ODCE

BRIGHT SPOTS AMIDST MODERATING RETURNS

The NFI-ODCE achieved a total gross quarterly return of 1.87% in 3Q17, comprised of 107 basis points from income and 79 basis points from appreciation. Total return performance is up 17 basis points quarter-over-quarter due to an uptick in appreciation. However, a broader moderation in returns continues as the trailing 12-month total gross return declined to 7.66%, marking the seventh consecutive quarter of moderating annual returns. Despite moderating performance, the trailing 12-month total gross return ending 3Q17 remains above the ten-year total return.

Income represents 58% of the trailing 12-month total return for the NFI-ODCE index versus representing 42% of the total return since 2010. Despite some signs of easing over the last several quarters, appreciation returns continue to trend lower. Trailing 12-month appreciation returns edged down 213 basis points year-over-year, from 5.32% ending 3Q16 to 3.19% ending 3Q17.

Total quarterly returns for the NFI-ODCE by property sector illustrate a more dynamic story than headline trends discussed. During the last six quarters, all major property sectors experienced an overall moderation in quarterly total returns with the exception of industrial (see Exhibit 1). Not only have returns for industrial accelerated during the last six quarters, but they have also outperformed the next best performing asset class by 170 basis points during 3Q17. Demand for warehouse space remains strong, driven by e-commerce, food and beverage, residential construction and manufacturing. Retail experienced the starkest downward trend, amidst widespread store closures as retailers rethink real estate strategies.

Regional returns highlight the West as the strongest performer during the last six quarters (see Exhibit 2). The Pacific division specifically has been a top performer. Outside of the West region, the South experienced the next best performance during this period, bolstered by consistently strong performance in the Southeast division. Not surprisingly, industrial in the West region was the top performing sector and region combination during 3Q17, achieving a 16.1% total quarterly annualized return, which outpaces the benchmark return by 980 basis points during this period.

The economy remains on solid footing and consumer confidence remains high, buoyed by an improving labor market and record-level stock prices. Despite positive sentiment, valuation metrics reflect a moderating economic outlook overall, as we move through the eighth year of the expansion cycle. Consequently, discount rates edged up for the first time since 2012 on a quarter-over-quarter basis, and rent growth expectations continue to soften. Property fundamentals remain intact as occupancy levels continue to edge up. However, rent growth continues to moderate across all sectors with office experiencing the strongest slowdown, according to CoStar data. Capital markets also remain intact despite a moderate slowdown in investment sales volume, as pricing levels continue to edge up and cap rates move modestly lower.

Balance sheets reflect solid conditions as well, with leverage at 21.3%, cash balances at 3.7%, and occupancy at 92.3%, generally unchanged during 3Q17. Similarly, contributions roughly matched distributions at $4.07 billion each during 3Q17, reflective of healthy activity and greater balance in fund flows.

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Exhibit 1 Source: NCREIF.

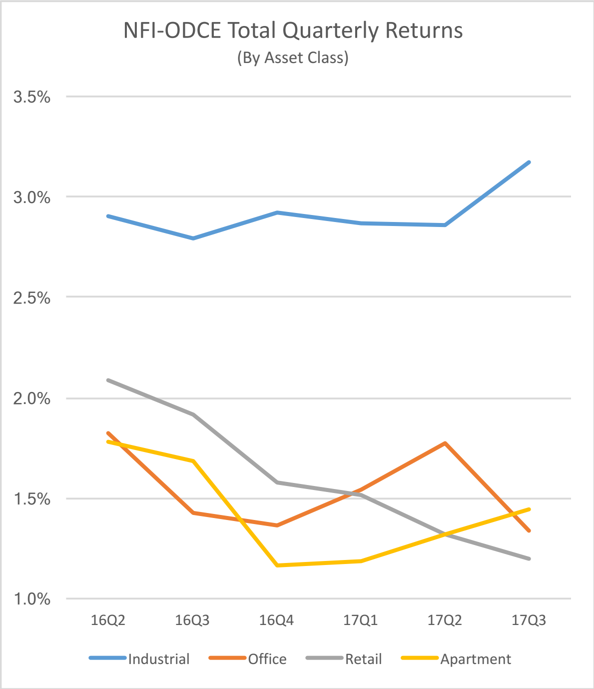

Exhibit 2 Source: NCREIF.