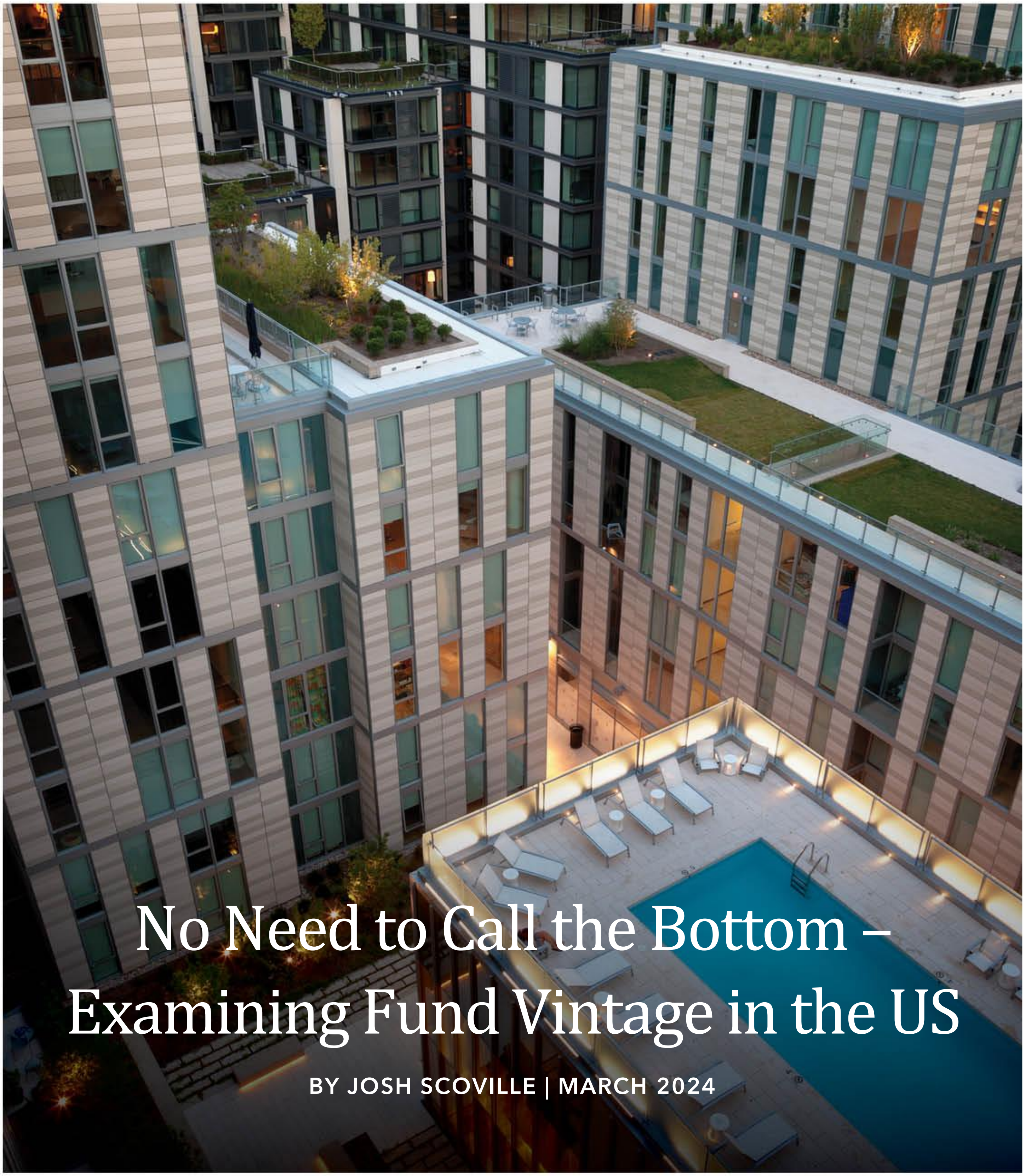

No Need to Call the Bottom – Examining Fund Vintage in the US

BY JOSH SCOVILLE | MARCH 2024

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Hines

Introduction

Investors may assume funds launched at the bottom of the market achieve the most compelling returns over the subsequent cycle; but historically some of the strongest returns have been generated by funds launched in years where property values are still declining[1].

A key reason is a consistent disconnect between appraised and actual transaction values during any given downturn, allowing funds to achieve "market beating" returns on those discounted opportunities.

While this analysis focuses on the US, we think the findings have application to real estate investment experience outside the US as well.

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Hines Focus

The average outperformance of vintage years for three cycles we looked at skews heavily to years 2 and 3. Over later years, underperformance or very moderate outperformance is the norm.

[1] Source: Preqin, NCREIF, Hines Research. As of December 2023.

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No Need to Call the Bottom – Examining Fund Vintage in the US

Rising financing costs since the Fed began to institute a series of rate hikes in March 2022 have put downward pressure on commercial real estate values. Indeed, the 11.9% annual decline in property values in the NCREIF Property Index (NPI) in 2023 was slightly worse than the annual losses suffered in 1991, 1992, and 2008 and is the second-worst year of appreciation returns since the index's inception in 1978. Only during the height of the great financial crisis in 2009 did property values fall faster over the course of a calendar year according to the NPI data.

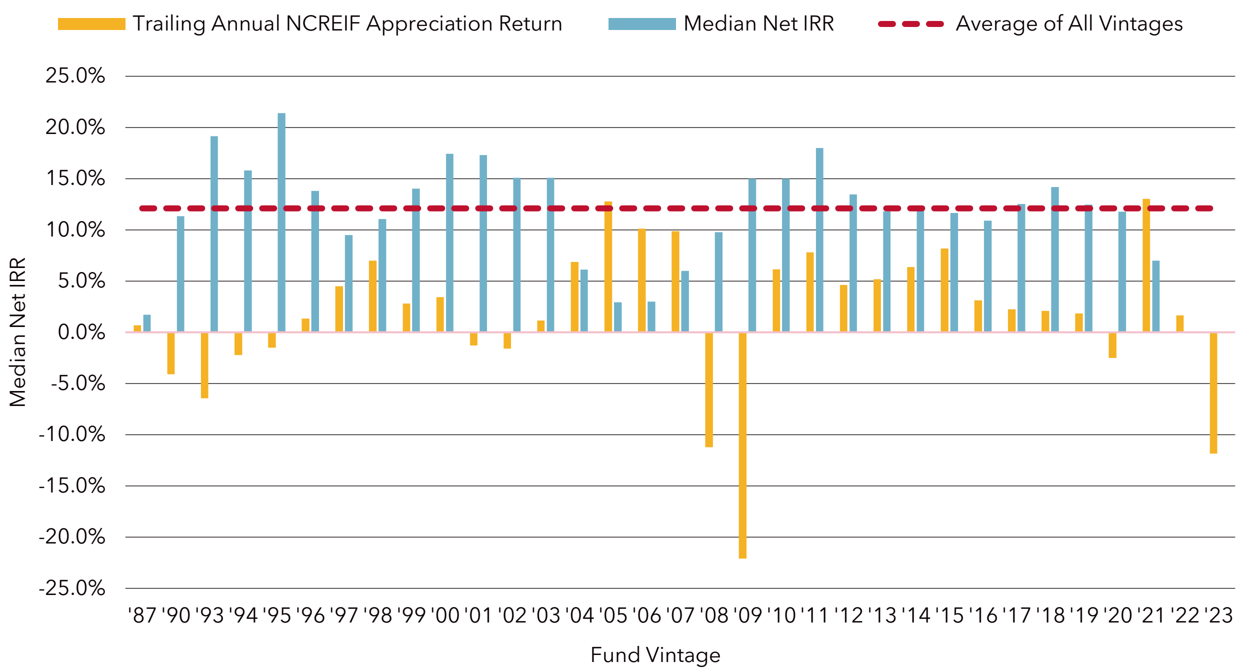
Private real estate valuations within the NPI database come from a mix of internal and external appraisals as well as actual transactions. However, as transaction volume has been relatively weak over the past 12-18 months, valuations within the database are more heavily driven by appraisals than they are during periods of greater transaction volume. In addition, given the lack of price discovery in the transaction market, appraisals are likely to be a bit more uncertain than they are during periods of robust transaction volume. As such, there remains a disconnect between appraisal and transaction cap rates[2] as previously detailed in our 2024 Outlook.

Historically, this disconnect has continued to put downward pressure on book valuations during periods of market dislocation and that may likely be the case this year and maybe into 2025. However, that does not mean 2024 won't be a good vintage to be investing in private real estate. In fact, history suggests it could very well be an excellent vintage given the valuation declines suffered in 2023.

To illustrate this point, Exhibit 1 depicts trailing annual appreciation returns for NPI as indicated by the blue bars relative to the median net internal rate of return for North American funds in each vintage year as reported by Preqin.[3]

2 Cap rate is the yield at initial purchase of an asset. It is a snapshot in time and varies over the life of a project. It is not indicative of long-term fund performance. 3 Preqin defines fund vintages as the first year that capital was called for each fund.

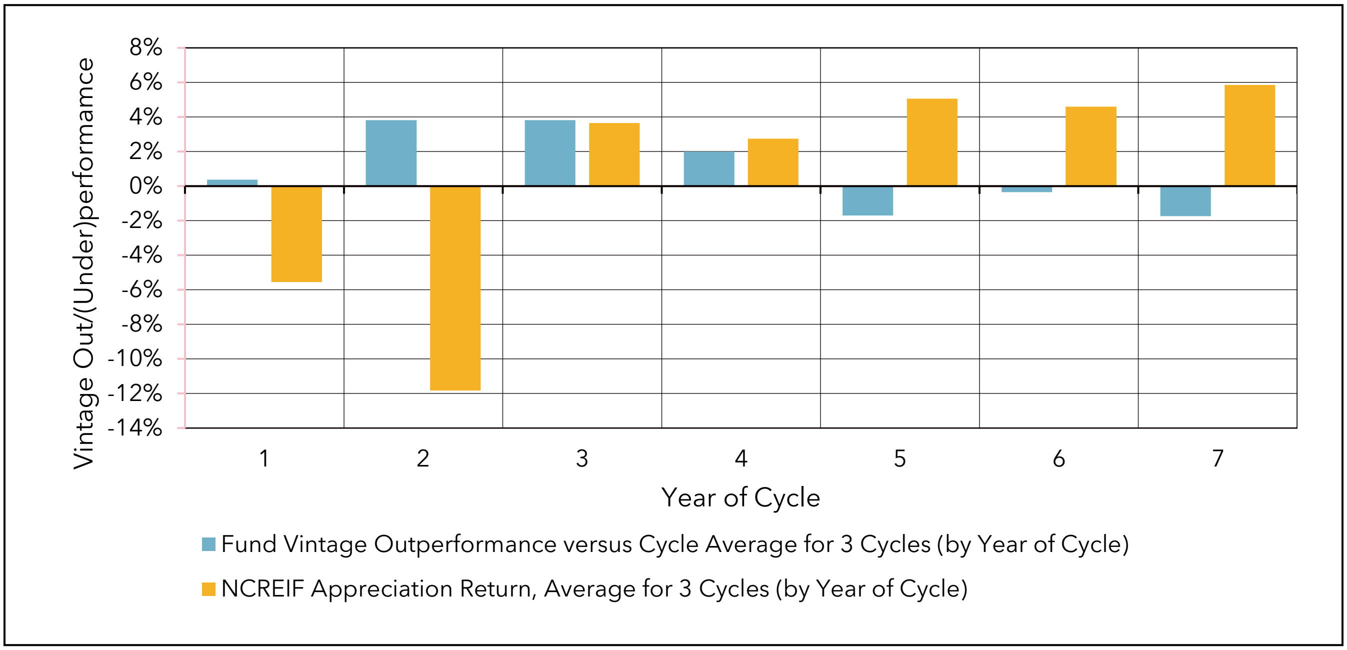
Exhibit 1: Some of the Best Fund Vintages Have Occurred When Values are Correcting



Sources: NCREIF; Preqin; Hines Research; as of 2023Q4

Within the historical data, 1993 stands out as a good example of a year where book valuations were still two years away from finding a bottom but funds launched in 1993 delivered the second-best vintage in the history of Preqin's North American funds data with a median net IRR of 19.2%. In the early-aughties, the aggregate impact of the dot-com bust on real estate valuations in 2001-02 was more muted as that downturn was concentrated in tech-oriented cities such as San Francisco, Boston, and Austin, but 2001 is another good example of book values continuing to be written down over the next year but funds launched in the year generated above-average returns. Finally, even in the worst of years, when private real estate valuations fell just over 22% in 2009, funds that had their first capital calls in that year produced an attractive median net IRR of 15%.

Exhibit 2: Seeking Outperformance – Frontloaded with Diminishing Opportunity



Sources: NCREIF; Preqin; Hines Research; as of 2023Q4. We use three cycles that begin with price declines: 1990-2000, 2001-2007, 2008-2019. We averaged the NCREIF capital appreciation returns and the vintage return per year relative to the overall cycle average return. Then those figures are averaged for years 1-7 for all three cycle, wherever data is available. We stop at seven years as that is the length of the shortest cycle.

It isn't just a case of specific fund vintages doing well early on. It turns out that relative to average returns over property cycles, the vintage outperformance is heavily front-loaded in the first few years. As we progress into any given property cycle, performance versus the cyclical vintage average has historically turned into underperformance. Exhibit 2 provides evidence. The average outperformance of vintage years for three cycles we looked at skews heavily to years 2 and 3. Over later years, underperformance or very moderate outperformance is the norm.

In the midst of write-downs and continued market dislocation, why does the market tend to generate outsized returns? There are several probable contributing factors but the greatest one is the fact that fresh capital is not being put to work at NPI book valuations but rather at market-clearing valuations which, as stated earlier, are likely a bit lower than book during times of market disruptions. So while write-downs on assets that haven't transacted may continue during downturns, assets that transact are more likely to reflect the full reset in value that any given correction is causing. In fact, those transactions are then likely to provide the evidence that appraisers are looking for to take additional marks on assets that haven't transacted. Hence, additional write-downs in book values persist.

While this analysis focuses on the US, the findings may have application to real estate investment experience outside the US. In all these property markets, US and outside the US, private real estate values are appraised. It is likely that during inflections in the market, appraisals lag actual market values for transactions, both on the downcycle and upcycle. It is likely that shared phenomenon that explains, at least partially, why funds launched even during periods of falling appraisal values have historically achieved competitive and often cycle-leading returns.

So are we at a market bottom? We don't know that we are within the context of the formal data but given the correction in values to date, history would suggest 2024 may be an excellent vintage to put fresh capital to work at reset valuations.

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Past performance is not indicative of future results. Represents the subjective opinion of Hines. Other market participants may have reasonably differing opinions.

The NCREIF NPI, short for the NCREIF Property Index is a quarterly index tracking the performance of core institutional property markets in the U.S. The objective of the NPI is to provide a historical measurement of property-level returns to increase the understanding of, and lend credibility to, real estate as an institutional investment asset class. The universe of investments: 1) is comprised exclusively of operating properties acquired, at least in part, on behalf of tax-exempt institutions and held in a fiduciary environment; 2) includes properties with leverage, but all returns are reported on an unleveraged basis and 3) includes Apartment, Hotel, Industrial, Office and Retail properties, and sub-types within each type. The database fluctuates quarterly as participants acquire properties, as new members join NCREIF, and as properties are sold. Sold properties are removed from the Index in the quarter the sales take place (historical data remains). Each property's market value is determined by real estate appraisal methodology, consistently applied. Please note that when returns are computed for the NPI, the returns for the levered properties are computed on a de levered basis, i.e. the impact of financing is excluded A benchmark Index is not professionally managed. Investors cannot invest directly in an index.

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