AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

# Look Back, Look Forward

## Commercial Real Estate Review and Outlook

In line with our expectations outlined in last year's "Look Back, Look Forward", 2019 was marked by continued but slowing economic growth and ongoing trade policy uncertainty as U.S.-China trade developments continued to dominate news headlines. Central banks around the world reversed course from their paths in 2018 amidst weakening in several key economic indicators, taking long-term government bond yields lower or even negative. The US yield curve[1] inverted in May and remained inverted through September, prompting speculation about an inevitable downturn that by year end had still not materialized.

Against this backdrop, commercial real estate continued to exhibit steady and solid performance. Annualized unlevered total returns of the NCREIF Property Index (NPI) were 6.24% as of the third quarter, with the majority derived from income. Why is this important? Our view is that the period of widespread cap rate compression as a significant driver of total returns is largely behind us, and that income will drive returns in the near term. As a result, we favor opportunities supported by both resilient demographic/technological tailwinds and predictable supply pipelines. The multi-family and industrial sectors remain our favored property types given expectations of sustained demand for both housing and e-commerce compatible space.

> "Commercial real estate continued to exhibit solid performance amidst a slowing macroeconomic backdrop and trade policy uncertainty."

### 2019 Year in Review and Outlook for 2020

Annualized GDP growth for 2019 is anticipated to come in at 2.3%[2], down from 2.9% in 2018. This is to be expected late in the cycle; and, as economic cycles do not merely end due to old age, many key drivers of national economic growth remain intact – composite indices for services and manufacturing reflected an uptick in November, despite contractions elsewhere globally[3]; consumers continue to spend; and interest rates remain muted, supportive of responsible levels of borrowing activity. Business is a potential soft spot, with investment turning moderately negative during the year, amidst moderating profit growth. As corporations today are more highly levered than in the past (given the attractiveness of low rates), a decline in profits could add pressure. However, consumer spending has thus far offset lackluster growth from the business side and should remain a pivotal driver of future economic growth.

Solid macro fundamentals and a "lower-for-longer" monetary policy environment continued to support investor demand for institutional real estate during 2019, as investors renewed their search for yield-bearing assets. Transaction volumes of core property types in the year through Q3 2019 totaled nearly US$500 billion, up 6.9% from the year through the same period in 2018 (Figure 1 - pg. 3).

It is our view that key risks to the outlook today include the longer-term impact from sustained US-led trade wars and whether or not global central banks are able to reverse slowing global growth.

Even with an initial trade agreement between the U.S. and China, businesses are likely to remain cautious. President Trump has insinuated other countries may be in his crosshairs

Continued

[1]The U.S. yield curve is defined as the spread between the 10-year U.S. Treasury rate and the 3-month U.S. Treasury rate.
[2]Based on The Conference Board estimates as of January 8, 2020.
[3]IHS Markit U.S. flash manufacturing and services PMI as of November.

as well, so trade-related risks are not likely to abate any time soon. Further deterioration in trade relations would continue to adversely impact business confidence and, depending on the depth of the impact to businesses, consumers, which could create a substantial drag on economic growth in 2020 and beyond, should that scenario materialize. In this environment, the ability of central bank policy to offset the effects will be at least as important, if not more so, in 2020.

> "Even with an initial trade agreement between the U.S. and China, businesses are likely to remain cautious."

Notwithstanding any unanticipated shocks to the system, we believe US GDP growth will continue to moderate in 2020. While this is expected to translate into moderating real estate fundamentals, NCREIF unlevered property returns should hold up fairly well, as they have historically in periods of moderating economic growth (Figure 2 - pg. 3).

## Property Sector Outlook

### Multi-Family

As we anticipated, multi-family fundamentals strengthened as the wave of new deliveries in 2017-18 moderated in 2019 amidst increased land, labor, and construction costs, offering a welcome respite to landlords. We anticipate a moderate uptick in supply in 2020 relative to 2019, as there were approximately 421,000 units under construction across our preferred markets as of December[4], up from 404,000 during the same period one-year prior. While this, coupled with a reserved economic outlook, may have the effect of dampening rent growth in select areas most impacted by supply in 2020, it will also offer some much-needed housing stock in markets where vacancy has driven rents to new highs. Affordability is the topic *du jour*, and rightfully so – according to data from the Census American Community Survey, nearly half (49.7%) of American renters are considered "cost burdened" defined as those whose monthly housing costs comprise more than 30% of household income. Cities have begun to implement rent control regulations in an attempt to ease the burden, to varying results. This is positive for renters but may pose challenges to institutional real estate owners who own and operate properties in these markets if the controls become more widespread.

Near term, we continue to underweight markets with near-term oversupply risk and moderating net absorption and are maintaining our focus on acquiring assets in markets with a combination of highly skilled workers, a dynamic economic base, and higher barriers to entry. We also favor opportunities to develop product that offers a rental discount to new Class A product in high-growth locations.

### Industrial

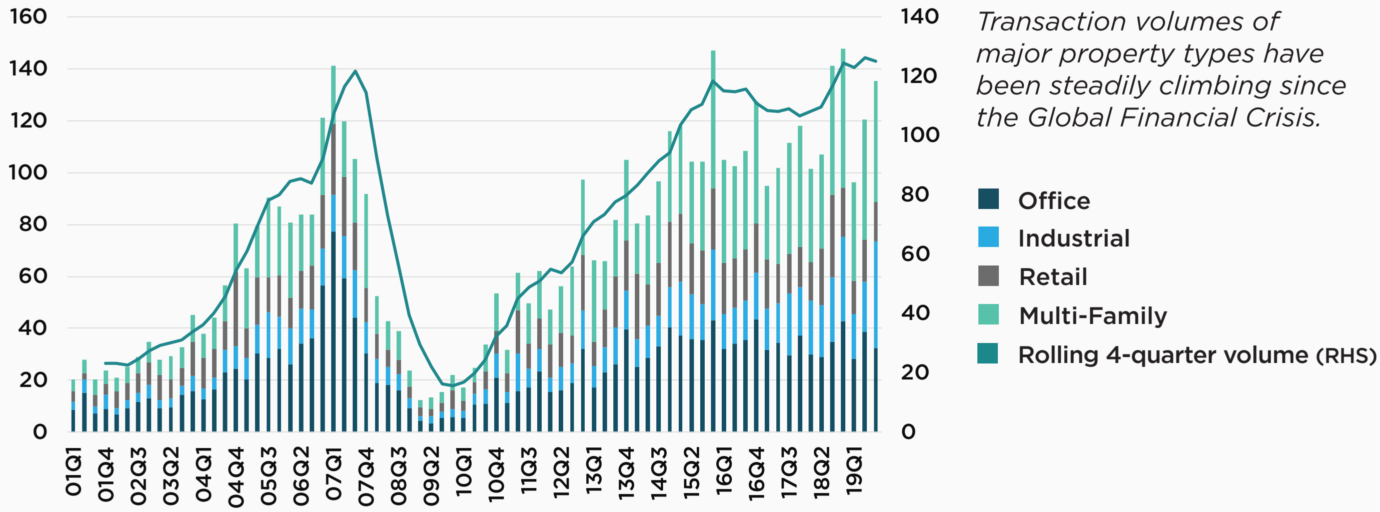
We are maintaining our overweight position to industrial. The asset class has outperformed the office, multi-family, retail, and hotel NPI sub-indices over the one-, three-, five-, seven-, and ten-year periods through Q3 2019 (Figure 3 - pg. 3). As a result of this outperformance, investor appetite for industrial has remained robust - 2019 saw a number of portfolio-level transactions, most notably GLP's two-part transaction with Blackstone totaling an aggregated $18.6 billion. We strongly believe our positions will benefit in the coming year as competitive bidding on industrial continues with investors seeking to increase their allocation to the sector.

While construction activity has been gradually picking up over the last few years, we believe developers are delivering much-needed Class A product that can serve to replace older stock that is reaching the end of its useful life, but to date this has been sufficiently matched by demand. It is our conviction that fundamentals will continue to be favorable for industrial through 2020.

*Continued*

[4]In American Realty Advisors preferred markets.

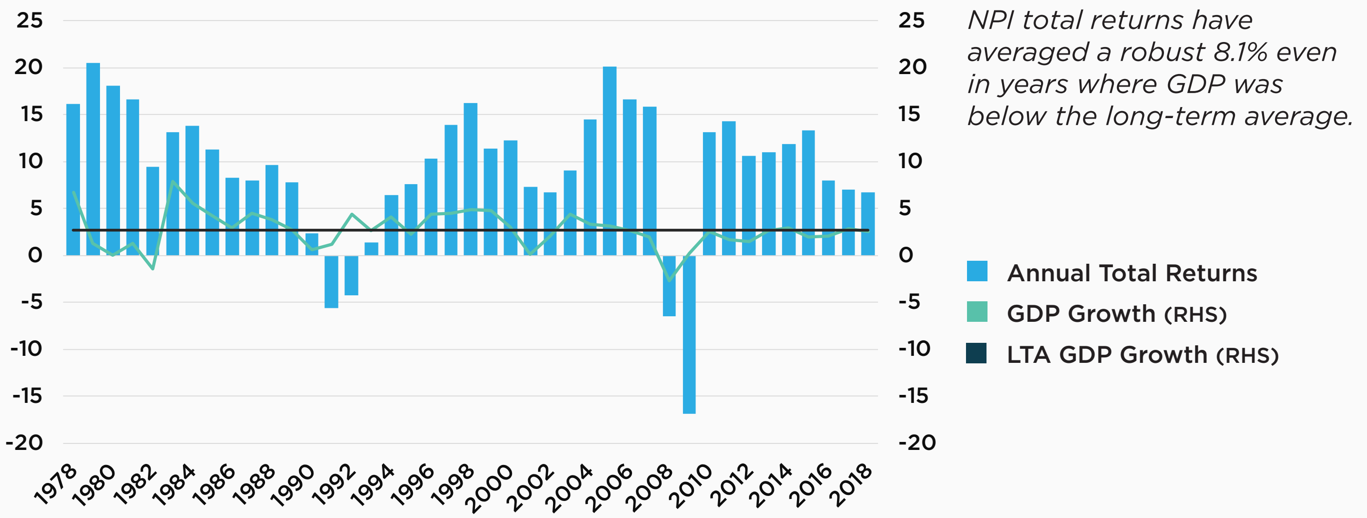
### Figure 1: Transaction volumes by property type, 2001-19




*Transaction volumes of major property types have been steadily climbing since the Global Financial Crisis.*

Source: Real Capital Analytics as of December 2019. Core property types include office, industrial, retail and apartment. Totals include transactions of properties of US $2.5 million or greater.

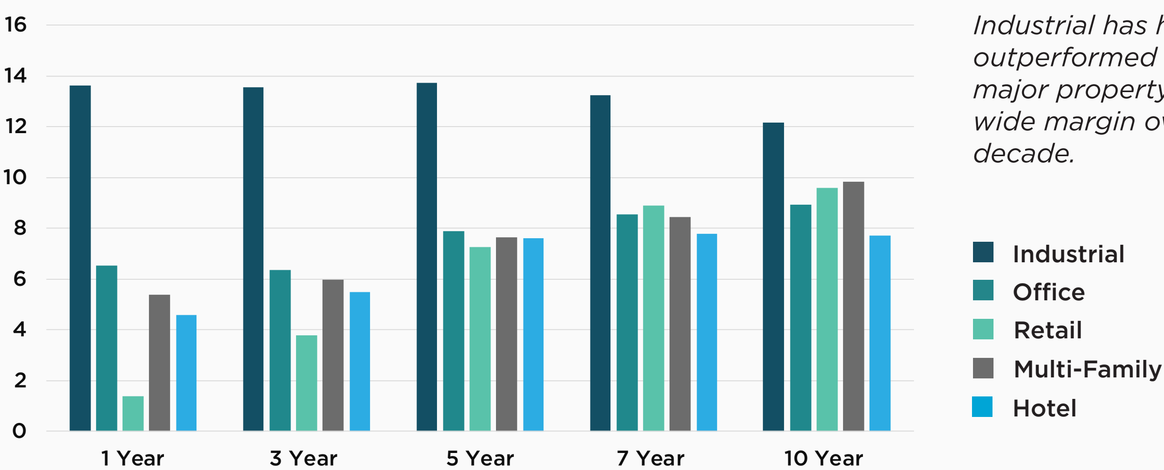
### Figure 2: NCREIF Property Index Annual Total Returns and Real GDP Growth, 1978-2018




*NPI total returns have averaged a robust 8.1% even in years where GDP was below the long-term average.*

Source: American Realty Advisors based on data from NCREIF and the U.S. Census Bureau as of November 2019.

### Figure 3: Annualized total returns by property types through Q3 2019




*Industrial has handily outperformed all other major property types by a wide margin over the last decade.*

Source: American Realty Advisors based on data from NCREIF as of November 2019.

## Office

Office demand is most closely tied with employment growth and, as a result, has benefited throughout this cycle. However, as national employment growth moderates, lower growth presents tailwinds for office fundamentals in the year ahead – through the first ten months of 2019, the US added an average of 167,000 jobs, roughly 33% less than during the same period in 2018. Given the tight labor market, this trend is not likely to abate in 2020.

With a decelerating employment backdrop, our office exposure will remain focused on opportunities where we can acquire or create differentiated product most in demand among tenants in markets that offer a combination of highly skilled workers, constrained construction pipelines, and a meaningful tech presence.

## Retail

2019 was "more of the same" on the retail front, continuing the trend of store closures nationally outpacing openings by a ratio of more than 2:1 amidst increased pressures from e-commerce[5]. Not surprisingly, the NPI retail sub-index was the laggard over the one-, three-, and five-year periods through the third quarter. Yet, despite a challenging retailer environment and lackluster returns, yields/cap rates for some retail properties have not, in our view, sufficiently adjusted to compensate for the elevated risks, particularly for regional malls. Retail cap rates only offered a 43-basis point premium over offices and a 53-basis point premium to industrial as of Q3 2019[6].

There is an increasing divergence within the retail sector – higher-quality and grocery-anchored centers in dense locations have fared better than regional malls, which have historically been anchored by now-struggling retailers such as Sears, JCPenney's, and Macy's, whose offerings are most easily replicated online.

As a result, few deals are expected to trade without a sizable amount of value creation required. This may entail re-tenanting vacant spaces to reactivate a center, pivoting towards a more experiential-based offering, or repositioning from retail to another use entirely, suggesting there may be greater opportunity for value-add capital. In our core portfolios we are maintaining an underweight to retail, with a narrow focus on only best-in-class assets. For value-add, we prefer repositioning strategies in irreplaceable locations that have a captive trade area and limited propensity for new supply.

## Summary

There is little doubt that we are nearer to the end of the current economic cycle than its beginning. The primary economic question is to what degree the renewed easing by the Fed and other central banks may prolong the current "lower-for-longer" growth environment, as monetary policy seeks to extend the capital cycle.

We expect this to impact real estate in two key ways:

1. The window of time within which investors can execute on and realize value-add strategies may widen, and
2. There may be sustained, if not elevated, levels of transaction volume as investors broaden their search for yield-bearing assets amidst ultra-low bond yields.

We are counseling our investors to remain diligent as we execute strategies that are fundamentally sound and do not take on unnecessary risk in placing capital. This means maintaining a focus on acquiring properties whose returns are underpinned by a steady and sustainable income component, and positioning portfolios to take advantage of structural drivers while mitigating against cyclical headwinds.

**In a word – it's all about balance.**

[5]Sources: CoreSight Research as of December 2019, [6]NCREIF as of Q3 2019.

Research is the starting point for everything we do for our clients. ARA provides useful and timely thought leadership to help our clients get a clear view of the critical issues affecting their investments.

**To read more of ARA's Research Insights, please visit: www.aracapital.com/insights**



Authored by:

**Stanley L. Iezman**
Chairman & CEO
siezman@aracapital.com

**Christopher Macke**
Managing Director,
Research & Strategy
cmacke@aracapital.com

**Sabrina Unger**
Vice President,
Research & Strategy
sunger@aracapital.com

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT