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April 3, 2023

Fourth quarter private real estate returns move negative

SUMMARY

US private real estate returns went negative in Q4 2022 as the impact of higher interest rates continued to ripple through to market pricing and appraised values. This trend is expected to continue through the first half of 2023 with stability projected to return later in the year.

Returns in the fourth quarter showed negative appreciation and income returns in line with previous quarters, resulting in negative total returns for both the NPI and ODCE. The slowdown in returns was most significant for industrial, with retail delivering the highest returns of the major sectors (this is a notable shift from trends of the last 5+ years). Looking ahead, the dominant theme in sector performance is expected to be the under-performance of offices.

This note provides details on the fourth quarter performance of the NPI and ODCE indices, summarizes the outlook for future returns, and provides some information regarding insights from the first release of data related to the new NCREIF subtypes.

Highlights from the Q4 data releases include:

- The quarterly total NPI return declined 410 bps from Q3 to -3.5%. The Q4 return comprised a 0.95% income return and -4.45% appreciation return.
- The trailing-year return declined more than 1,000 bps quarter-over-quarter to 5.53%.
- Returns for all property types were down from the previous quarter and in negative territory, with industrial seeing the greatest decline for the second consecutive quarter. Retail was the highest-returning property type for the first time since Q1 2016.
- The ODCE value-weighted quarterly gross total return of -4.97% was down 440 bps from the third quarter. Appreciation remained negative at an index level and the income return was flat at 0.80%, an all-time low. Mark to market on leverage was a positive as interest rates rose, but negative appreciation caused leverage to be an overall negative to returns.

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Figure 1	Trailing four-quarter return	10-year return
NCREIF Property Index (NPI)	**5.5%**	**8.8%**
NCREIF ODCE Index	**7.5%**	**10.1%**
FTSE NAREIT (Equity REITs)	**-24.9%**	**7.1%**
S&P 500	**-18.1%**	**12.6%**
MSCI World Total Stock Index	**-17.7%**	**9.5%**
US Government 90 Day T-BIll	**2.1%**	**0.8%**
Citigroup Broad Corporate Bond Index	**-15.7%**	**2.0%**

Source: NCREIF, Bloomberg, 4Q 2022. All pre-fee.

Retail leads as returns on all major sectors turn negative

The NPI returned -3.5% in the fourth quarter, down from 0.6% in Q3 2022. All four major property sectors saw negative returns for the first time since Q4 2009. Retail returns were the highest among the four main property types, followed by apartments. Industrial slightly underperformed the index and office trailed by a wide margin. Hotels saw the only positive quarterly return.

- **Apartment returns negative but lead overall index–** Total returns for the apartment sector were -3.2% in Q4. Apartments outperformed the index on total and appreciation returns (-4.1%) and were in line on income returns at 0.9%. NOI was up 2.3% from Q3 and 10.4% y/y. Suburban apartments outperformed apartments in urban areas according to the new NPI+ data, with the former returning -2.6% (10.3% in 2022) versus the latter at -3.9% (3.8% in 2022).
- **Industrial returns slip below the index –** Industrial returns moved down to -3.6% in the fourth quarter, outperforming only office. Appreciation returns declined 470 bps from Q3 to -4.3% and the sector's income return remained flat Q/Q at 0.8%. NOI grew 1.1% from Q3 and 12.0% over Q4 2021. Despite the slowdown, industrial still holds the top spot for total returns over the 1-, 3-, 5-, 10-, and 15-year history.
- **Office returns remain lowest of all property types –** Office returns were the lowest among all property sectors in Q4 at -4.8%. While the sector's income return outperformed the index at 1.1% that was offset by appreciation returns of -5.9%. NOI growth increased 480 bps Q/Q to 1.1%, in line with industrial, and 3.7% y/y. Suburban office continued to outperform with a total return of -3.9% compared to -5.5% for CBD office. However, the former likely benefits from a larger share of medical office and life science buildings, which returned -1.5% and -2.2%, respectively, according to the new NPI+ data which is discussed in more detail below. Traditional suburban office (without life science or MOBs) returned -4.4% in Q4 and -2.3% in the trailing year period.
- **Retail takes the lead on quarterly returns –** Retail saw the highest total return of the four main property sectors in Q4 for the first time since Q1 2016. At -1.6%, returns were driven by the highest income return at 1.2% and the lowest decline in appreciation at -2.9%. NOI was up 4.9% from Q3, reversing last quarter's decline, and 4.6% higher than Q4 2021. However, the sector's 1-year returns still trail apartments and industrial by a wide margin at 2.7%. Retail pricing is showing less sensitivity to interest rate moves due to less yield compression post-pandemic relative to apartments and industrial along with stable fundamentals. Open-air retail continued to outperform at -0.9% versus a -2.5% total return for malls. Grocery-anchored strip centers outperformed with a quarterly return of -0.6% and a 1-year return of 6.0%.

NPI return detail (as of Q4 2022)

		1 year			Historic total returns			
	Current NPI weight	Total return	Income	Appreciation	3 year	5 year	10 year	15 year
All property	100.0%	5.5%	3.9%	1.6%	8.1%	7.5%	8.8%	6.5%
Apartment	28.1%	7.1%	3.7%	3.3%	9.3%	7.9%	8.6%	6.7%
Hotel	0.3%	10.0%	6.9%	3.0%	-4.8%	-0.8%	3.6%	2.1%
Industrial	32.1%	14.6%	3.2%	11.1%	22.4%	18.9%	16.0%	10.9%
Office	25.7%	-3.4%	4.3%	-7.4%	1.4%	3.5%	6.3%	4.4%
CBD office	14.0%	-5.7%	4.1%	-9.5%	-0.7%	1.9%	5.5%	4.2%
Suburban office	11.8%	-0.4%	4.6%	-4.8%	4.2%	5.6%	7.4%	4.9%
Retail	13.8%	2.7%	5.0%	-2.2%	-0.3%	0.6%	5.7%	5.2%
Open-air retail	7.5%	5.2%	5.2%	0.0%	2.4%	2.8%	6.4%	5.2%
Mall retail	6.3%	0.0%	4.8%	-4.6%	-3.0%	-1.6%	5.0%	5.2%

Niche sectors outperform traditional property types

The new sub-type definitions and NCREIF data gathering efforts provides some preliminary return data on property types and sub-types that were often over-looked in analysis of institutional investor portfolios, including single-family rentals, life sciences, and data centers. These sub-types, along with the entire NPI and some other property types that were tracked, but not included in the NPI (such as self-storage and senior housing) are included in the NPI+ index. The NPI+ returned -3.3% in Q4 2022, slightly ahead of the NPI as a result of the inclusion of additional higher-returning niche sectors.

- **Residential subsectors outperform the index, led by manufactured housing**. Manufactured housing saw the highest return of any sector or subsector in Q4 2022 at 4.1%. The sector's outperformance was driven by a strong 3.3% appreciation return with an income return of 0.8%. Annual returns also outperformed the NPI+ but lagged some other sectors at 9.2%. Student housing also performed well with a Q4 total return of -0.4% driven by 1.1% income return and a -1.5% appreciation return. Trailing-year total returns were strong at 10.6%. Single-family rentals (SFRs) returned -2.9% in Q4 as a result of a -3.6% appreciation return and 0.7% income return. However, SFR 1-year returns remained elevated at 12.2%.
- **Office specialty subsectors outperform in Q4**. Total returns for the life science and medical office (MOB) sectors were -2.2% and -1.5%, respectively, in Q4. Both sectors experienced a negative appreciation return, with -3.1% for life science and -2.7% for MOBs, while income returns were in line with past performance. Life science properties saw a 0.9% income return, up 10 bps from Q3 and flat from Q4 2021. MOB income returns of 1.2% were unchanged from the previous quarter and year. Performance of trailing-year total returns diverged, however, with life science properties outperforming the NPI+ at 10.6% while MOBs lagged at 4.5%.
- **Self-storage returns move negative for the first time**. Self-storage properties returned -1.1% in Q4, the first negative return for the sector in the data history going back to 2013. The sector's income return of 1.0% was down 10 bps from Q3 and down 20 bps from Q4 2021. Appreciation returns were -2.1%. Trailing-year returns remained among the highest in the NPI+ at 15.6%.
- **Senior housing and data centers led the index in Q4 but trailed in 2022**. The senior housing sector's total return of -0.8% was driven by a 0.9% income return, which was up 10 bps from the previous quarter and year-ago periods. Appreciation returns for the sector were -1.7%. Trailing-year returns of 2.1% lagged the index. Similarly, data centers outperformed in Q4 with a -1.9% total return driven by income returns of 1.1% and appreciation returns of -3.0%. The sector's trailing-year return of 4.9% underperformed.

NPI+ return detail (as of Q4 2022)

		1 year			Historic total returns	
	Current NPI+ weight	Total return	Income	Appreciation	3 year	5 year
All property	100.0%	5.8%	3.9%	1.8%	8.2%	7.6%
Manufactured housing	0.1%	9.2%	3.2%	3.3%	*	*
Single-family rentals (SFR)	0.3%	12.2%	3.0%	-3.6%	*	*
Student housing	1.2%	10.6%	4.4%	-1.5%	7.6%	7.2%
Life science	2.5%	8.7%	3.5%	-3.1%	17.2%	15.2%
Medical office	2.0%	4.5%	4.9%	-2.7%	7.9%	8.1%
Self-storage	2.2%	15.6%	4.3%	-2.1%	17.8%	14.1%
Senior housing	1.1%	2.1%	3.5%	-1.7%	2.3%	4.4%
Data centers	0.3%	4.9%	4.7%	-3.0%	11.0%	*

*Note: Periods missing data due to insufficient history in the NCREIF database to calculate a sub-type return.

Valuation trends and dynamics

Valuation data was collected and released by NCREIF for 24 of the 27 ODCE funds in aggregate form. This data is similar to, but not as detailed as information shared by the Altus Group with investment managers who are clients of Altus. The NCREIF-released datapoints are summarized in the table below by property type. The changes relative to last quarter are also shown in the table to give an indicative direction of change, but it is important to note this is not a same-property sample, and some variation between quarters can be attributed to a changing sample of properties in the funds and shifts in the funds participating.

	Discount rate	Terminal cap rate	Implied 1-year cap rate	10-year average market rent growth
Overall	6.51% (+31 bps)	5.20% (+26 bps)	4.01% (+23 bps)	3.21% (-4 bps)
Apartment	6.22% (+30 bps)	4.75% (+29 bps)	4.00% (+29 bps)	3.23% (-5 bps)
Industrial	6.27% (+41 bps)	4.96% (+34 bps)	3.31% (+20 bps)	3.35% (-5 bps)
Office	6.96% (+32 bps)	5.81% (+24 bps)	4.52% (+26 bps)	2.90% (-1 bps)
Retail	7.10% (+17 bps)	5.83% (+13 bps)	5.07% (+18 bps)	2.86% (+2 bps)

With the caveat mentioned above, it is clear appraisal yield metrics are putting downward pressure on property values. This was evident across all property sectors in the fourth quarter, with retail seeing the least impact. Movement has been greater in apartments and industrial, where assets are more liquid, and office, where distress is more evident. Retail already had the highest discount and terminal cap rates so while directionally the changes are negative for value the impact is less, helping retail out-perform. Appraisals are an exercise in modeling, with changes to valuation metrics and cash flows determining value changes. But appraised values are also assessed relative to the transaction value of properties. Often there is an observable transaction value, but the valuation metrics associated with the transaction are not known. This means it is important to view valuation metrics as only part of the story of what is causing property appraised values to shift.

As discussed below in the forecast return section, we expect further changes in these valuation metrics in the coming quarters. If appraisal cash flow projections are accurate on average, the discount rate can be viewed as the stabilized return. We expect apartment and industrial discount rates to be revised higher towards the upper 6% range. Discount rates for office and retail are expected to remain higher still. And in the case of office there will be further downward pressure on value because appraisal cash flows are overly optimistic. As those cash flow projections are revised lower it will also contribute to value declines.

Open-End Core Equity Fund Index (ODCE)

The NCREIF Open-End Core Equity Fund Index (ODCE) posted a -3.91% gross total return in Q4 2022, down 440 bps from Q3. This brought the full-year gross ODCE return to 6.02%, down from 22.1% in Q3. Income returns were flat at 0.80%, remaining at an all-time low. The appreciation return was -5.76%.

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 moved up to 22.7% from 21.5% in Q3, but the overall impact of leverage turned negative at -1.23%. While mark to market impacts remained slightly positive, this was offset by funds' negative appreciation during the quarter. The positive mark to market will eventually 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 from quarter to quarter.

Net capital flows to ODCE funds went negative in Q4 after moving back into positive territory in Q3. Contributions totaled $3.2 BN, down from $5.3 BN in Q3. Distribution were also down Q/Q at $4.2 BN versus $4.5 BN in Q3. Distributions remained above their 10- year average while contributions fell below the 10-year average of $4.1 BN. This resulted in net cash flow of -$1.1 BN. It is important to note that distributions include both capital redemptions as well as income distributions. While actual fund flows show something close to stability investor behavior is tilting more towards redemption requests than new commitments. Fund managers appear to be taking a slow approach to meeting those redemption requests, which means the redemption queue in many funds is increasing. For many investors these redemption requests are driven by denominator effect issues, and they see open-end funds as the first stop to lower real estate allocations. In our view it is just as likely over-allocation to real estate is corrected by a combination of value declines in real estate and a recovery in other asset classes as a liquidation of real estate positions.

ODCE return reconciliation	Q4 2022	Trailing year
Unleveraged property returns	**-3.91%**	**+6.02%**
Leverage (principal impacts)	-1.35%	+0.59%
Leverage (marked-to-market impacts)	+0.12%	+1.37%
Cash balances	+0.11%	-0.18%
Acquisitions (partial period)	+0.01%	-0.03%
Other non-property investments	+0.02%	+0.04%
Other assets and liabilities	-0.05%	+0.07%
Fund costs	-0.02%	-0.07%
Other (including JV structuring)	+0.11%	-0.35%
Total gross returns	**-4.97%**	**7.47%**

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. Performance is color coded within each property type, so the lowest-returning industrial market is orange/red even though returns are higher than most retail market returns.

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 17.0% return on Miami apartments and a 12.6% return in Austin. By comparison, the returns in gateway markets are much weaker. The lowest returns in apartment markets are -2.6% in San Francisco and 0.9% in San Jose, likely driven by softness in the tech industry.

Although industrial returns vary widely, almost all markets have returns that would be considered strong to phenomenal in a historical context. However, exposure to the right industrial markets provides a significant boost to investors aiming to outperform the index. The southern California industrial markets of Riverside and Los Angeles saw the largest gains over the past year at 26.4% and 22.9%, respectively. Meanwhile Denver and Houston came in on the low end at 3.5% and 5.3%, respectively.

Retail assets show less variation by market, which is partly due to property-level distinctions. However, there is some geographic correlation, with some of the strongest returns concentrated in Sunbelt markets like Atlanta and San Diego. The lowest returns are in San Francisco and Washington, DC. The exception is Seattle, which tops the retail rankings with a 13.1% return.

Office returns are generally weak across markets. The top markets of San Diego and Cambridge likely benefit from their high concentration of life sciences buildings. Excluding those, the next highest performing markets were Miami and Austin at 1.9% and 1.8%, respectively.

NPI trailing 1 year Total returns by metro	Total	Apartment	Industrial	Office	Retail
Riverside	24.0%	9.4%	26.4%	-	5.3%
Miami	12.7%	17.0%	19.4%	1.9%	-1.4%
San Diego	11.1%	12.5%	15.9%	9.3%	7.8%
Orange County	9.3%	7.5%	19.6%	-7.5%	1.7%
Austin	8.6%	12.6%	12.0%	1.8%	6.3%
Atlanta	8.4%	9.0%	15.1%	-4.8%	7.8%
Phoenix	7.5%	10.6%	14.6%	-1.3%	-1.8%
Dallas	7.5%	8.7%	9.9%	0.0%	7.9%
Los Angeles	7.2%	1.3%	22.9%	-5.5%	3.5%
Cambridge	5.4%	7.8%	21.2%	3.4%	0.3%
Oakland	4.6%	1.3%	10.1%	-0.9%	1.5%
Denver	3.6%	7.3%	3.5%	-3.6%	1.0%
Seattle	2.7%	4.1%	7.2%	-3.1%	13.1%
Houston	2.3%	7.7%	5.3%	-5.0%	2.8%
San Jose	1.5%	0.9%	9.9%	-0.7%	3.5%
Chicago	0.9%	2.2%	7.8%	-6.5%	-3.2%
New York	0.3%	4.0%	11.0%	-5.7%	-1.4%
Boston	-0.3%	5.1%	9.7%	-3.8%	2.6%
Washington DC	-1.6%	5.2%	15.1%	-6.4%	-3.9%
San Francisco	-2.4%	-2.6%	12.7%	-3.3%	-4.7%
US	**5.5%**	**7.1%**	**14.6%**	**-3.4%**	**2.7%**

Return forecasts

PREA and LaSalle return forecasts are both lower than in previous quarters based on higher interest rates, evidence from transaction pricing, and, most significantly, appraiser behavior. The downward revision was less in the LaSalle outlook as we were previously lower than the Consensus outlook. The impact is most significant in 2023 with 2024 revised moderately lower. The pace of adjustment that appears to be underway should allow the downward pressure on appraisal values to be alleviated by the second half of 2023; this assumes market conditions do not change and excludes the special case of offices.

As always, it is important to note that these return forecasts are a combination of an outlook on the market and a call on appraiser behavior. Our outlook calls for the quarterly pace of depreciation in the first half of 2023 to match what was experienced in the fourth quarter of 2022. At that point we believe discount rates will be under less downward pressure and go-forward returns will stabilize around 7%, with the exception of office. For industrial, apartment, and open-air retail, it is relatively straightforward to reach that stabilized return level with a moderate level of value declines in the next couple quarters. This value decline is consistent with what we have seen in the transaction market in the second half of 2022. For office, the value decline required to reach a consistent 7% return is much greater based on our outlook. Realistically we expect that even with greater write-downs for the office sector in the near-term, it will still not be valued at a level to deliver the returns new buyers might require. In addition, we are seeing much less transaction activity in the office sector, which is making it challenging for appraisers to peg a market value to match appraisals to.

The net result of this outlook is shown below. It is for a negative return in 2023 followed by returns in the 6% to 7% range from 2024 onward for industrial, apartments, and retail. Office returns will be much lower and mall retail remains an unknown in terms of return outlook based on the wide differences in asset situation and the lack of transaction evidence. In our forecast the situation is closer to office, but there is upside to that forecast.

The PREA Consensus forecast is higher than the LaSalle forecast, but directionally similar. The difference in the two outlooks is largely due to the dimmer outlook LaSalle has on office. The expected under-performance of traditional office means that sector allocation will continue to have a major impact on relative portfolio performance, with our view that portfolios underweight to office are positioned for better relative performance not just in the near-term but in the long-term as well.

NPI forecast returns										
	2017	2018	2019	2020	2021	2022	2023	2024	2025	Average 2023-2027
Income return	4.7%	4.6%	4.5%	4.2%	4.2%	3.9%	~4%	~4.5%	~4.5%	4.7%
Appreciation return	2.2%	2.1%	1.8%	-2.5%	13.1%	1.6%	~ (-10%)	~ (-1-0%)	~1%	-1.3%
Total return	7.0%	6.7%	6.4%	1.6%	17.7%	5.5%	~ (-6.0%)	~4-5%	~6%	3.3%
PREA Consensus Survey Forecast							-5.3%	4.5%	6.4%	4.3%

ODCE forecast returns										
	2017	2018	2019	2020	2021	2022	2023	2024	2025	Average 2023-2027
Income return	4.4%	4.3%	4.3%	3.8%	4.0%	3.4%	~3.75%	~4%	~4%	~4.5%
Appreciation return	3.2%	3.7%	1.7%	-2.6%	17.6%	3.9%	~ (-12%)	~0%	~1%	~ (-1%)-(-2%)
Total return	7.6%	8.0%	5.9%	1.2%	22.2%	7.5%	~ (-8%)	~5%	~6%	~3%

NPI income comparison (As of Q4 2022)

	NPI Trailing Four-Quarter Income Return	NPI Transaction Cap[1] Rate (# of Transactions)	NPI Appraisal Cap Rate	15-Year Income Return
Apartment	3.7%	4.0% (42)	3.7%	4.7%
Hotels	6.9%	*	*	6.2%
Industrial	3.2%	3.8% (63)	3.3%	5.5%
Office	4.3%	4.2% (18)	4.4%	5.1%
CBD	4.1%	5.1% (3)	4.3%	4.7%
Suburban	4.5%	6.7% (15)	4.6%	5.6%
Retail	4.9%	6.2% (20)	5.0%	5.4%
Open Air	5.1%	6.5% (17)	4.9%	5.1%
Malls	4.7%	*	5.1%	5.5%
All Property	**3.9%**	**4.6% (143)**	**3.9%**	**5.1%**

* Too few transactions to calculate an average

[1] NCREIF Cap rates are calculated using income from the most recent quarter as a percent of the quarter's ending market value (multiplied by four). As a result, they are not directly comparable to cap rates typically used in the real estate industry, which incorporate the expected next year's income as a percent of the quarter's ending market value.