COMMERCIAL REAL ESTATE PERFORMANCE MODERATION CONTINUES

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Representing $516.4 billion in market value, the quarterly NCREIF Property Index (NPI) total return continued to slow on weaker appreciation. The total return was 1.77% in the third quarter 2016, down from 2.03% last quarter and 3.09% in the third quarter 2015. This marked the first sub-2% total return since the commercial real estate recovery began in 2010.

The third quarter 2016 total return consisted of a 1.16% income return and 0.60% appreciation. Although trending down since 2010 with property values rising faster than income, the quarterly income return has been relatively steady in 2016. Appreciation has been on a steeper downward trend with the third quarter capital return at less than one-third of the rate returned in the same quarter a year ago. On an annual basis, the NPI total return for the year-ending third quarter 2016 was 9.22% and consisted of a 4.81% income return and 4.26% appreciation.

Although appreciation has moderated considerably, it remains positive, reflecting continued improvement in market values. The Market Value Index (MVI) measures the trend in capital value changes for properties with consistent characteristics (i.e. not undergoing significant capital expenditures) and is more comparable to a price index. Improvement in market values has driven the MVI to a new peak. The MVI has been rising at a slower pace this year, but is 15% above its prior peak in 2008 and well above its long-term trend.

Industrial was the lone bright spot for appreciation, securing its commanding lead over the other property types for quarterly and trailing year total returns. Industrial was the only property type with a quarterly total return above 2% and retail was nearly 2%, while both were the only property types to outperform the NPI for the trailing year. Nearly all (92%) industrial market value is accounted for in warehouse properties and performance among warehouses was stronger for larger properties with a quarterly total return for warehouse 500,000 square feet or more at 3.04%.

Retail had a relatively healthy total return, although appreciation was largely tied to super regional and regional malls. Neighborhood and community shopping centers have seen a steady drop in quarterly appreciation over the past year, to 0.70% in the third quarter 2016 from 2.47% in the third quarter 2015. The remaining retail subtypes have experienced an even steeper drop in appreciation with fashion retailers and power centers under pressure from ecommerce.

Apartment and office had nearly equivalent income returns for the quarter, but differed on appreciation. The 0.60% appreciation for apartment properties kept it in the middle of the pack as opposed to just 0.15% appreciation for office. The apartment total return is beginning to diverge across subtypes with garden properties leading (2.20%) and high-rise (1.42%) lagging the overall apartment performance. In this cycle, development has been concentrated in urban areas, driving more competition for leasing in the high-rise segment. Garden apartments have held a modest income return lead over high-rise properties throughout the recovery and, in the past year, garden property appreciation has been double that of high-rise properties.

Among office properties, the CBD income return (1.00%) and appreciation (0.13%) are both trailing overall office after strong recoveries in values and rental rates this cycle. The suburban office income return (1.26%) is running ahead of CBD properties and appreciation of suburban assets valued at $100 million or more was the strongest office segment, at 0.57%.

Hotels experienced their third consecutive quarter of depreciation with a 1.35% quarterly total return and
remain the weakest property type over the trailing year with a 7.17% total return. Mid-size hotels, from $25 million-to-$75 million in market value, have been hit hardest by depreciation in 2016, resulting in negative quarterly total returns. Hotels valued at $75 million or more have fared better, while smaller hotels have outperformed due to a strong income return.

The NPI and its disaggregated segments represent unlevered property performance. Given the longevity of low interest rates, higher returns could be achieved by investors utilizing leverage. Nearly half of the properties in the NPI utilize leverage. Total leveraged returns for these 3,454 properties were 2.35% in third quarter 2016 and 12.95% for the trailing year, comparing more favorably to other asset classes.

Total returns, gross of fees, for the NCREIF Fund Index – Open-end Diversified Core Equity (NFI-ODCE) have held near 2% in 2016 and were 2.07% in the third quarter. This is down marginally over the quarter, from 2.13% in the second quarter 2016, but a marked deceleration from the roughly 3.5% trend in 2015. At 1.12% in the third quarter, the quarterly income return has been essentially unchanged in 2016, but is down from 1.17% in the third quarter 2015. Meanwhile, there have been marginal declines in appreciation each quarter this year. Appreciation was 0.94% in the third quarter, down from 1.01% in the second quarter and 2.51% in the third quarter 2015. The annual NFI-ODCE total return gross of fees was 10.08%, comprised of a 4.57% income return and 5.32% 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. In the third quarter 2016, NFI-ODCE leverage was 22.1%.

Net flows into the 24 NFI-ODCE funds have pulled back to $3.2 billion over the year ending third quarter 2016 from their $5-to-$6.5 billion annual trend from the prior two years. Contributions remain near peak levels for the trailing year, at $18.1 billion. Meanwhile, distributions/redemptions have increased sharply in 2016 with quarterly average distributions/redemptions of $4.1 billion in the first three quarters of the year, for a new peak of nearly $15 billion over the trailing year.

As the NFI-ODCE funds have grown to $165.5 billion in net real estate assets over time, it is worthwhile to examine aggregate fund flows as a share of these assets. By this measure, trailing year net fund flows (1.9%) are at their lowest level since the recovery began in 2010. Annual contributions as a share of NFI-ODCE net real estate assets are 10.8%, which is half the 20% post-recession peak achieved in 2011 and well below the 14% average since the series began in 2000. Distributions/redemptions as a share of net real estate assets are at their highest level since the recovery began, at 8.9%.

Although NFI-ODCE flows reflect core real estate investment demand, the trend tends to track closely with broader institutional investment performance.
measured by the NPI. Slower net fund flows may simply be indicative of the current stage of the real estate cycle. With appreciation slowing, there is an incentive to realize gains for strong assets and perhaps deploy the proceeds into higher yielding strategies. Trends in sales transactions among NPI properties are sending a similar signal.

With 215 properties traded, transaction volume for NPI properties totaled $9.6 billion in the third quarter 2016, for a 24% increase in volume over the same quarter a year ago. Year-to-date transaction volume, at $37.5 billion, was up 28% from the same period last year.

On a value-weighted basis, the implied valuation cap rate edged down to 4.48% in the third quarter 2016 for a new historical low. While average cap rates have been near 4.5% over the past four quarters, the 10-year U.S. Treasury has trended down at a faster pace, slightly increasing the cap rate spread to nearly 300 basis points (bps) in the third quarter 2016.

Cap rate compression occurred across all property types for the quarter, led by apartment and office. The industrial average cap rate is barely above 5%, while apartment and office are near 4.3% and retail is 4.67%. Cap rates for all sectors, except apartment, are at historical lows.

Discount rates are available by property type from Altus using assets held by most NFI-ODCE funds. From this sample, discount rates have converged at about 6.75% for industrial and office from 8.5% and 8.0% five years ago, respectively. The apartment discount rate moved from the lowest across property types in 2011, at 7.5%, to 6.4% in third quarter 2016. Retail, at 6.3%, shifted from the middle-of-the-pack five years ago to the lowest discount rate.

Property fundamentals were stable in the third quarter 2016 with occupancy holding at its 15-year high of 93.2% and trailing year net operating income (NOI) growth of 5.4%, including hotels. Although occupancy was steady overall, there was considerable variance by property type. Occupancy was up for industrial and office over the quarter and the year, but down for apartment and retail. With a 110 bps increase over the year, to 95.9%, industrial occupancy remains the highest of all property types, while office, at 88.4%, has the lowest occupancy rate. Despite a 110 bps decline in occupancy over the year, apartment remains the leader for trailing year NOI growth, at 7.8%. At 4.0%, office had the slowest trailing year NOI growth.

Amid solid fundamentals, the appreciation cycle for institutional real estate has entered a new phase such that total returns are more dependent upon their income component. With an above average cap rate spread to the U.S. Treasury, the asset class should remain attractive even as interest rates begin to rise.