Is Core Over-Valued?

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As commercial real estate markets have recovered from the financial crisis, the flow of capital seems to have been concentrated in the so called "core" properties. This has driven up the price of the core properties in the top markets relative to those that are not considered core. As a result, many investors have wondered if the core properties have gotten over valued.

In this month's Research Corner, we will attempt to shed some light on this question using the NCREIF data. The NCREIF Property Index (NPI) is usually considered representative of the returns for a core or perhaps a "core plus" portfolio because it is concentrated in the top markets and only includes existing operating properties. Although NCREIF collects data on development properties and properties that are not considered core such as parking garages, these properties are not included in the NPI. There are, however, properties in the NPI that have a fairly wide range of occupancy and that are not in what might be considered the top markets. For example, a property may have been acquired in a market where occupancy levels have dropped considerably, especially as a result of the financial crisis and resulting great recession. These properties remain in the NPI because they reflect what has happened in the market to what may have initially been considered a core property. There are also properties in geographic areas that provide diversification to a core portfolio but by themselves would not be considered core markets.

With the above in mind, we set out to carve out what might be considered a pure "core" (perhaps "super core"!) portfolio from the NCREIF data. This was done by defining core as follows:

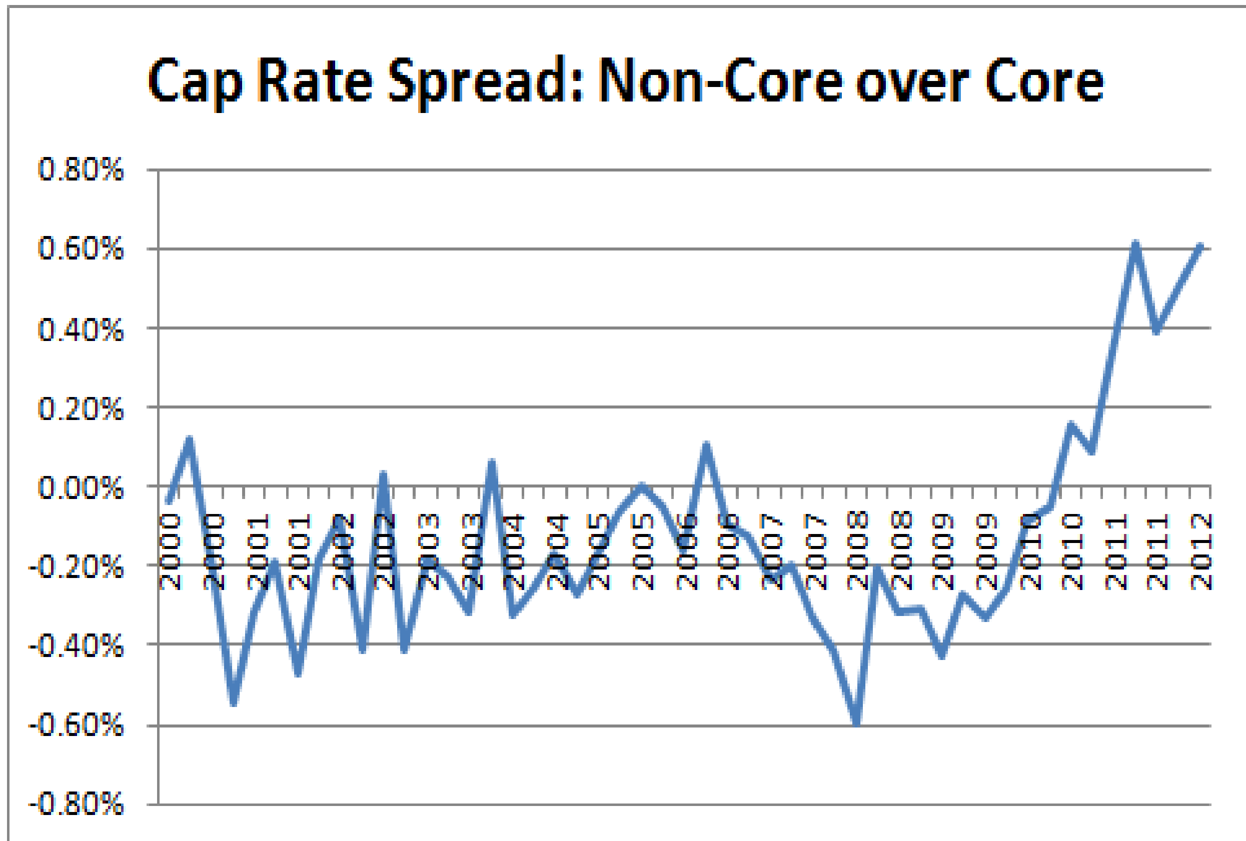
- Properties in the top 10 markets based on the amount of institutional capital (represented by NCREIF properties) in that market.
- Properties that are less than 11 years old (10 years or less)
- Properties that are at least 90% occupied.

These criteria had to be met each quarter that we calculated the measures discussed below. Of course we don't expect properties to change locations but if they became more than 10 years old they left our "core" portfolio or if occupancy dropped below 90% they left our core portfolio. We did not put a minimum size or market value limitation on the individual properties included in the core portfolio although some might also include these criteria.

Cap Rate Spread for Core vs. Non-Core

Based on the above definition of core, we first looked at the cap rate spread between the capitalization (cap) rate for the core portfolio versus everything else which for this exercise we consider non-core. Exhibit 1 below shows the results.

Exhibit 1: Cap Rate Spread



The spread (non-core less core) is mostly negative prior to the financial crisis. This might be attributed to the expectation that a non-core portfolio has more upside potential. For example, they were acquired with less than 90% occupancy and considered lease-up opportunities. In recent years, however, we see a significant increase in the spread of non-core over core. Investors are now buying core at lower cap rates (higher prices) relative to non-core. But does this mean core over valued?

Clearly something changed in recent years. Several factors could cause cap rates to differ between two different properties. First, there could be differences in the perceived risk between core and non-core. We looked at the standard deviation of the core and non-core

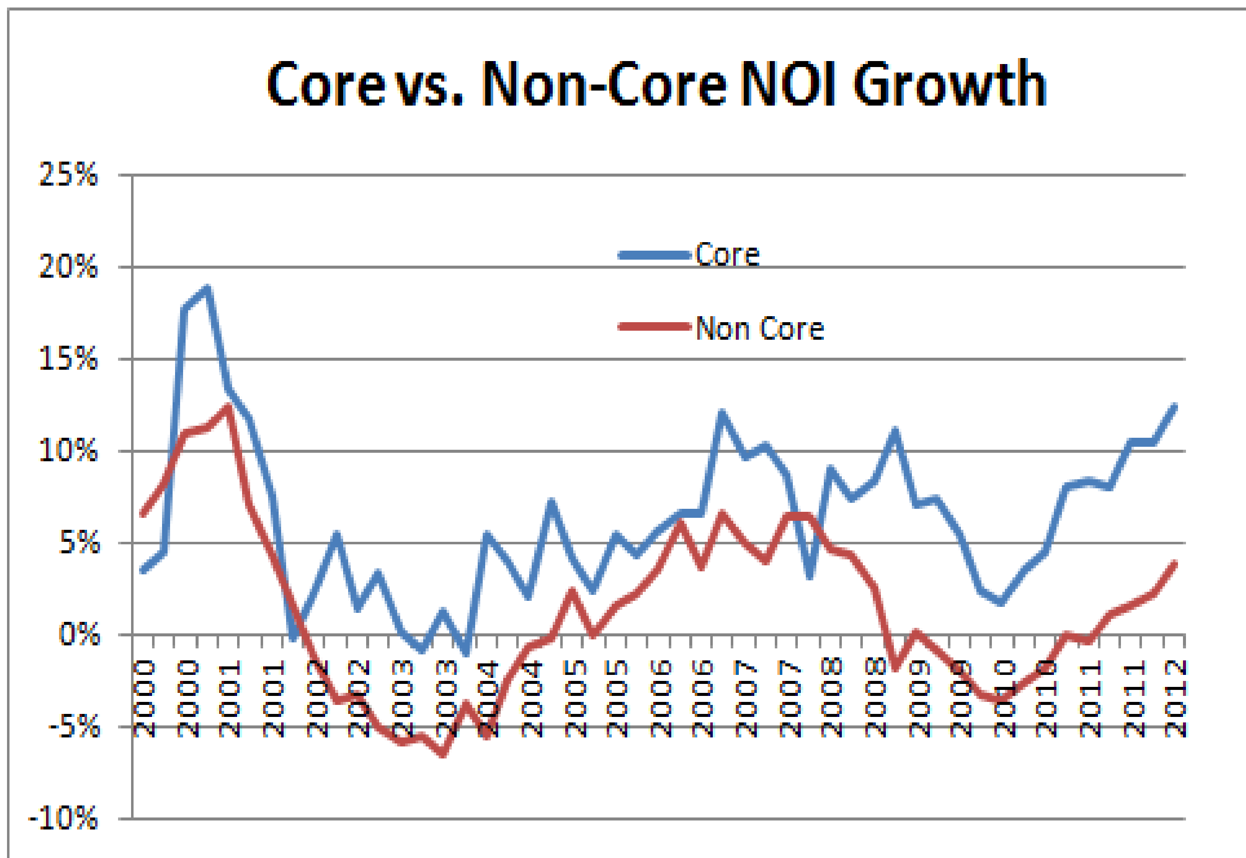
portfolios and historically they were virtually the same. However, it could be that in current market properties in the top markets that are newer with high occupancy are considered more liquid and less risky relative to properties that are considered non-core.

Second, there could be differences in expected growth. A cap rate is essentially a discount rate less expected growth. That is, the return investors expect is equal to the current yield reflected by the cap rate plus expected growth in income and value. With this in mind, we next look at the difference in NOI growth for core vs. non-core.

NOI Growth for Core vs. Non-Core

Exhibit 2 shows the NOI growth (percentage change in NOI) for the core and non-core portfolios. It is interesting and perhaps somewhat surprising the core portfolio almost always had higher NOI growth over the period examined (2000 to 2012) and in fact was hardly ever negative whereas the non-core portfolio had negative NOI growth during both the 2001 and 2008 recessions.

Exhibit 2: NOI Growth



So it appears that a lower cap rate for the core portfolio might be justified by the higher NOI growth, assuming that this is expected to continue. Whether this means that the pricing for core is “correct” relative to non-core is hard to say. All we can say is that the higher NOI growth for core portfolios is consistent with a lower cap rate for core portfolios. Another reason for a lower cap rate would be if core is considered less risky in the current market. They might be considered less risky because they have higher occupancy so more of the value is from current NOI rather than expected future NOI. Markets with more institutional capital in place might be also may be considered more liquid because there are more potential institutional buyers in that market. And newer properties may be considered less risky because they have more predictable operating expenses and are more likely to have been constructed as “sustainable” real estate which is more attractive to tenants.

Although we have not ventured to provide a definitive answer as to whether core is over-valued, we have shown you how the NCREIF data can be used to explore this question. NCREIF members can use the online query tool to do the same type of analysis as was done in this article and come to their own conclusion. Differences in opinion make a market!