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Private Real Estate returns slow; further deceleration expected

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SUMMARY

The strong US private real estate returns in 2Q 2022 are only starting to reflect the shifts in market conditions in 2022. In 2Q, appreciation slowed as compared to the previous three quarters, and we expect appreciation to approach zero in the remainder of 2022 and the start of 2023.

The transaction market has adjusted to changes in interest rates and growth outlooks. In the coming quarters, appraisals will reflect that change. There is uncertainty on the timing of appraisal convergence to market pricing and how much change in value is required to align appraisals with market pricing. Despite these shifts, relative sector performance is unchanged.

This note provides details on the second quarter performance of the NPI and ODCE indices and details on our performance outlook given our expectations of appraisal adjustments.

Highlights from the 2Q data releases include:

- The quarterly total NPI return of 3.23% is strong relative to history, but down over 2% from the 1Q return. The 2Q return was a 0.97% income return (an all-time low) and a 2.26% appreciation return.
- The trailing-year return dipped slightly to 21.45%, but that is still in the 99th percentile of all trailing-year returns.
- The relative performance of sectors did not change, with industrial leading, followed by apartments, retail, and then office. However, industrial returns slowed the most relative to previous quarters, and the quarterly out-performance of industrial relative to the overall index is now the lowest since 3Q 2020.
- The ODCE value-weighted quarterly gross total return of 4.77% was down 260 bps from the first quarter. This was comprised of a 0.87% income return and a 3.9% appreciation return. The trailing-year ODCE gross total return is up to 29.5%; 28.3% on a net basis--both all-time highs.

Figure 1	Trailing Four-Quarter Return	10-Year Return
NCREIF Property Index (NPI)	21.5%	9.7%
NCREIF ODCE Index	29.5%	11.2%
FTSE NAREIT (Equity REITs)	-5.9%	8.3%
S&P 500	-10.6%	13.0%
MSCI World Total Stock Index	-13.9%	10.1%
US Government 90 Day T-BIll	0.4%	0.6%
Citigroup Broad Corporate Bond Index	-14.1%	2.7%

Source: NCREIF, Bloomberg, 2Q 2022. All pre-fee.

Sector divide narrows, but no change in relative sector rankings

In the second quarter, industrial and apartments were the only property types to out-perform the NPI overall return. Retail is continuing to post stronger returns than office after more negative performance at the outset of the Pandemic.

- **Apartments continue to out-perform -** Apartment returns of 3.9% in 2Q were down 140 bps from 1Q; but because apartments slowed less than the overall index, apartments are out-performing again. Apartments benefit from strong NOI growth, with NOI up 3.8% quarter-over-quarter. While strong, this is slower than a year ago, which lowered trailing-year NOI growth to a still-robust 22.3%. Suburban apartments continue to out-perform urban apartments in both the quarter and trailing 1-, 3-, 5-, and 10-year periods.
- **Industrial returns slowing, but still leading other property types –** The quarterly return of 5.9% was above all other property types by at least 200 bps. However, it is down 510 bps from 1Q, reflecting shifts in the industrial market. Income returns are down to 0.78% (3.15% annualized), the lowest of all property types. Low income returns will require out-sized appreciation for this sector to match other sectors' total return going forward. Continuation of strong recent NOI growth will help with second quarter NOI growth of 3.8%, and brought trailing year income growth to 12.6%.
- **Office returns lowest of all property types –** The quarterly return of 0.58% was a combination of 1.08% income and negative 0.5% appreciation. Office was the only property type to see negative appreciation. The trailing-year return of 5.8% remains the lowest of all property types. Suburban offices continue to lead CBD offices, with suburban offices having trailing-year total returns over 600 bps higher than CBD offices. However, some portion of this is likely due to the higher share of medical office and life sciences buildings in the suburbs. Despite market headwinds, NOI growth was +3.8%, raising trailing-year NOI growth to 2.7%.
- **Retail maintains momentum –**The 2Q return of 1.7% was only 60 bps lower than 1Q; less decline than other sectors. The 1.25% income return (5.0% annualized) is the highest income return of the major sectors. Trailing-year returns are up to 7.9%, the highest since Q4 2016. The recovery is supported by NOI growth, with 4.4% growth in 2Q, bringing trailing-year growth to 13.6%. Open-air continues to lead malls, with a 9.7% trailing-year return compared to 6.0% for malls. Open-air also has a higher income return than malls.
- **Specialized property types –** NCREIF tracks data of several specialty property types (self-storage, senior housing, healthcare, and parking), which are not included in the NPI. Some are becoming a larger part of institutional portfolios, and NCREIF will be increasing the coverage of specialty property types in the near future. The current data shows self-storage delivering exceptional returns, with a 5.8% 2Q return and a trailing-year return of 37.8%. Self-storage investment continues to increase, with $20 BN of assets tracked. Healthcare returns are also solid, with a 3.1% quarterly return and a 13.2% trailing-year return. Senior Living and Parking returns are weaker, with trailing-year returns of 4.8% and 7.3%, respectively.

NPI return detail (as of 2Q 2022)

		1 Year			Historic Total Returns			
	Current NPI Weight	Total Return	Income	Appreciation	3 Year	5 Year	10 Year	15 Year
All Property	100%	21.5%	4.1%	16.9%	10.2%	8.8%	9.7%	7.2%
Apartment	27%	24.4%	3.8%	20.0%	11.1%	8.8%	9.4%	7.2%
Hotel	0.2%	10.4%	5.0%	5.2%	-6.1%	-1.3%	3.5%	2.2%
Industrial	31%	47.7%	3.6%	43.0%	26.0%	18.7%	16.9%	11.6%
Office	27%	5.8%	4.4%	1.4%	4.4%	5.9%	7.4%	5.4%
CBD Office	15%	3.0%	4.1%	-1.1%	2.4%	4.9%	6.7%	5.4%
Suburban Office	12%	9.6%	4.7%	4.8%	7.0%	7.3%	8.2%	5.7%
Retail	14%	7.9%	5.0%	2.8%	0.2%	3.6%	6.4%	5.7%
Open-Air Retail	8%	9.7%	5.3%	4.3%	2.7%	3.4%	6.9%	5.5%
Mall Retail	7%	5.9%	4.7%	1.2%	-2.3%	-0.6%	6.0%	6.0%

Valuation trends and dynamics

Valuation data is now being collected and released by NCREIF for 25 of the 27 ODCE funds in aggregate form. This data is similar to, but not as detailed as the information shared by the Altus Group to investment managers who are clients of Altus. The NCREIF-released datapoints are summarized in the table below by property type.

	Discount Rate	Terminal Cap Rate	Implied 1-Year Cap Rate	10-Year Avg. Market Rent Growth
Overall	6.03% (+5 bps)	4.85% (unchanged)	3.69% (-4 bps)	3.26% (+2 bps)
Apartment	5.71% (+4 bps)	4.35% (+2 bps)	3.54% (-1 bps)	3.32% (+8 bps)
Industrial	5.63% (+14 bps)	4.48% (+5 bps)	3.04% (-10 bps)	3.41% (-1 bps)
Office	6.52% (+2 bps)	5.51% (-3 bps)	4.21% (unchanged)	2.93% (+3 bps)
Retail	6.86% (+4 bps)	5.68% (+1 bps)	4.77% (+10 bps)	2.83% (+5 bps)

In our view, these metrics point toward downward pressure on appraisal values coming from increases in discount rates and terminal cap rates. Apartment and industrial are the most transacted sectors currently, and we have observed discount rates on transaction underwriting have increased to the mid-6% range. We expect there will be a lag in these shifts being reflected in appraisals; and as discussed in our forecast section, the time of that lag is a driver of index return forecasts for the coming years. There is some offset to the yield pressure from rent growth and rent levels. In apartment and industrial appraisals, we see those levels sometimes lower than market average. This will generate some upward pressure on values as realized property cash flows beat expectations, but we expect the downward pressure from yields to be more significant.

The second quarter appraisal data has been published by NCREIF, which allows a comparison to the previous quarter levels. The changes reflect a mix of dynamics between sectors. Office and retail have meaningfully higher discount rates and terminal cap rates than the apartment and industrial sectors. This is the reason the increases in those metrics have generally been less in the last quarter. There is also a spread in the implied Year 1 cap rates across sectors, which is indicative of the relative change in values to the next year income. The decline in Year 1 cap rates for industrial mean values have increased more than Year 1 income, and with long-term leases in this sector common, the expectation is that future cash flow will be higher. For retail, income has increased faster than values, thus boosting the Year 1 cap rate. Our view is this reflects the increasing occupancy at retail properties as pandemic vacancies are back-filled.

Open-End Core Equity Fund Index (ODCE)

The NCREIF Open-End Core Equity Fund Index (ODCE) posted a 4.77% gross total return in 2Q 2022, down 260 bps from that in 1Q. This brought the full-year gross ODCE return to 29.5%, an all-time high. Income returns continued to decline, down to 0.87%, an all-time low.

The table below shows the buildup to the fund-level index return. The largest portion of return comes from unleveraged property returns, but leverage is also a meaningful contributor. Average index leverage was up about 50 bps to 21.5%. The leverage boost of 1.61% was sourced from a mix of positive appreciation and mark to market on existing debt as interest rates moved higher in 2Q. The positive mark to market will unwind as below-market debt gets closer to maturity; but until that happens (or interest rates fall again), it will be an asset for open-end funds. Other contributors to the index return were relatively minor and tend not to vary much quarter to quarter.

Net capital flows to ODCE funds moved back to negative after two positive quarters. Distributions and redemptions exceeded contributions by $874 M. This occurred as contributions remained well above historic averages at $6.3 BN, but distributions and redemptions continued to move higher, to an all-time high of $7.2 BN. Distributions include income distribution, so this is not just a capital redemption figure. The move to negative cash flow is consistent with an environment where some investors are becoming overweight in real estate due to negative stock and bond returns in 1H, while real estate returns have been strong. Open-end funds are often the first stop for diversified institutional investors looking to re-balance their portfolios. For investors overweight real estate, the "denominator effect" pressure will continue until either stock and bond prices rebound, real estate values decline, or new allocations to other asset classes lower the relative weight of real estate. There are still many investors - notably high-net-worth investors - who have limited allocations to real estate and despite market shifts are looking to increase their real estate allocations.

ODCE Return Reconciliation	2Q 2022	Trailing Year
Unleveraged Property Returns	**+3.67%**	**24.00%**
Leverage (Principal Impacts)	+0.82%	+6.21%
Leverage (Marked to Market Impacts)	+0.59%	+1.19%
Cash Balances	-0.11%	-0.91%
Acquisitions (Partial Period)	-0.03%	-0.24%
Other Non-Property Investments	-0.02%	0.15%
Other Assets and Liabilities	0.05%	0.33%
Fund Costs	-0.02%	-0.09%
Other (Including JV Structuring)	-0.18%	-1.15%
Total Gross Returns	**4.77%**	**29.51%**

Market performance

The table below shows trailing-year returns by market and property type. Property type mix remains the dominant driver of relative market performance. Color coding is within each property type, so the lowest-returning industrial market is orange/red even though returns are higher than the best-returning retail market.

With total market returns being heavily driven by property type mix, perhaps the best view on relative market performance comes from a comparison of apartment returns across markets. This shows the very strong performance of Sunbelt markets, led by the 44.5% return on Phoenix apartments. By comparison, the returns in gateway markets are much weaker, although still solid if viewed on an absolute basis relative to history. The lowest returns in apartment markets are 8.7% in San Francisco and 11.5% in Chicago.

There is a broad spread in industrial returns, but almost all markets have returns that would be considered phenomenal in a historical context. However, for investors focused on performance relative to the benchmark, it is a huge difference if they are over- or under-allocated to a market like Riverside, which delivered a 79% trailing-year return.

Office returns are generally weak across all markets, with the only exceptions being Cambridge and San Diego, where a large portion of assets are life sciences related. Retail also shows more limited dispersion in performance by market, with the assumption being that most of this is asset rather than market driven.

NPI Trailing 1 Year Total Returns by Metro	Total	Apartment	Industrial	Office	Retail
Riverside	70.2%	37.7%	79.0%	-	7.5%
Orange County	32.6%	30.0%	64.8%	-0.6%	5.6%
Phoenix	31.2%	44.5%	47.9%	4.2%	13.4%
Miami	28.2%	35.4%	43.5%	7.4%	5.0%
Los Angeles	27.6%	17.5%	70.4%	5.8%	6.0%
Atlanta	26.9%	31.4%	41.5%	3.4%	14.2%
San Diego	25.7%	31.1%	50.4%	22.7%	9.2%
Austin	24.7%	34.3%	38.8%	12.2%	11.2%
Dallas	24.1%	26.5%	40.8%	6.4%	9.1%
Cambridge	22.4%	28.7%	41.3%	21.5%	-2.6%
Denver	21.3%	31.9%	27.3%	4.0%	8.5%
Oakland	20.9%	15.4%	36.6%	9.9%	6.8%
Seattle	19.1%	23.6%	32.8%	9.8%	14.2%
Houston	13.9%	21.2%	27.8%	2.9%	11.0%
New York	12.1%	12.7%	46.6%	1.6%	1.4%
Chicago	11.8%	11.5%	27.0%	-0.5%	6.8%
San Jose	11.4%	12.6%	25.9%	9.9%	5.3%
Boston	10.5%	20.2%	39.5%	4.8%	5.8%
Washington DC	8.3%	17.2%	42.2%	2.6%	4.8%
San Francisco	6.9%	8.7%	23.2%	6.1%	-2.3%
US	**21.5%**	**24.4%**	**47.7%**	**5.8%**	**7.9%**

Return forecasts

Evidence from our market activities as both a buyer and seller shows transaction return metrics have changed in response to higher interest rates and slower economic growth forecasts. The depth of evidence varies by sector, with transaction volume slowing in recent months to varying degrees. This drives our conviction that index returns will slow dramatically from the record levels seen in the last 12-18 months. There is uncertainty around the timing of appraisal adjustments and the extent to which appraised values need to change to converge with market pricing. In updating our index return forecasts, these were just a few of the questions to answer; and in the process, we explored scenarios to frame what is possible.

Our base case timing for apartments, industrial, and retail is appraised values adjust over the next 2-3 years. There is a scenario where appraisals adjust quickly, which would imply lower returns in the next 12 months but better returns following. There is also a scenario where values are very slow to adjust. We believe a very slow adjustment is unlikely for apartments and industrial; however, for office, this is our base case given limited transaction volume and since values have already been slow to adjust since the onset of the Pandemic.

The amount of value change by sector is driven by a forecast of NOI growth, and the yield we estimate will produce a long-term return in the mid-6% range. Even though the economy is slowing, we still expect strong NOI growth in the near term for apartments and for an extended period for industrial due to the steady realization of higher NOI from rolling leases to higher market rents. Our office NOI growth forecast is below what we estimate is underwritten in the average appraisal. This drives a slow value adjustment as the appraisal assumptions are not achieved. Said another way, we expect offices will continue to be valued based on a view that better days are always just around the corner.

The combination of these sector views produces the index forecast summarized below. A comparison with the PREA Consensus forecast is also included. The PREA Consensus and LaSalle are generally aligned on outlook for 2023 and beyond. The 2022 LaSalle forecast is above the PREA Consensus. We have confidence in our forecast given that YTD NPI return is already 8.7%, and believe that flat valuations with some income return is a more likely scenario for the remainder of the year than is seeing appraisal value declines sufficient to entirely offset positive income returns.

NPI Forecast Returns

	2017	2018	2019	2020	2021	2022	2023	2024	Average 2022-2026
Income Return	4.7%	4.6%	4.5%	4.2%	4.2%	~4%	~4%	4 - 5%	4.3%
Appreciation Return	2.2%	2.1%	1.8%	-2.5%	13.1%	6-7%	~0%	0-2%	1.9%
Total Return	7.0%	6.7%	6.4%	1.6%	17.7%	10-11%	3-5%	4-6%	6.2%
PREA Consensus Survey Forecast						8.7%	4.4%	6.1%	6.3%

ODCE Forecast Returns

	2017	2018	2019	2020	2021	2022	2023	2024	Average 2022-2026
Income Return	4.4%	4.3%	4.3%	3.8%	4.0%	~4%	~4%	~4.5%	~4.5%
Appreciation Return	3.2%	3.7%	1.7%	-2.6%	17.6%	~10%	~0%	~1%	~3%
Total Return	7.6%	8.0%	5.9%	1.2%	22.2%	13-15%	4-5%	5-6%	7-9%

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