SUBPRIME, CREDIT CRISIS, REITS DOWN 12.7%, NPI 3.21%??

Douglas M. Poutasse, NCREIF Executive Director

"I cannot believe these numbers...it is not reflective of market at all. I know there is an appraisal lag, but this seems totally off. What do you think?"

"15.8% for the year, that's strong!"

"Great numbers."

"… retail surprises me a lot…."

"I can say there are a lot of shocked people at the moment... at the IREI conference everybody seemed to have a worried tone and yet they aren't showing it in the numbers. You know the real estate community better than me but this does surprise me."

When I first saw the preliminary fourth quarter NPI results on January 24th, I knew there were going to be a lot of questions and concern when we released the numbers the next day. Two weeks earlier we had released the preliminary figures for the NFI-ODCE, reporting a 2% total return for the open-end diversified core equity funds, and even those results had generated many questions in the intervening period in light of the clearly slowing American economy, the meltdown in the single family market and the -12.7% total return for REITs in the fourth quarter of 2007.

The quotes above are a sample of the messages I received after we released the NPI on the 25th. There was surprise in the strength of the return even among regular observers, who are used to significant persistence of return inherent in a valuation based index. Clearly some explanation is necessary.

First, as I said to the people who emailed me: we (NCREIF) do not make up the returns, we report what our data contributors report to us. I will add "and they report, much of the time, what external appraisers report to them". This quarter there was a heavy preponderance of external appraisals on very large assets and those assets reported strong appreciation. Every quarter we analyze what properties are the "largest movers", ranking the assets by how many basis points each one represents of the reported NPI. This quarter forty-three assets (out of almost 6,000) contributed one basis point or more to the 321 basis points of total return in the NPI. These properties, with $23 billion of market value, produced 117 of the 321 basis points of return. Put a little differently, these 43 properties, which average slightly over $500 million each in value, represent less than 1% of the properties and less 8% of the total market value but produced 35% of the NPI total return. Almost all of these assets were externally appraised (only two of the 43 were sold this quarter, so it was not a sold property issue). These properties were written up by almost $3 billion for an appreciation return of 16.2%, producing roughly 100 basis points of appreciation on the entire NPI). Twelve of these properties were regional and super regional malls, with roughly $8.2 billion of market value. Twenty seven of the properties were large office buildings with a combined market value of $12.8 billion. These properties were almost exclusively in the Boston, New York, Washington, D.C., San Francisco and Los Angeles metro areas.

The moral of this first part of the story: trophy properties in the strongest markets were still being valued highly by appraisers in the latter part of 2007. No big surprise here: remember all of us (yes, you and me) who were saying last fall that while B properties in secondary markets were being impacted by the credit crunch, the best properties in the best markets were not? Well, somebody apparently was listening.

On the other side of the ledger, only two properties moved the index down by at least one basis point and only 719 properties total (roughly 13%) had a negative total return. These properties totaled only $28 billion in total market value, with an average value per property of less than $40 million. While much more diverse than the positive index movers, the South region and the apartment and retail property types were overweighted in this group of properties compared to the overall NPI. This result is clearly consistent with the "flight to quality" thesis of last fall.

Looking across all 5,711 properties in the NPI this quarter, 1,492 (26%) were externally appraised. An additional 1,886 (33%) were internally valued. Managers reported that 41% of the properties (2,333) were not valued this quarter. Overall, positive appreciation was reported for 1,921 (34%) of the properties, depreciation was reported for 1,458 properties (26%), while 2,332 properties recorded a zero capital return. Taken together, this indicates that roughly 60% of the properties were valued this quarter, above the average result for recent quarters but still clearly not consistent with the REIS standard (and as of January 1st the GIPS standard for managers claiming GIPS compliance) that properties be valued quarterly.

The moral of the second part of the story: returns were mixed for the quarter, with nearly as many properties decreasing in value as increasing. While the data contributors continue to value properties more frequently, there are still a large proportion of properties which are not valued each quarter.

What about the sold properties? In recent quarters, sales well above reported carrying values have contributed significantly to the strong NPI returns. In several quarters most of the major positive index movers were sold properties. This quarter, only two of the 43 were sold properties. There were 127 sales recorded this quarter or roughly 2.5% of the previous quarter's properties, well below recent quarters in both number and ratio. These properties sold for a little over $5.2 billion, representing only about a $200 million gain on previously reported market value. Almost half the properties sales were reported at less than the previous quarter market value. Clearly sold properties contributed very minimally to the NPI this quarter, accounting for only roughly 10 basis points of the total return.

This apparent turning point in the transaction market is reinforced by the results of the Transaction-Based Index (TBI) of Institutional Commercial Property Investment Performance. The MIT/CRE CREDL Initiative developed the TBI *"to measure market movements and returns on investment based on transaction prices of properties sold from the NCREIF Index database… Using econometric techniques, the TBI estimates quarterly market price changes based on the verifiable sales prices of all and only properties sold from the NPI database each quarter. The TBI controls for differences in the properties that are sold each period, for transaction sample selection bias, and for estimation error noise."* [i]

As reported by MIT, TBI results for the 4th quarter of 2007 show a negative 5% capital return for the properties sold in the NCREIF database. This is the second consecutive negative quarterly price change in the all-property TBI, a cumulative fall of more than 7% since the peak in the 2nd quarter of 2007. The investment total return for all properties in the 4th quarter also registered a decline of 4.3 percent. [ii]

Moral of the third part of the story: it wasn't sold properties driving the NPI up. Depending on how you measure, transaction data may even indicate that a decline in property values began in the fall.

Finally, did anything other than valuation frequency drive the discrepancy between the NPI and the NFI-ODCE? The 1,576 ODCE fund properties in the NPI in the fourth quarter recorded a 2.02% return, virtually identical with the fund index return. With an income return two basis points less than the NPI, virtually all of the 119 basis point return difference came in appreciation. Was this return difference driven by a different composition of properties or by other factors. Since a small number of very large properties, principally CBD office and malls, were responsible for 35% of the total return of the NPI, under-representation of these property types in the ODCE index could explain the difference. This is not the case: the market value weights of the ODCE properties and the overall NPI are almost identical for CBD Office (16.5% vs 16.3%), Malls (12.8% vs 11.1%), and for properties over $100 million in value (55.3% vs 50.2%). Property type and property size differences do not explain the difference in returns between the ODCE properties and the rest of the NPI properties, leading me to the conclusion that the difference is best explained by valuation policy and frequency. But before the open end fund sponsors crow too loudly, the total return for these 14 managers, including both the properties in their ODCE funds and their other accounts, was 2.72% in the fourth quarter. Since the ODCE properties represented more than half of their market value, the return of their non-ODCE properties was higher than the NPI!

Moral of the last part of the story: when looking for an explanation of NCREIF Property Index returns, it is not "them" but "us". Of the 60 data contributors, only two reported a negative total return for their properties in the fourth quarter and 40 reported a return of 2% or more, representing 82% of index market value.

[i] http://web.mit.edu/CRE/research/credl/tbi.html

[ii] Note from above site: Please note that the TBI is a statistical methodology that produces estimates of price movements and total returns based on transactions of properties sold from the NCREIF Index database. MIT makes no warranty or claim regarding the usefulness or implications of the index. It should also be noted that TBI results for the 1st, 2nd, and 3rd quarters of any year are considered preliminary and subject to revision until the calendar year is completed with the 4th quarter results