UBS Asset Management, Real Estate & Private Markets

Income still driving solid US growth, appreciation despite political noise of 2017

Recently, **Jonathan Schein,** managing director of global business development for Institutional Real Estate, Inc, spoke with **Tiffany Gherlone,** executive director, Real Estate Research & Strategy – US, for UBS Asset Management, about how the US real estate markets might look to the European investor. The following is an excerpt of that conversation.

Returns have come down in the US commercial real estate markets. Should investors be concerned?

I would be more concerned if we were still seeing the increases we had in appreciation and transaction volume two years ago today — the 20 percent to 25 percent year-over-year increases in transactions and double-digit returns. Now, we've actually seen a period where returns have followed the fundamentals. The markets are fairly rational given where the spreads are, which is still near or just below long-term averages.

As we know, the economy in the US has been expanding now for eight or nine years. There is a feeling that it just can't keep going this way. A concern?

If we saw more overbuilding, I would be more concerned about real estate. That is not the case at the moment, and our expectation for growth in 2018 is fairly similar to 2017 — a continuation of about a 2.3 percent growth is our internal best-case scenario with around 2 million jobs created, similar to what we saw in 2017. We have about long-term average levels of construction in the office sector, and we are still seeing some increases in industrial. Apartments and hotels are at peak and have had enough demand to absorb the supply that is coming on, for the most part. Retail is the only sector where the competition has been more virtual than in the physical space.

What about the gap between the Treasury rates and real estate? Is that still looking okay?

It is still near or just below its long-term average, so looking at the expectation for growth, plus a risk premium that is embedded in real estate today, we are not seeing a tremendous amount of compression there.

Sometimes we think of compression as the price coming down. But interest rates could be going up. Do you see this changing the debt markets? Or has it already been worked into what people are underwriting?

The changes in monetary policy have been pretty well expected and written into the numbers. And yet, the interest rates remain low. Still, the cost of debt is unlikely to go lower, although there is still a fairly wide spread between the cost of debt and the yields on properties today. In the US, core real estate yields are somewhere between 4.5 percent and 5.0 percent, which is a pretty attractive place to be when the long-term interest rate is still under 2.5 percent.

If interest rates do go up, could real estate have a problem getting financing?

There is no easy money out in the market today, whether we are talking about debt or equity. Yet we have a sales volume in the US that is, while somewhat down from the last two years, still near record levels. There is plenty of liquidity available, although I think on the debt capital side we have seen opportunity for alternative lenders — funds and private equity ventures — to come into the space, taking some of market share away from what, 10 years ago, would have been CMBS. A difference in the US market is that there are numerous sources of debt capital for investors, and the banks are lending.

You mentioned earlier that the core return is a pretty attractive return. Is it high enough, though, for someone from outside the United States? I know when US investors go to Europe, they are often looking for a premium, even on core assets. Do European investors feel that same way? Or are there other reasons to invest in the US core market?

On a relative basis, it has been an attractive return. The long-term expectation for a core diversified real estate portfolio in the US is going to be something like US inflation plus 5 percent, so about a 5 percent real return over the long term, not withstanding that any given year would differ from that. If you are coming into the US now, I think it is probably less for the search for a higher yield — I would hope that it is not the only reason — but also for the benefits of diversification and diversifying for a better risk-adjusted return overall.

What are the key investable property sectors in the US? Which would be attractive to a European investor?

We have a proprietary model where we are looking at the investable universe across the US — all investable commercial, high-quality real estate in the US. We would put the multifamily sector at just about 30 percent of the market, a similar percentage made up of office, a little less for retail, and the balance industrial, meaning the warehouse logistics sector, specifically.

How are they performing?

On a relative basis industrial has been the only sector performing above our national index, the NCREIF property-level index, which is an unlevered index. We could see

Please note that past performance is not a guide to the future.

another year of that, but I wouldn't extrapolate a single sector's performance too far out past a year. We are seeing a lot of supply coming on in the industrial sector. I think, rather, I would classify the performance across all the sectors as fairly close to an equilibrium state or heading toward an equilibrium state, where we are seeing a balance between supply and demand, a level occupancy rate and the growth in the income being driven by the rents.

You mentioned mainstream sectors. Are you also looking at some of the smaller niche opportunities such as data centers instead of downtown office, or self-storage instead of logistics, or student housing instead of multifamily?

There is no obvious slam-dunk available even in the niche sectors at the moment. Our focus is primarily on the four largest sectors. We invested in some hotel and medical office and made some incremental moves in seniors housing, but they have been small, and it is more for a long-term strategic position in those sectors, rather than a short-term tactical move. The short-term tactical moves would be difficult because the return expectations have come down, the supply growth is up, and they are delivering generally positive rental-rate performance, positive fundamentals.

What do you see happening in 2018?

That is front and center on a lot of investors' minds, especially outside of the country. Really, the changes that we've seen in policy — primarily at the moment, tax policy — have merely reinforced our expectation for 2018. The actual policies that have been signed into being are much more modest than what had been floated around as ideas, which would have been more directly impactful to commercial real estate. Policy changes typically take more than a year to really impact the market, but it is likely the tax reform that was passed should add a few dozen basis points worth of growth to GDP, which merely takes us to a continued moderate, positive outlook for GDP — basically where we were before. It would be very difficult to bring the US unemployment rate down materially from here. We are really very close to full employment, and we hope there will be some pressure on wages, because the GDP is on the verge of growth above its potential. This is all good for commercial real estate demand, whether we are talking about office building tenants, retailers or tenants in apartment buildings.

Is the tax reform likely to do anything to help retail?

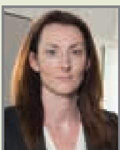
The tax reform should generally be supportive of consumer spending. On the retail side, it is mainly a quality question. The US clearly has too much lower-quality retail, and it is already being repurposed into things like medical office parks and mixed-use development. But really US retail has been one of the best-performing sectors over the last seven years. 2016 was the first year we started to see that performance slow and come in line with office and apartments. In the public markets, retail has been quite punished in terms of the stock prices and the shorting that is going on with the retail REITs, but the fundamentals don't line up to the public market sentiments. We haven't seen any material decline in the occupancy rate or the income generated by higher-quality retail.

If you had a European investor sitting in front of you right now, looking to put a chunk of capital into the US market, what would you tell them?

I would tell them to look for strategies that are very focused on income. Income is not just driving the performance now; it is also driving the appreciation we are seeing in the market. It is a fairly balanced market, and we are back to looking for value in income and in value creation. I wouldn't be afraid to make moves that require spending some capital, but I would stay focused on the income growth associated with them.

A last word?

The US offers a very robust, long history of investing across at least the four major property sectors, including multifamily here in the US, plus some smaller positions available in more niche sectors.



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