

**TH** Real Estate

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# 2018: A year of stability with economic growth sustaining the current cycles

Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc, sat down with **Alice Breheny**, Global Head of Research at TH Real Estate to talk about what 2018 might bring. The following is an excerpt of that conversation.

*Following a sixth year of recovery in the commercial real estate market, what do you predict for 2018, and where should global investors be looking for market opportunities?*

We believe commercial real estate markets will remain stable in 2018, supported by faster economic growth as record-high prices curtail demand in the cycle's late stage. Whilst we believe the cycle is nearing its end, we do not expect a downturn in the next year or two. Capitalisation rates — the ratio of net operating income to property value — have fallen to record lows as real estate prices have risen faster than operating income. Although further capital appreciation is unlikely, global economic growth should sustain above-inflation income returns and property values. Despite record valuations, there are few signs of bubble conditions that developed at the end of the last cycle 10 years ago. Investors remain cautious in response to high valuations and rising interest rates as central banks unwind stimulus. They are reducing their return expectations as allocations to real estate continue to rise, pushing up prices and depressing yields. Overall, we expect 2018 will be a year of stability for real estate, with supply and demand generally in balance and supportive fundamentals.

*Given this global economic picture, where are the opportunities in commercial real estate?*

We have identified three types of investments based on the needs of a variety of global investors.

## **Commercial real estate (CRE) debt: access to secure, income-focused returns**

Commercial real estate debt enhances portfolio performance due to its modest correlation and higher risk-adjusted returns, relative to most other asset classes. The sector is becoming more mainstream than it was five to seven years ago. While it used to be more of a niche play, now an allocation is becoming part of institutional investors' fundamental line-up.

Analysis from our global research team shows that commercial real estate debt enhances multi-asset portfolio performance, depending on the allocation to equities and fixed income instruments. In particular, our analysis suggests that adding commercial debt to a real estate equity or multi-asset portfolio during the later stages of the real estate cycle can enhance performance by 20 to 50+ basis points.

We believe that it is an opportunistic time to add CRE Debt to a real estate equity or multi-asset portfolio, given

## **European Economic Outlook**

Momentum in the European economy has been strong. This is most apparent in employment, where the latest surveys suggest Europe is creating jobs at the same pace as during the pre-financial crisis boom. This is generating a boost to income, which is supporting stronger consumption and investment. Despite the strong euro, the robust start to 2017 was maintained throughout, and exports were a key contributor to the surprising strength. Combined with solid domestic demand and improving prospects in other advanced economies, this points to a sustained period of economic strength and upside potential to forecast. As at year-end 2017, commercial real estate investment levels for 18 major European countries were running at nearly 50 percent above their 10-year average. Among major markets, Germany was 65 percent above average, the United Kingdom nearly 20 percent, and France 10 percent. Given these three countries alone accounted for just over 60 percent of the core European investment market in Q3 2017, the attractiveness of real estate as an asset class cannot be overstated.

the abundance of lending opportunities available. Elevated real estate transaction volumes and commercial mortgage loan maturities suggest the pipeline for mortgage originations will remain strong for the next several years.

In the United States, real estate market conditions remain well-balanced, and economic growth is expected to strengthen over the next several years, but the business cycle and real estate cycle are mature, and the Federal Reserve is expected to continue to gradually raise interest rates. This transitional period creates risk and opportunities for commercial real estate lenders, as stronger economic growth implies stronger demand for all types of real estate but with associated cycle risk. With an increasing amount of capital targeting CRE debt, we believe it is more important to choose a commercial mortgage origination platform and manager that can

## **Asia Pacific Economic Outlook**

Economic growth in Asia Pacific was well ahead of Europe and on track to match or exceed the United States for 2017. Strong economic growth was apparent in Japan, Australia, Singapore, South Korea and Hong Kong. Growth conditions in the region should help to mitigate any of the downside risk from tightening financial conditions in some of the Asia Pacific markets into 2018 and in the short term. The region will continue to benefit from demographic megatrends, such as urbanisation and a rising middle class.

### US Economic Outlook

The current economic expansion in the United States is on pace to become one of the longest periods of growth in US history. If growth continues through February 2018, the expansion would set a record as the third longest. Solid real estate fundamentals and economic growth suggest the US real estate cycle will last several more years. The US real estate market is in its mature phase, as characterised by slowing rent and appreciation growth. However, real estate fundamentals remain solid, with supply and demand largely in balance. The biggest risk to US real estate is exogenous. Should the geopolitical landscape hamper US economic growth, the US real estate cycle will suffer in tandem.

couple cycle-tested underwriting standards with astute loan structuring. Superior execution of commercial mortgage lending requires size, scale and industry relationships.

And in the United Kingdom and Europe, in the context of retrenching traditional lenders and the persistent narrow focus on prime assets, we feel opportunity can be found in “off the radar” assets, particularly core-plus assets in established markets. Assuming robust underwriting, these underserved markets present the most appealing opportunity for selective “cherry-picking” of transactions with strong fundamentals and return characteristics.

### Resilient investments: providing income, diversification and long-term capital growth

We believe that an investment approach that focuses on resilient and sustainable investments, from an economic and environmental perspective, could help deliver attractive long-term and stable core returns for investors in 2018. A cities-based investment approach could prove a more resilient choice. Picking the right cities, with their own unique DNA, for example “lifestyle leaders” or “millennial magnets”, overlaid with an in-depth understanding of local micro-market dynamics, has shown to deliver outperformance in the long-run.

Investors should look beyond the traditional core markets, as there can be strong merits to allocating and investing into alternatives to future-proof a broader portfolio. For example,

many Chinese cities are not obvious targets for core investors; however, they are developing at a rapid pace and should be closely monitored for future investability. After all, growth cities of today are the core cities of Tomorrow's World.

Within cities, different sectors can then be chosen based on their ability to perform over the long term. For instance, changes to the retail environment have changed the way we shop, but stores remain paramount to the success of retailers. Globally, stores capture over 85 percent of all retail trade, and even in the most mature e-commerce markets, such as the United Kingdom, stores are still expected to capture 73 percent of all sales by 2021. Combining a cities approach with in-depth research on a sector can deliver capital growth.

### An enhanced strategy: for an enhanced level of capital growth

For those investors looking for greater levels of capital growth in 2018, an enhanced strategy that works within market cycles and uses a more active asset management and repositioning approach might be the right fit. This strategy could invest in emerging sectors and locations, is usually progressive in light of megatrends and market cycles, and seeks to identify mispricing and cyclical opportunities.

The logistics sector is a good example of this, and we believe it is a sector that is well-positioned to outperform the major sectors (office, retail, residential) once more in 2018. Logistics has benefited from the rise of e-commerce and the transformation of the retail real estate sector.

The pace of e-commerce growth has put tremendous pressure on existing logistics infrastructure, pushing availability rates to near all-time lows. Concurrently, rents have climbed as landlords have been able to push increases on tenant renewals and new leases. More supply is on the way, which could bring markets closer to equilibrium and cause rents to moderate, but higher development costs may push rents even higher.

Given the positive outlook, investors are pushing cap rates to new lows, just as other major sectors see cap rates move upward or sideways. We believe the logistics sector will continue to outperform its peers in 2018, as healthy market conditions and continued e-commerce sales keep supporting higher rents and capital values.



**Author**  
**Alice Breheny**  
**Global Head of Research at TH Real Estate**

### CORPORATE CONTACT

For more information, please contact  
**Laura Barstow, Managing Director**  
International Advisory Services  
+44 (0)20 3727 8110  
laura.barstow@threalestate.com  
www.threalestate.com  
Follow us on Twitter @threalestate14

### CORPORATE OVERVIEW

TH Real Estate, an affiliate of Nuveen, the investment manager of TIAA, is one of the largest real estate investment managers in the world with \$107 billion in AUM.\* Managing a suite of funds and mandates spanning both debt and equity across diverse geographies, sectors, investment styles and vehicle types, we provide access to every aspect of real estate investing. With over 80 years of investing experience, and more than 500 real estate professionals located in over 20 cities throughout the United States, Europe and Asia-Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise.

*\*AUM figures as at 30 September 2017*

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