Why core apartments now?

The case for investing in core apartments rests on the potential for higher risk-adjusted returns

by Gleb Nechayev

The year began with increased market volatility and uncertainty in the national and global economic outlooks. As a result, more institutional investors are adjusting allocations toward sectors and strategies that help reduce risk exposure in their portfolios. Within real estate, this could trigger a renewed interest in apartments, which have one of the most favorable risk-adjusted return profiles.

While cap rate compression has driven most of the appreciation returns in recent years, the role of net operating income growth was far greater in apartments than in other property sectors. With NOI growth becoming an increasingly important driver of return, the ability to actively manage revenue and expenses on a more frequent basis gives apartments a potential advantage.

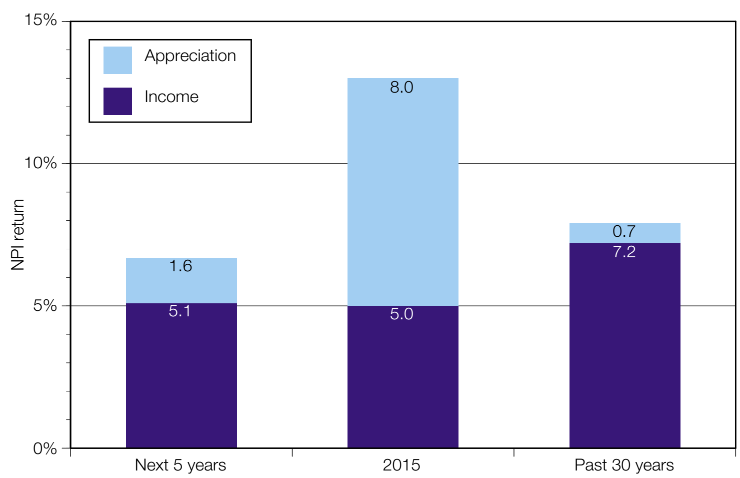
The essence of a core real estate asset is its ability to produce a more stable, durable income and dividend yield and to preserve value over time. Core is not risk-free, but it offers less risk than other investment strategies. Historically, risk across major property sectors appears to be mispriced, with apartment and retail displaying higher returns and lower volatility of those returns when compared with office and industrial, which have had lower returns with higher volatility. Within the apartment sector, unleveraged core returns have been higher than value-add returns, both on an absolute and a volatility-adjusted basis. Real estate investors seeking attractive risk-adjusted returns can benefit from an increased long-term portfolio allocation to apartments, particularly core product.

Why now?

Demand for core product tends to rise in periods of turbulence, when relative stability is scarce and when investment horizons become longer. A number of factors indicate commercial real estate might be entering such a period. Although the turbulence and increased volatility in the capital markets have subsided since the beginning of the year, the primary sources of short-term risks still exist — mounting uncertainties regarding expected interest-rate trajectories, currency exchange rate risk, falling oil prices, a potential hard landing in China and rising global geopolitical uncertainty. Compared with other developed economies, the United States appears more solid, and mainstream forecasts predict the expansion is likely to continue during the next couple of years.

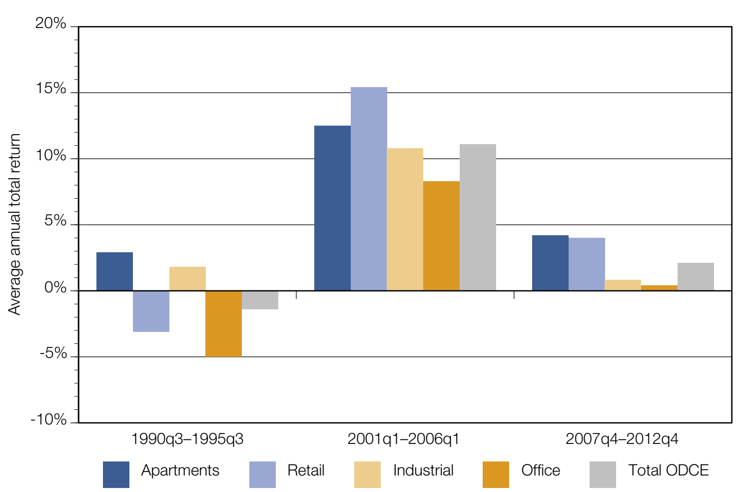
U.S. investors are less confident about the outlook, however, and becoming more conservative about their expectations for future returns. The second quarter 2016 PREA Consensus Forecast Survey of the NCREIF Property Index shows the average expected return for privately owned real estate is 6.7 percent over the next five years, or 120 basis points below the 30-year average, as measured by the total unleveraged return based on properties qualifying for inclusion in the NPI. The current consensus among institutional investors is future returns will be notably lower than in the past, reflecting a recognition that both the business and real estate cycles are maturing, and higher volatility is part of the "new normal" and should be priced accordingly. (See "Private real estate returns, expectations vs. history, to the left.)

Private real estate returns, expectations vs. history



Sources: NCREIF, PREA Consensus Forecast Survey, Berkshire Group Research

Private real estate return performance post–business cycle peak



Sources: NBER, NCREIF, Berkshire Group Research

Why apartments?

During the past 30 years, the apartment sector has gained a reputation as one of the strongest performers, based on both absolute and volatility-adjusted returns. An analysis of unlevered total returns for properties included in the NCREIF Property Index shows apartments closely followed retail, having a high return, low volatility and high volatility-adjusted returns over the past 30 years. In contrast, industrial and office properties had lower total returns and higher volatility.

The chart to the left, "Private real estate return performance post–business cycle peak," shows average annual total returns over five-year periods following business cycle peaks since 1990 for properties in the NCREIF ODCE index, which tracks real estate returns in open-end diversified core equity funds. Apartments are the only major property sector that has consistently outperformed the overall index in each period. The relative outperformance during 2001–2006 is particularly impressive considering, through much of this period, apartment demand was facing a headwind from booming homeownership.

From a fundamentals perspective, two main interrelated reasons explain the strong historical performance of apartments. On the demand side, a relatively short leasing cycle of about a year — compared with more than five years in other major property sectors — allows apartments to adjust to market changes more rapidly and efficiently. On the supply side, a shorter construction cycle allows developers to respond to changing

Gilmore Associates has sold the San Fernando Building, a residential loft property at 400 S. Main in downtown Los Angeles, to M West Holdings. Mesa West Capital provided $21.6 million in short-term first mortgage debt for the acquisition.

market conditions quickly, keeping price levels close to equilibrium and reducing volatility in rents and property revenues. Recent research from William Wheaton in the *Journal of Portfolio Management* indicates, over longer periods, supply in apartments also helps reduce volatility in vacancy rates because it offsets potential demand shocks. This contrasts with office, where supply has a positive contribution to vacancy volatility.

From a property operations standpoint, apartments also have a greater ability to translate income into cash available for distribution. A tangible difference exists across property types in capital expenditures, tenant improvements and leasing commissions. As a result, the share of NOI that translates into cash flow is higher in apartments, averaging almost 80 percent compared with 60 percent to 70 percent for other property types. Considering the share of total return derived from cash flow tends to be greater and less volatile in apartments, the total return also tends to be more stable.

The greater stability of cash flow in apartments is an advantage and particularly important when total returns are driven more by growth in underlying property income rather than cap rate compression, a more likely scenario in the next five to 10 years.

While cap rate compression affected all property types, it was less pronounced in apartments, where 45 percent to 55 percent of the appreciation was still derived from growth in NOI, and more pronounced in office, where NOI growth actually has had a negative contribution to appreciation. A lower rate of increase in apartment cap rates relative to those of other property types is anticipated based on the degree sector-specific cap rates, as well as rents, have departed from their long-term average levels in recent years. (See "Share of appreciation due to change in NOI," page 54.)

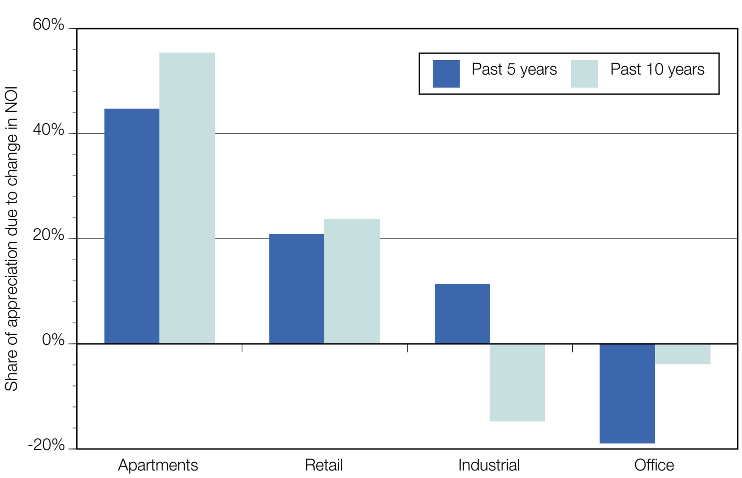
Without the major capital markets tailwinds that contributed to declining cap rates, returns in U.S. real estate would be much lower, particularly in the office sector. Since 2010, apartment properties have had both the highest NOI growth and the lowest degree of cap rate compression. Because NOI growth has been more of a contributing

An affiliate of Berkshire Group purchased a 264-unit class A property in Fort Lauderdale, Fla., from The Related Group in May. The property will be renamed Berkshire Lauderdale by the Sea.

factor in appreciation for apartments during the past decade, future cap-rate risk is expected to be lower in apartments than other property types.

Property-level effects, including property management, remain another major driver of investment performance. With a greater share of future asset appreciation likely to come from underlying income growth, the ability to actively manage revenue and expenses, as well as monitor

Share of appreciation due to change in NOI



Sources: NCREIF, Berkshire Group Research

the property daily, gives multifamily an edge over other major property sectors in the changing economic and capital-markets environment.

Investors also should consider the long-term effects of demographic and technological changes on major property sectors and compare the risks they might pose to investment performance.

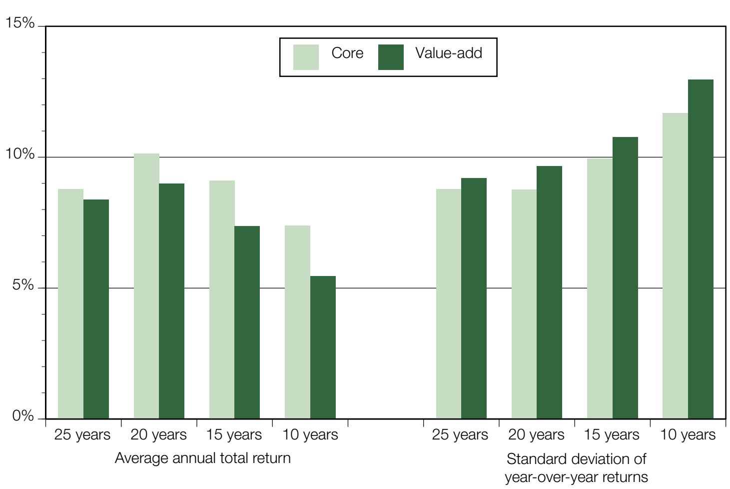
The United States is in the early stages of a major demographic shift, as baby boomers enter retirement. Without an increase in immigration, implications for the economy will include: slower job growth, a rising dependency ratio (the population in the labor force compared with population not in the labor force), rising costs of healthcare and social security, and changing consumption patterns. This trend also presents uncertainties and potential headwinds for aggregate real estate demand, which depends on job growth as a key driver. For apartments, however, there is a mitigating factor: Older renters have a higher preference for multifamily rather than single-family living.

Another source of long-term risk, as well as opportunity, for real estate is technological change and how it results in more productive uses of resources — including land and buildable space. Rapid growth in e-commerce is bound to reshape retail and industrial demand, while advances in supply-chain management likely will reduce growth in inventories and, subsequently, demand for traditional warehousing. Changing workplace patterns already are contributing to efficiencies in the use of office space, as space per worker is reduced — a trend that is expected to continue. Apartment demand is least affected by technological change and, therefore, more stable.

Risk to appreciation comes from three main sources: macro-level factors, market- or submarket-level factors, and property-level risk. Macro-level factors include capital market liquidity, the availability of debt, long-term interest rates, spreads between short- and long-term interest rates, and risk premiums. These macro-level factors primarily influence cap rates and their movement because they heavily influence investor demand. Market- and submarket-level factors are traditional supply/demand fundamentals, which influence income and appreciation. Property-level risk relates to age, size, quality, functionality and the ability to actively manage a specific asset. Property-level factors can influence both income and appreciation potential.

Overall, apartment appreciation is expected to be less risky than other property sectors because of a combination of these factors. On the macro level, debt financing is more plentiful and typically at lower rates of interest, and investors typically assign a lower risk premium to apartments, as evidenced by lower cap rates relative to other property sectors. For market fundamentals, the long-term outlook remains favorable due to demographic demand drivers. Property-level risk is also more insulated for apartments due to lower exposure to technological impacts and the ability to actively manage expenses and revenue on a more frequent basis. The outlook for appreciation with a continued positive outlook for income returns and the lower associated risk around both future income and appreciation make apartments an attractive property sector for a real estate investment portfolio.

Core vs. value-add apartment returns and volatility



Sources: NCREIF, Berkshire Group Research

Why core?

Core strategies pursue the least risky properties with a stable, durable income and dividend yield, and lasting value preservation. Because of lower perceived risk, return expectations for core assets are lower compared with value-add properties.

Investment performance of core apartments versus value-add apartments shows the expected positive trade-off between risk and return does not exist, suggesting a potential mispricing within apartment investment strategies. Unlevered returns for apartment properties in NCREIF's ODCE have been consistently higher and less volatile compared with those in closed-end value-add funds, as indicated in "Core vs. value-add apartment returns and volatility," below left.

In theory, higher risk associated with investing in value-add properties should be reflected in a pricing premium relative to core. In today's market, however, cap rates for value-add apartment acquisitions are only 20 basis points to 30 basis points higher than for core. Given such a relatively narrow spread, prudent underwriting of a value-add deal would have to assume notably higher income growth over the next five to seven years even to get a comparable, let alone higher, return relative to a core strategy. Therefore, the likelihood of achieving a higher risk-adjusted return still appears to be higher in core apartments today.

Conclusion

In a time of rising global uncertainty, investors seeking higher risk-adjusted returns can benefit from increasing their portfolio allocations to core apartment properties in the United States. This sector not only has a proven track record of higher returns and lower volatility, but also appears to be better positioned to deal with cap-rate and income risks. Within the apartment sector, long-term investors would be more prudent to focus on core rather than value-add investments, given the recent convergence in pricing between the two types of product. As demographics and technology reshape demand for commercial real estate over the next decade, apartments are well positioned to become a larger component and solid foundation of diversified core real estate portfolios. ❖

Gleb Nechayev is senior vice president, head of economic and market research, at **Berkshire Group.**