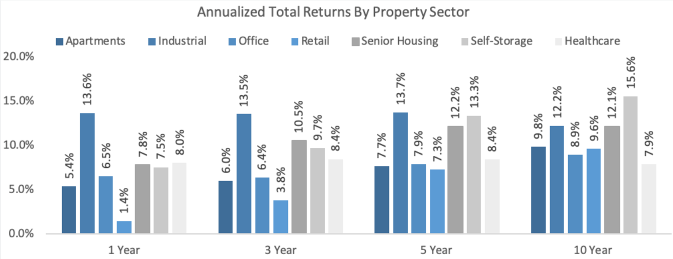
ODCE

NON-TRADITIONAL PROPERTY SECTORS: LATE CYCLE OR LONG-TERM INVESTMENTS?

The U.S. economy has enjoyed ten-years of consecutive economic growth, and the U.S. property market has produced positive returns for 39 consecutive quarters. Over this period, cap rates have compressed to historic lows due to monetary policy easing, an improving economic backdrop, and healthy supply and demand fundamentals attracting additional capital inflows to real estate. As a result of significant growth and cap rate compression, income returns have decreased and return expectations for the real estate asset class have moderated. In addition, more recently traditional property sectors, such as office and malls, have fallen out favor in the U.S. core fund space as they historically exhibit more volatility. Given this combination of moderating returns and preference to shift away from more cyclical property types, real estate investment has increasingly shifted towards non-traditional property types that offer additional yield and are purportedly less cyclical. The question is whether this shift is the result of late-cycle yield-seeking behavior or the emergence of property sectors into the institutional fund space.

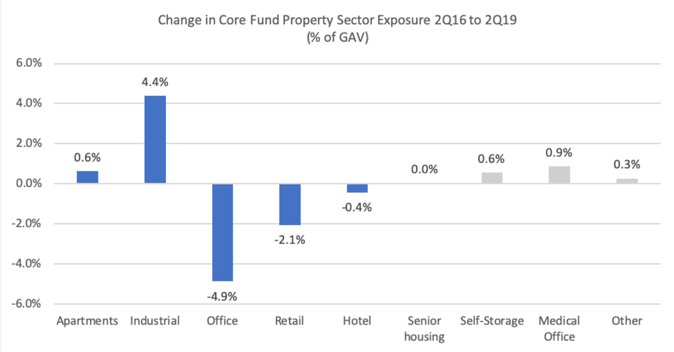
Traditional and Non-Traditional Property Sectors Historic Returns



Source: NCREIF NPI (3Q19)

Non-traditional property types have performed well over almost all measured periods relative to the apartments, retail, and office sectors. These non-traditional property sectors have benefited from secular drivers of growth, defensive income characteristics, and a higher income return than traditional property sectors. Senior housing and healthcare have benefited from an aging population and the increasing demand for healthcare. Self-storage has seen increasing demand as housing affordability continues to worsen. Industrial, the only sector to generate stronger returns, has benefited from its own secular demand driver, e-commerce.

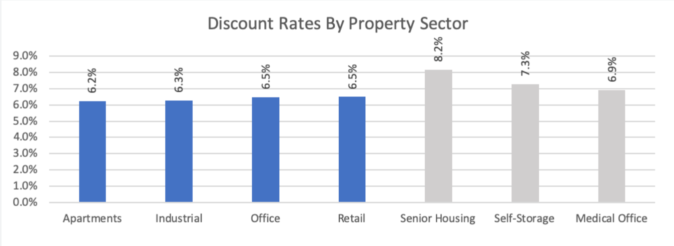
Growth in Non-Traditional Property Sectors



Source: The Townsend Group

Non-traditional property sectors remain a relatively small portion of the institutionalized U.S. property market, accounting for roughly 5.7% of the $260 billion in gross assets value in NFI-ODCE today. The rapid rise of the non-traditional property types, increasing 1.8% or approximately $4 billion over the past three-years, in the U.S. core fund market is noteworthy. Medical office and self-storage have seen particularly high growth, with the NFI-ODCE funds in aggregate increasing exposure approximately 1.5% since mid-2016. It is our expectation this increasing allocation to non-traditional property types will continue.

How Do Non-Traditional Property Types Look Going Forward?



Source: NCREIF, Altus (NFI-ODCE only), *The Townsend Group (OECF Database) (2Q19)

Based on discount rate data, go forward return expectations remain higher for non-traditional property types. Whether it be the aging population and the increased healthcare spending that comes with it or consumers wanting additional space, non-traditional sectors are poised to benefit from secular trends. While the yield premium these sectors offer has shrunk, the income returns generated continue to be higher than traditional property types. Furthermore, the non-traditional property types exposures to differentiated growth factors is expected to provide diversification benefits within portfolios. Given all the benefits of investing in the non-traditional property types, the industry is trending towards an increasing allocation. With the growth in prominence in the NFI-ODCE, NCREIF is actively in the process of recategorizing student housing and medical office to increase transparency for these sectors.

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