A Tale of Two Indices

The flagship NCREIF Property Index (NPI) showed considerable strength in the first quarter with a 1.80% total return, up 43 basis points (bps) from the 1.37% total return last quarter. Conversely, the Open-end Diversified Core Equity (NFI-ODCE) index showed weakness, with a 1.42% total return, down 33 bps from 1.76% last quarter. While the NPI measures property level returns, and the NFI-ODCE measures fund level returns, it is unusual to have such divergence in these two indexes.

The two can be compared on a more ‘apples-to-apples’ basis by looking at the properties in ODCE funds that qualify for NPI. Here we see the same pattern, with ODCE properties down 31 bps to 1.31%, from 1.62% in Q4 2018.

Chart 1: NPI vs. ODCE, Unleveraged Property Total Returns

Both indices managed to continue the trend of positive capital appreciation returns (change in value, net of capex expenditures). The NPI had a capital return of 0.69% whereas the ODCE properties had a capital return of 0.24%. Thus, based on either index, on average, market values continued to increase during the quarter.

Retail Makes the Difference……..

Looking more closely, we see that the difference in performance of the NPI vs ODCE is due to retail properties. Returns for retail properties in the NPI rebounded during the quarter from a negative 0.43% last quarter to a positive 1.74%. Conversely, for ODCE retail properties, total return fell from a positive 0.85% last quarter to a negative 0.06%. As can be seen in Chart 2, returns in the other major property types for ODCE were similar to the NPI overall.

Industrial Properties Still Lead the Pack

Industrial properties, which are primarily warehouse, continue on average to be the strongest performers with a return of 3.02% for the quarter. While still strong, it is a decline from the prior quarter return of 3.40%. Retail
follows this quarter, knocking office from its number two rank. As noted earlier, retail total return averaged 1.74%, a strong showing after last quarter’s -0.43%. Office follows with a return of 1.63% that was only 2 bps off of its 1.65% return last quarter. Apartment returns were unchanged at 1.35% while hotel returns dropped from 1.21% to 0.44%.

**Cap Rates at Historic Lows While Occupancy Remains High**

For the past two years, property cap rates have, on average, fluctuated up and down from quarter to quarter, with each uptick prompting suspicions of a new trend, and each subsequent downtick providing a new low. The pattern continues this quarter, with a 2018 Q4 uptick followed by a 2019 Q1 decline to the historic low of 4.69%. This also contributed to the rebound in the NPI for the quarter. Though quarter-to-quarter cap rates have shown directional volatility, a four-quarter moving average, shown in Chart 3, clearly indicates the continued downward momentum environment thus far since mid-2010.

**Chart 4: Cap Rates, equal weighted, four-quarter rolling average**

Occupancy was down just slightly to 93.8% from 94.0% last quarter; this continues to be at very high historic levels.

**Conclusion**

The future course of the NPI appears to be dependent on industrial properties continuing to outperform and retail properties not reversing course again. Our investigation this quarter has shown that there are clearly differences of opinion as to the direction of retail properties. Occupancy continuing at near record highs coupled with cap rates continuing near all time lows will also be important to keeping returns steady for the rest of 2019.