

REIA 11/17/11

Institutional Investment Outlook: Am I investing or riding a roller coaster?

The November REIA panel gathered on November 17 to discuss the institutional investment outlook through 2012 and recap third quarter National Council of Real Estate Investment Fiduciaries (NCREIF) Real Estate Indices. Featured panelists included Jeffrey R. Havsy, Director of Research, NCREIF; Wade Judge, Chief Investment Officer, LaSalle Investment Management; and David Reahl, Executive Director, USAA Real Estate Company. The program was moderated by Roy Rendino, the President of REIA.

The panel opened with Havsy's Third Quarter NCREIF recap. NCREIF collects data from member firms to produce benchmarks at the property and fund level. Commercial real estate returns dropped slightly from last quarter, he said. However, multifamily was the best performing property type, followed by retail. Regionally, the West performed best, while the South improved. The Midwest lagged overall.

Fundamentals improved, with occupancy up from the previous quarter and year-over-year. Thanks to multifamily, NOI growth turned positive. Cap rates continued to drop, while transaction activity increased slightly, though remained below normal levels. The complete presentation can be found attached.

After Havsy's presentation, talk turned to the 2012 investment outlook and recent trends:

Key Markets

Panelists said that the vast majority of their investments, across all product types, were concentrated in six markets: New York, DC, Los Angeles, San Francisco, Seattle and Chicago.

Local Investment

LaSalle has been acquiring bulk industrial properties in Chicago, at or below replacement cost, said Judge. Rents have been depressed here for the last 3-4 years, he said, and if you can get in, there is an opportunity for these rates to increase in the next few years, he added. Additionally, LaSalle has been focused on multifamily properties in urban areas near mass transit, and Chicago excels according to this metric. There is also "good momentum in rental rate increases in the downtown market," he added.

Reahl noted that, as an institutional investor advisor, capital USAA places comes from state and municipal pension fund accounts. These funds' conservatively driven return-needs have favored markets USAA would go to anyway, such as the coastal, core markets listed above, but a herd mentality among investors can make these markets frothy. As a result, he's now seeing an adjustment to investment in markets like Chicago (and other markets that had fallen out of favor from a core perspective), for value-add return, across many property types.

Best and Worst Performing Property Types

In the apartment sector, demand has recently been heavy. Both Reahl and Judge predict that multifamily will remain a strong investment for the near future, especially multifamily in urban areas near mass transit. Judge attributes this to the lack of new construction and limited supply for the next one to two years in most markets. In addition, increased numbers of renters, both those who are priced out of home ownership and those now renting by choice, will keep cash flowing on these properties. Even in the tough period from 2008-2009, he notes, apartments stayed afloat because apartments could be kept leased and cash flowing to cover debt service, even if rental rates had to be reduced. Reahl concurred, adding that, in good markets, population growth and demand for rentals means that it will remain a good investment over the next 2-4 years, even as supply increases.

LaSalle has been acquiring and developing multifamily properties, while USAA has preferred to be involved in multifamily development, as it allows for more control over the features and amenities they can offer to draw renters.

Grocery-anchored retail product has been the next strongest performer, they say, as long as the anchor is the top or second ranked grocer in the market. Because grocery leases are long, and these tenants draw traffic to the retail center, this should continue to perform well. Reahl cautioned that location and configuration is important, however, saying that the centers shouldn't be too deep or feature too much in-line space. Both LaSalle and USAA have preferred acquiring existing retail product to new retail development.

Though desirability is affected by the strength of the market in which it is located, Judge notes that he has seen a bias against office product. The volatility of returns over the last year has been dramatic, he said. In addition, capital expenditures often required for leasing and building improvements, and the risk of inability to generate enough cash-flow to cover debt service when vacancy rises, render it a riskier investment. LaSalle views office as more of a value-add prospect. Havsy noted that office was the worst performing property type even on a risk-adjusted basis.

International Market Crisis Impact

Judge noted that, at the beginning of the year, there were more optimistic forecast of rental rate growth and absorption. In light of recent tremors in domestic and international markets, projections have been dialed back and focus has returned to inspecting current cash and income, and lease renewal rates. Currently, lenders are looking harder at tenants and how closely their business is tied to Europe and other international markets.

Havsy predicts natural disasters will have a bigger economic impact than the European crisis. Recent natural disasters in Asia have rippled through, affecting supply chain. For example, auto production fell after disasters. On the flipside, people are shortening supply chains by bringing manufacturing back to US, Mexico, etc.

Stagnation Risks

Despite general economic uncertainty, cap rate compression, and flat NOI (except for apartments), deals have still been getting done at very low cap rates. When asked what they predict will happen if the economy stagnates, the panelists were again in agreement. Low level of new supply of product is a positive in this instance, said Judge. As it relates to core investments, a stagnant economy won't have that big an impact. These properties are well-leased, for long-terms, and have lower debt. The risk of a stagnant economy will have the biggest impact on higher risk deals—new developments, value-adds counting on lease-up and rental rate growth over defined periods of time, and those with higher leverage. This, he explained, is why these deals over the last several months have been really difficult to close. Havy predicts that the properties at greatest risk should the economy stagnate are those whose owners sought extensions a few years ago at the bottom of the market, hoping that the economy would improve.

Specialty Products

When asked about the future of specialty products like senior housing, student housing, and medical office space, Havy noted that NCREIF is currently considering putting these products in its index. If that happens, he says, these property types will benefit.

Judge indicated LaSalle has been investing in medical office recently, noting that it has performed well and is expected to continue to do so. As such it has become more accepted as an institutional quality investment, especially if located on or near a major hospital campus. In addition, lease renewal for medical office is much higher than on typical office, typically around 90%, making it a good core-plus product.

USAA doesn't deal in student or senior housing, but is engaging in medical office development, Reahl said, and he also anticipates medical office will remain a strong performer.