STABLE VALUE OR TOO GOOD TO BE TRUE?

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The NCREIF Property Index (NPI), representing 3680 properties with an aggregate value of $122 billion, recorded a 1.67% return in the fourth quarter of 2002, completing a year of remarkably consistent returns. With the revision of the third quarter return to 1.79%, the annual return for the NPI was 6.75%. While this represented a slight decline from the 7.28% return in 2001 and was the lowest annual return since 1994 (6.38%), the private real estate investments continued to provide a solid counterbalance to institutional investor's struggling equities portfolios. In 2002, the NPI exceeded the S&P 500 return by 2885 basis points, the largest spread in 20 years. Of course, this reflected the worst year in the S&P in a generation more than strength in the NPI!

The NPI was remarkably consistent throughout the year, with a low of 1.51% in the first quarter and a high of 1.79% in the third quarter. By way of comparison, in 2001, the quarterly returns ranged between 0.67% and 2.47%. Looking back over time, only three other years (1989, 1996 and 1999) in the 25 year history of the NPI have shown similar stability. For those of us who are perpetually pessimistic, it is very interesting to compare the NPI results for 2002 to 1989. In both periods, returns weakened but remained solidly positive despite massive increases in vacancies and significant income declines. Falling income returns (read cap rates) made this possible. In 1989 the income return declined to 6.65% from 7.04% in the previous year, allowing slight appreciation despite a nearly 10% decline in NOI. In 2002, income returns declined 25 basis points, from 8.67% to 8.42%, limiting depreciation to 1.58% despite a roughly 5% decline in NOI. When looked at on a quarterly basis and by property type, the decline in income returns is even more striking: the 2002Q4 income return of 1.96% represented the lowest level since third quarter of 1993. Over the four quarters of 2002, the income return declined from 2.07% to 1.96%, over 40 basis points on an annualized basis.

Declining income returns were concentrated in the apartment sector: the fourth quarter income return of 1.62% was 28 basis points below the 1.90% in the 2001Q4. For the year, NPI apartments recorded a 7.11% income return, nearly 100 basis points below the 8.07% income return in 2001 and the lowest annual income return in the sector since at least 1989. With the benefit of this decline in income return, apartments in the NPI recorded positive appreciation of 1.57% in 2002 despite an estimated 10% decline in NOI. The total return of 8.76% was the lowest since 1993. Clearly both investors and appraisers believe that the decline in apartment rents and operating income will be reversed in the near future, but it is still striking for value to have increased in 2002 despite the significant declines in NOI. Clearly operating performance will have to recover strongly for apartment properties to continue to provide strong positive returns.

Retail properties reported by far the best results in 2002, with the 13.74% total return more than double the overall NPI. While the other three major property types recorded their lowest total returns since 1993, 2002 brought the highest return in the retail sector since 1988. With a very strong fourth quarter (2.13% income return, 4.66% total return), the 546 retail properties in the NPI finished the year on an especially strong note. The $23.4 billion of retail properties accounted for slightly less than 20% of the NPI in the quarter but produced over half of the NPI's total return. Ending the year with the highest income return of the major property types, retail remains well positioned to provide strong returns in 2003. This is what happens when the economy drops into recession and the American consumer refuses to join it!

The large office sector showed by far the worst returns in 2002. With 1,117 properties valued at $49.1 billion, office properties represented 40.2% of the NPI, more than double the share of each of the other three major property types. Dramatic increases in vacancy rates and declining rents cast a pall on most of the nation's major office markets. Since much of the vacancy remained concentrated in sub-lease space and many expiring leases still reflecting the depressed conditions of the early 1990s, office property income declined roughly 5%. Investors fully reflected this decline in lower values, leaving income returns relatively unchanged at 8.77% for the year, resulting in depreciation of 5.6%. Returns for the past five years clearly demonstrate the high volatility of office properties, from the 19.62% peak in 1998 to 2.78% in 2002. Over the past 10 years, office surpassed retail as the dominant sector in the NPI. Recently office has consistently represented more than 40% of the index, resulting in potentially greater volatility for the overall index. Office properties should continue to struggle to produce positive returns in 2003 in the face of continuing high vacancies and declining rents. It is likely that NOI declines will accelerate in 2003 as direct vacancies replace sublease space and rent levels on expiring leases exceed market rents in more markets.

Industrial markets in much of the country suffered with their highest vacancy rates in at least a decade, but overall investment returns very closely tracked the overall NPI. High income returns entering the year and relatively small declines in income during the year allowed the sector to record a 6.7% total return, down from 9.3% in 2001. As with the overall NPI, this represented the lowest total return since 1993. While income declined from 2.1% in 2001Q4 to 2.03% in 2002Q4, prime, well-leased warehouse properties remained at the top of many institutional buy lists.

DOES LEVERAGE MATTER: COMPARING THE UNLEVERED AND DELEVERED PROPERTIES

One of the most striking results in this quarter's NCREIF Property Index Detailed Quarterly Performance Report is the significant difference in total return of the NPI and the NCREIF Classic Property Index, which represents the return of the properties in the NPI which are owned without any debt. In 2002, the NPI recorded a 6.75% total return, while the Classic Index posted a 4.79% total return. Currently (2002Q4), the 2,304 unleveraged properties representing $58.67 billion that make up the Classic Property Index rep-

resent roughly 48% of the NPI. 1376 leverage properties valued at $63.3 billion make up the rest of the NPI. The deleveraged properties ("non-classic") recorded a total return in 2002 of 8.7%. The nearly 400 basis point spread between these two roughly equal components of the NPI represents by far the largest gap in returns in recent years. What is the cause of this gap? Is performance better for leveraged properties? Are their different valuation metrics being applied to properties just because they are being held with leverage? Or does this striking difference represent differences in property type and geographic mix of the properties?

For newcomers to the NCREIF Property Index, a little historic explanation is necessary. When NCREIF developed its first index of property performance in 1982, only properties which were owned without leverage were eligible for inclusion. In the mid 1980's, NCREIF began collecting data for properties with debt, but until 1993 the NPI was calculated based only on the unleveraged properties. In 1993, this index was renamed the NCREIF Classic Property Index and the current NPI was introduced, reflecting the performance of both the unleveraged properties and the property level (deleveraged) performance of the leveraged properties. Due to the collection of historical data, the NPI includes properties with leverage from 1984 forward.

What are the differences between these two universes? The first is obvious from the property counts: the average leveraged property has a value of $50 million, nearly double the $25.5 million value of the average unleveraged property. Much of this reflects the far higher share of retail properties in the "non-classic": 27% by value in 2002Q4 compared to 11% of classic index. Smaller industrial properties are much more highly represented in the classic, with 24% of the market value in 2002Q4 compared to only 14% of the non-classic. Since retail properties had by far the best performance over the last year, this simple difference in composition helps to explain the difference in overall returns.

Geographically, the East region represents 24% of Classic market value and 34% of the Non-classic properties. The Classic index is relatively overweighted in the South (24% compared to 19%) and the West (38% compared to 31%). The East had the highest return in 2002 and the South and West had the lowest returns, further explaining the higher return for the non-classic.

Do these differences explain all of spread in returns in 2002? Returns by property type for the classic and non-classic properties are displayed in Table 1. In all four major property types, returns are higher for the non-classic properties than for the classic properties, although only in retail is the spread greater than the 390 basis point spread at the all property level. Looking in more detail at the retail sector reveals dramatically different property subtype mixes in the classic and non-classic indices. In the fourth quarter of 2002, the neighborhood and community centers dominated the classic index retail sector (see Table 2), with nearly 80% of the market value. Regional and super regional malls represented roughly 75% of the non-classic retail properties. During 2002, these large non-classic properties recorded very high returns (18.6% for regional centers and 15.5% for super regional centers) while the smaller neighborhood and community centers recorded more moderate returns. Higher returns in 2002 for non-classic retail (and much of the higher return for the entire non-classic universe) can be explained by the absence of regional and super-regional malls in the classic index and their heavy weight in the non-classic.

The differences in composition of the NPI and the NCREIF Classic Index can clearly create very different return patterns. It is very important that users of the NPI be fully cognizant of its composition and construction. When used as a benchmark, it is important to understand if investment restrictions such as limits on use of leverage and individual investment size are creating differences between the composition of the NPI and the investable universe.

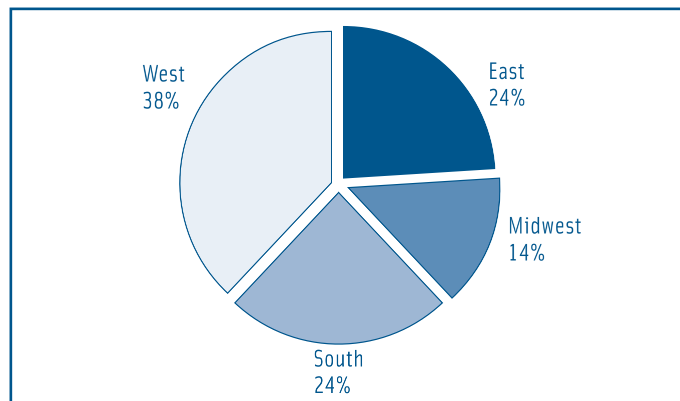
TABLE 1

2002 Total Return	Classic	Non-Classic
Apartment	8.0%	9.6%
Industrial	6.1%	7.8%
Office	1.1%	4.5%
Retail	10.9%	15.0%

TABLE 2

	Classic		Non-Classic	
	2002 Return	2002Q4 MV	2002 Return	2002Q4 MV
Neighborhood Centers	13.8%	$1.71 BN	12.5%	$1.55 BN
Community Center	12.1%	$2.66 BN	11.6%	$2.63 BN
Regional Malls	10.2%	$0.86 BN	18.6%	$4.12 BN
Super-Regional	-0.6%	$0.34 BN	15.5%	$7.71 BN

MARKET VALUE BY REGION: CLASSIC



MARKET VALUE BY REGION: NON-CLASSIC