While the quarterly NPI total return remains modest, returns for the second quarter of 2018 were the highest return for the NPI since the 2nd quarter of 2016. The total return was 1.81% in the second quarter, up slightly from 1.70% last quarter. This is an unleveraged return for what is primarily “core” real estate held by institutional investors throughout the US.

The average quarterly return over the past five years was 2.38% or 9.85% annualized. Although the current quarter’s return of 1.81% or 7.44% 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 second quarter 2018 total return consisted of a 1.14% income return and 0.67% capital appreciation. The positive capital return indicates that on average, properties in the NPI are still increasing in value after deducting capital expenditures that have been added.

**NPI Quarterly Unleveraged Returns**

Industrial properties, which are primarily warehouse, continue to be the stellar performer with a return of 3.58% for the quarter. A distant second was hotel at 1.95% followed by office and apartment which were tied at 1.54%. Retail recovered nicely from 0.72% last quarter to 1.32% for the current quarter.

**NPI Total Returns by Property Type**

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**Return Drivers**

Occupancy for NCREIF-tracked properties increased to a new 16-year high, at 93.75% which is up slightly from 93.50% last quarter. The highest occupancy was for industrial properties at 96.73%. The second highest was retail at 92.82%.

**NOI Growth**

Somewhat surprising was a strong NOI growth for office at 6.6% for the quarter. Industrial and apartments tied at 2.2% and retail was slightly negative at 0.7%.

One answer may be to look at where rents are during the current quarter compared to where they were 5 to 7 years ago. The following chart has an index of rent levels for each property type starting in
2007. Apartment rents are the leader but apartments have short term leases and we would expect their NOI to be keeping up with market rents. Office rents are up around 25% from where they were 5 to 7 years ago. If leases were signed 5 to 7 years ago and are rolling over today, they could be experiencing a rent pop of almost 25%.

Cap rates

Cap rates were essentially flat for the quarter, continuing to remain at historical lows.

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 3,658 NPI properties utilizing leverage, the leveraged total return was 2.13% in the second quarter 2018 or an annualized return of 8.80%. Thus, leverage continues to be favorable with the unleveraged return exceeding the interest rate on the debt financing used by 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 annual interest rate being paid is just over 4% which is slightly higher than the rate last quarter which was just under 4%.

Conclusion

Although the NPI was up this quarter since the 2nd quarter of 2016, we owe much of this to the continued strong performance of industrial warehouse space. It is unlikely that we can rely on any further compression in cap rates to bolster price appreciation. It will be important for rent and NOI growth to be positive for most sectors for returns to remain at current levels.