MSCI Global Intel Report Property Income Risk & Performance

Max Arkey
MSCI Real Estate

National Market - USA

As of 2016 Q3, more than a third of U.S. leases tracked by MSCI were set to expire in less than 40 months. Nearly 60% of the underlying contracted rents in these leases were tied to office assets, two-thirds of which were located in CBDs. Timing matters for these expiring leases, especially for contracts ending in the next two to three years, a period when U.S. domestic and foreign policy priorities could experience transition. For institutional investors, uncertainty — whether upside or downside — requires careful management of risks to the income stream. The analysis of the CBD office sector in these pages covers the four primary dimensions of risk in IRIS (MSCI's property income risk and performance service): concentration, lease length, market conditions, and tenant credit.

Sector Focus - CBD Office

Two of every five dollars held by institutional investors in U.S. non-residential rental contracts could be traced to CBD offices as of 2016 Q3. And within this property type, nearly half (48%) of assets were located within the big three CBDs of the Northeastern corridor: New York, Boston, and Washington. The average CBD office lease in the U.S. was set to expire in 5.6 years, making it only a few months longer than the 5.2-year average for the overall U.S. commercial market. If expiring leases were to roll to current market rents, investors could reasonably expect a 4% premium on their CBD office allocations, with rents in this property type rising by 19.1%, on average, above current contracts (versus a 14.8% rise in rents for the all-sector average).

USA: National Overview As Of September 2016

THE FOUR MAJOR COMPONENTS OF REAL ESTATE INCOME RISK*

		CONCENTRATION	TERM	MARKET	CREDIT
		CONTRACTED RENT *% of national market*	REMAINING LEASE TERM *years (weighted)*	% GAIN / LOSS TO LEASES *market vs contract rent*	TENANT RISK LOW MED HIGH
	ALL PROPERTY	100.0%	5.2	14.8%	
BY EXPIRATION	2016	3.4%	—	25.8%	
	2017	9.9%	—	13.6%	
	2018	11.1%	—	8.9%	
	2019	10.8%	—	10.7%	
	2020	10.7%	—	15.4%	
	2021 and beyond	54.1%	—	16.1%	
BY LOCATION	LA/OC/Riverside	13.5%	4.9	14.2%	
	SF Bay Area	11.6%	4.7	27.1%	
	NY/NNJ/LI	11.3%	6.4	31.5%	
	Chicago	10.1%	6.3	11.6%	
	Washington DC	8.3%	5.6	0.5%	
	Boston	7.1%	5.4	15.0%	
	South Florida	4.2%	4.4	11.9%	
	Seattle	4.1%	5.1	18.7%	
	Houston	3.4%	5.3	16.2%	
	Atlanta	3.3%	6.2	3.8%	
BY SECTOR	CBD Office	38.0%	5.6	19.1%	
	Industrial	20.6%	4.3	7.1%	
	Retail	20.4%	6.0	18.4%	
	Suburban Office	20.3%	4.5	11.0%	
BY TENANT INDUSTRY	Banks/insurance (OFF)	10.5%	4.7	18.1%	
	IT/R&D/consulting (OFF)	6.7%	5.1	11.0%	
	Legal services (OFF)	5.6%	6.3	17.8%	
	Software & media (OFF)	4.0%	5.4	17.2%	
	Manufacturers (IND)	3.9%	4.3	8.4%	
	Wholesale traders (IND)	3.6%	4.3	7.9%	
	Retailers (OFF)	3.4%	6.7	14.1%	
	Medical/dental (OFF)	3.4%	5.6	8.7%	
	Mfg ex-pharma/med (OFF)	3.3%	5.6	26.3%	
	Clothing/fashion (RET)	3.3%	5.1	18.6%	

Source: MSCI (IRIS)

**based on the current status and expiration schedules of actual lease contracts held by institutional owners. This is not a forecast.*

CONCENTRATION RISK

		ALL SECTORS	CBD OFFICE
		CONTRACTED RENT *% of national market*	CONTRACTED RENT *% of property sector*
	USA	100.0%	100.0%
BY EXPIRATION	2016	3.4%	3.1%
	2017	9.9%	7.4%
	2018	11.1%	10.3%
	2019	10.8%	9.6%
	2020	10.7%	8.5%
	2021 and beyond	54.1%	61.1%
BY LOCATION	LA/OC/Riverside	13.5%	7.4%
	SF Bay Area	11.6%	11.1%
	NY/NNJ/LI	11.3%	22.0%
	Chicago	10.1%	13.7%
	Washington DC	8.3%	12.8%
	Boston	7.1%	12.9%
	Seattle	4.1%	5.2%
BY TENANT INDUSTRY	Banks/insurance (OFF)	10.5%	19.0%
	Legal services (OFF)	5.6%	12.7%
	IT/R&D/consulting (OFF)	6.7%	11.4%
	Retailers (OFF)	3.4%	7.2%
	Software & media (OFF)	4.0%	6.3%
	Mfg ex-pharma/med (OFF)	3.3%	4.2%
	Accounting (OFF)	1.6%	3.3%
	Medical/dental (OFF)	3.4%	3.1%
	RE sales & leasing (OFF)	1.5%	2.9%
	Public sector (OFF)	1.1%	2.8%

KEY POINTS

- As of Q3 2016, expirations of CBD office leases were back-loaded relative to all U.S. commercial leases, with just over 60% of CBD office leases up for renewal after 2020 compared with an all-sector average below 55%.
- Nearly half (48%) of all institutional investment in U.S. CBD offices could be found in the big three Northeastern markets of New York, Boston, and Washington. The two major California markets (LA and the Bay Area) accounted for less than 20% of the national total.
- The tenant base for CBD offices differs from the overall non-residential market. The top five tenant groups for CBD leases include banks, law firms, consultants, media, and ground-floor retailers. These five groups together account for 57% of all CBD rents, but only 30% of all non-residential rental contracts held by investors.

TERM RISK

		ALL SECTORS REMAINING LEASE TERM *years (weighted)*	CBD OFFICE REMAINING LEASE TERM *years (weighted)*
	USA	5.2	5.6
BY LOCATION	LA/OC/Riverside	4.9	5.3
	SF Bay Area	4.7	3.5
	NY/NNJ/LI	6.4	6.9
	Chicago	6.3	6.1
	Washington DC	5.6	6.3
	Boston	5.4	4.7
	Seattle	5.1	5.5
BY TENANT INDUSTRY	Banks/insurance (OFF)	4.7	5.2
	Legal services (OFF)	6.3	6.8
	IT/R&D/consulting (OFF)	5.1	5.1
	Retailers (OFF)	6.7	7.5
	Software & media (OFF)	5.4	6.4
	Mfg ex-pharma/med (OFF)	5.6	6.6
	Accounting (OFF)	6.8	7.6
	Medical/dental (OFF)	5.6	4.1
	RE sales & leasing (OFF)	4.4	5.1
	Public sector (OFF)	4.8	5.0

**based on the current status and expiration schedules of actual lease contracts held by institutional owners. This is not a forecast.*

KEY POINTS

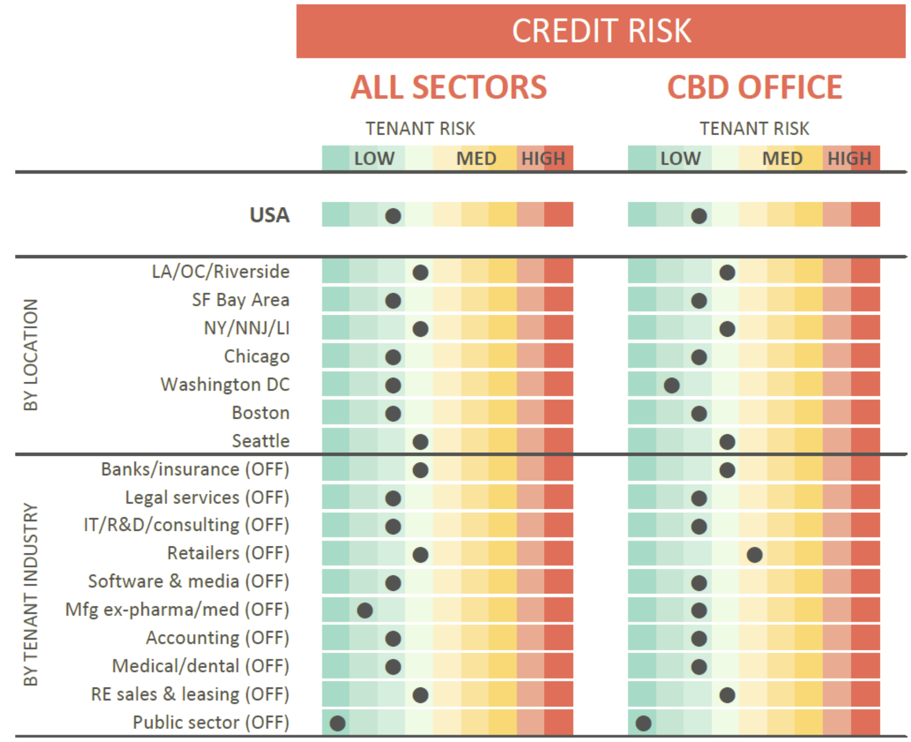
- The average commercial lease in the U.S. expires in 5.2 years, with the remaining lease term falling a few months short of the 5.6 year average for CBD offices.
- Of the major CBD markets in the U.S., the Bay Area leases were the most front-loaded with an average remaining lease term of just 3.5 years. New York, Chicago, and Washington were the only CBD markets with an average exceeding six years.
- Financial services firms as a group represent nearly one-fifth (19%) of all CBD leases. The remaining lease terms for these financial tenants averages 5.2 years, somewhat short of the CBD average of 5.6 years.

MARKET RISK

		ALL SECTORS % GAIN / LOSS TO LEASES *contract rent vs market rate*	CBD OFFICE % GAIN / LOSS TO LEASES *contract rent vs market rate*
	USA	14.8%	19.1%
BY EXPIRATION	2016	25.8%	36.5%
	2017	13.6%	20.9%
	2018	8.9%	17.4%
	2019	10.7%	18.6%
	2020	15.4%	25.8%
	2021 and beyond	16.1%	17.4%
BY LOCATION	LA/OC/Riverside	14.2%	11.5%
	SF Bay Area	27.1%	44.7%
	NY/NNJ/LI	31.5%	28.2%
	Chicago	11.6%	7.0%
	Washington DC	0.5%	1.2%
	Boston	15.0%	16.8%
	Seattle	18.7%	26.4%
BY TENANT INDUSTRY	Banks/insurance (OFF)	18.1%	22.1%
	Legal services (OFF)	17.8%	18.6%
	IT/R&D/consulting (OFF)	11.0%	13.2%
	Retailers (OFF)	14.1%	12.5%
	Software & media (OFF)	17.2%	19.1%
	Mfg ex-pharma/med (OFF)	26.3%	15.7%
	Accounting (OFF)	15.5%	17.7%
	Medical/dental (OFF)	8.7%	24.1%
	RE sales & leasing (OFF)	27.7%	33.4%
	Public sector (OFF)	3.7%	3.2%

KEY POINTS

- As of Q3 2016, CBD office leases were better placed for rental gains than the all-sector average. If all expiring leases were renewed at current market rents, the average U.S. lease would roll up by 14.8% compared to 19.1% for CBD offices. This CBD premium would be front-loaded, with potential gains on lease renewals occurring over the next five years and then largely aligning with the all-sector average by 2021.
- Potential gains on CBD office lease renewals in the Bay Area New York, and Seattle exceed the national average for this property type. In Washington, however, CBD leases rolling to open market rents would likely produce only marginal gains.
- Across most (but not all) tenant industries, potential gains tended to be higher for CBD offices than for the all-sector average.



Source: MSCI (IRIS) and Dun & Bradstreet

KEY POINTS

- Credit risks at the tenant level can be weighted and rolled up to identify discernible but often nuanced differences when aggregated across geography or tenant industries.

- Credit risks for CBD office tenants showed a degree of minor variation when aggregated to the metropolitan level. Tenants in Los Angeles, New York, and Seattle exhibited modestly higher aggregate risks. Washington, despite its limited potential for rental gains, held the lowest weighted risk score of the major markets, reflecting underlying differences in its local tenant base and distinguishing its risk/return profile among the major markets.

Author's Bio

Max Arkey
Vice President
Product Management
MSCI Real Estate

Max Arkey works in product management at MSCI Real Estate where he heads up indexes and market information products. These analytics are mission critical to the investment process for 19 of the top 20 largest global asset managers, all the way through to specialized domestic investors.

For further details contact: max.arkey@msci.com

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