

US Real Estate: Buy, Hold or Fold?

by Floris van Dijkum and Elysia Tse

In Brief

- ▶ Unlevered core US commercial real estate (CRE) are projected to deliver between 6% to 7.5% average annual returns over the next decade.
- ▶ CRE offers attractive income yields vs. stocks and bonds.
- ▶ We recommend a full allocation to CRE given uncertain economic environment.

Executive Summary

Coming out of the most devastating CRE downturn in history, pricing for well-leased, stabilised properties in most US markets is strong with capitalisation rates in the 4% to 6% range. This paper explores whether buying at such tight yields is appropriate.

With expectations of subdued economic growth over the next decade, BlackRock forecasts unlevered core US CRE to deliver between 6% to 7.5% average annual returns during the same period. Although these returns are lower than historical averages, they are higher than the expected returns for fixed income. Additionally, core US CRE appears attractive when compared to the expected returns for stocks (which are leveraged) over the next decade. As a result, CRE offers a compelling investment option among investors seeking yield, particularly in light of the 10-year Treasury yielding around 2%.¹

Real estate is typically a long-term investment. Over the long-term, CRE offers a compelling blend of high income and competitive risk-adjusted returns when compared to other asset classes. We recommend institutional investors only consider strategic allocations to CRE in the context of a long-term investment perspective. While we do not advocate an overweight to real estate given the significant economic uncertainties, we believe that it is still a good time for strategic institutional investors to be fully allocated to CRE if they are not already. For those who currently have an overweight to real estate, it could also be a good time to dial back on risk and bring the allocation back to neutral.

Structural Shifts to Likely Subdue Economic Growth

We expect the US economy to experience lower GDP growth over the next decade. Structural shifts are underway that are likely to affect investment patterns and returns for all asset classes. The aging population in the U.S. (though to a smaller extent than in other developed countries) is expected to slow the growth of the labour force and potentially reduce growth in both real GDP and earnings. Additionally, the current deleveraging process underway in the U.S. (and in the rest of the developed world) combined with an aging population in developed countries may increase savings rates. These trends are expected to result in lower real interest rates, substantial pools of investment capital and strong investor demand for income-producing assets. Low real interest rates and a subdued long-term inflation outlook are expected to underpin lower than average returns in all asset classes, including CRE.

About the Authors

Floris van Dijkum is a Managing Director for BlackRock's Real Estate Equity Group. Mr. van Dijkum has 22 years of global real estate experience and earned a Bachelor of Arts degree from the University of Virginia.

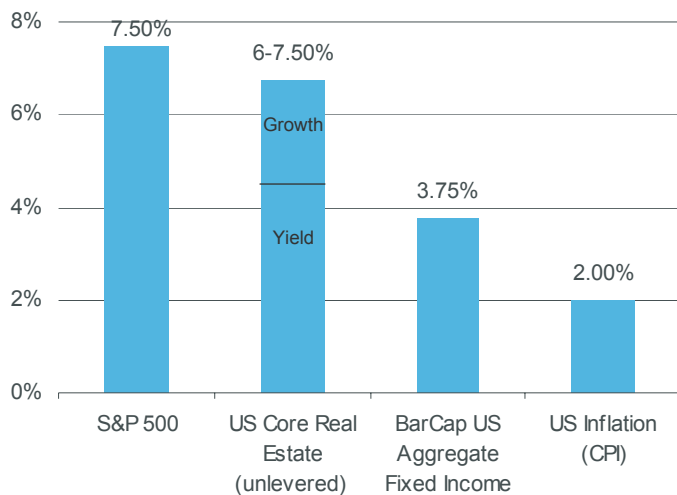
Elysia Tse is a Vice President for BlackRock's Real Estate Equity Group. Ms. Tse is part of the team that develops global investment strategy and conducts global real estate market and risk analyses. Ms. Tse has 10 years of real estate experience and earned a Masters degree in Real Estate from Cornell University.

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Unlevered Core US CRE to Generate between 6% to 7.5% Annual Returns over the Next Decade

Given the economic headwinds, we recommend a full allocation to real estate with a weighting toward lower risk assets. Core real estate equity, lying on the lowest risk/return spectrum within the asset class, meets the requirement. Over the next decade, BlackRock projects unlevered core real estate in the U.S. to generate average annual total returns in the range of 6% to 7.5%. Our projection consists of 4.5% to 5.5% current cash yield and anticipated earnings growth of 1.5% to 2% per annum which is in line with our inflation expectation but below the historical average of 2.2% (See **Figure 1**). The expected total returns for unlevered core CRE in the US appear relatively attractive over the next decade, as they are much higher than those of bonds, although with higher risks. Additionally, the unlevered core CRE returns in the U.S. are attractive when compared to the expected returns for stocks (which are levered) over the next decade.

Figure 1. Expected Annual Average Total Returns: CRE vs. Stocks and Bonds

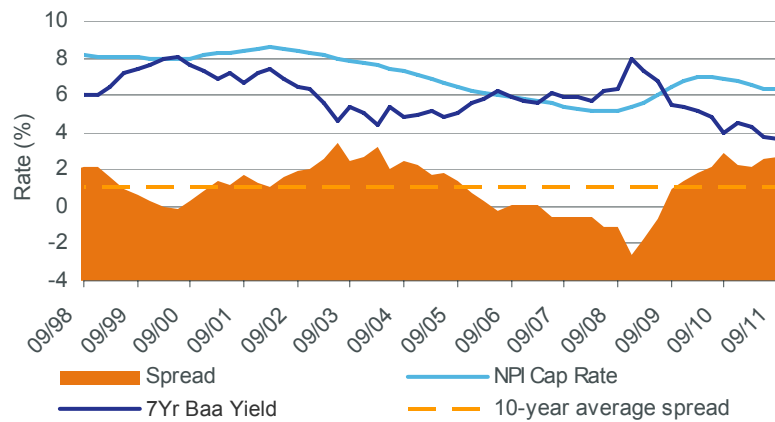


Source: BlackRock projections for the next 10 years.

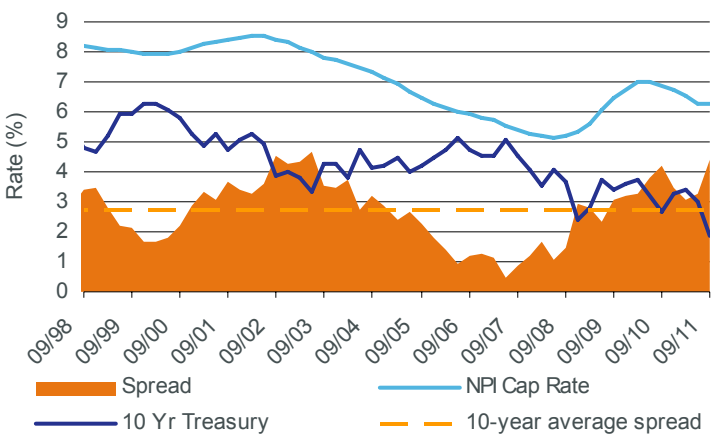
One of the risks to our return projection lies in another recession leading to lower earnings growth and lower returns. Even if we cut our growth rates from our current 1.5% to 2%, real estate is expected to deliver respectable returns relative to stocks and bonds, as no growth would also impact returns in those asset classes as well. Another risk to our return projection lies in persistent high CRE risk premia as debt problems in the U.S. and developed European countries have a substantial impact on the CRE capital market for an extended period. With the 10-year Treasury yielding around 2.0% and Baa yielding 3.6%, risk premia for CRE have risen over the past six months and are currently much higher than their 10-year averages (see **Figure 2**). If CRE risk premia rise further and existing bond yields remain stable, value would fall. However, over the long term, should risk premia revert to the mean, investors could experience CRE appreciation. As a result, CRE is expected to continue to attract capital from institutional investors that need to balance their exposure to the asset class over the long term.

Figure 2. CRE Risk Premia

CRE Cap Rate vs. Baa yield spreads



CRE Cap Rate vs. 10-Year Treasury yield spreads



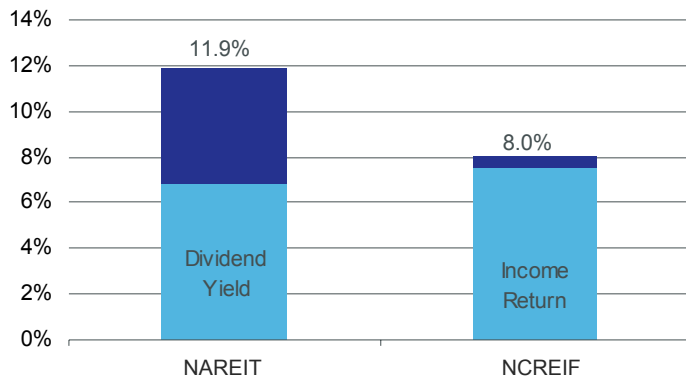
Source: Economy.com. Historical NPI cap rate data through 6/30/11; Treasury and Baa data through 9/28/11; NPI cap rate as of 9/28/11 is estimated by BlackRock.

CRE Remains Attractive vs. Stocks and Bonds

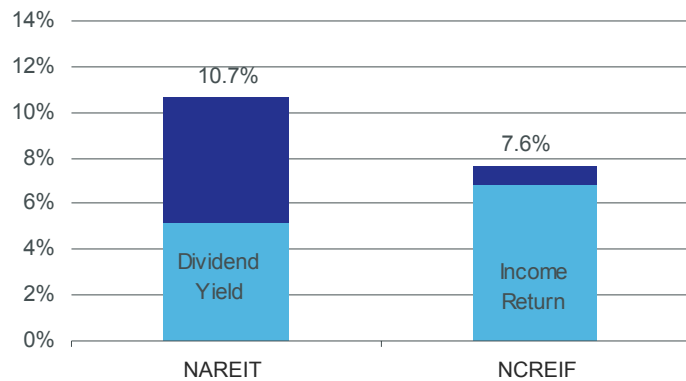
CRE has offered an attractive blend of high income returns and competitive risk-adjusted total return when compared to other asset classes over the past 20 years. Income has comprised the majority of both private and public real estate equity total returns (see **Figure 3**). Current and long-term historical average income yields for both public and private real estate equity sectors have been much higher than those of bonds and stocks.² Furthermore, private real estate equity has provided competitive risk-adjusted returns when compared to stocks and bonds. Over the past 20 years, with almost double the risk, stocks (represented by the S&P 500) only delivered 130 bps of extra return relative to private real estate equity (see **Figure 4**). As a proxy for leveraged real estate, Real Estate Investment Trusts (REITs) have outperformed stocks during this period.

Figure 3. Income Represents Majority of Private and Public Real Estate Equity Total Returns

30-Year Average (2Q 1982 - 2Q 2011)

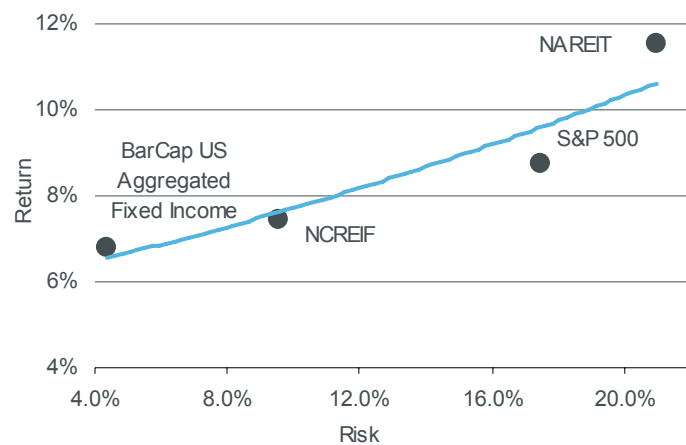


10-Year Average (2Q 2002 - 2Q 2011)



Source: NCREIF Property Index
 Note: Based on year-over-year return from 2Q 1982 to 2Q 2011, annual frequency, As of June 2011

Figure 4. 20-Year Historical Total Return & Risk By Asset Class (3Q 91 - 2Q 11)

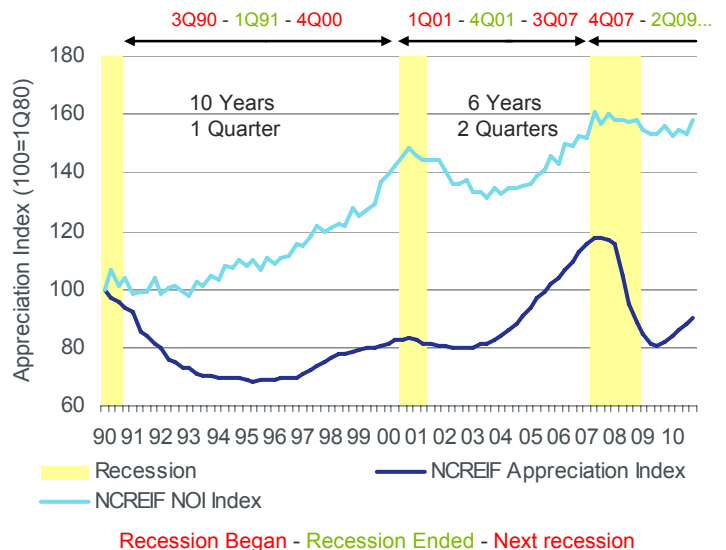


Source: NCREIF Property Index, FSTE NAREIT All Equity REIT Index, Barclay, Ibbotson, BlackRock
 Note: Based on year-over-year return from 3Q 1991 to 2Q 2011, annual frequency, As of June 2011

CRE Fundamentals Healthier than Housing

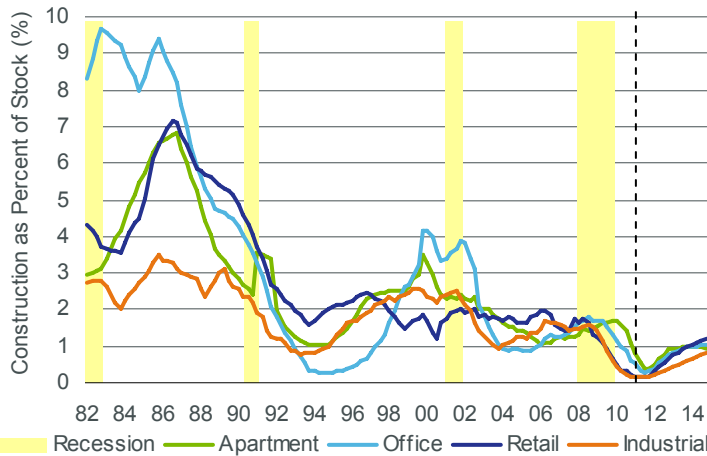
The US economy has been out of recession for approximately two years³ with the CRE market lagging the recovery, as it has historically done (see **Figure 5**). During this cycle, the real estate capital market recovery has led the recovery in space market fundamentals. CRE values (represented by NCREIF Property Index) are now more than a year into recovery while CRE fundamentals are beginning to recover. The apartment sector space market fundamentals are more than a year into the recovery, leading all major CRE sectors; office space market fundamentals are only two quarters into recovery; industrial occupancies are improving but rents are still lagging; and retail fundamentals are not yet in recovery. Overall, we are still in the early stage of the CRE cycle when compared to the typical 6.5- to 10-year cycles experienced in the early 1990s and 2000s. Looking forward, due to historically low supply levels (see **Figure 6**), CRE does not need much additional demand to significantly improve occupancy and net operating income (NOI) growth, which offers upside for this cycle as the market recovers. Nonetheless, the near-term downside risks lie in the threat of a double-dip recession and its impact on CRE NOI growth and value recovery.

Figure 5: Past Cycles



Source: National Council of Real Estate Investment Fiduciaries (NCREIF), BlackRock

Figure 6: Historical CRE Construction by Property Type



Source: REIS, CBRE

1. As of October 5, 2011
2. Floris van Dijkum and Elysia Tse. Implications of the US Government Debt Downgrade and Rent Market Volatility on Commercial Real Estate. BlackRock, August 2011
3. Although it does not seem that the U.S. is in a recovery under the current economic environment, the U.S. is technically two years into the economic recovery.

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The National Council of Real Estate Investment Fiduciaries ("NCREIF") Property Index (the "Index" or "NPI") and the National Council of Real Estate Investment Fiduciaries ("NCREIF") Fund Index – Open-ended Diversified Core Equity (NFI-ODCE) have been taken from published sources. The NPI is based on the unleveraged performance of stabilized, income-producing U.S. apartment, industrial, office, R&D, hotel and retail properties owned by tax-exempt entities reporting to NCREIF. The Index excludes cash and other non-property related assets and liabilities, income and expenses.

The Moody's/REAL Commercial Property Price Index ("CPPI") is published by Moody's Investor Service, Inc. The CPPI is based on the repeat sales of the same assets at different points in time. See www.moody's.com for additional information regarding the calculation methodology of the CPPI.

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Conclusion

Core real estate, as a long-term investment, plays an important role in a mixed-asset portfolio, especially during uncertain economic times such as these. Although significant economic risks exist, core US CRE is expected to provide attractive returns in a slow-growth environment. In the meantime, structural shifts underway should result in continued low real interest rates and a subdued inflation outlook over the next decade. These trends should underpin lower than average returns in all asset classes, including CRE. We believe pricing for core CRE is appropriate, and CRE will remain attractive compared to other asset classes and favourable among investors starved for yield. While we don't advocate an overweight to real estate given the significant economic uncertainties, we believe that it is still a good time for strategic institutional investors to be fully allocated to CRE if they are not already. For those who currently have an overweight to real estate, it could also be a good time to dial back on risk and bring the allocation back to neutral.