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Why Core Apartments Now?

A BERKSHIRE RESEARCH VIEWPOINT

June 2016

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SUMMARY

2016 started with increased market volatility and uncertainty in the national and global economic outlook. As a result, more institutional investors are adjusting allocations to 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 track records—even during periods following business cycle peaks.

While cap rate compression has driven most of the appreciation returns over the last 5-10 years, the role of net operating income (NOI) growth was far greater in apartments than in office, industrial and retail. With NOI growth becoming an increasingly important driver of property appreciation and subsequently total return, the ability to actively manage revenue and expenses on a more frequent basis gives apartments an edge over other major property sectors.

The essence of a core real estate asset is the ability to produce a more stable, durable income and dividend yield and 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 to 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 portfolio allocation towards apartments, particularly core product.

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WHY NOW?

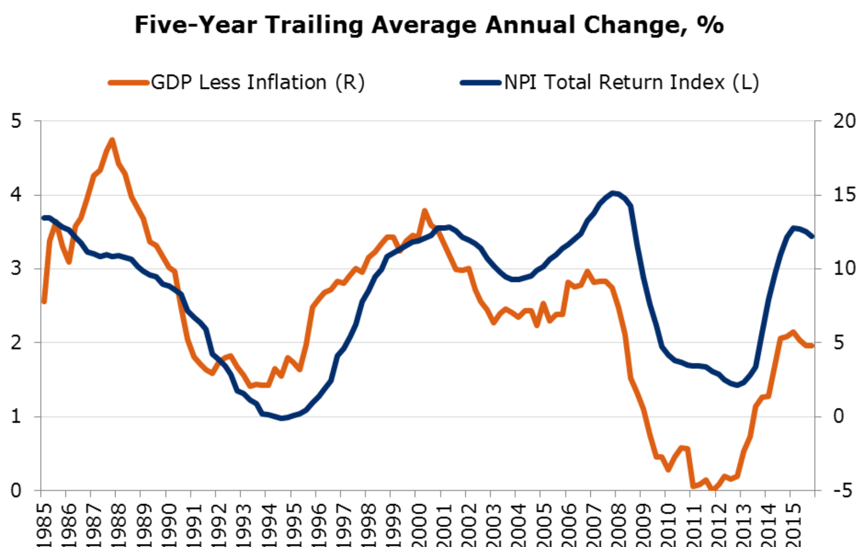
Demand for core product tends to rise in periods of turbulence when relative stability is scarce and when investment horizons become longer. There are a number of indications that commercial real estate might be entering such a period. While the turbulence and increased volatility in the capital markets has subsided since the beginning of the year, the primary sources of short-term risks still exist such as mounting uncertainties regarding expected interest rate trajectories, currency exchange rate risk, low oil prices, a potential hard landing in China and rising global geo-political instability. Compared to other developed economies, the U.S. appears more solid and mainstream forecasts predict that the expansion is likely to continue over the next couple years before slowing as the business cycle matures.

However, investors are less confident about the outlook and becoming more conservative about their expectations of future returns. The Q1 2016 PREA Consensus Forecast Survey of the NCREIF Property Index (“NPI”) shows that

the average expected returns for privately-owned real estate is 6.8% over the next five years, about 100 basis points below the 30-year average.[1] The contrast is even greater when these expectations are compared to more recent returns with slightly over a 12.0% total return over the 2014-2015 timeframe, one of the strongest in the 30-year history.

As indicated below in Exhibit 1, the five-year trailing average annual change in NPI index and inflation-adjusted GDP growth track closely together. Both began to slow in the middle of 2015.

Exhibit 1: Economic Growth and Commercial Real Estate Returns



Sources: BEA, NCREIF, Berkshire Group Research.

Based on recent forecasts, the real GDP is expected to average about 2.0% per year over the next five years. All else being equal, the macro-economic outlook implies that commercial real estate should see total annual returns close to the historical average. However, the current consensus among institutional investors is that future returns will be notably lower than in the past, reflecting a recognition that both the business and real estate cycles are maturing and that higher volatility is part of the “new normal” and should be priced accordingly.

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[1] As measured by the total unleveraged return based for properties qualifying for inclusion in NCREIF’s national property index (NPI). NPI is a quarterly time series composite total rate of return measure of investment performance of a large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

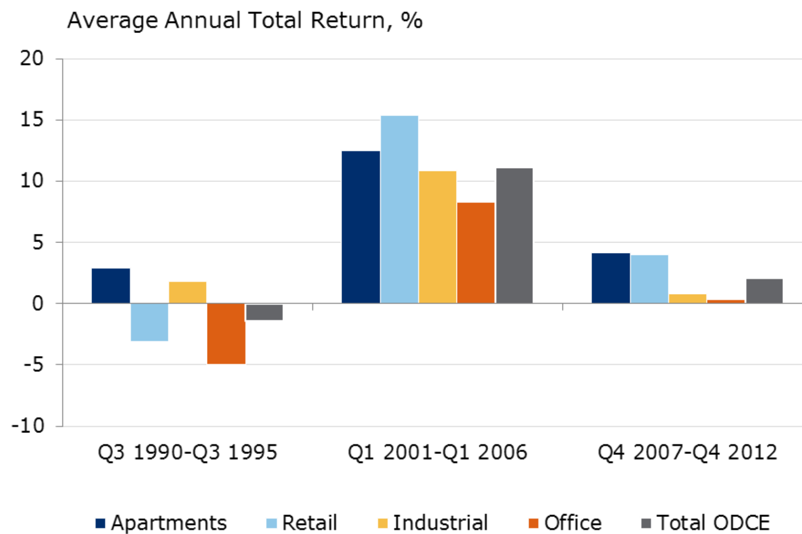
WHY APARTMENTS?

Over the last 30 years, the apartment sector has gained a reputation as one of the strongest performers based on both absolute and volatility-adjusted returns.

Over the last 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 NCREIF's NPI index shows that apartments closely followed retail, having a high return, low volatility and high volatility-adjusted returns over the last 30 years. In contrast, industrial and office properties had lower total returns and higher volatility. A similar pattern exists with publicly-traded equity REITs. Sector-specific data reported by NAREIT since 1994 indicates that apartment and retail REITs also had the highest returns adjusted for volatility relative to office and industrial.

The chart below shows average annual total returns over five-year periods following business cycle peaks since 1990 for properties in the NCREIF ODCE index, which represents primarily core real estate in diversified open end 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 that through much of this period apartment demand was facing a headwind from booming homeownership.

Exhibit 2: Private Real Estate Return Performance Post Business Cycle Peak



Sources: BEA, NCREIF, Berkshire Group Research.

From a fundamentals perspective, there are two main interrelated reasons for the strong historical performance of apartments. On the demand side, a relatively short leasing cycle of about a year compared to over 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 market conditions quickly, keeping

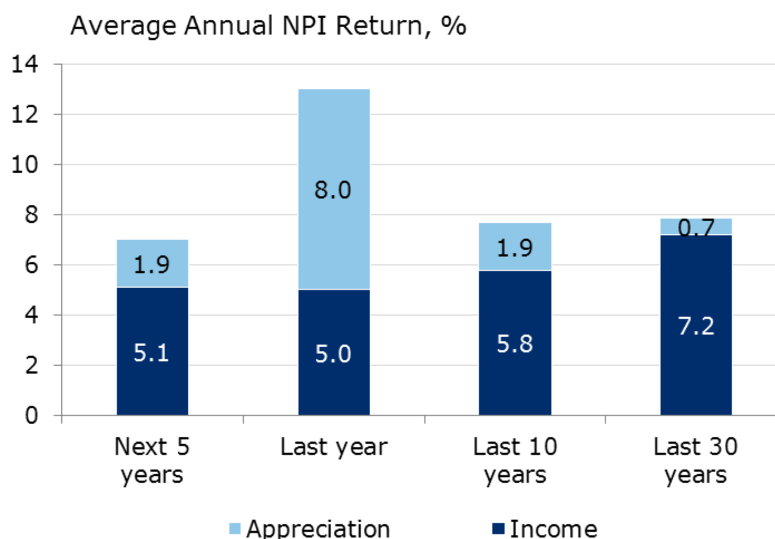
price levels close to equilibrium and reducing volatility in rents and property revenues. Recent research indicates that over longer periods, supply in apartments also helps reduce volatility in vacancy rates as it offsets potential demand shocks. This contrasts with office where supply has a positive contribution to vacancy volatility.[2]

From a property operations standpoint, apartments also have a greater ability to translate income into cash available for distribution.

From a property operations standpoint, apartments also have a greater ability to translate income into cash available for distribution. There is a tangible difference across property types in capital expenditures, tenant improvements and leasing commissions. As a result, the share of net operating income that translates into cash flow is higher in apartments, averaging almost 80% compared to 60-70% for other property types. Considering that 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 5-10 years. The Q1 2016 PREA Consensus Forecast Survey indicates that although investors expect total returns for private real estate to be lower than historically, appreciation is still likely to remain at a higher share of total returns than in the past and the income (cap rate) component of the total return is expected to be slightly higher than in 2015.

Exhibit 3: Private Real Estate Returns: Expectations vs. History



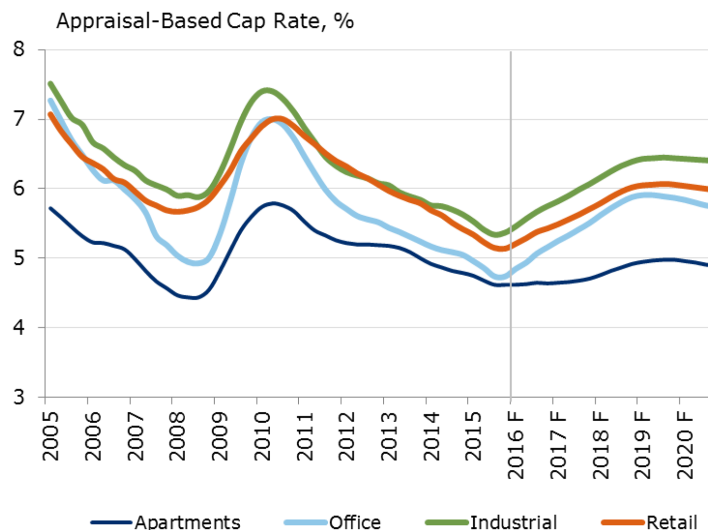
Sources: NCREIF, PREA Consensus Forecast Survey, Berkshire Group Research.

Various recent industry surveys and forecasts suggest that investors expect cap rates to rise slightly over the next five years implying that income will

[2] William C. Wheaton. The Volatility of Real Estate Markets: Decomposition. Journal of Portfolio Management, Vol. 41, No. 6, 2015.

become a more prominent driver of appreciation. This is a major departure from the pattern over the last 5-10 years where most of appreciation return was driven by declining cap rates.

Exhibit 4: Appraisal-Based Cap Rates

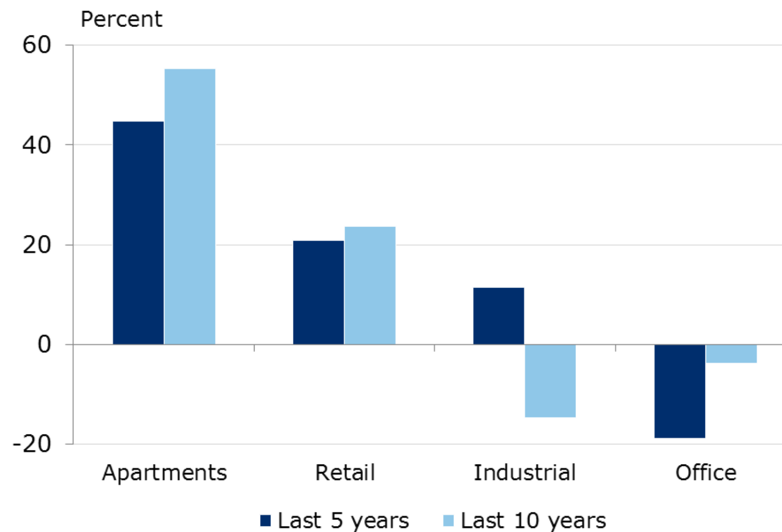


Source: CBRE Econometric Advisors, NCREIF.

While cap rate compression affected all property types, it was less pronounced in apartments where 45-55% of the appreciation was still derived from growth in NOI and more pronounced in office where NOI growth has actually had a negative contribution to appreciation. The cap rate forecast presented above in Exhibit 4 indicates a lower rate of increase in apartment cap rates relative to other property types. In addition to the macro-level factors, this forecast is influenced by how much sector-specific cap rates, as well as rents, have departed from their long-term average levels in recent years. [3]

[3] Serguei Chervachidze, William Wheaton. What Determined the Great Cap Rate Compression of 2000-2007, and the Dramatic Reversal During the 2008-2009 Financial Crisis? Journal of Real Estate Finance and Economics, Vol. 46, No. 2, 2013.

Exhibit 5: Share of Appreciation due to Change in NOI



Source: NCREIF, Berkshire Group Research.

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 factor in appreciation for apartments over the last 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 the property daily, gives multifamily an edge over other major property sectors in the changing economic and capital markets environment.

Investors should also 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 U.S. 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, rising dependency ratio (population in the labor force compared to 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. However, for apartments 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 economic resources. Rapid growth in e-commerce is bound to reshape retail and industrial demand while advances in supply-chain management will likely reduce growth in inventories and, subsequently, demand for the traditional warehousing. Changing workplace patterns are already 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/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 as they heavily influence investor demand. Market/submarket-level factors are traditional market fundamentals for a property type within a certain market and are influenced by supply and demand. For example, an oversupply or depressed demand situation in a market will typically lead to an increase in cap rates and lower income projections. 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, the expectation is that apartment appreciation is less risky than other property sectors due to 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 continues to remain attractive due to demographic demand drivers favoring the product type. Property level risk also is 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.

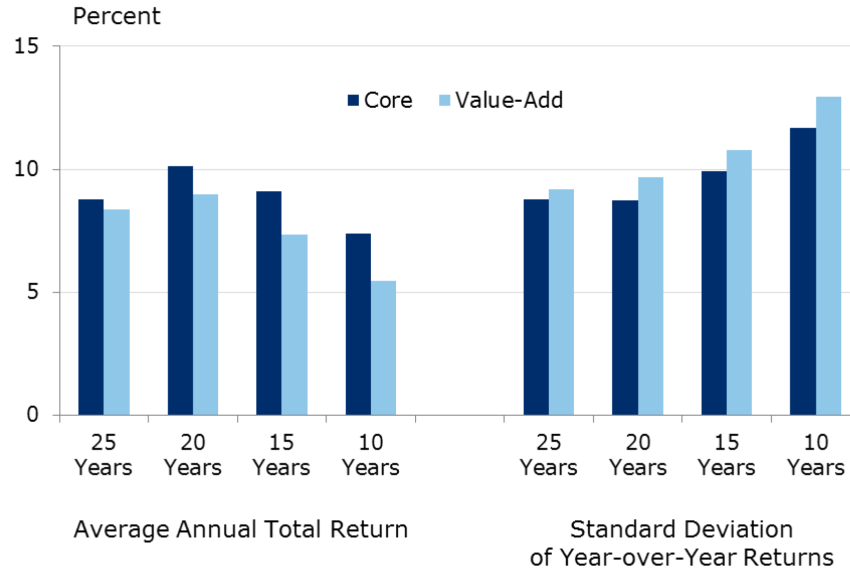
WHY CORE?

Core strategies pursue the least risky properties with a stable, durable income and dividend yield, and lasting value preservation.

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 to value-add properties.

Investment performance of core apartments versus value-add apartments shows that 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 open-end diversified core funds have been consistently higher and less volatile compared to those in closed-end value add funds, as indicated in the following chart.

Exhibit 6: Core vs. Value-Add Apartment Returns and Volatility



Sources: NCREIF, Berkshire Group Research.

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 20-30 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 5-7 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 allocation to core apartment properties in the U.S. This sector not only has a proven track record of higher returns and lower volatility historically, 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.

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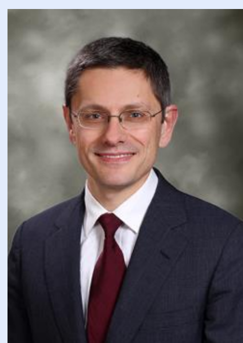

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Mr. Nechayev leads the development of original real estate research at Berkshire Group. He is a recognized real estate economist specializing in multifamily markets, with nearly two decades of industry experience counseling institutional and private clients. Mr. Nechayev holds a Masters in City Planning from the Massachusetts Institute of Technology, and is a graduate of the National Economic University of Kiev, Ukraine. He is a member of both the Urban Land Institute and National Multifamily Housing Council.

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