Comparing Real Estate Sectors

Who's the best NFL quarterback of all time? Brady, Manning, Montana? Ask a group of fans and you will get a wide range of opinions. Part of the reason for the contentious debate is that there are a number of great quarterbacks who played in the NFL. But another factor is that each fan probably has a slightly different criteria for deciding who is the greatest of all time. One fan might value super bowl wins, another might measure "greatest" by the number of touchdowns. Different criteria, different results.

That's true in comparing the financial performance of different commercial real estate sectors. An investor must determine what criteria are the most important and which factors stand out as crucial to evaluating a commercial real estate investment.

Commercial real estate is in itself a broad term that typically includes office buildings, industrial properties, retail centers and multi-family (apartment) properties. The four sectors within this booming industry area all influenced by a wide range of economic factors. To date, current commercial real estate accounts for approximately 25% of total GDP, which is below the pre-recession average of 28.1 percent.

In this article, we will examine how Real Estate Investment Trusts (REITs) earnings, valuation influencers, the current economic forecast, and embracing real estate diversification have created the foundation needed for an acceptable return on investment (ROI) in commercial real estate investments across the four main sectors.

I. Understanding Each Sector

The Office Sector

There are three main classes within the office sector of commercial real estate. Understanding the intricacies of each class is paramount to analyzing the risks and potential investment re-

Class A—This is the highest quality office space. Class A office properties are most often newly constructed, completed with best-in-class features, and have a luxurious central lobby. Additionally, they feature an aesthetically pleasing design. High rise office buildings in prime locations are typically Class A office buildings and will typically drive rents within their market.

Class B—Class B properties are the second-tier office building that are typically older buildings that don't have the same impressive architectural details. In addition, Class B properties generally have secondary locations. However, they are usually fully functional with a good layout and quality, usable spaces.

Class C—Class C office spaces fall on the lowest rung of the ladder. They are often located in the least desirable areas, need complete or at least major renovations, and are often more than 20 years old. The good news for investors in high priced areas with booming economies, is that it's possible for Class C office buildings to be upgraded to a Class B and, in some cases, Class A status.

The Industrial Sector

The industrial sector of commercial real estate is an umbrella term that includes a wide range of building and property types. While the industrial sector is less flashy than its office and retail counterparts, it plays an essential role within global commerce and has proved a reliable investment over the years. The main types of industrial properties include heavy manufacturing, light assembly, flex warehouse, and bulk warehouse.

The industrial sector is uniquely poised to capitalize on two main location strategies. These strategies include being located adjacent to the area's key transportation hubs, or near large population centers, so that companies can capitalize on the growing trend for same-day deliveries. The current real estate trends suggest that a well-located, and properly maintained industrial property, cannot only fulfill a valuable component of the world's supply chain, but it can also lead to high ROIs.

The Retail Sector

Commercial retail spaces are can be defined by a few key types of properties, including: strip centers, community retail centers, power centers, regional malls, and out parcel plots.

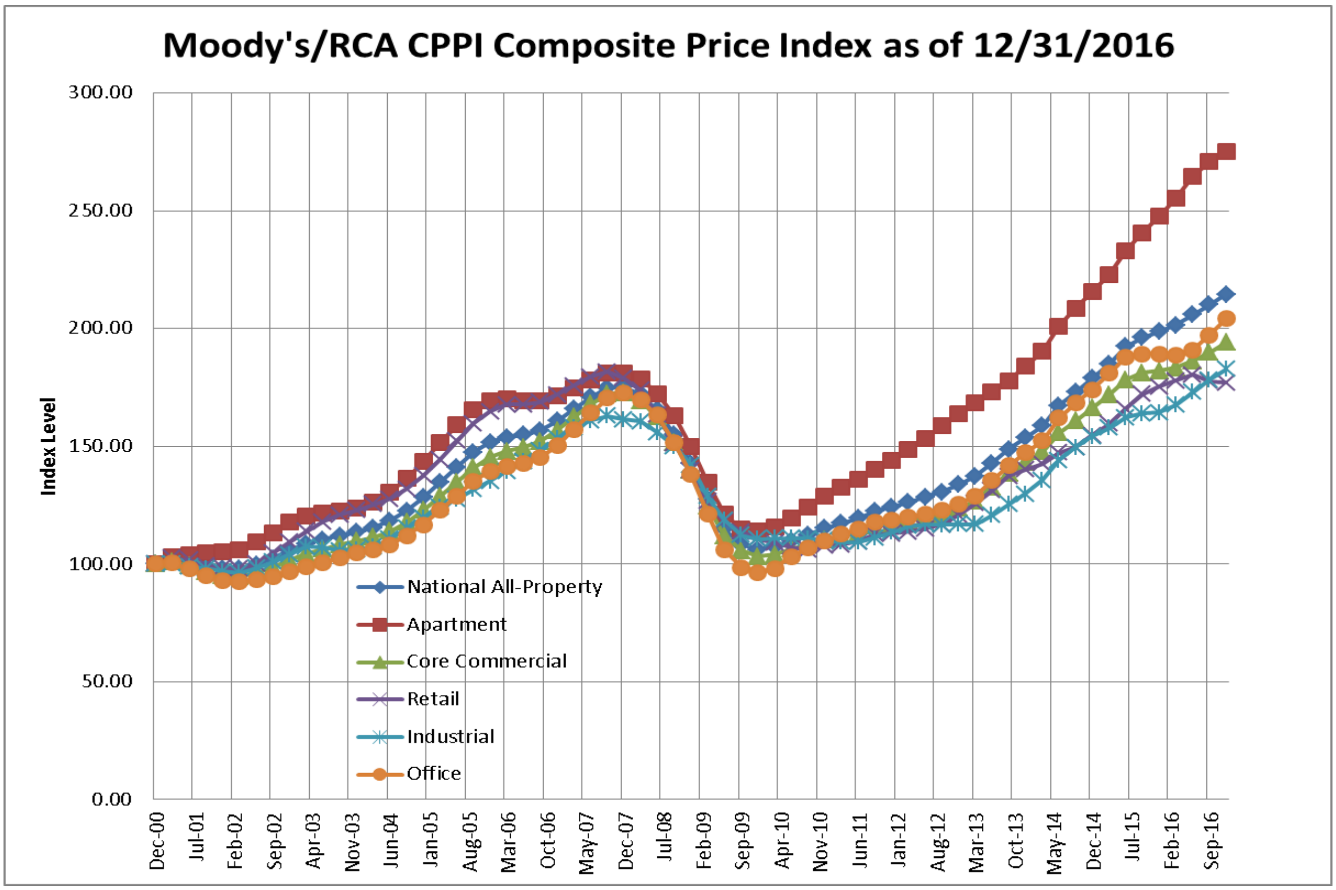
- **Strip Center**—Strip centers typically have small properties with anchor tenants.
- **Community Retail Center—**Community retail centers range between 150,000 to 350,000 square feet with multiple anchor tenants, including at least one restaurant (or similar type commercial enterprise).
- **Power Center—**A power center features one main retailer with a location of 30,000 to 200,000 square feet and a few other adjacent smaller retail stores.
- **Regional Mall—**Regional malls can range in size from 400,000 to 2,000,000 square feet and feature anchor tenants, including brand name department stores.
- **Out parcel—**Many large retail centers also have out parcel land that is set aside for an individual tenant, typically a restaurant or bank branch.

The Multifamily Sector

Multifamily real estate can be used to describe a wide range of buildings that hold multiple units. This classification can be assigned to duplexes, townhomes, apartments, triplexes, and other housing solutions that feature multiple family units. Historically, multifamily real estate has been a proven investment strategy for companies and individuals interested in minimizing vacancy risks, accessing attractive financing options, and enjoying positive ROIs in steady-growth economies. The demand for apartments comes from the increase in household formations which is the result of population and job growth. The more rapid the job and population growth, the more demand there is for housing. A large portion of that housing demand in any market gets met by apartment rentals.

II. Valuations

The chart below shows the year to year changes in value for each commercial real estate sector from 2000 to 2016. Looking at the chart, several things emerge. First, the valuations of the different sectors to a large extent rise and drop together. The macro economic factors that drive commercial real estate values impact each sector at the same time. You don't see once sector rising while the others are declining or vice versa. Apartments appear to provide higher returns in both up markets from 2000-2008 and from 2010-2016. Especially from 2010-2016, apartments noticeably outperform the other four commercial sectors. How long into the future this trend will continue is anyone's guess.



Data: CoStar Group Inc. (constructed using a repeat sales methodology, measuring the movement in commercial properties prices by collecting data on actual transactions, equally weighted)

Valuations & Return on Investment (ROI) For Office Buildings

Due to their pristine appearance, high-quality features, and sought-after locations, Class A office buildings have the highest rental rates. These rental rates are typically higher than the city's average rents. They also have low vacancy ratings due to their high-profile status. Unlike Class A buildings, which often have the highest rents (especially for the top floors), Class B offices typically have "average market" rents. The latter buildings are usually four stories or shorter and can be found in desirable areas of the city, including near the local suburbs. Class B buildings are also 10 years old or older and most often show the beginning signs of wear-and-tear. Class C office buildings attract tenants who cannot afford the prime locations or amenity-rich Class A offices. In short, determining the pricing and valuations for each class of office space will depend on a multitude of factors, including the local market and the status of the building. With these insights in mind, it is important to note that the price evaluations for Class A, Class B, and Class C office buildings is objectively based off of market data and current local economic factors with some cities showing accelerated growth, while others are in decline.

Valuations & ROI For Industrial Locations

Consumption and trade are the two main valuation drivers for the industrial real estate sector. These two valuation drivers refer to the amount of products that need to be stored and/or made in industrial locations. For example, consumption in terms of an ecommerce warehouse refers to the number of orders that are being filled and shipped from the warehouse on a daily basis. The third main component that must be considered when establishing a value for an industrial property, as well as estimating its potential ROI, is the area's supply chain. As the U.S. economy has continued to grow since the 2007 recession, companies in developing geographical markets have begun to transition to new and larger industrial buildings that feature modern upgrades. Established markets continue their decade's long trend of focusing on locations and popular delivery routes. The latter trend is a direct response to the prominent rise of consumer markets. The consumer market has also created a heightened demand for new industrial buildings across the country, especially in heavily populated regions.

Valuations & ROI For Retail Locations

Valuations for retail properties depend on local market conditions, including local job growth, population growth and growth in household income. The continued growth of the retail sector relies in part on unemployment rates remaining low, while incomes continue to increase. Since the 2007 recession, the average rents for retail spaces in expanding markets has continued to grow by more than one percent year-over-year.

With the latter insights in mind, the past five years have shown that Class A malls are in the best position to adjust to changing environments by proactively responding to growing consumer demands for "value retail." Power centers have also seen an increase in rents over recent years, with a 1.8 percent year-over-year increase recorded from 2018 to 2019. Community retail centers and strip centers have shown exceptional growth with 3.6 percent rent increases year-over-year. In short, the sustainability of growth margins within the retail sector will rely on stable local economies coupled with low unemployment rates and disposable income of local residents.

Valuations & ROI In The Multifamily Sector

According to a CBRE report, an estimated 13.5 million households live in workforce housing, which has created the foundation for multifamily investment opportunities. Just in the past five years, more than $375 billion has been invested in workforce housing. It should also be noted that in the past decade, many older apartment communities have been demolished in favor of Class A style multifamily apartments. The result has created an abundance of luxury buildings, a minimal number of new workforce housing, and a subsequent divide that the savvy investor can fill. Finally, it is important to remember that above all else, the local conditions have the greatest impact on deciding when to purchase, sell, or enhance a multifamily property.

Investment returns for multifamily are further enhanced by attractive debt options. Generally speaking, the variety of loan options available to a multifamily owner are much more attractive than someone looking to put a loan on office, industrial and retail properties. Typically, interest rates are lower, personal guarantees less common and higher loan to value ratios are available for multifamily borrowers as compared to borrowers of other real estate classes.

Concluding Thoughts On Commercial Real Estate Trends Over The Past Two Decades

Over the past 20 years, the commercial real estate industry has seen highs, lows, and periods of steady growth. After the 2007 recession, the private equity sector has seen an unprecedented $180 billion invested in commercial real estate opportunities. Should the market decline, experts predict that new buyers will still emerge, which means that the values of property are likely to drop by only 5 to 10 percent, which is far less than the decline suffered in certain regions during the 2007 recession. 25 – 34 year olds still heavily favor renting, with the age group's homeownership rate falling well below the 64 percent average. The Tax Cuts and Jobs Act of 2017 is the final factor that must be considered when weighing the outlook for the commercial real estate industry.

The Tax Cuts and Jobs Act of 2017 created Qualified Opportunity Zones that created the opportunity for lucrative commercial real estate investment. In layman’s terms, the program creates the opportunity for Opportunity Funds to significantly reduce their capital gains liability, while simultaneously paying (or deferring payment on) lower taxes. If the Opportunity Funds hold onto the opportunity zone real estate properties for at least 10 years, then in some cases it is possible that the investors will be permanently excluded from the taxable income on the capital gains on profits from the property sale. This long-term strategy is only applicable to properties that are purchased within qualifying opportunity zones, and owned for at least 10 years. It is yet another way that investors can diversify their commercial real estate investments, while simultaneously reaping the immense tax benefits. Together, the above trends support a stable commercial real estate industry in pre, during, and post-recession markets.