BEOS Survey 03: June 2013

Corporate Real Estate: Performance Indicators and Benchmarks Compared to Other Asset Classes

INTRODUCTION

The BEOS Survey analytic series publishes the latest research findings in the corporate real estate segment on a quarterly basis. While its first two issues took a detailed look at the various property types and stock structures involved, this issue will devote itself to the performance of corporate real estate as investment property. The performance is expressed in the form of empirical data and indicators that are put in relation to the established asset classes. They are supplemented by market data definitive for corporate real estate.

Market and return ratios for German corporate real estate are reported within the framework of an initial survey in 2010.[1] But to this day, barely any long-term time series have been published on a regular basis. At the same time, figures that were published would often lump together the categories commercial, industrial, or logistics, making a differentiated approach all but impossible.

COMMERCIAL REAL ESTATE – A HIGH-YIELD SEGMENT IN THE US

In other markets such as the United States, the corporate real estate segment has been firmly established for some time, and is sometimes referred to with the terms “industrial” and “logistics.” The rate of return, as reflected in the distributions disbursed, may also be represented by comparing long-term time series. Compared to the office and retail categories, a long-term holding period of 10 to 15 years will return an above-average performance.[2]

Segment \ Years	1	3	5	10	15
Retail	-0.22	-1.88	4.69	9.51	9.04
Office	-1.96	-5.26	4.39	6.41	9.04
Industrial real estate	**-3.74**	**-5.52**	**3.16**	**6.94**	**9.20**
Total NPI	-1.48	-4.70	3.79	7.16	8.78

Fig. 1: NCREIF Property Index (NPI) Total Returns USA in % by segment and holding period[2] (source: NCREIF 2013)

HIGH CATCH-UP POTENTIAL COMPARED TO PRE-CRISIS LEVEL IN EUROPE

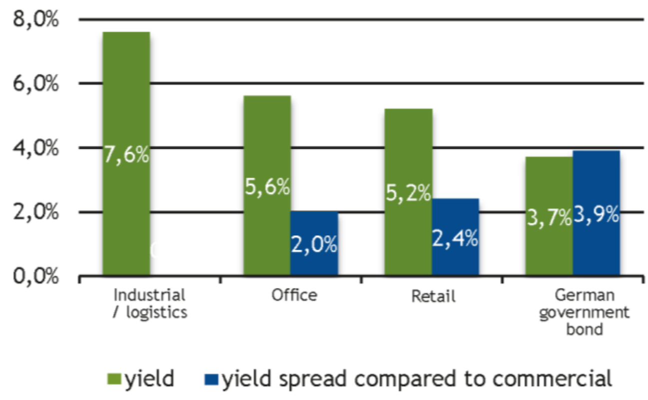

Fig. 2: Average 10-year dividend yield in Europe, by segment (source: Prologis 2012)

The yield performance of corporate real estate in Europe may be determined by studying long-term logistics time series, because other commercial properties are often subsumed under this category. Here, the situation appears to repeat patterns familiar from the US market. Over an extended average ownership period of ten years, the segment returns a markedly higher yield that office, retail, or German government bonds.[3] Prologis analysed the average yield rate for the segments logistics, office and retail across Europe over a ten-year period. The findings suggest a clear yield spread of at least 2 % between the office and retail segments, on the one hand, and the logistics segment, on the other hand, which was found to have an average yield rate of 7.6 %. The rate and stability of the commercial yield performance is particularly interesting for dividend-oriented investors who rely on secure cash flows.[3]

In the United States, the empirically backed strengths of the commercial segment are known to a larger investor basis, and the fact has boosted the acceptance and fungibility of assets belonging in the segment. It is obvious when you look at its amazing recovery from its low point in the wake of the financial crisis. Despite the harsher loss in values that US real estate suffered, they are back up at two-thirds of the pre-crisis level, whereas European stock has recovered at an average rate of barely 1.3 %.[3]

STABLE TOTAL RETURN FOR GERMAN CORPORATE REAL ESTATE

With the issue of the vague aggregation of corporate real estate in the commercial real estate segment remaining unresolved, corporate properties are still not listed as separate segment by the German Property Index (GPI) and the Deutscher Immobilien Index (DIX), but are subsumed under the commercial / industrial category. The latter is clearly distinguished from retail and office real estate and permits a comparison of segments even on the international level. Both indices map the trend of the total return by segment, but rely on different data sources. As a transaction-based index, the GPI tracks potential investments in the latest top properties, whereas the DIX as valuation-based index focuses on a basket of portfolio properties that is reshuffled from time to time. This explains why the scores returned by either index do not always match.[4,5]

Historically, it was especially the office segment that achieved a very high return on investment, according to the GPI, while also showing a higher annual volatility, as did retail property.[4] During economic boom cycles, the total return of office real estate tended to outperform commercial real estate on average. This cyclicality is definitively caused by valuation gains, whose high degree of volatility moves in sync with economic cycles. The commercial segment, by contrast, is characterised by stable returns, which not only paid high dividends but also remained stable across cycles and never dipped into the negative range, unlike office real estate.

Even prior to the onset of the most recent economic crisis, it was obvious that classic real estate cycles generally have a flatter curve. Forecasts for 2012 and thereafter suggest moreover a convergence of the classes on a comparable total return level between 5 % and 10 %. With a total return of 7.5 %, the commercial segment turned out to be the real estate segment with the finest development dynamic.[4] The robustness of corporate and commercial real estate is particularly conspicuous during down cycles. Its total returns barely softens whereas the segments retail and office are noticeably more sensitive, and keep showing upward and downward spikes. These segments are evidently more susceptible to cyclic economic influences.

The DIX, by contrast, registered the highest total return of all commercial segments in absolute terms between 1997 and 2007. 2008 was characterised by a deeply negative performance. The property valuations suggest that results had overshot the mark. It should be taken into consideration that the industrial assets included in the portfolios of asset holder supplying data for the DIX are too low in number to present a truly representative picture. Nonetheless, the industrial segment yielded higher total returns over holding period of one, three and ten years than the office segment, even though it fell slightly short of the retail segment. In terms of the net cash flow yield, the industrial segment easily outperforms all other segment at 7.7 %.[5]

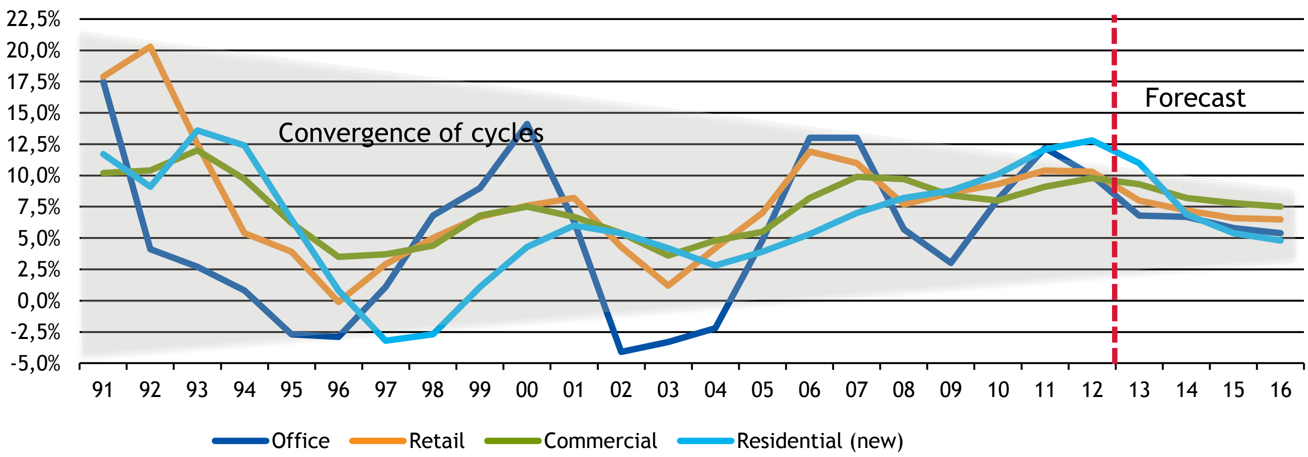

Fig. 3: German Property Index (GPI): Annual change of the total return, in %, by segment[4] (Source: BulwienGesa AG 2013)

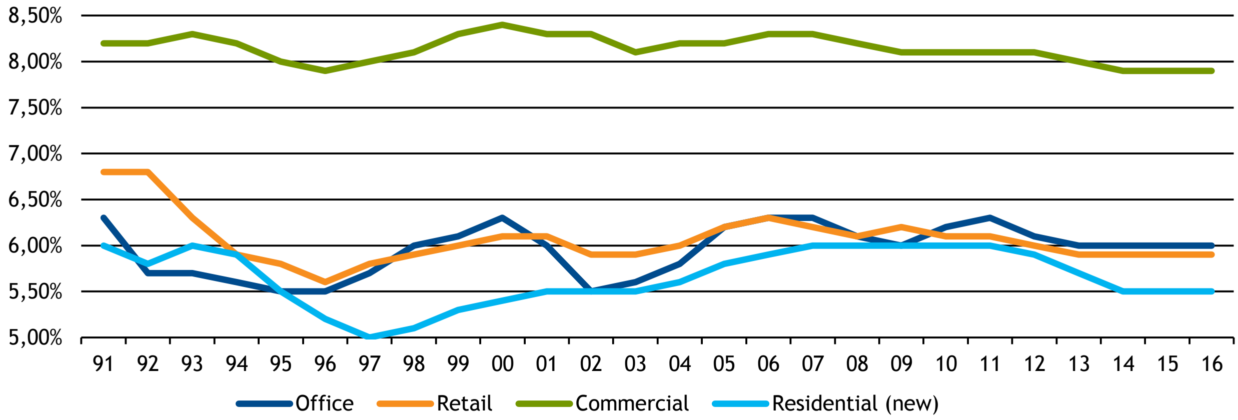

Fig. 4: German Property Index (GPI): Annual change of the cash flow, in %, by segment[4] (Source: BulwienGesa AG 2013)

HIGH RATE OF RETURN COMBINED WITH LOW-LEVEL VOLATILITY

Rent revenues generated from corporate real estate have proven particularly stable. Since the turn of the millennium, yields have softened by a mere 30 basis points to around 8 % today.[4] Other segment have been more volatile, and remain on a much lower level. Thus, the annual change in dividend yield, too, has been demonstrably more stable than in other segments.

Over extended holding periods, direct investments in corporate real estate returned a higher yield than did commitments in office or retail real estate. But few investors have the asset management competency to prosper in this sector. The sensible thing to do from an investor's point of view is therefore to benchmark the performance achievable with alternative investments opportunities, especially the performance of institutional funds and corporate bonds. Commercial yields could be compared to the SFIX German Quarterly Spezialfonds Index published by the IPD Investment Property Database, and with with Markit iBoxx corporate bond index. Most funds included in the SFIX index are almost exclusively committed in other types of use, such as office and retail. They have, across the board, proven to pay much lower rates of return than corporate real estate.[4,5,6] Corporate bonds as the capital market equivalent of corporate real estate are prone to serious fluctuations. On average, the commercial segment realised returns of around 8.8 %[4], whereas the SFIX generated but 2.8 % during the same period of time,[5] and corporate bonds only 2.3 %.[6] Direct comparison with the SFIX reveals a safety margin of well over 4 % to 6 %.

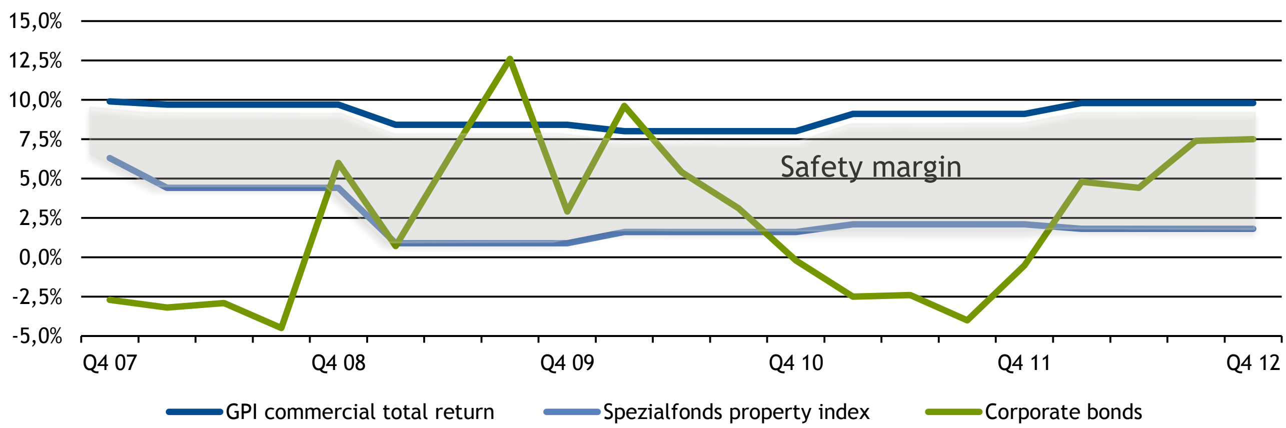

Fig. 5: Yield performance of the GPI Gewerbe compared to the SFIX German Quarterly Spezialfonds Index and the corporate bonds rated by the Markit iBoxx EURO Corporate Bond[4,5,6] (source: BulwienGesa AG, IPD, Deutsche Börse 2012)

CORPORATE REAL ESTATE PERFORMANCE

The sound performance of corporate real estate is based, as suggested above, mainly on a stable and high cash flow combined with a low default risk, low volatility, and moderate appreciation. This profile is rooted in the diversity of the use options, along with the wide spectrum of rent rates and lease terms. Listed below are the average market values for rent rates, lease terms, and yield rates for corporate real estate.

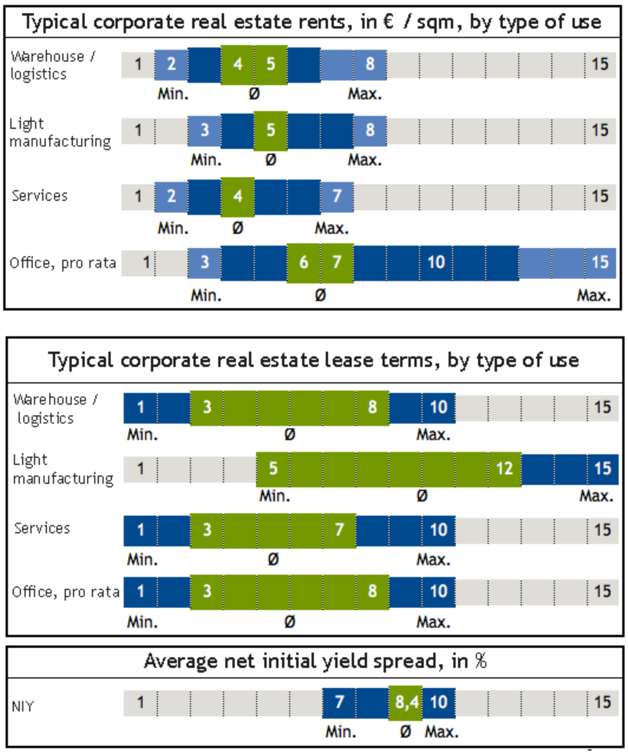

Fig. 6: Average market values for corporate real estate[1] *(source: BulwienGesa AG 2010)*

Especially as far as rent rates and lease terms are concerned, there are massive differences depending on the type of uses and the corporate property type. The drilldown lists maximum (dark blue) and minimum (green) rents, terms, and yields, as well as the average bracket. In the case of rent rates, the absolute maximum and minimum (bright blue) are posted as well. All of the values are based on the cross-type surveys of the corporate property types transformation, light manufacturing, logistics, and business park. [1]

Depending on the floor area type, corporate real estate rents can strongly diverge Office space, for instance, commands much higher rents than simple warehouse space. The differences in rent rates depending on the type of use are complemented by differences in lease terms for the same reason. These, too, can differ considerably, again depending on the type of use. The longest leases tend to be signed for manufacturing plants. Unlike simple warehouse areas, whose average lease term can be anywhere from one year to three years, modern logistics area rent out for terms of three to five years.

DIVERSE INVESTMENT OPPORTUNITIES FROM CORE TO OPPORTUNISTIC

At around 8.4 %, the average net initial yield (NIY) across types underlines the yield performance of corporate real estate compared to retail and office assets (NIY for retail and office properties: 4.5 % / 6.7 %). Since these are obviously average figures, and since corporate real estate need to be valuated on the property level, just like any other real estate type, it pays to differentiate between corporate real estate types.[1]

The metrics reported here refer to corporate real estate collectively across types of use. They present an average snapshot of corporate real estate and the floor area it includes. Depending on the property and the type of floor area, this will let you pursue any of various investment strategies.

OUTLOOK

Survey No. 4 will therefore undertake a differentiated study of the several corporate real estate type, highlighting strengths and weaknesses. It will be published in October 2013.

1) BulwienGesa AG et al., 2010 Gewerbe- und Industrieimmobilien in Deutschland, bos.net/sites/beos.net/html/media/pdfs/downloads/BulwienGesa_Gewerbe_Industrie-immobilien_2010-06-08.pdf
2) NCREIF 2013, http://www.ncreif.org/, Chicago
3) ProLogis, 2012, Opportunities in the european industrial market, San Francisco
4) BulwienGesa AG, 2013, German Property Index
5) IPD (Investment Property Databank Ltd.), 2013, DIX; SFIX, London
6) Deutsche Börse AG, 2013, Markit iBoxx Corporate Bond, Eschborn

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