year total return for ODCE was 4.9% as of 1Q20, marking the index's lowest one-year return in ten years (Figure 1).

Figure 1: Trailing 1-Year Total Return By Component (As Of Q1)



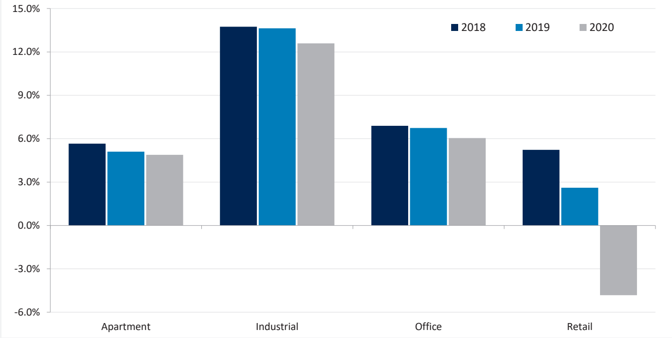
With cap rates now below their pre-recession floors in each of the primary property sectors, asset appreciation will need to come through improving property operations instead of cap rate compression. Industrial is the lone sector still achieving cap rate compression but the spread to the other primary sectors is at its lowest level in over ten years, which could limit further compression. Meanwhile, investor interest for retail has waned as the sector continues to grapple with challenges of adapting to the rise of E-commerce, resulting in a 35 bps rise in cap rates over the last year (Figure 2).

Figure 2: Cap Rate By Property Type (Trailing 4-Quarter)



Total returns across each of the sectors continue to moderate, with the most significant slowdown being experienced within retail (-4.8%). The industrial sector remains the beneficiary of the evolution of E-commerce, garnering an unleveraged one-year return of 12.6% as of the first quarter, which more than doubled office (6.0%) and apartment (4.9%) (Figure 3). It is worth noting that asset appreciation has comprised 65% of the sector's one-year return. With limited potential for further cap rate compression, the sector's outperformance is likely to moderate in coming quarters. Overall, income growth remains at or above inflationary levels for each sector (excluding retail), which should continue to generate stable income returns and limit further moderation of total returns.

Figure 3: Trailing 1-Year Total Return By Property Type (As Of Q 1)



Despite the near-term headwinds facing commercial real estate, there is reason to be optimistic for the long-term outlook. Prior to the pandemic, property fundamentals were healthy across the sectors (exclusive of retail). Secondly, demographics are in the economy's favor as the Millennials, the largest adult generation, are now entering their prime spending years, which should provide a needed boost to the economy in coming years. These factors should help offset deterioration in property fundamentals in the near-term and drive stable income returns over the long-term horizon.

Christopher Fruy
Senior Vice President - Asset Management
Heitman