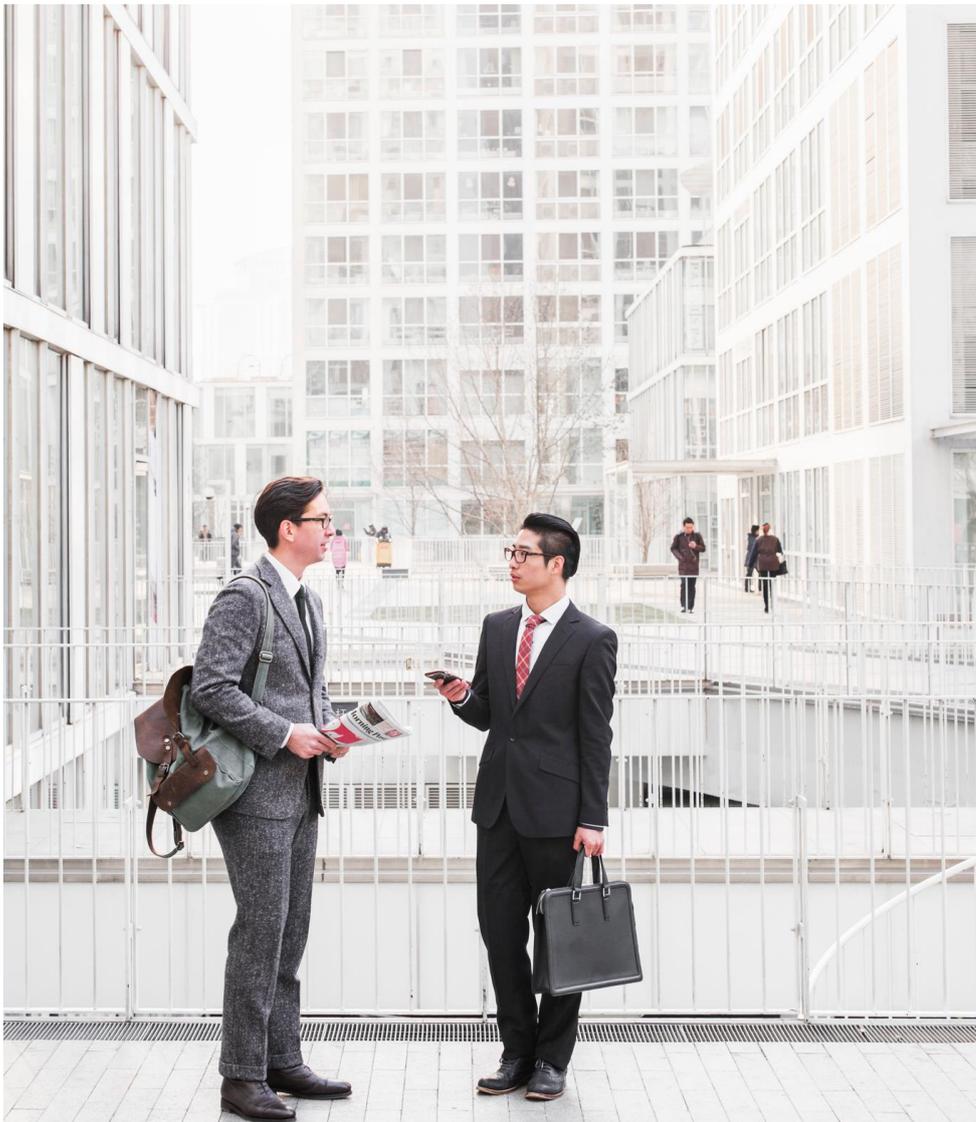


# The nature of income

The true and reliable nature of commercial real estate income

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Private real estate income is steady and reliable. We should not oversell the return point but rather take comfort in its absolute persistence.

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# Cash is king

Income stability is one of the key features attracting institutional investors to private commercial real estate. The total return produced by real estate is dominated by its income component, providing the sector with a reputation for low volatility. Stable income can help investors weather turbulent economic conditions and avoid having to realize losses that may recover in the longer term.

## Understanding income

Property-level income is the absolute amount (in any currency) produced from property operations. Simply stated, it is the collected rent minus operating expenses. Real estate investors refer to this as Net Operating Income (NOI) and it is directly comparable to Corporate Earnings.

Like Earnings, NOI represents an asset's performance from conducting business in a specific market. It is measured before the decision to reinvest in the asset and before the impact of financing. It represents the basic periodic performance of an asset, recognizing that some of the income will be either reinvested or retained, used for debt-service or made available for distribution.



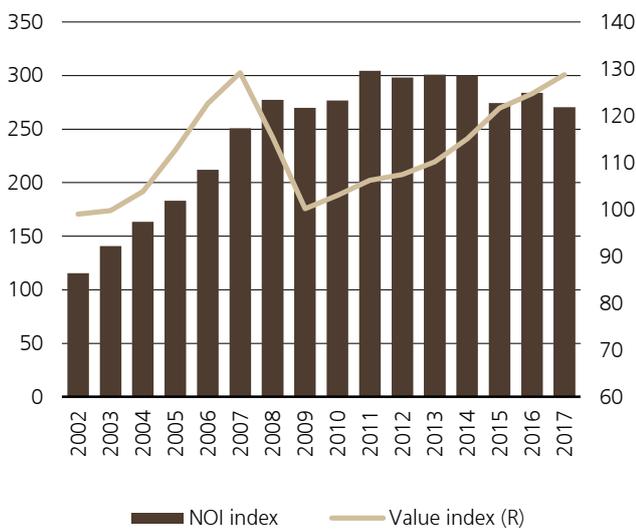
## Income only

The income component of performance is considered the lower-risk component of the total return, compared to appreciation. Due to its periodic receipt and attachment to fundamentals, it is viewed as more consistent and reliable than the appreciation component, which may come or go over time and is only realized upon sale.

These are the characteristics that drew our attention to the income component in the first place. Thus, showing that property income insulates our investments from some pricing dynamics will be an important feature of real estate assets. The higher proportion of total return that is delivered from income, the more reliable the investment performance and the shorter the duration. Furthermore, if it can be demonstrated that property income is less than perfectly correlated with market pricing, the volatility of performance is mitigated.

Figure 1 compares an index of same-store NOI to a same-store value index. Several points of this chart are important to our understanding of stable real estate income and the impact of market pricing. First, notice that the columns, representing the NOI index, are not always rising but vary only slightly from year to year. There are many factors affecting this result and one of those factors is the contractual nature of commercial real estate. Property generally operates under a series of rent contracts for various spaces within the asset. These are typically multi-year contracts which vary depending on the property type. Thus, when market rents change, only the space transferring from one contract to another is affected by the market change. Over time, the entire property will turn but this typically occurs gradually over years.

**Figure 1: NOI index**



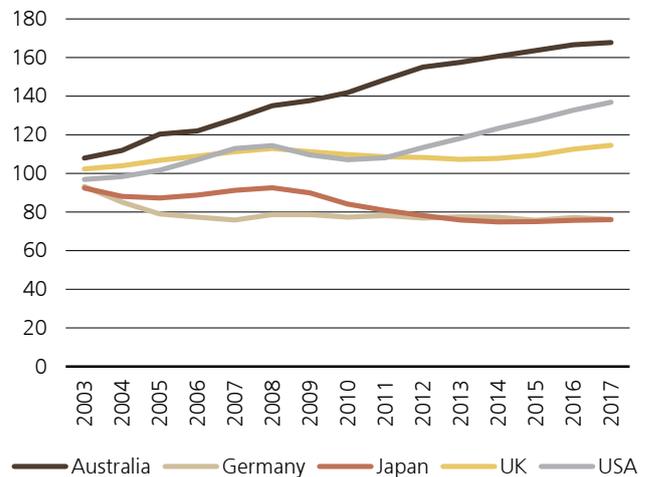
Source: MSCI Global Intel, September 2018

A second point to note is the relationship between NOI and value. Recall the severity of the Global Financial Crisis during the years of 2008 and 2009. Values fell dramatically, in response to the extreme uncertainty entering the financial market. All asset values were affected and commercial real estate was not spared. However, note how the values fell but income remained virtually unchanged. Since the crisis was one of spiking uncertainty and rising risk premiums, values of all assets were affected. During this time, tenants continued to operate, allowing them to occupy contracted space and pay current rent. This resulted in very stable income, during a time of value volatility. Those who held property through this event witnessed a dramatic recovery and avoided realizing losses – all the while collecting similar periodic income.

## Stable but not the same

The fact that real estate income is stable, at the property level, does not imply that all assets and all markets produce the same income. There are diversification benefits to combining multiple assets of different property types across various locations, as shown in Figure 2. This chart shows the compound income growth pattern across different countries in local currency. Each line represents a country index following the average nominal NOI growth for all measured property. Investors can select property-type, country, currency, and various other features to fit specific goals. Building a portfolio of different assets following these characteristics will diversify specific risks, while achieving desired objectives.

**Figure 2: Compound income growth**



Source: MSCI Global Intel, September 2018

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