TALE OF TWO PROPERTY SECTORS

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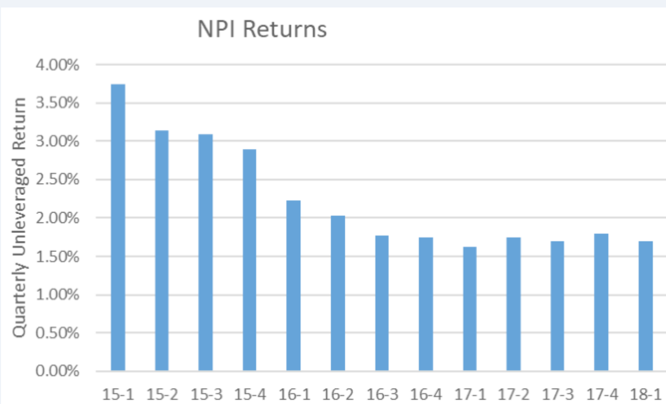
While the quarterly NPI total return remains modest, returns for the first quarter of 2018 were slightly higher than the first quarter of 2017. The total return was 1.70% in the first quarter, down slightly from 1.80% last quarter. For the current and previous three quarters, the total return was just slightly over 7% - a slight improvement over the four quarters of 2017.

The average quarterly return over the past five years was 2.43% or 10.08% annualized. Although the current quarter's return of 1.70% or 6.98% annualized is down from the torrid pace during the previous 5 years, the downward drop in returns that we witnessed for several years stopped at the beginning of 2017 and returns have held remarkably steady since then.



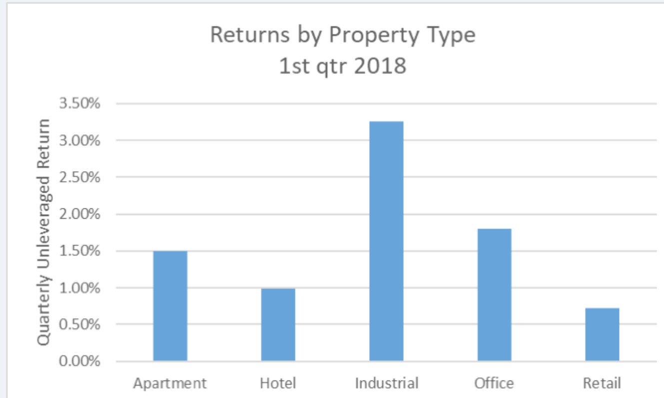
The first quarter 2018 total return consisted of a 1.12% income return and 0.58% capital appreciation. Over the past four quarters, both components of the total return have been relatively stable with the quarterly income return ranging from 1.12%-to-1.15% and appreciation in the 0.56%-to-0.63% range.

A Tale of Two Sectors

Industrial properties which are primarily warehouse continue to be the stellar performer with a quarterly return of 3.25% for the quarter. A distant second was office at 1.80% followed by apartment at 1.5%. Retail was only 0.72% for the quarter and had a negative capital return (change in value net of capital expenditures).

The spread between industrial and retail returns is a "tale of two sectors" with online shopping creating increased demand for last mile warehouse space and hurting many traditional retailers.

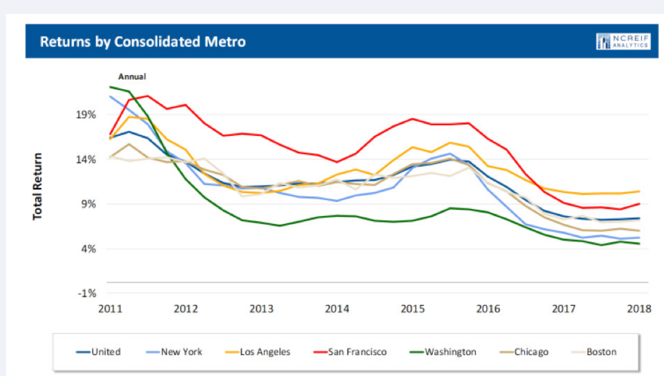
NPI Total Returns by Property Type



What is striking is how the spread between returns for industrial and retail space have widened since 2010. That spread was negative 1.25% in 2010 and is now a positive 2% (rounded). The spread increased rather significantly from about zero in 2015 to the current spread of 2%.

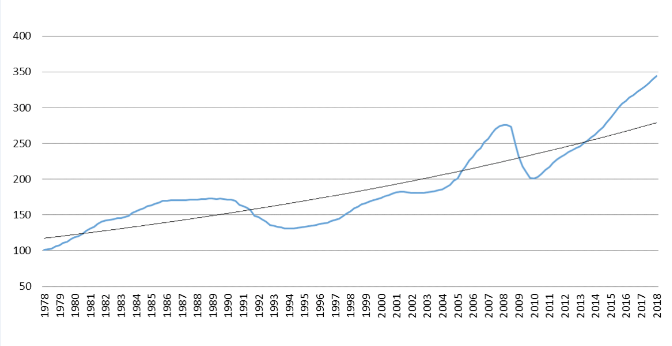
Returns in Selected CBSAs

Of the larger markets, LA had the highest return this past quarter followed by San Francisco. These CBSAs had returns that were higher than the NPI. DC and New York at the lowest returns. So there is a coastal affect in the current quarter returns.



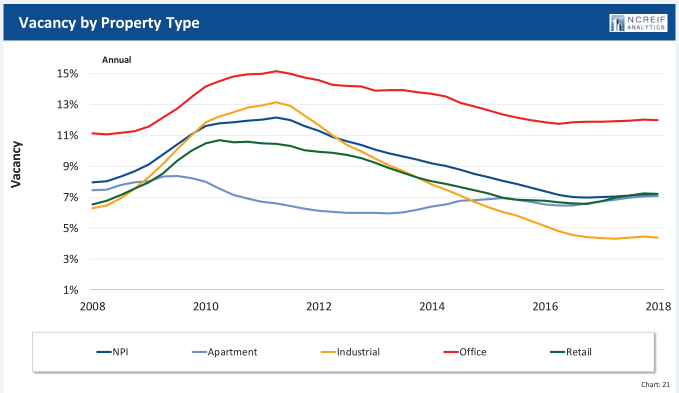
Prices Still Reaching New Highs

Although returns have been dropping, price appreciation remains positive and price levels have continued to reach new highs.

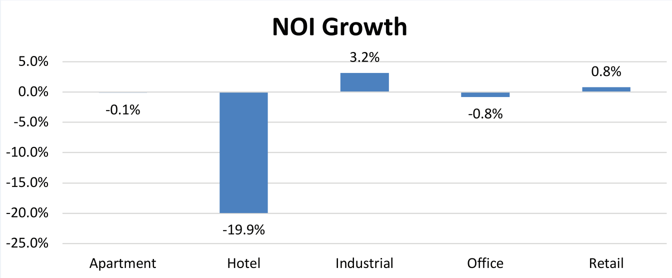


Fundamental Return Drivers

Occupancy for NCREIF-tracked properties remains close to its 16-year high, at 93.50% which is down just slightly from 93.55% last quarter. The highest occupancy (lowest vacancy in the chart below) was for industrial properties at 96.34%, just slightly lower than the 96.37% reached the prior quarter. The second highest was retail at 93.09%, which was slightly higher than the 93.05% the prior quarter. Office has the lowest occupancy with vacancy around 12%.

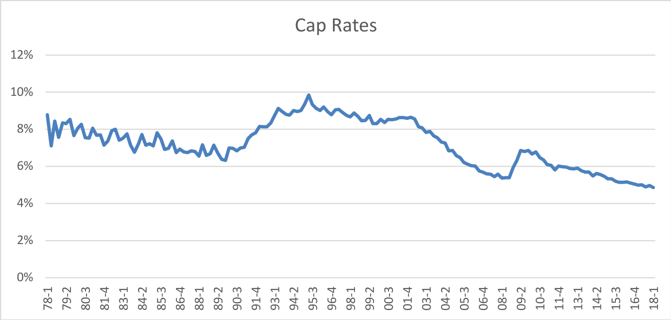


The industrial sector was the only one with significantly positive NOI growth. The other sectors were close to zero. If NOI growth continues to be negative, this could ultimately put pressure on returns – especially if cap rates increase. Cap rates declined slightly for the quarter from about 5% to 4.86% but there could be upward pressure as interest rates start to rise.



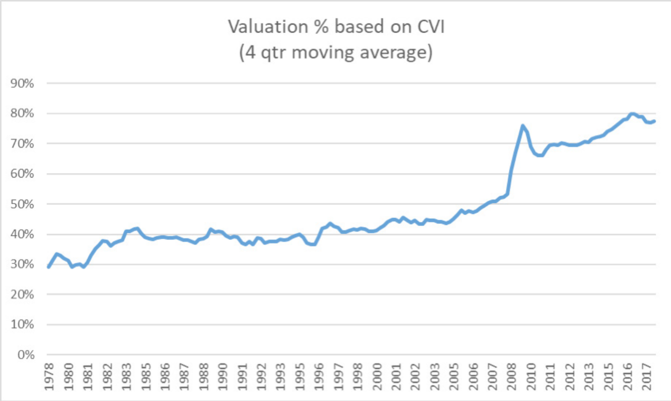
Cap rates

Cap rates remain at historic lows despite concerns that interest rates will rise. Higher interest rates could put upward pressure on cap rates although this could be offset by higher inflationary expectations.



Valuation Frequency

A question that is frequently raised is how often properties in the NCREIF index are revalued. A criterion that we have used for many years is the Current Value Indicator or CVI. The CVI for a property is true if the property had an external appraisal or if the internal appraisal resulted in a change in value beyond just adding capex to last quarter's value. That is, the internal appraisal must be more than just an accounting update. Based on this criterion, the percentage of properties has steadily increased every year from only around 30% at the start of the NPI to around 80% of the properties today.

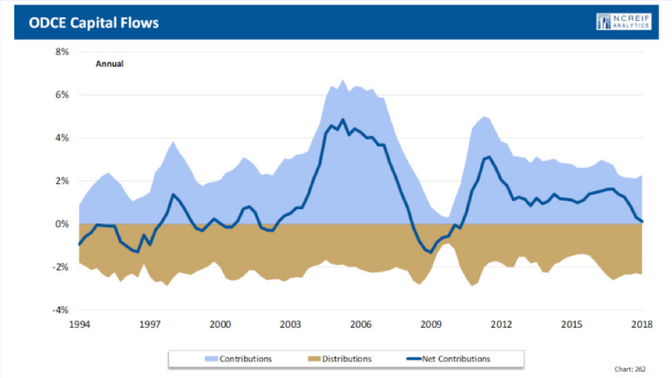


Leverage Continues to Be Favorable

The NPI represents unleveraged property performance. However, about half of the properties in the NPI utilize leverage, which can provide an opportunity for higher returns given the low interest rate environment. For the 3,615 NPI properties utilizing leverage, the leveraged total return was 1.96% in the first quarter 2018 or an annualized return of 8.07%. Thus, leverage continues to be favorable with the unleveraged return exceeding the interest rate on the properties in the index. But this is an extremely modest amount of leverage. For properties that have leverage, the average loan to value ratio is 42% and the average interest rate being paid is just under 4%.

Fund Contributions Equal Distributions

Net fund flows into ODCE funds continue to hover around zero with fund contributions being offset by distributions. In the past, ODCE funds have been negative during period of declining returns or recessions as seen in the following exhibit. ODCE refers to open end diversified core equity funds. The question is always if lower returns causes less net fund flows, or if the decline in net fund flows causes lower returns. In either case, it is clear that they are correlated and we need to keep our eye on the fund flows and if queues are beginning to develop.



Conclusion

Total returns have been very stable for over a year. But this may mask the dynamics going on within property sectors with warehouse returns increasing and retail returns decreasing. Thus, we have a balancing act between these two sectors. The winner may ultimately determine if the NPI capital return becomes negative or remains positive.