Perspectives

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2019 Market Preview: Real Estate

NAVIGATING THROUGH A LATE MARKET CYCLE

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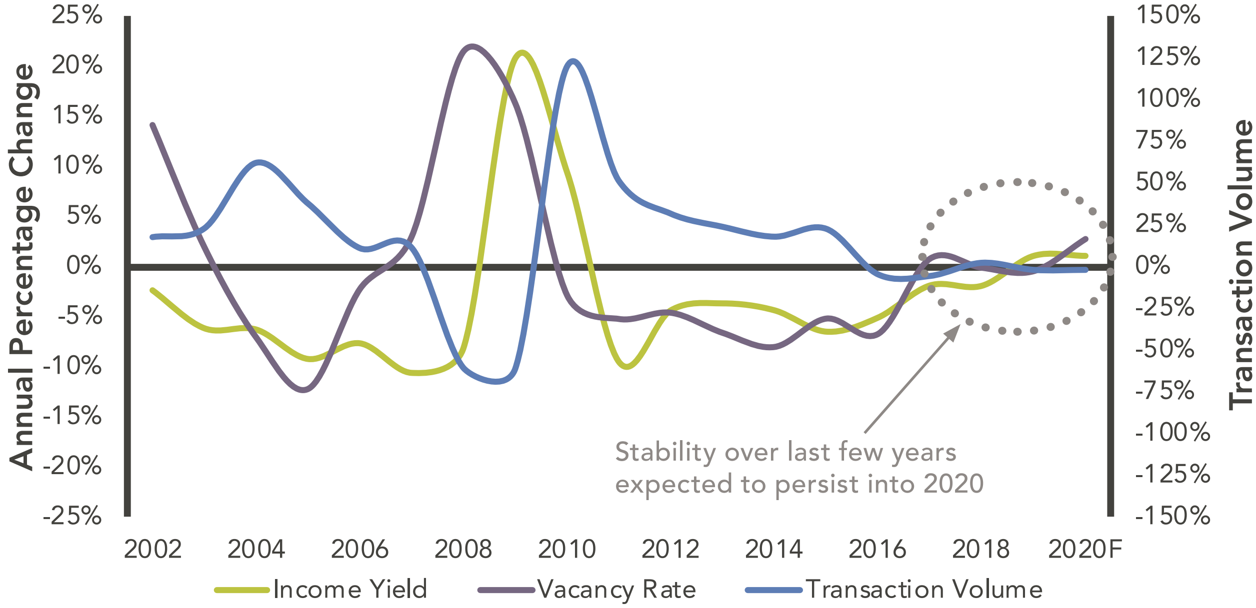
The real estate sector managed to pull off another strong year in 2018, delivering a total return of 8.35%,[1] exceeding consensus expectations for a further slowdown. Looking into 2019, however, the outlook is not as clear. From a fundamentals perspective, the data on occupancy, supply, demand and rents looks stable, but the macro picture is filled with uncertainty driven by a slowing economy, slower job growth, and potential negative impacts from a trade war. In this 2019 market preview we review the current state of the real estate market and examine some of the trends and implications reshaping the sector going forward.

FUNDAMENTALS

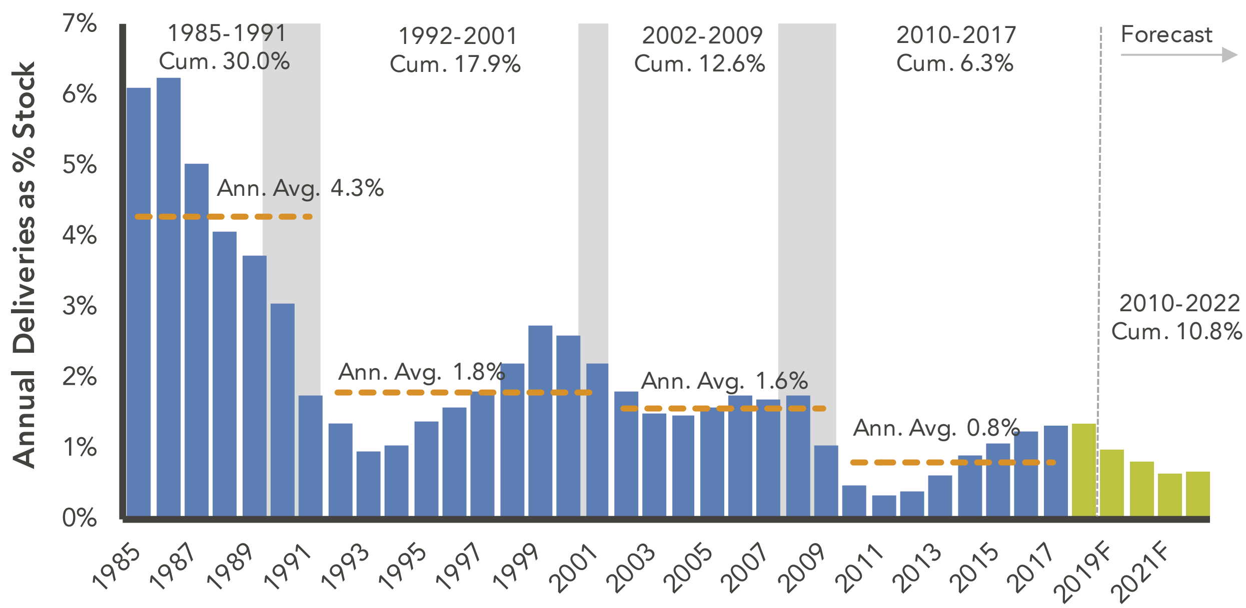
Overall fundamentals within the real estate sector are stable, illustrated on the next page in Exhibit 1, with consistent income, vacancy rates, and transaction volumes. Income within the NCREIF Property Index is delivering a healthy 4.6% return on a 1-year basis (as of 3Q18), and vacancy rates are at historical lows, sitting at 6.2% in the third quarter of 2018. From a supply perspective, cumulative new supply as a percentage of stock is significantly lower in this cycle relative to previous cycles, illustrated in Exhibit 2, and forecasted to drop over the next few years as a result of rising construction costs and a shortage of skilled labor.

Exhibit 1: Stable Market Conditions Across U.S. Real Estate



Sources: CBRE-EA, MPF, NCREIF, RCA, LaSalle Investment Management; data as of 3Q2018

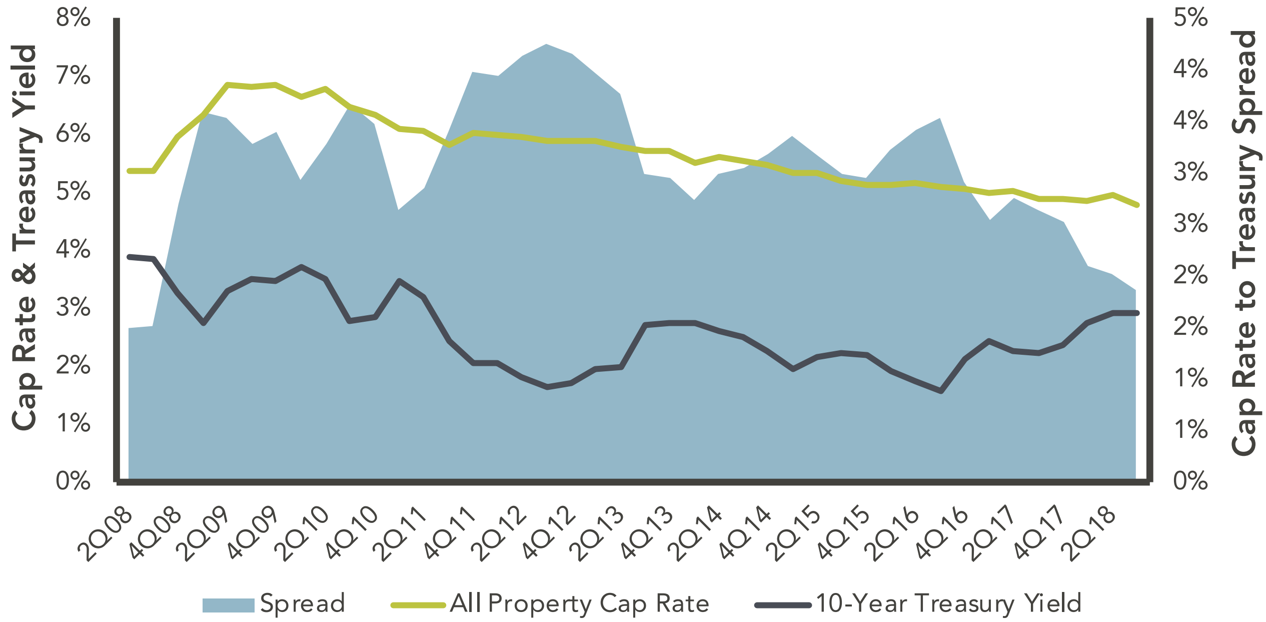
Exhibit 2: Real Estate Supply in Check



Sources: Clarion Partners Investment Research, CBRE EA as of 2Q2018. Gray bars represent recessions.

Cap rates, which are used to value real estate properties and defined as net operating income (NOI) divided by market value, have been trending downward since the real estate recovery began in 2010 and are currently 4.8% across all major commercial property sectors. Today, real estate cap rates represent a premium to fixed income, but the spread between the 10-Year U.S. Treasury, illustrated in Exhibit 3 on the next page, continues to shrink. Thus far, increases in interest rates have not had a material impact on real estate prices, but if the 10-Year Treasury climbs above 3.5% towards 4%, we expect cap rates will start to be impacted.[2] Thus, maintaining a high level of NOI growth in order to offset potential rising cap rates will be critical in this current market environment.

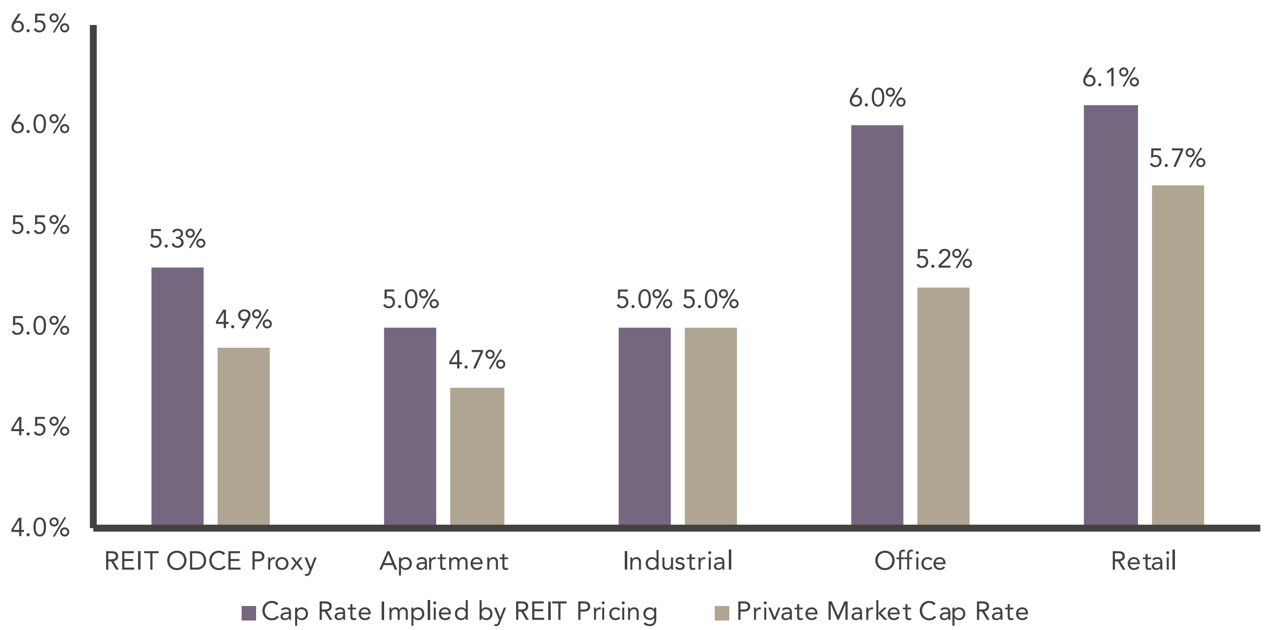
Exhibit 3: Real Estate Cap Rate Spreads vs. Treasury Yields



Sources: NCREIF, Bloomberg

Not surprisingly, cap rates for publicly traded real estate are trading higher than the private markets as illustrated in Exhibit 4. Publicly traded REITs tend to lead the private markets as a result of being valued daily, but at times tend to overstate/understate the market. Ultimately, public markets have already baked in real estate price declines and rising cap rates whereas the private markets have yet to react. Whether or not private market cap rates will follow suit has yet to be determined, but something to keep an eye on as we head into 2019.

Exhibit 4: Private vs. REIT Implied Cap Rates



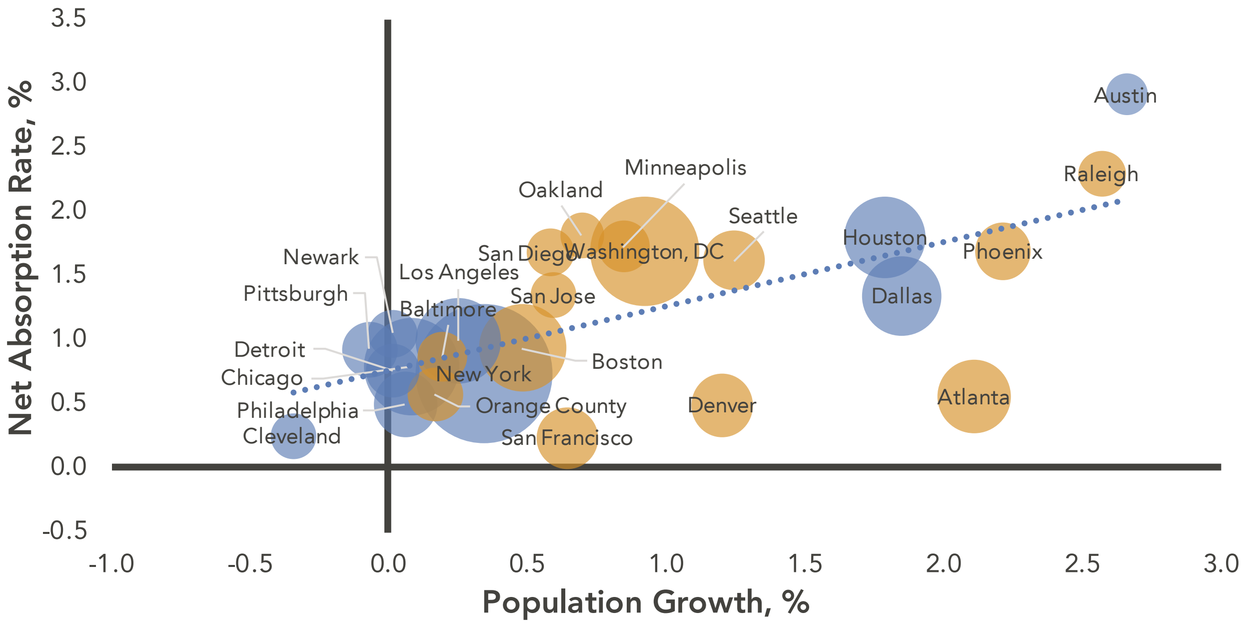
Source: CenterSquare Investment Management as of September 30, 2018

TRENDS

Secondary Market Growth:

Strong demand and population growth are key characteristics real estate investors seek when determining where to invest. As major gateway and coastal markets (e.g., New York and San Francisco) are now priced to perfection, tenants have migrated to more affordable secondary markets attracting large companies such as Amazon and Apple, which has created new technology hubs and where supply is beginning to emerge. To help illustrate this, Exhibit 5 shows how the demand outlook for top office markets is strongest in both high-tech and demographic growth centers[3] such as Austin, TX and Raleigh, NC. The graph shows the two-year average annual percentage change of net absorption, the real estate proxy for demand, on the Y-axis and population growth on the X-axis. Cities filled with orange indicate high-technology locations which exhibit strong demand and are well positioned to absorb excess supply. We would anticipate demand and population growth in select secondary markets with a strong technology presence and affordable pricing to continue in 2019 and beyond.

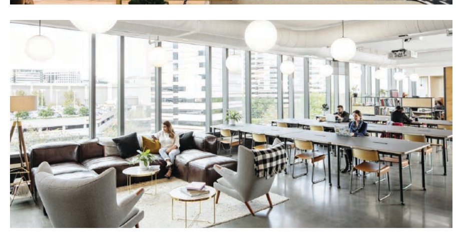
Exhibit 5: Demand and Population Growth Forecast, 2-year average annual % change



Sources: CBRE EA, US Census Bureau, Moody's Analytics, Principal real Estate Investors, as of 2Q2018.
Note: the graph shows net absorption (demand) on the Y-axis and population growth on the X-axis. Cities filled with orange indicate high-technology locations.

Flexible Office/Coworking Space:

The Millennial generation is reshaping the way office owners think about the sector as evidenced by the growing demand and execution of shared/flexible office space. Companies like WeWork have laid the ground work in this arena by listening to the needs of Millennials who are driving much of the change given their desire for flexible office space. Real estate managers and office owners will need to decide whether to pursue flexible office tenants or stick with the traditional tenant base with a superior credit history. There are still a lot of questions surrounding flexible office tenants and how they will react during the next downturn. For instance, flexible tenants may be at greater risk for default and require rent relief when times are



via WeWork

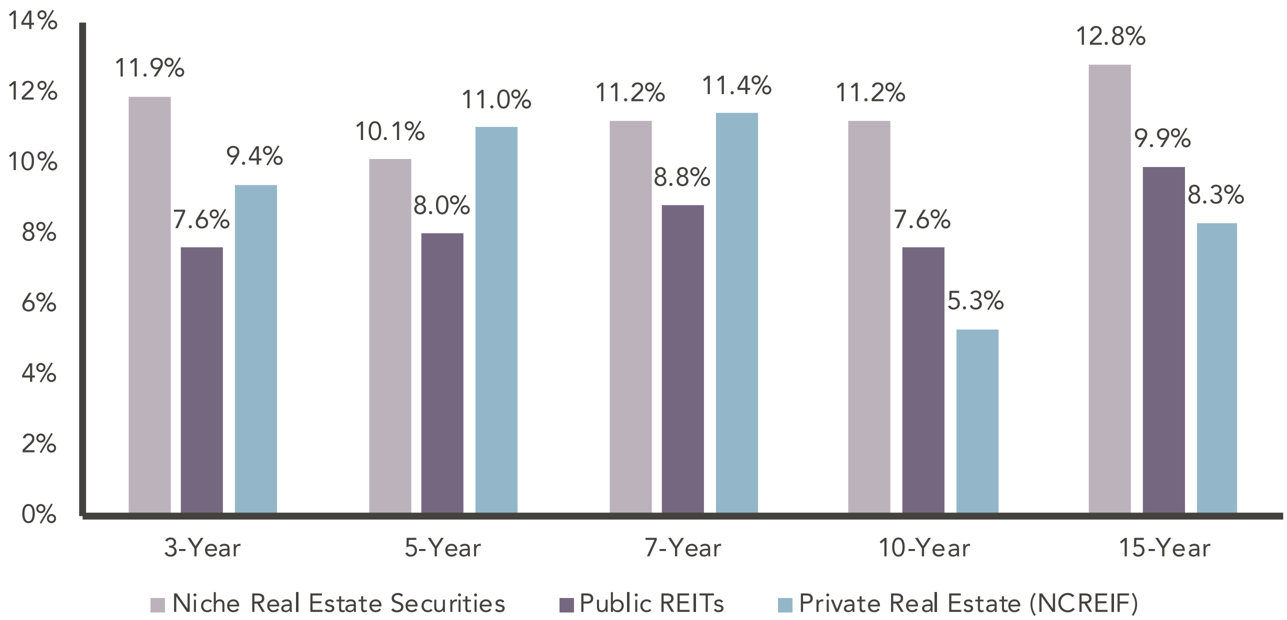
bad. Additionally, the likelihood of defaulting on a lease is higher than a traditional tenant with a corporate guarantee. On a positive note, flexible office offers benefits such as accelerated occupancy when demand for coworking space is strong, repositioning a building's image, and generating leads for permanent tenants from coworking members.

Niche Property Sectors:

Over the past several years, NCREIF has been trying to capture and measure "niche" property subtypes such as student housing, medical office, life sciences, manufactured housing and senior living under a field labeled for usage, but the reporting among ODCE managers has been inconsistent across the board. For example, a manager may report a student housing asset as apartment with a classification for garden, high rise or low rise, while at the same time submit the asset under the "usage" field making it unclear how much student housing is represented within the apartments sector.

Consequently, real estate managers have started and are likely to increase their exposures to these "niche" property types given their unique risk-adjusted return profiles, illustrated in Exhibit 6, particularly in this mature market cycle. For example, medical office and life science tenants tend to be much stickier and sign longer-term leases compared to traditional office tenants making them a more attractive tenant to have. The question going forward will be whether or not these "niche" sectors develop into more mainstream standalone sectors and how much they will represent within the ODCE over the coming years.

Exhibit 6: Niche Real Estate Securities Outperform Over Most Time Periods



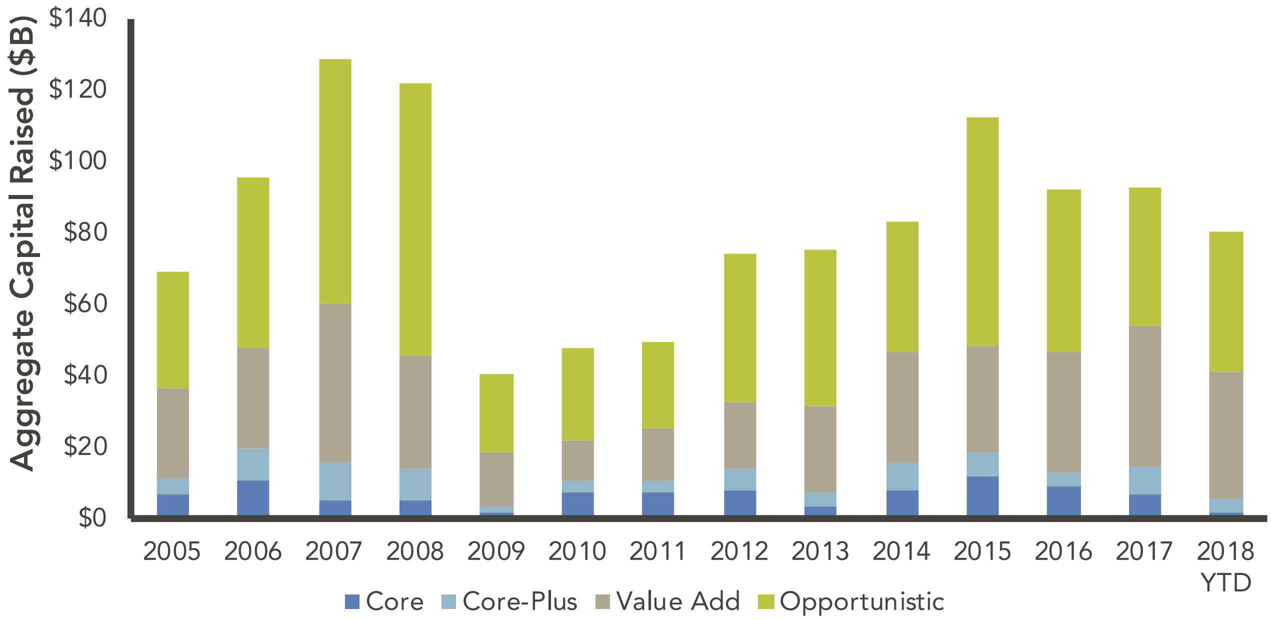
Sources: NAREIT, NCREIF-ODCE, and LaSalle Investment Management; data as of June 30, 2018

WHERE DO WE GO FROM HERE?

Given where we are in the real estate cycle, investors may be asking themselves what to do with their real estate portfolios? Should they invest in core strategies (risk-off) or shift gears to core-plus, value-add, and/or opportunistic (risk-on)? The search for higher returns in this low returning market environment has led to increased fundraising for value-added strategies over the last few years *(See Exhibit 7 on the following page)*, thus making it difficult to find attractive opportunities.

In an effort to help guide investors to the right path, Exhibit 8 provides a breakdown of expectations for each investment style. Choosing the appropriate real estate investment strategy will largely depend on the investor's risk tolerance, return goals, and overall plan objective. Core real estate investments reside on the low-risk/low-return end of the real estate risk spectrum compared to value-added and opportunistic investment styles which often invest in riskier projects that require higher capital expenditures and include exposure to leasing, redevelopment, higher leverage, and often development risk.

Exhibit 7: Real Estate Fundraising by Investment Style



Source: Preqin; 2018 YTD through September 30, 2018

Exhibit 8: Market Expectations by Investment Style

Strategy	Expectations
Core: Risk-off	Lower returns with positive spread to investment-grade bonds; emphasis on income and preservation of capital
Core-Plus/Value-Add: Risk-on	Higher returns than core through active leasing, development, repositioning, and cap-ex improvements; higher risk levels than core, but manageable as long as economic growth continues; short-term income; higher correlations with economic growth; difficult deal execution as a result of abundance of value-add capital
Opportunistic: Risk-on	High risk levels; distressed opportunities; entry points at a deep discount to previous cycle highs; gaps in capital markets may generate higher return opportunities

Sources: Marquette Associates, LaSalle Investment Management

CONCLUSION

While the outlook going into 2019 is not exactly clear, real estate fundamentals are generally strong and should provide support for a continuation of moderate returns with an emphasis on income growth and a premium to fixed income over the near future. However, the uncertainty of the macro picture driven by a slowing economy, slower job growth, and potential negative impacts from a trade war may lead to overall lower returns for the asset class.

Nevertheless, the real estate landscape is constantly evolving with new trends reshaping the way investors approach the market. Large tech-driven companies are in secondary cities over more expensive gateway markets creating strong demand and population growth; the Millennial generation's desire for flexible office space and coworking space is disrupting the office sector; and niche sectors such as student housing, medical office, self-storage, and senior housing are in higher demand given strong demographics and positive risk-adjusted return characteristics, particularly in a mature market environment. As such, real estate has been a great place to be over the past several years and we anticipate a continuation of moderate returns in the mid -single digit range over the next few years.

[1] NCREIF-ODCE preliminary 4Q18 returns
[2] LaSalle Investment Management ISA 2019
[3] Principal Real Estate Investors

Appendix: Sector Views

	Positives	Negatives
Apartments	Strong demand driven by demographics	Elevated supply, particularly in luxury/ Class-A
Industrial	Strong demand driven by ecommerce	Premium pricing
Office	Strong job growth driven by technology	High capital requirements
Retail	Ecommerce-resistant retail and grocery-anchored centers; mispricing opportunities	Regional malls continue to struggle with high vacancy, shift to ecommerce

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