Black Creek Group

Black Creek Research

Market Insights

Commercial Real Estate Opportunities In 2018

JANUARY 2018

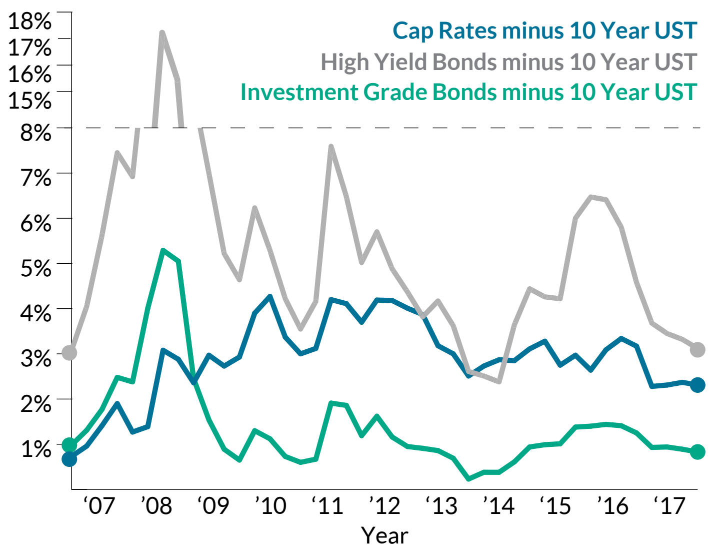
More than eight years into the current commercial real estate cycle, economic expansion has produced low growth and inflation, low interest rates, and more recently, low unemployment. While slow, relatively steady GDP growth averaging just 2.2% has produced one of the longest expansions in modern history — it has also made it difficult for many investors to achieve their return requirements. Investors favor the approximately $13 trillion U.S. commercial real estate (CRE) market for its compelling asset class yields, inflation hedging capabilities[1] and a chance to invest in growth areas throughout the economy. The current cycle is no exception, providing investors with an opportunity to add current income[2] to their portfolios while hedging against future inflation,[1] and to exploit many of 2018's driving economic trends: the rise of e-commerce, competition for skilled workers, retail store closures and wage growth and the new tax laws.

Why Invest In Commercial Real Estate Now?

Per National Council of Real Estate Investment Fiduciaries (NCREIF) data, institutional-quality CRE yielded 4.9% (cap rates)[3] on average from 2015-2017, better than the 4.3% earnings-to-price ratio for the S&P 500 and 3.7% for investment-grade (Moody's Baa-rated) corporate debt. Historically, capital has found CRE most attractive when NCREIF yields exceed yields on investment-grade corporate debt. The new tax law's favorable treatment of pass-through entities will make direct CRE investments even more attractive. The real estate investment trust (REIT) structure has become even more advantageous, as dividends will receive the 20% pass-through deduction while having to meet fewer requirements.

With CRE liquidity near historic highs, going-in yields are near historic lows. The spread between cap rates and the 10-year U.S. Treasury, however, is nowhere near its historic lows. In fact, cap rates are 2.3% points higher than the 10-year U.S. Treasury, which is in line with its long-run average, and 1.6% points higher than during the peak of the last expansion. This is in contrast with the spreads between both high yield and corporate bonds and the 10-year U.S. Treasury, which are both currently at the low end of their historical range. With cap rate spreads versus the 10-year U.S. Treasury so wide, investors should feel confident about buying CRE despite low cap rates. (See Exhibit 1)

Exhibit 1: Real Estate and Fixed Income Spreads to the 10-year U.S. Treasury[4]



The spread between cap rates and the 10-year U.S. Treasury is 1.6% points higher than during the peak of the last expansion; fixed income is at or below the peak of the last expansion.

There is little impetus for interest rate increases and inflation, for one simple reason: U.S. working-age population growth will approach 0% by 2020[5], cooling the economy. However, should the economy exceed growth expectations, causing the Federal Reserve to accelerate rate increases as it has recently signaled it will do in response to the newly passed tax cuts, today's wide cap rate spreads leave plenty of cushion to absorb interest rate rises. Furthermore, real estate should be a good inflation hedge,[1] having posted 9.1% average annual total returns during economic expansions since 1982 (per NCREIF data), compared to 2.6% increases in the Consumer Price Index.

How Commercial Real Estate Investors Can Exploit Economic Trends In 2018

Beyond adding income[2] to a portfolio and hedging against inflation,[1] CRE offers opportunities to invest in growth areas throughout the economy. Investors can take advantage of many of 2018's driving economic trends by owning CRE:

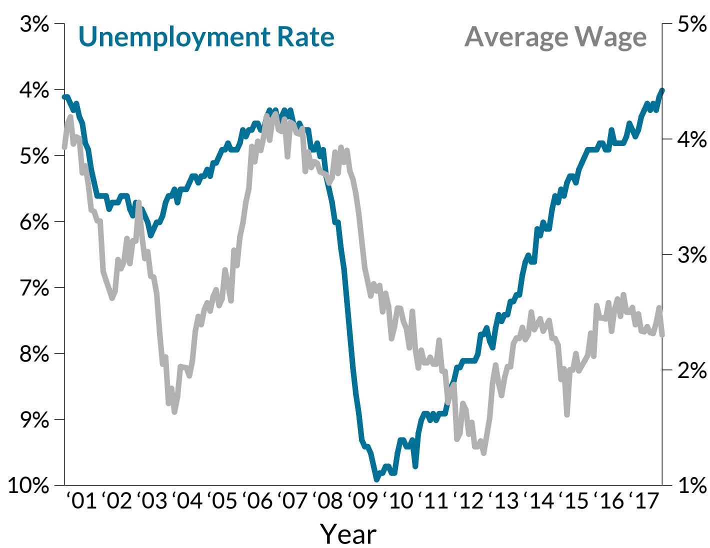
1. Amazon's 140 million square feet (SF) industrial portfolio is just the beginning. In an age when shoppers can buy everything on their smartphones, e-commerce is an increasingly important driver of industrial demand. Of the 200 million industrial SF absorbed in 2017, e-commerce contributed 67 million SF, or about a third. Amazon is clearly the dominant player, accounting for roughly half the absorption attributable to e-commerce. Since 2012, Amazon has doubled its industrial portfolio to reach 140 million SF, with plans to double its portfolio again to 280 million SF by 2022. However, Amazon is not the only player — from Walmart to Home Depot and Macy's, retailers are racing to grow their online sales. In 2018, e-commerce will account for more than 40% of overall industrial absorption, yet it will make up only about 10% of total retail sales. The shift to online shopping will continue to lift the industrial market, stoking demand for industrial buildings of different shapes and sizes, in both traditional and nontraditional distribution markets.

2. Corporations are waging a war for talent with office buildings. Slowing working-age population growth has heightened the competition for workers, and employers are increasingly looking to their office space as one way to attract and retain top talent. This helps explain why high-quality office space has captured more than twice its fair share of leasing for the past decade unabated and in virtually every major market. Additionally, and partly due to the unusually long length of this cycle, corporate profits are at record highs, making it easier for firms to reinvest. Thanks to workplace efficiencies like digitization, bench seating and work-from-home policies, companies can afford to pay a higher price per square foot with only a modest increase to their overall real estate expenditure. With limited construction, the shortage of high-quality options will continue to enable owners of high-end office properties to command rent premiums.

3. Retailers are recalibrating their brick-and-mortar strategies. Retailers shuttered a record number of stores — 108 million SF — in 2017. This trend will likely accelerate in 2018 due to several factors. First, e-commerce has grown by 15% annually since 2009, and it continues to steal revenue away from brick-and-mortar stores. (A bright spot is grocery, which so far has remained insulated from online competition.) Secondly, there is one billion SF of badly located retail space not supported by trade-area demographics. Finally, a wave of corporate debt maturities will accelerate restructurings at many of the weaker retailers, which may be supporting outdated business models with high leverage. The silver lining for real estate investors is that store closings will allow better retail concepts to replace weak ones in good locations, while the shuttering of poorly located retail centers will grow well-located centers' share of the trade area.

4. Wage growth and the new tax laws will encourage more households to rent apartments. Declining homeownership accounted for approximately 70% of the apartment demand added since 2009, as many households were either forced out of — or chose to exit — the for-sale housing market. With the boost from falling homeownership over, rental demand has continued to grow, albeit at a slower pace. Meanwhile, apartment rents have climbed significantly, to the point of encountering some resistance due to affordability issues at the high end of the market. On the margin, the recent changes to the tax law should discourage homeownership by reducing its tax benefits, particularly in high-price regions of the country like California and New York. This, along with accelerating wage growth as the unemployment rate approaches 4%, is likely to give rental demand a boost, by making rental housing more affordable relative both to incomes and to the cost of owning. (See Exhibit 2)

Exhibit 2:
U.S. Unemployment Rate And Wage Growth[6]



The Opportunity

Investors who own CRE can exploit many of 2018's driving economic trends, from the rise of e-commerce, to competition for skilled workers, retail store closures and wage growth and the new tax law. It represents a durable, long-term investment that can add current income to a portfolio while hedging against future inflation. With a total asset valuation of approximately $13 trillion, we believe U.S. CRE has a place in any diversified investment portfolio.

[1] Although commercial real estate has historically provided returns that have exceeded inflation, there is no guarantee that the REITs sponsored by Black Creek Group LLC can generate the returns necessary to exceed inflation.

[2] Many REITs do not produce income but still pay distributions. These distributions may represent a return of capital. There is no guarantee that shareholders will receive distributions or that an investment in the REITs sponsored by Black Creek Group LLC will be profitable or that the REITs will realize growth in the value of their assets. A REIT's distributions may be paid from sources other than cash flows from operating activities, such as cash flows from financing activities, which may include net proceeds from primary shares sold and borrowings (including borrowings secured by a REIT's assets). A REIT's future distributions may be paid from these sources as well as proceeds from the sales of assets, proceeds from the issuance of shares pursuant to the REIT's distribution reinvestment plan cash resulting from a waiver or deferral of fees, and interest income from its cash balances. There is no limit on distributions that may be made from these sources. To the extent a REIT pays distributions from sources other than cash flows from operating activities, it may have less funds available for the acquisition of properties, and stockholders' overall return may be reduced.

[3] Source: NCREIF. An investment in a non-traded REIT sponsored by Black Creek Group LLC is not a direct investment in commercial real estate, but rather an investment in a REIT that owns commercial real estate, and has material differences from investing directly in commercial real estate. An investment in a non-traded REIT sponsored by Black Creek Group LLC is subject to upfront selling commissions and dealer manager fees, distribution fees and advisory fees and expenses, as well as certain risks specifically applicable to an investment in the securities of a non-listed REIT, which may adversely impact the value of an investment in the REIT's common stock. For more information, please refer to the applicable prospectus. Capitalization rates are based on a property's projected net operating income from the in-place leases for the 12 months after the date of purchase, including any contractual rent increases contained in such leases for those 12 months, divided by the purchase price for the property, exclusive of acquisition costs and fees.

[4] Source: NCREIF, Moody's, CoStar Portfolio Strategy. As of: September 30, 2017.

[5] Source: CoStar Portfolio Strategy. As of: September 30, 2017.

[6] Sources: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta; Moody's Analytics; CoStar Portfolio Strategy. As of September 30, 2017.

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518 17th Street, 17th Floor | Denver, CO 80202 | 303.869.4600 | blackcreekgroup.com

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