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Principal®

The case for private U.S. commercial real estate

In search of investment returns

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The investment landscape since the Global Financial Crisis (GFC) more than a decade ago has been significantly impacted by a sea change in central bank policies, ushering in a period of unprecedented low interest rates and increased adoption of Keynesian approaches. Post-GFC, the Fed remained very deliberate in its removal of accommodative policy to ensure stronger growth and achieve its inflationary target of roughly 2%. The onset of COVID-19 and subsequent economic recession saw the Fed dust off its GFC playbook by lowering interest rates to the zero bound and rapidly expanding its balance sheet by raising its purchase of bonds.

Risk assets rebounded as central banks flooded markets with liquidity despite the deep recession. Deep liquidity and the assumption of lower discount rates have allowed yield on core, institutional grade assets to stay flat or even compress in some property types despite short-term dislocations in transactions and occupier markets. Income returns—a hallmark of private equity real estate—has also helped stabilize the market, resulting in moderate but positive returns for investors.

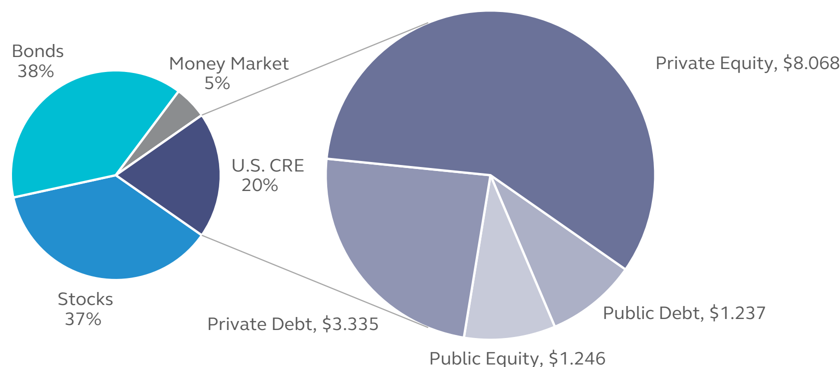
With medical solutions now being implemented to mitigate the COVID-19 pandemic, and a nascent global recovery underway, investors are pivoting to optimize their portfolios for the next business cycle, including their tilts within commercial real estate. In this update, we re-examine the ongoing case for private U.S. commercial real estate and conclude that the asset class remains very relevant as an investment opportunity and should remain a key component of any mixed-asset portfolio.

Continued scale and diversity

Despite the turbulence associated with the transaction market over the past year and a subsequent pull-back in cross-border inflows, private U.S. real estate remains a highly sought-after destination for global institutional investors. This is particularly true of coastal global markets such as New York, Los Angeles and San Francisco, which continue to rank among the top five destinations for global capital, notwithstanding the current pause in transactions. Moreover, the U.S. commercial real estate market is large, with an estimated market capitalization of just under $14 trillion (as of the end of 2019), accounting for roughly 20% of the investable universe.[1] To put this in context, the value of the U.S. stock and bond markets are $26.4 and $27.7 trillion respectively.[2] Within the developed world, Europe is a close second with roughly $12.84 trillion in market capitalization, followed by China and Japan adding $6.2 trillion and $3.34 trillion respectively.

Exhibit 1: The U.S. commercial real estate market is deep and diverse

Commercial real estate universe in the U.S.
(in $ trillions)



As of 4Q 2019

Source: Federal Reserve, NAREIT, Preqin, CoStar Portfolio Strategy, Barclays , Principal Real Estate Investors

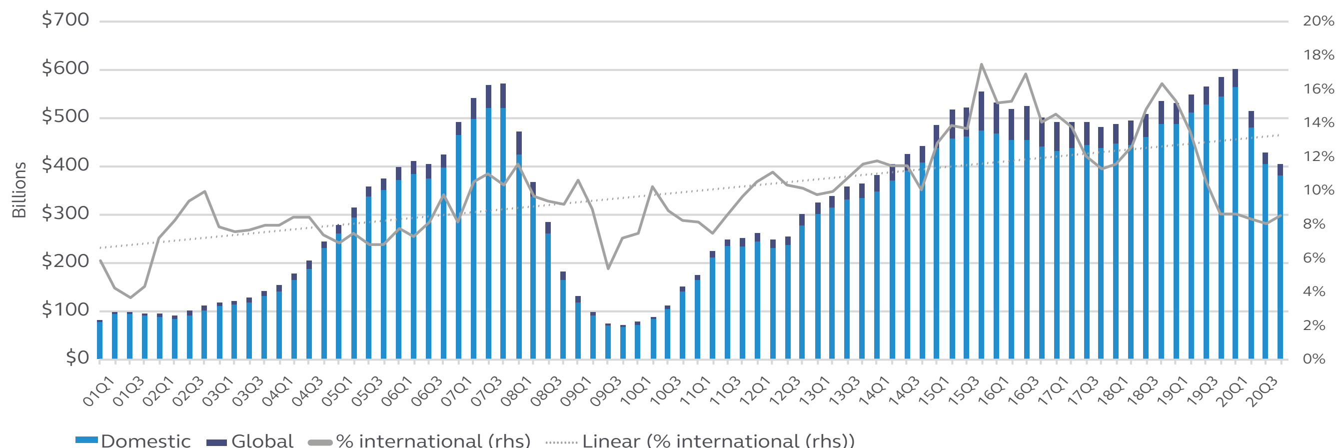
[1] CoStar Portfolio Strategy (2019)

[2] Market Value Capitalization of the Wilshire 5000 (US Stocks) and the Barclays/Bloomberg US Aggregate, YE 2019

Furthermore, investors in the U.S. can access a wide array of risk/return strategies across the real estate debt and equity spectrum. The majority of the investment universe is within the private market (82%) with equity investment (direct property ownership) contributing the largest portion (58%) followed by debt investment (direct loans/mortgages) adding the remaining 24%. The balance is split between public debt, commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs), which account for 8.91% and 8.97% respectively (Exhibit 1 on page 1).[3]

In addition to its substantial investible universe, the U.S. market is also relatively liquid, as measured by the velocity and volume of transactions (Exhibit 2)—supported by a well-developed and efficient debt market. U.S. transaction volumes, barring the period during the peak of the pre-GFC bubble, have been trending at historically high levels in recent years with a noteworthy share of sales (just around 8%) generated by international investors outside of the U.S.[4] Since the GFC, these foreign transactions have ranged from 7% just following the recession to a peak of 17% led by mainland China investors. Even with the shift in investment, the more recent flow of international capital is meaningful in its contribution to the depth of the market and is perhaps more in-line with historical norms.

Exhibit 2: U.S. commercial real estate sales trend upward on a long-term basis



As of January 2021

Source: Real Capital Analytics, Cross-Border Compendium

Breadth of investments is another constructive feature of the U.S. private real estate market. The sheer size and variety of the U.S. economy provides both regional and economic diversities from the tech-focused markets in the Northeast and Northern California, to metropolitan areas with outsized demographic growth in the Southeast and Southwest regions that take advantage of both business and household migration due to lower costs and warmer weather. Older and more established coastal markets like New York, with its focus on finance; Chicago, known for infrastructure and corporate headquarters; and Washington DC, which serves as a seat of global political power, all offer diverse industrial and commercial real estate drivers across various property types.

[3] Source: Federal Reserve, NAREIT, Preqin, CoStar Portfolio Strategy

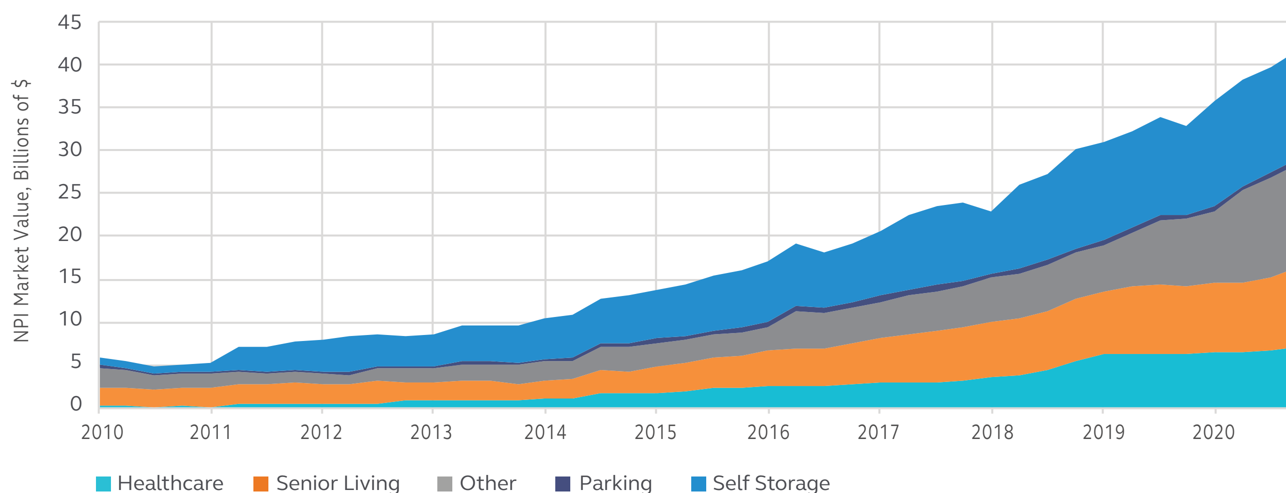
[4] Real Capital Analytics, Cross Border Compendium, November 2020.

Growth in alternative sectors

Private commercial real estate in the U.S. has long been thought of by investors as the four, or perhaps five, major property types: hotel, industrial, office, multifamily and retail. Though these sectors continue to comprise a lion's share of institutional portfolios according to data from the NCREIF research database (94.8% as of Q4 2020), the growth of other niche properties over the past decade has been significant.[5]

To put into perspective, "other" property types (properties not classified as a subtype under the five major sectors) accounted for just 2% of all investment properties in 2010. Fast-forward 10 years and that proportion has more than doubled to 5.2% of total. In terms of value, niche and other property types have increased from just over $5 billion in 2010 to over $40 billion by the end of 2020 (Exhibit 3).

Exhibit 3: Alternatives to major property types are on the rise



Source: NCREIF Query Tool; Principal Real Estate Investors, Q4 2020.

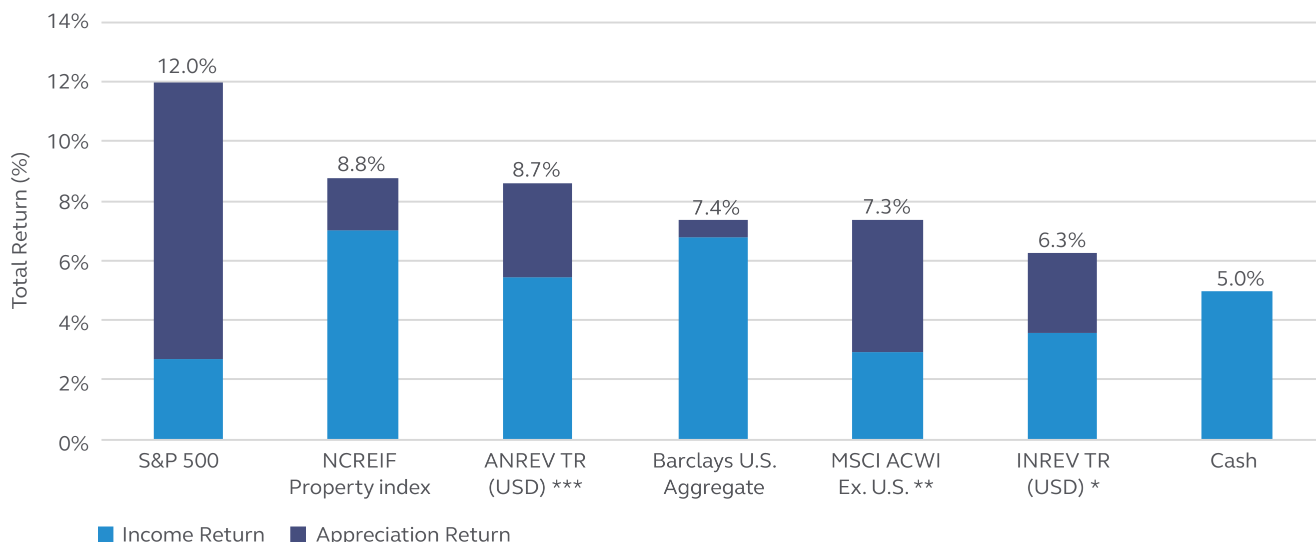
For its part, the private market is somewhat behind the curve—but catching up quickly—as public markets have long been active participants in niche sectors such as data centers, cold storage facilities, seniors housing, medical office, and self-storage. As a result, private benchmarks such as the NPI and ODCE have a way to go before there are better and more granular data on the sectors. There is little doubt, however, that these smaller but expanding sectors will offer more depth and diversity as they expand through the next decade.

Investment performance provides a compelling argument

Despite whatever compelling arguments may be made regarding liquidity, stability or diversity, the goal for asset managers is to deliver a portfolio strategy that offers attractive returns to their clients. On both a risk-adjusted and absolute basis, U.S. private real estate has a proven track record. Since its inception in 1978, the NCREIF NPI has shown that U.S. commercial real estate has historically been one of the better performing asset classes. While U.S. stocks have delivered top performance (12%), private commercial real estate hasn't been far behind delivering a compounded average annual total return of 8.8% since data started being tracked in 1978 (Exhibit 4). One of private real estate's greatest attributes, however, is its ability to provide stable and consistent income returns to investors, which acts as governor on volatility through business cycles. Like the coupon payments from a bond, most of commercial real estate's return is generated through income derived from rental payments on long-term leases. As a result, real estate has not only outperformed many other assets classes' income return component, but has also done so with much less volatility over the measured time horizon. This relatively stable and consistent return characteristic is highly valuable to income-seeking investors.

[5] Based on data from NCREIF Query Tool, NCREIF Research Database, Q4 2020 for all properties in NPI or ODCE. NCREIF ODCE Attribution based on NPI assets held in open-ended funds is reported at 95.3%.

Exhibit 4: Commercial real estate performance holds its own as an asset class



Source: NCREIF, Barclays, Federal Reserve , MSCI, INREV, ANREV, Bloomberg, Principal Real Estate Investors, Q4 2020.

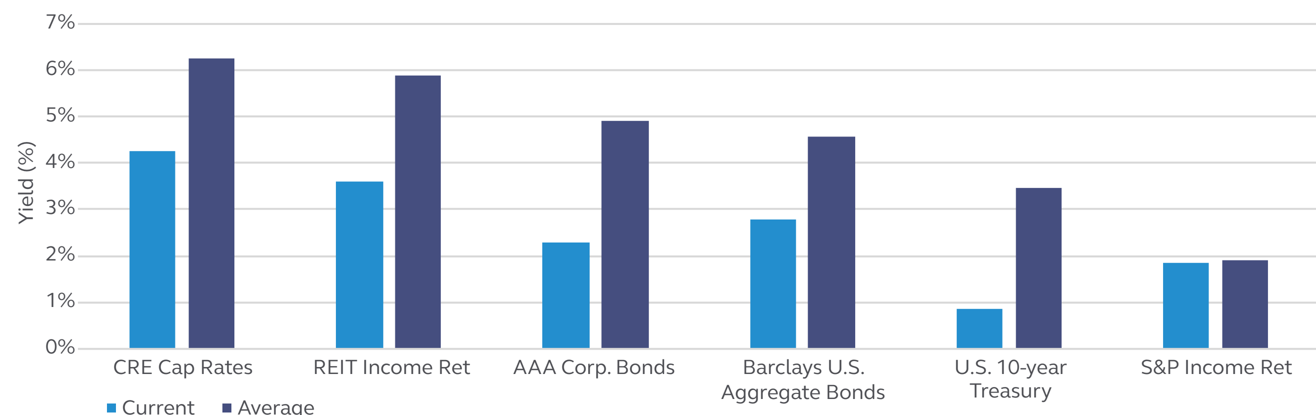
* Data only goes back to Q1 2000

** Data only goes back to Q4 1994

*** Data only goes back to Q4 2004

The income component of real estate is perhaps as important in today's environment than ever. Due in part to the accommodative stance of major global central banks including the Fed, and increased global investor demand for low risk assets, the term structure of the yield curve has been relatively flat, compressing spreads on fixed income investments to historic lows. Yields on commercial real estate assets (best represented by its capitalization rate), however, have not only remained one of the more attractive among asset classes in the current economic cycle, they have also held up well relative to other asset classes with respect to their historical average (Exhibit 5).

Exhibit 5: Real estate yields are holding up well on a relative basis



Source: NCREIF, Barclays, Bloomberg , Federal Reserve, Principal Real Estate Investors, Q4 2020.

While some of U.S. commercial real estate's income yield can be attributed to its illiquidity premium, a large portion can be explained by rent growth, occupancy levels, and long-term leasing agreements that help lock in stable income returns—even through periods of negative economic growth.

Commercial real estate as an inflation hedge

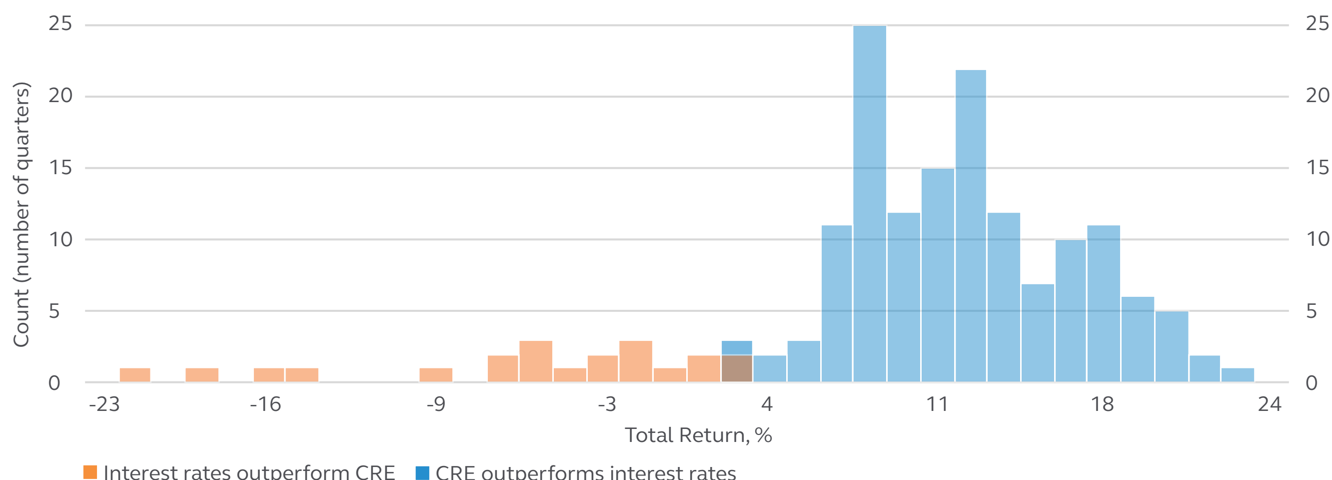
Recently, inflation hawks have rekindled fears of an overheated economy and the return of inflation as additional rounds of fiscal stimulus checks have hit household bank accounts. Such fears generally conjure images of the damaging inflation that occurred in the late 1970s and early 1980s when price increases outpaced both economic and wage growth, ultimately leading to a soft investment environment and a series of damaging recessions. While it's true that nascent inflationary pressures are indeed evident, our view is that they are more likely transitory given underlying trends in worker productivity, wage growth and uncertainty on the future velocity of money. In most cases where we see inflation today, it is more likely caused by short-term disruptions in the supply chain and depleted inventory levels—which tend to ebb and flow during periods of economic flux.

For its part, unanticipated inflation creates problems for real estate investors, such as cost overruns on new development; overages on operating expenses; and more costly tenant improvement packages. Real estate, however, is unique among most other asset classes in that much of its return is derived from income that is generated from longer-term leases (with the notable exception of hotels). Income is often indexed to inflation with escalator clauses built into leases that are tied to CPI inflation, which protect income. This is particularly true for office and industrial leases where leases run between five to 10 years, while shorter leases in retail and multifamily may also offer benefits through the pooling effect from multiple tenants within a single asset.

Perhaps most important, the performance data are conclusive. Commercial real estate returns have historically outpaced inflation offering excess return 87.5% of the time based on quarterly returns since 1980 across all property types (Exhibit 6). What is also apparent is that periods where commercial real estate underperformed inflation are not random and have only occurred during and following significant recessions. The first was following the Savings and Loan crisis in the early 1990s, where rampant speculation within the real estate sector and shoddy lending practices caused both a business cycle downturn and a correction in property values. The second followed the GFC a decade ago when the recession resulted high levels of distressed sales that also undermined property values. It is important that during both periods, inflation was either tracking at low levels, or declining rather than accelerating.

Exhibit 6: Inflation is no match for commercial real estate performance

(Q1 1979 - Q4 2020)



Source: NCREIF NPI, Federal Reserve, Principal Real Estate Investors, Q4 2020

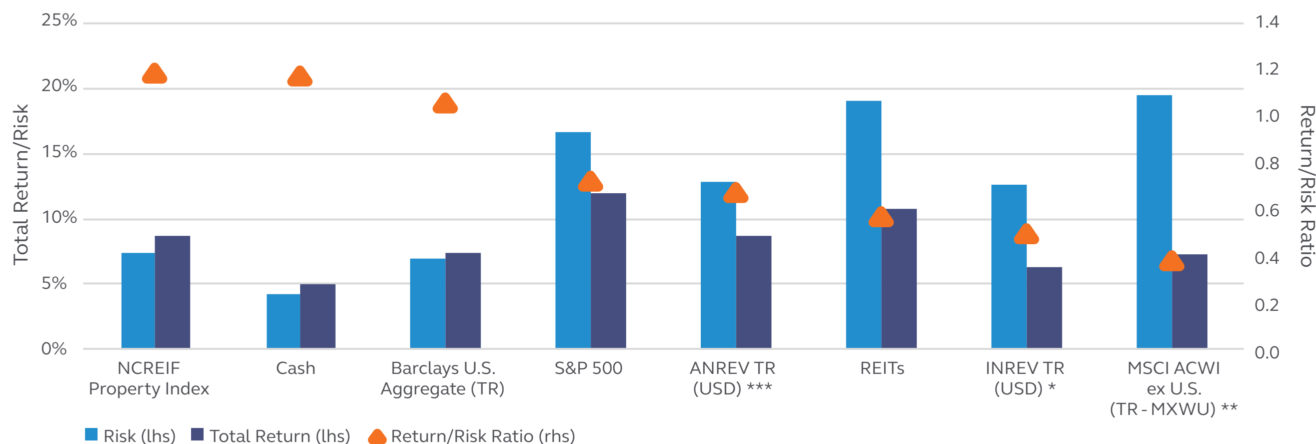
In fact, commercial real estate performance can be shown to have a positive correlation with inflation. This is partially due to asset inflation or increases in capital values that occur during periods where price increases are high, as well as the ability to increase income based on leasing structure. But not all property types are created equal—office and multifamily having the strongest correlation, with retail and hotel having the weakest outperforming inflation in 73.3% of all quarters since 1980.

Lower volatility, better risk-adjusted returns

When compared to higher beta risk assets, such as stocks and even REITs, commercial real estate is a comparatively low-risk and high return option. When defining risk of an asset, it is frequently quantified as the degree to which the return varies from period-to-period—the term standard deviation or volatility is commonly used. When calculating commercial real estate's volatility against other asset classes, it is less risky (7.40% vs 12.42% average), and its return per unit of risk (i.e. return-to-risk ratio) is almost equal to that of short-term cash, which is often considered risk-free. This high reward to risk tradeoff is convincing, however, one of its most persuasive arguments comes with its addition to a well-diversified investment portfolio.

Exhibit 7: U.S. commercial real estate returns are attractive on an absolute and risk-adjusted basis

(Q1 1978 - Q4 2020)



Source: NCREIF, NAREIT, Barclays, Federal Reserve, MSCI, INREV, ANREV, Bloomberg, Principal Real Estate Investors, Q4 2020

* INREV data back to index inception, Q1 2000

** MSCI ACWI ex. US data back to index inception, Q4 1994

*** ANREV data back to index inception, Q4 2004

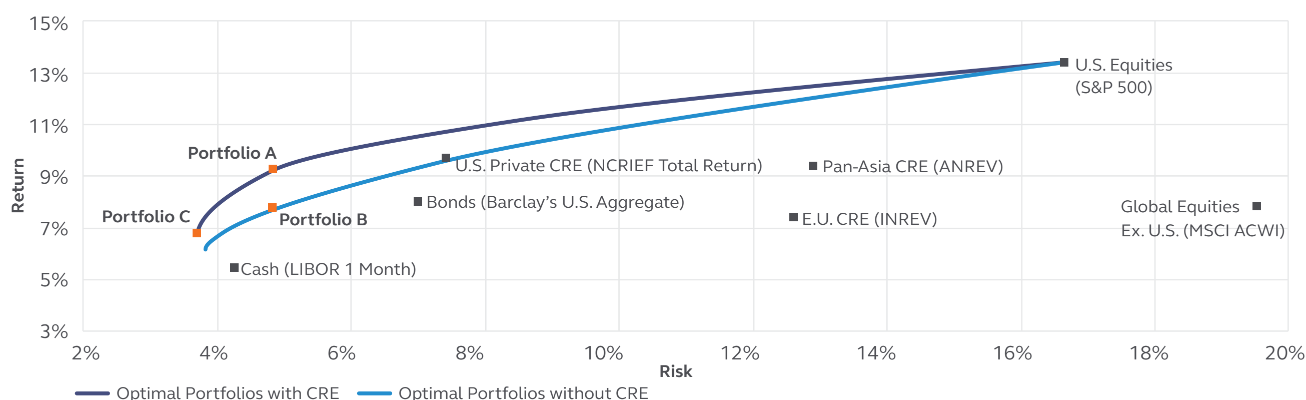
Commercial real estate continues to improve portfolio outcomes

A well-held belief in finance is that a properly diversified portfolio of multiple assets will allow investors to gain a greater return for each unit of risk taken. In deciding this optimal allocation of investment funds, an asset's risk-return profile, as well as its correlation with other assets, plays an important role in this decision.

Using the quarterly annual total returns of seven asset classes (Cash, U.S. Bonds, U.S. Stocks, Global Stocks ex. U.S., Pan-Asia commercial real estate, E.U. commercial real estate, U.S. commercial real estate) from Q4 1978 to Q4 2020, Exhibit 8 displays the optimal investment portfolios constructed on risk-return basis (as shown on page 7). The upper line (purple) outlines the highest return for each level of risk taken in a portfolio that includes all asset class options mentioned above while the lower line (blue) displays the same frontier of assets, but with U.S. commercial real estate removed as an investment choice. What this illustrates is that adding any allocation of U.S. commercial real estate to a portfolio already invested in some combination of global stocks, bonds, cash, and non-U.S. commercial real estate increases the portfolio's overall return while

also reducing its risk. For example, looking at portfolios A and B outlined below, if an investor wanted to construct the highest historical return portfolio choosing a level of 4.8% risk, a portfolio comprised of bonds, cash, U.S. stocks, and Pan-Asia commercial real estate would yield an expected return of 7.2%. At that same level of risk, however, if the investor added U.S. commercial real estate in the portfolio construction, they would have been able to achieve roughly a 150 basis point increase in the portfolios return (8.7%). Moreover, this example also reveals that an investor wanting to take the least amount of risk possible would be better served not investing entirely in short-term cash (traditionally considered risk-free). Portfolio C in the diagram reveals that an allocation of 25% in bonds, 14% U.S. commercial real estate, 3% international equities, and the remainder in cash would have achieved a 3.7% level of risk compared with 4.2% entirely invested in short-term cash. This allocation would also have realized an average annual return of 6.3% versus 5.0%.

Exhibit 8: Optimal portfolio asset frontiers with and without U.S. commercial real estate



Source: NCREIF, NAREIT, Barclays, Federal Reserve, INREV, ANREV, Bloomberg, Principal Real Estate Investors, Q4 2020

* INREV data back to index inception, Q1 2000

** MSCI ACWI ex. US data back to index inception, Q4 1994

*** ANREV data back to index inception, Q4 2004

	U.S. CRE	E.U. CRE	Pan-Asia CRE	Non-U.S. Stocks	U.S. Bonds	U.S. Stocks	Cash	Returns	Volatility	Return/Risk Ratio
Portfolio A	50%	0%	0%	0%	43%	6%	0%	8.7%	4.8%	1.8005
Portfolio B	0%	0%	10%	0%	40%	11%	39%	7.2%	4.8%	1.4926
Portfolio C	14%	0%	0%	3%	25%	0%	58%	6.3%	3.7%	1.6956

Conclusion

While it may appear that the global investment landscape calls for a more cautious risk-off approach, as evidenced by historically low yields on long-dated sovereign bonds, asset classes that dampen volatility, reduce correlation to global markets and generate income, remain at the forefront for prudent investors. At its core, U.S. commercial real estate is an asset class that can benefit from positive economic fundamentals and demographics which should be positive attributes as recovery from COVID-19 accelerates in the coming quarters. Regional diversity within the U.S. economy—across metro areas—and the potential for lower correlation across certain markets that may not be as closely tied to broader macroeconomic cyclical events offers investors further diversification benefits. Additionally, with the stability of its income return, U.S. commercial real estate has the potential to provide attractive risk-adjusted returns allowing investors to take advantage of increased returns and reduced risk of a well-diversified portfolio.

Exhibits 4, 5, 7 and 8: The S&P 500 is a market-capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market; The NCREIF Property Index (NPI) is a quarterly, unleveraged composite total return for private commercial real estate properties held for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors and held in a fiduciary environment; The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). (Future Ticker: I00001US); Cash: LIBOR 1-Month Rates: U.S. Dollar Denominated Deposits- The ICE LIBOR is the primary benchmark for short-term interest rates globally, used for mortgages, loans, for interest rate contracts on futures and options exchanges, and as a general gauge of the health of financial monetary markets; REITS: FTSE NAREIT All REITs (FNAR)- The FTSE NAREIT All REITs Index is a market capitalization-weighted index that and includes all tax-qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List. The FTSE NAREIT All REITs Index is not free float adjusted, and constituents are not required to meet minimum size and liquidity criteria.

ANREV TR (USD): The ANREV Total Return (TR) Index is a quarterly value weighted benchmark that measures the net asset value performance of Asia Pacific non-listed real estate funds. Performance is measured net of fees and costs, and unhedged total returns are then converted from local currency to USD.

INREV TR (USD): The INREV Total Return (TR) Index is quarterly value weighted benchmark that measures the net asset value performance of European non-listed real estate funds. Performance is measured net of fees and costs, and unhedged total returns are then converted from local currency to USD.

MSCI ACWI ex U.S. (TR – MXWU): The MSCI ACWI ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries. (excluding the US) and 27 Emerging Markets (EM) countries. With 2,344 constituents, the index covers approximately 85% of the global equity opportunity set outside the US, and is market-capitalization-weighted of the Gross total returns denominated in USD.

CRE Cap Rates: The capitalization rate calculated from the NCREIF Property Index (NPI)

REIT Income Ret: Income Return from the FTSE Nareit All REITs index

AAA Corp. Bonds: Moody's Not Seasonally Adjusted Aaa Corporate Bond Yield [AAA], retrieved from FRED, Federal Reserve Bank of St. Louis Barclays U.S.

Aggregate Bonds: Income return from the Bloomberg Barclays US Aggregate Total Return Value Unhedged USD

U.S. 10-Year Treasury: US Department of Treasury, closing market bid yields on the 10 year US Treasury security.

S&P Income Ret: Income return from the S&P 500 Total Return Index (Internal Calculation). To note, every index in the paper is on end of period quarterly basis.

Risk Considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

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