The IPD Global Intel Report

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IPD GLOBAL INTEL REPORT

US COMMERCIAL PROPERTY PERFORMANCE & INCOME RISK

Q4 2014

MSCI

US TOTAL RETURNS **Q4 2014**

	3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
INFLATION	-1.4	0.8	1.7	2.1
BONDS	3.0	8.6	6.0	5.6
EQUITIES	4.8	13.4	15.5	7.8
LISTED PROPERTY	12.5	28.1	16.6	7.1
UNLISTED PROPERTY	3.0	11.5	12.6	7.9

RELATIVE TO UNLISTED PROPERTY (in basis points)

		3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
BY SECTOR	*Retail*	-24	13	-14	7
	Office	11	41	-64	-21
	Industrial	87	179	58	1
	Residential	-78	-209	129	38
BY MAJOR URBAN AREA	*Washington DC*	-109	-489	-150	-11
	New York City	21	-47	13	60
	Los Angeles	81	162	-16	39
	Chicago	-17	-109	-179	-183
	Boston	-68	13	13	12
	San Francisco	163	514	381	184
	Dallas	-53	-28	67	-29
	Atlanta	62	126	-199	-166
	Miami	-1	143	-36	-28
	Houston	-31	45	85	252

US INCOME RETURNS **Q4 2014**

	3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
UNLISTED PROPERTY	1.3	5.3	5.9	6.0

RELATIVE TO UNLISTED PROPERTY (in basis points)

		3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
BY SECTOR	*Retail*	7	22	24	19
	Office	-5	-8	-4	-1
	Industrial	12	48	57	50
	Residential	-10	-49	-65	-78
BY MAJOR URBAN AREA	*Washington DC*	-12	-27	-40	-38
	New York City	-11	-58	-59	-46
	Los Angeles	-8	-31	-18	-21
	Chicago	8	26	30	30
	Boston	-3	-26	-36	-50
	San Francisco	-10	-39	-30	-21
	Dallas	9	53	51	52
	Atlanta	9	67	68	45
	Miami	2	5	1	-19
	Houston	6	31	13	30

Sources: MSCI for equities, listed property, unlisted property (IPD US Quarterly Index); JP Morgan (bonds); and US Bureau of Labor Statistics (inflation)

IPD GLOBAL INTEL REPORT

US COMMERCIAL PROPERTY PERFORMANCE & RISK **Q4 2014**

SPOTLIGHT THIS QUARTER **HOUSTON**

Unlisted real estate in Houston provided investors with an annualized return of 10.4% over the past 10 years (previous page), outperforming other major US cities over the same period as well as other major asset classes. By Q4 2014 Houston's performance had slipped below the IPD US Quarterly Index for unlisted property. This paralleled a slide in oil prices, a commodity closely tied to the city's economy. Houston property owners may be left to wonder, how secure is my investment here, especially my income stream? In this issue, we mine MSCI's IPD Rental Information Service (IRIS) to investigate.

US REAL ESTATE INCOME RISK—As of Q4 2014, more than half the US tenant leases tracked by MSCI were set to expire by 2018. Those leases that came due in late 2014 were well positioned for gains, with leases ready to roll to market rates averaging more than 20% above expiring contracts. Expiring leases in New York and the Bay Area are particularly poised for future gains if they renew at current market rates. More than half of contracted rent in the institutional US market falls in the office sector, with investors generally favoring CBD over suburban spaces. Industrial properties are the next biggest concentration but these leases have shorter average terms than office or retail as well as fewer opportunities for rolling to higher market rates. Credit risks can be masked when individual tenants are pooled to higher categories, but nuances exist nonetheless, such as the slightly elevated risks associated with industrial and retail mall tenants.

US REAL ESTATE INCOME RISK* Q4 2014

		CONCENTRATION	TERM	MARKET	CREDIT
		CONTRACTED RENT *% of national market*	REMAINING LEASE TERM *years (weighted)*	% GAIN / LOSS TO LEASES *contract rent vs market rate*	RISK SCORE LOW MEDIUM HIGH
	US ALL PROPERTY	100.0%	5.1	7.9%	
BY EXPIRY	2014	3.8%	—	22.1%	
	2015	11.1%	—	2.9%	
	2016	11.8%	—	2.7%	
	2017	12.6%	—	5.9%	
	2018	12.1%	—	3.6%	
	2019 & beyond	48.6%	—	11.1%	
BY METROPOLITAN AREA	LA / OC / Riverside	12.7%	4.5	2.4%	
	Washington DC	11.0%	5.7	2.2%	
	SF Bay Area	11.0%	4.7	19.2%	
	NY / NNJ / LI	9.1%	6.0	26.3%	
	Boston	6.0%	5.5	11.5%	
	Houston	5.3%	5.8	3.8%	
	Chicago	4.7%	6.6	12.1%	
	Seattle	4.5%	5.7	5.7%	
	South Florida	4.5%	4.0	5.0%	
	Dallas / Ft. Worth	4.4%	5.5	-9.1%	
	Denver	2.3%	6.4	17.4%	
	San Diego	2.2%	2.9	-1.9%	
	Atlanta	2.0%	5.1	2.6%	
BY PROPERTY SECTOR — OFF	CBD Office	36.3%	5.7	12.6%	
	Suburban Office	21.5%	4.5	5.4%	
IND	Warehouse	18.3%	4.1	3.8%	
	Flex/R&D	2.5%	2.7	-3.5%	
	Other Industrial	0.2%	7.0	12.1%	
RET	Community/Neighborhood	11.9%	6.2	5.5%	
	Super/Regional Malls	3.0%	4.5	2.5%	
	Other Retail	3.0%	5.4	19.5%	
	Power Centers	2.9%	5.8	5.6%	

Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

*based on IPD databases of institutional property holdings

HOUSTON REAL ESTATE INCOME RISK* **Q4 2014**

CONCENTRATION **RISK**

		US CONTRACTED RENT *% of national market*	HOUSTON CONTRACTED RENT *% of Houston market*
	ALL PROPERTY TOTAL	100.0%	100.0%
BY EXPIRY	2014	3.8%	2.4%
	2015	11.1%	4.4%
	2016	11.8%	7.8%
	2017	12.6%	9.6%
	2018	12.1%	7.7%
	2019 & beyond	48.6%	68.1%
BY PROPERTY SECTOR – OFF	CBD Office	36.3%	59.2%
	Suburban Office	21.5%	27.4%
BY PROPERTY SECTOR – IND	Warehouse	18.3%	7.8%
	Flex/R&D	2.5%	—
	Other Industrial	0.2%	—
BY PROPERTY SECTOR – RET	Community/Neighborhood	11.9%	5.7%
	Super/Regional Malls	3.0%	—
	Other Retail	3.0%	—
	Power Centers	2.9%	—

TERM **RISK**

		US REMAINING LEASE TERM *years (weighted)*	HOUSTON REMAINING LEASE TERM *years (weighted)*
	ALL PROPERTY TOTAL	5.1	5.8
BY EXPIRY	2014	—	—
	2015	—	—
	2016	—	—
	2017	—	—
	2018	—	—
	2019 & beyond	—	—
BY PROPERTY SECTOR – OFF	CBD Office	5.7	5.7
	Suburban Office	4.5	6.2
BY PROPERTY SECTOR – IND	Warehouse	4.1	3.9
	Flex/R&D	2.7	—
	Other Industrial	7.0	—
BY PROPERTY SECTOR – RET	Community/Neighborhood	6.2	7.3
	Super/Regional Malls	4.5	—
	Other Retail	5.4	—
	Power Centers	5.8	—

Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

**based on IPD databases of institutional property holdings*

■ **HOUSTON CONCENTRATION RISK**—When the futures price of WTI crude oil tumbled from $91/bbl to $53 during the course of Q4 2014, many property investors were left wondering, what about Houston? Those investors with long memories can still recall the twin shocks of oversupply and dissipating demand that swept the local real estate market in the late 1980s as oil prices collapsed. An immediate concern this time around is that institutional investors are very heavily concentrated in the Houston office sector—about 87% of contracted rent lies in this sector alone, with more than two-thirds of it clustered in the few dozen blocks just south of Buffalo Bayou that make up the CBD. But within this concentration rests one potential upside: nearly 70% of the institutional market is locked up in long-term leases which may yet outride the temporary downturn in the energy market.

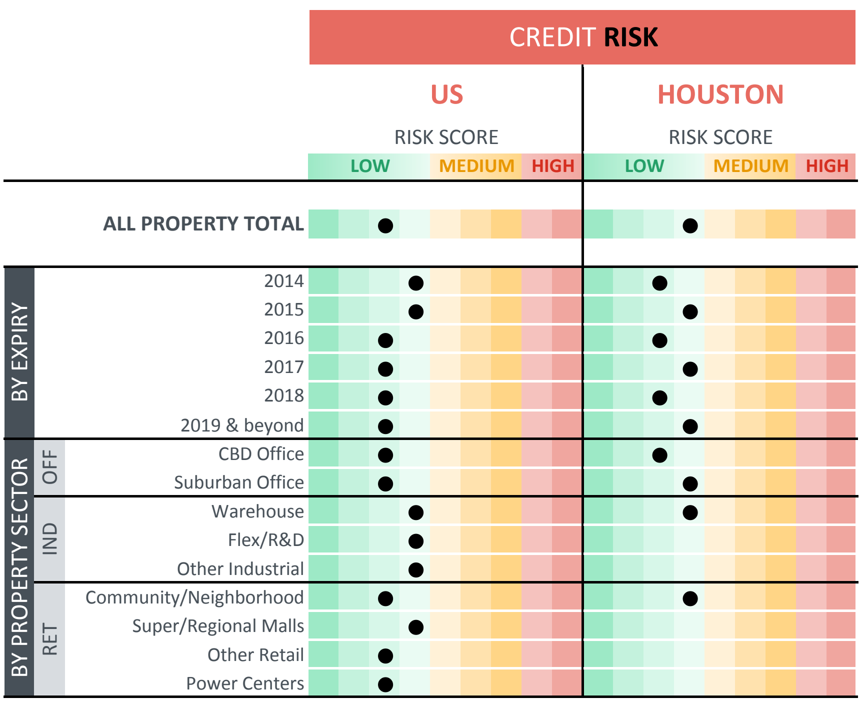
■ **HOUSTON TERM RISK**—The average remaining lease term in the US institutional property market is 5.1 years. Houston is closer to 6.0, and this is especially true in the heavily concentrated office sector where the average remaining lease term is 5.7 years in the CBD and 6.2 years in the suburban market. Among other sectors of the Houston market, community and neighborhood shopping centers show longer expected lease terms than the US average, but for warehouses the average remaining lease term trails the US average by a small margin.

■ **HOUSTON MARKET RISK (next page)**—Alhough two-thirds of institutional leases in Houston are locked up past 2018, sooner or later those contracted leases will expire. And to what? Houston has not experienced the same degree of market rent increases as a New York or a San Francisco has in this cycle. In fact, the 4-5% of leases due to roll in 2015 are currently overrented. Renewing these expiring leases at market rates will pull contracted rents down by nearly 3%. While 2015 expirations will be a small portion of the contracted institutional market, the two-thirds coming due in 2019 or beyond are currently expected to see a slim gain to market of just 3.4%, and this is less than one-third of the overall 11.1% US gain to market expected for long-run expirations.

HOUSTON REAL ESTATE INCOME RISK* **Q4 2014**

MARKET **RISK**

		US % GAIN / LOSS TO LEASES *contract rent vs market rate*	HOUSTON % GAIN / LOSS TO LEASES *contract rent vs market rate*
	ALL PROPERTY TOTAL	7.9%	3.8%
BY EXPIRY	2014	22.1%	24.2%
BY EXPIRY	2015	2.9%	-2.9%
BY EXPIRY	2016	2.7%	4.8%
BY EXPIRY	2017	5.9%	2.1%
BY EXPIRY	2018	3.6%	5.8%
BY EXPIRY	2019 & beyond	11.1%	3.4%
BY PROPERTY SECTOR – OFF	CBD Office	12.6%	3.3%
BY PROPERTY SECTOR – OFF	Suburban Office	5.4%	11.1%
BY PROPERTY SECTOR – IND	Warehouse	3.8%	-2.4%
BY PROPERTY SECTOR – IND	Flex/R&D	-3.5%	—
BY PROPERTY SECTOR – IND	Other Industrial	12.1%	—
BY PROPERTY SECTOR – RET	Community/Neighborhood	5.5%	-17.2%
BY PROPERTY SECTOR – RET	Super/Regional Malls	2.5%	—
BY PROPERTY SECTOR – RET	Other Retail	19.5%	—
BY PROPERTY SECTOR – RET	Power Centers	5.6%	—



Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

**based on IPD databases of institutional property holdings*

HOUSTON CREDIT RISK—Credit scores are assigned at the firm level, but inherent company or industry level risks can roll up to the asset or fund level depending on specific lease-up or investment strategies. Weighted credit risks can appear more diluted at a national or metropolitan level, so any geographic analysis requires a close look at the nuances. In Houston, the immediate concern is the credit health of energy industry tenants which pose a potential ripple effect in the local market. A number of energy tenants are likely to be found in CBD offices, but these leases in fact carry slightly lower weighted average risk scores than do other property types in Houston. A prolonged period of depressed oil prices would inevitably lead to downgraded credit scores for some energy tenants. For now, however, institutional owners hold a degree of security by having most of their Houston leases to these companies at least 4 years away from expiration, thus allowing some time for oil prices to rebound.

About MSCI

For more than 40 years, MSCI's research-based indexes and analytics have helped the world's leading investors build and manage better portfolios. Clients rely on our offerings for deeper insights into the drivers of performance and risk in their portfolios, broad asset class coverage and innovative research. Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research. MSCI serves 98 of the top 100 largest money managers, according to the most recent P&I ranking.

Author's Bio

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.

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