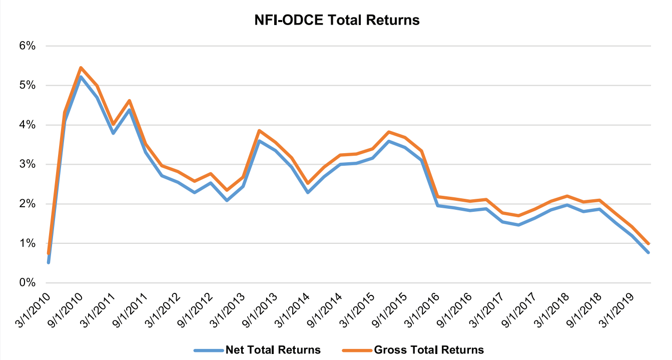
ODCE

NEGATIVE APPRECIATION RETURN IN 2Q 2019

For the second quarter of 2019, gross total returns for the NCREIF Fund Index (NFI-ODCE) came in at 1.0%, composed of 1.01% gross income returns and -0.01% of gross appreciation returns. Net total returns moderated to 77 basis points (bps) during the quarter, from 120 bps the prior quarter. Second quarter gross and net total returns came in at their lowest positive return levels reported since the end of the global financial crisis (GFC).



SOURCE: NFI-ODCE. As of June 30, 2019.
It is not possible to invest in an index.

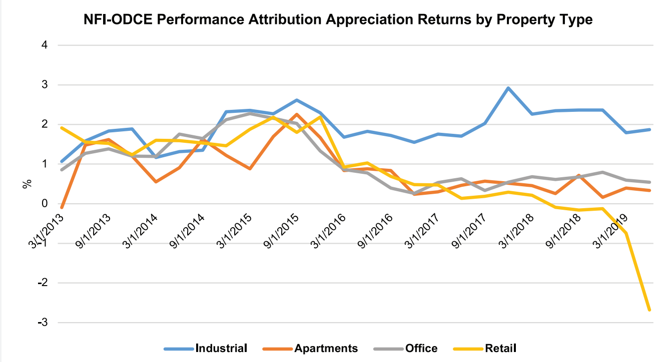
While gross income returns essentially remained unchanged from the prior quarter, at 1.0%, it was appreciation that saw its first negative value in 36 consecutive quarters, albeit only one basis point of detraction from total returns. Although it's too early to prognosticate gloom-and-doom from a single quarter, it is worth noting that since the inception of the NFI-ODCE index, most previous quarterly declines in appreciation have accompanied general business cycle contractions.

The sole exception was in the late 80s, which witnessed an asset price inflation[1] in the commercial real estate sector. This eventually led to the savings and loan crisis, and subsequently to the brief general business cycle recession of 1990-91. While it is tempting to attribute the current dip in appreciation to a potential asset price bubble or a general business cycle recession, as experienced in previous cycles, in our opinion neither hypothesis holds.

Sector fundamentals for commercial real estate property are remarkably healthy today, and although the general business cycle is in the late expansion phase, job growth and other macro indicators remain healthy; although, investor sentiment is susceptible to geopolitical shock.

Insights to the negative appreciation lie within the NFI-ODCE's sector-level performance. The preliminary second quarter NFI-ODCE-PA Property Detail spreadsheet reveals that the retail sector reported a dramatic drop of nearly 200 bps in appreciation returns (at -2.68%, down from -0.74% the prior quarter), representing the largest quarterly decline among the four property types.

Although the retail sector has reported negative appreciation returns over the previous five quarters (-0.09%, -0.16%, -0.13%, -0.74% and -2.68%, respectively), the second quarter of 2019 reported a significant quarterly write-down. Further investigation reveals that although all four regions (East, Midwest, South and West) reported a decline, the Midwest region (-4.83%) and specifically the East North Central division (-5.5%) were the largest detractors to the appreciation return.



SOURCE: NFI-ODCE. As of June 30, 2019.

Similarly, when analyzed by property sub-sector, the regional (-7.74%) and super-regional (-3.54%) malls were the primary detractors to retail appreciation, while neighborhood centers had the smallest detraction from appreciation performance of just five bps, pointing to the defensive characteristics and performance of these neighborhood centers among the different retail property sub-types.

These trends are generally consistent with the broader NCREIF Property Index (NPI) second quarter data, as a proxy. Retail assets reported the largest drag on quarterly appreciation amongst the four major property types. Within that, the Midwest region (-2.69%) and regional malls (-2.16%) reported the largest detraction from appreciation returns when viewed by region and property sub-type, respectively, similar to observations gleaned from the NFI-ODCE preliminary returns for the second quarter. However, the NPI data differed from the NFI-ODCE performance attribution data for the retail property type at the divisional level, wherein the Northeast division (-3.57%) reported the largest detraction from appreciation returns, rather than the East North Central division (-2.85%), as observed using the NFI-ODCE. One possible explanation for this difference may be the variation of properties by region within each index.

The takeaway from the above analysis is that the driver behind the negative appreciation appears to be a major write-down of retail holdings by some fund participants, and it remains to be seen in future quarters if this is a one-time phenomenon or a repeat occurrence.

Caveat: NFI-ODCE property-level performance attribution differs from fund-level total returns in several ways, as it relates to property leverage and fund vehicle structure impact on total fund returns. Similarly, the NFI-ODCE and NPI returns differ in several ways, as outlined in the document "Why do ODCE and NPI Returns Differ?" on the NCREIF research webpage. They have been used here to identify high-level trends and not for attribution purposes.

TJ Parker, CFA, CAIA
Director, Real Estate Research
Barings Real Estate Advisers

[1] Source: Commercial Real Estate and the 1990-91 Recession in the United States.