From pricing to fundamentals

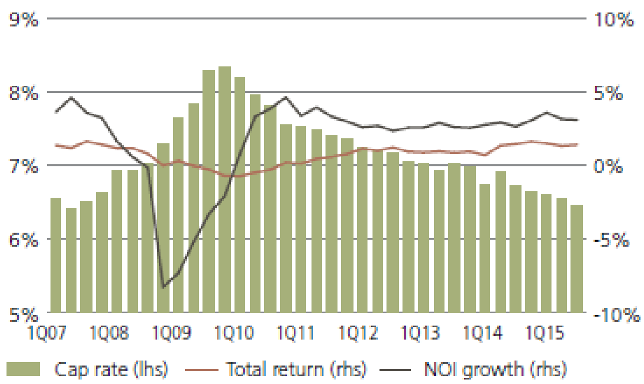
Strategies in Focus: Real estate

The performance of commercial real estate in recent years demonstrates a unique separation of pricing from fundamentals. As we begin 2016, pricing is absolutely high but relatively low. Initial yield levels around the globe are low by historical comparison but yield spreads over sovereign bond rates are relatively wide. Attention now turns to fundamental conditions.

Private commercial real estate worldwide offered some level of expansion during early 2007. The UK was most advanced, delivering a significant level of supply. The US was well balanced, with high rent growth and initial signs of development. Asia Pacific was still in a high growth mode, prior to any concerns of slowing demand. The global credit crisis shocked the system, causing real estate pricing, represented by cap rates which equal property initial yield, to move independently from income growth.

Data from the US tells a story that can be repeated around the globe. In the chart below, the 'income growth' line would move in concert with the 'total return' line, if pricing remained consistent over the period.

US real estate pricing



Data as of September 2015
Total return is quarterly actual
NOI (net operating income) growth is quarterly average of rolling 4 quarters
Source: Real Capital Analytics and NCREIF

The separation in the two lines is due to the fact that capital markets moved, pushing returns down at a time when income was still growing.

The ensuing recession caused income to fall during 2009. Throughout 2010, pricing improved, as shown in the chart's declining columns representing cap rates, at the same time that income was declining. This indicates that the market was pricing future income growth during a period when income was still falling, thus the two lines separated again. That expected income growth was realized from 2012 through 2015, with an acceleration over the past year. The cap rate has continued to fall over the past five years, leading to the opening remark that prices are absolutely high but relatively low.

From a current income perspective, real estate remains very compelling

Current property yields offer a relatively wide spread over sovereign bond yields, even though the current level is near historical absolute lows. Since asset yields are at low levels for most asset classes, real estate remains very compelling from a current income perspective. It is expected that future value growth, or appreciation, will be more influenced by income growth and less by declining cap rates, in contrast to the recent past. This prospect for continued appreciation as cap rates stabilize, along with the relatively high current yield, makes real estate an attractive investment in today's environment.

Driven by supply and demand fundamentals rather than capital market adjustments

Private commercial real estate performance over the next five years may return to more sustainable levels, driven more by the fundamentals of supply and demand and less by capital market adjustments. Today's real estate investors should expect returns from good relative income and fundamental growth.

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Source for all data and charts (if not indicated otherwise): UBS Asset Management, a business group within UBS.

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