The quarterly NCREIF Property Index (NPI) total return has been on a downward trend for two years. Reflecting performance of 7,139 properties and $533.8 billion of market value, the first quarter 2017 total return was 1.55%, down from 1.73% in the fourth quarter 2016 and 2.21% a year ago. For longer-term context, the quarterly total return has been below both its twenty-year (2.38%) and since inception (2.26%) averages for the past five quarters.

The first quarter 2017 NPI total return consisted of a 1.15% income return and 0.40% appreciation. The income return, although modest, has been relatively stable over the past three quarters. Appreciation has led the downward return trend since 2015 and first quarter 2017 marks the fourth consecutive quarter of sub-1% appreciation.

For the trailing year, the annual NPI total return was 7.27%, down from 11.84% a year ago and 12.71% for the year ending first quarter 2015. The annual NPI total return consisted of a 4.73% income return and 2.45% appreciation. The annual income return has trended down since 2010 and was the lowest in NPI history through the first quarter. Appreciation, although slowing sharply since 2015, remains above its annualized since inception pace of 1.86%.

Appreciation, even at modest levels, resulted in the Market Value Index (MVI) achieving another new high in first quarter 2017. The MVI is a NCREIF measure similar to a price index that shows value changes among NPI properties with consistent characteristics (i.e. not undergoing significant capex). While only up 1.0% in the first quarter, the MVI increased 5.1% over the past year, compared to 8.5% over the year ending first quarter 2016. The MVI is now 17.9% above its 2008 peak.

The NPI is an unlevered index and low interest rates have provided the opportunity for higher returns by utilizing leverage. For the 3,554 NPI properties utilizing leverage, the leveraged total return was 2.02% in the first quarter 2017 and 9.84% for the trailing year, comparing more favorably to other asset classes.

For the 24 funds tracked in the NCREIF Fund Index – Open-end Diversified Core Equity (NFI-ODCE) benchmark, quarterly total returns (gross of fees) slipped below 2% in the first quarter 2017. At 1.77%, it marked the lowest quarterly return since 0.75% in the first quarter 2010. The NFI-ODCE income return was unchanged from the prior quarter, at 1.07%, although it was down marginally from 1.11% in the first quarter 2016. Quarterly appreciation was down to 0.71% in the first quarter, from 1.04% in the fourth quarter 2016 and 1.07% a year ago.
For the trailing year, the annual NFI-ODCE total return gross of fees was 8.34%, down from 13.67% for the year ending first quarter 2016 and below the annualized since inception return of 8.74%. The annual total return was comprised of a 4.45% income return and 3.75% appreciation.

NFI-ODCE returns measure fund-level performance and therefore can reflect other investments beyond properties, including cash balances and leverage. Leverage is conservative among these funds given their core strategies, ranging from 15%-to-34% over the quarterly series history beginning in 2000. NFI-ODCE leverage was unchanged over the quarter, at 21.7%.

Turning back to the NPI, industrial remains the best performing property type maintained with 2.83% quarterly and 12.18% trailing year total returns, while other property types trail by a wide margin. Retail was the only other property type to outperform the NPI, although by a narrow margin. With the apartment capital return index value at 8.7% above its prior peak, its 1.30% first quarter return was almost entirely dependent upon income. Similar to apartment, office had a 1.11% income return and 0.16% appreciation in the first quarter. Hotels experienced a fifth consecutive quarter of depreciation for a negative 0.16% total return in the first quarter and a 3.34% total return for the trailing year.

Taking a deeper look into performance by property type, NCREIF examines the most influential market/property type combinations on the NPI for the Indices’ Review webinar each quarter. There were 18 market/property type combinations that had a positive or negative impact on the NPI of one basis point or more in the first quarter. Negative impacts do not necessarily imply a negative market/property type total return, but always reflect a drag on the overall NPI. Grouping these together, the industrial markets stand out with only positive NPI impacts, while the opposite is true of the most impactful apartment markets.

Positive NPI contributions by industrial markets were led by the West Coast – Inland Empire, Los Angeles and Oakland – but also include the key inland hub of Chicago and East Coast port of New York. Only the New York, Houston and Chicago apartment markets had a one basis point or more impact on the NPI and all were negative. Office markets were the largest drag on NPI performance with New York office flat for the quarter and continued weakness in Washington DC and Houston. However, the Dallas and Cambridge, MA office markets offered a slight positive offset. Retail impacts on the NPI across markets were also mixed with New York and Boston serving as a drag, while Houston, Los Angeles and Dallas provided a combined 5.4 basis point boost to the overall NPI.

Underlying property fundamentals, while resilient in early 2017, also show variance across property types. Occupancy, at 93.0%, was flat over the year, although down 20 basis points (bps) from fourth quarter 2016. Apartment was the only property type to see occupancy gains over the quarter, to 93.5%; however, this was down 30 bps from one year ago. Over the trailing year, office and industrial had occupancy gains of 70 bps and 20 bps, respectively,
while retail occupancy fell by 100 bps. Industrial has the highest occupancy rate, at 95.8%.

Net operating income (NOI) growth was 5.8% (including hotels) for the trailing year, down from 6.8% a year ago, but well above its 3.2% long-term average. Industrial holds the lead for annual NOI growth, at 6.8%, while apartment and office closely tracked the overall NPI. Retail had 5.2% NOI growth over the past year.

Transaction volume totaled $6.6 billion in the first quarter 2017 for the 121 NPI properties sold, down from $7.5 billion for 184 properties during the same quarter a year ago. For the trailing year, 742 NPI properties were sold with sales volume of $39.2 billion, a 15.7% increase in volume over the prior year. While sales volume reached new absolute highs in this cycle, the annual share of NPI market value trading has been close to its long-term average of 10.8% since 2015. This share hit a cyclical peak in third quarter 2013, at 12.8%, well below the 18.8% prior cycle peak of 18.8% in third quarter 2005.

Broader measures of commercial real estate sales volume from other sources have exhibited declines in activity since late 2016. Fewer entity-level transactions and declining activity for smaller assets led the downward trend in broader market sales, although the slowdown became more general in 2017. Meanwhile, institutional investors face an incentive from slowing appreciation to realize gains for strong assets. This is reflected in the steady NPI sales volume as well as shrinking net fund flows for the NFI-ODCE funds.

Quarterly net NFI-ODCE fund flows were negative for the second consecutive quarter, driving the annual trend into negative territory as well. Quarterly distributions/redemptions have been in the $3.5-to-$4.5 billion range for five quarters, while contributions had not been below $3.0 billion since fourth quarter 2014. On an annual basis, net flows totaled negative $1.2 billion on contributions of $15.0 billion and distributions/redemptions of $16.2 billion.

With the market for institutional-quality assets remaining active, the implied valuation cap rate has remained historically low and, at 4.44%, was essentially flat over the quarter. However, NPI cap rates were down about 10 bps over the past year. Quarterly cap rate changes were slight, yet varied across property types, ranging from a 10 bps decline for industrial to a 10 bps increase for office.

Despite historically low cap rates for commercial real estate, cap rates spreads to other yields imply relatively fair pricing for the asset class. The NPI cap rate spread to the 10-Year US Treasury was 204 bps in
the first quarter, compared to a 259 bps twenty-year average. Similarly, the NPI cap rate spread to the US Corporate BBB bond yield is 75 bps, compared to a 77 bps twenty-year average.

Discount rates based upon a ten-year hold are available from Altus by property type for underlying assets in most NFI-ODCE funds, providing further insight on return expectations. From this sample, discount rates have converged at about 6.65% for industrial and office in the first quarter 2017 from 8.06% and 7.69% five years ago, respectively. The apartment discount rate moved from the lowest across property types five years ago, at 7.27%, to 6.38% in the first quarter 2017. Retail, at 6.34%, shifted from the middle-of-the-pack five years ago, roughly in line with office, to the lowest discount rate in first quarter 2017.

Although investors expect lower returns ahead, the news is not all bad. Less appreciation increases the importance of income to the total return and healthy fundamentals bode well for income. Capital market conditions appear balanced with institutional assets in favor and cap rates leveling out as interest rates begin to rise, while spreads are in-line with long-term averages. In this mature stage of the real estate cycle, the balance between supply and demand as well as the pace of interest rate increases remains important factors to watch for their impact on real estate income and appreciation.