Retail-Office Performance Rotation

The office and retail sectors have a complicated relationship.

PHILIP CONNER
RYAN SEVERINO

THE OFFICE AND retail sectors of the U.S. commercial real estate market account for a significant share of institutional investment. However, their importance to investors and portfolio managers derives not only from their large size, but also from their long history of inverse investment performance. Since the inception of the National Council of Real Estate Investment Fiduciaries' Property Index (NPI) in 1978, the retail and office sectors have shown a distinct pattern of alternating relative outperformance compared with the overall NPI.

This pattern has been as predictable as it has been dramatic, due to fundamental differences between the office and retail property markets and investment cycles. The office sector historically has been prone to pronounced space market and investment cycles, while the retail sector has experienced relatively moderate cycles that have caused investment performance to deviate meaningfully from other major property types, especially office. As the past few years have shown, the resulting retail-office performance rotation has profound implications for investors, particularly those with portfolios benchmarked against the NPI. While retail's exceptional performance in recent years has provided a strong boost to portfolios holding retail properties, it has presented a formidable challenge for portfolios with an underweighting in the sector.

With the ongoing recovery in office market fundamentals gaining momentum and retail performance beginning to slow after years of strong gains, an impending rotation from retail toward office seems at hand. Total returns for the office sector of the NPI already have outpaced retail returns for three of the past four quarters. If history is any guide, the office sector will outperform both retail and the overall NPI over the near to medium term.

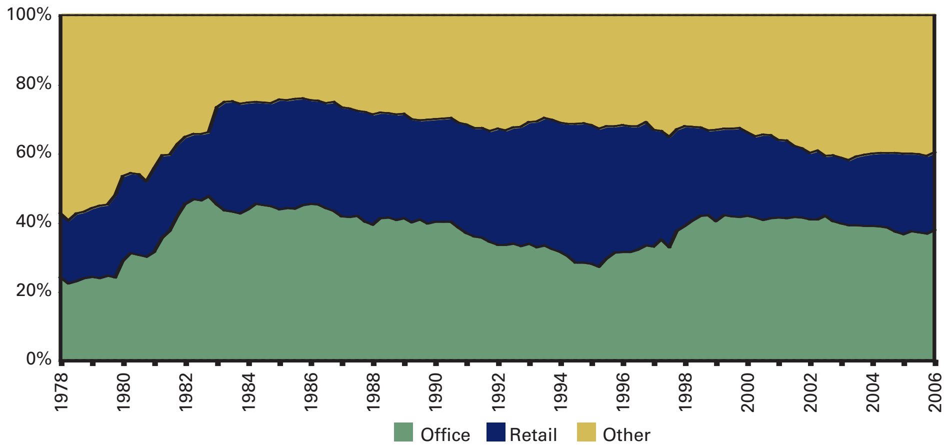
THE PERFORMANCE ROTATION PHENOMENON

The office and retail sectors are the mainstays of the U.S. commercial real estate market. Although each sector's share of the institutional real estate universe, as defined by the NPI, has fluctuated, together they have averaged about 65 percent of all NPI investments (by value) since 1978. Institutional investment in the office sector has been the highest among the major property types, averaging about 37 percent, followed by retail with an average share of about 28 percent.

Figure 1 shows a breakdown of the NPI by property type (based on market value) since 1978. Although current institutional allocations to the office sector are basically in line with their long-term average, allocations to retail property remain below their long-term average, despite robust gains in recent years. Institutional investment in the retail sector peaked at more than 40 percent of the NPI in the fourth quarter of 1994, and then declined steadily throughout the latter half of the 1990s and early 2000s, reaching a low of 17.4 percent in the third quarter of 2002. While several factors contributed to the decline, the rapid growth of the U.S. REIT market precipitated a transfer of assets, particularly regional malls, from private to public ownership during the mid- to late 1990s.

Historically, retail and office total returns have followed a fairly similar pattern. With a few exceptions, total returns for the two property types have moved roughly in tandem. However, as Figure 2 displays, the amplitude of the office return

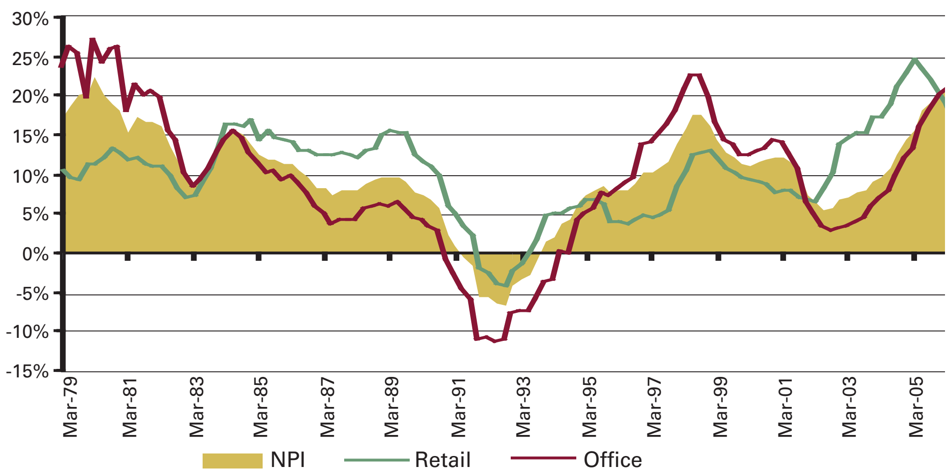
Figure 1: Office and retail as a share of institutional investments



Sources: NCREIF; Prudential Real Estate Investors

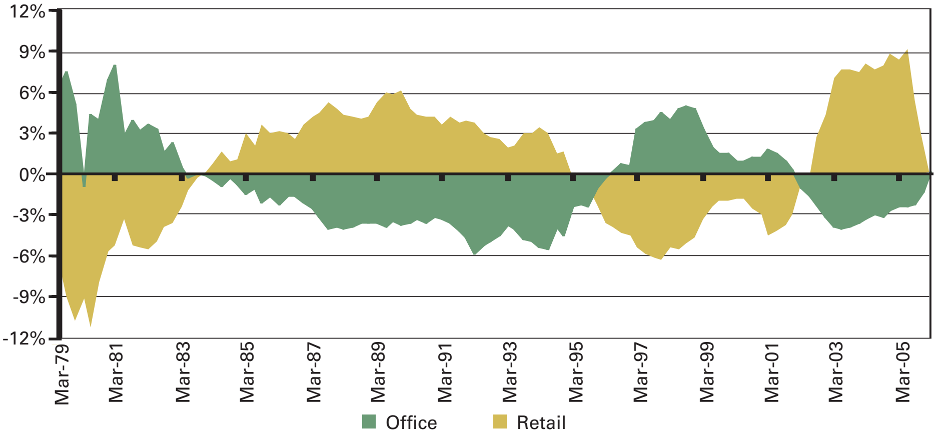
cycle has been much greater. The early 1990s market downturn and subsequent recovery were much more pronounced in the office sector than in retail. At the bottom of the last real estate market cycle, trailing one-year total returns for the office sector fell below –11 percent, about 600 basis points lower than retail. At the peak of the late 1990s market recovery, office returns climbed to more than 22 percent on a trailing one-year basis, versus about 12 percent in the retail sector.

Figure 2: Historical returns follow similar pattern



Sources: NCREIF; Prudential Real Estate Investors (quarterly data as of 1Q06)

Figure 3: Relative performance reveals rotation



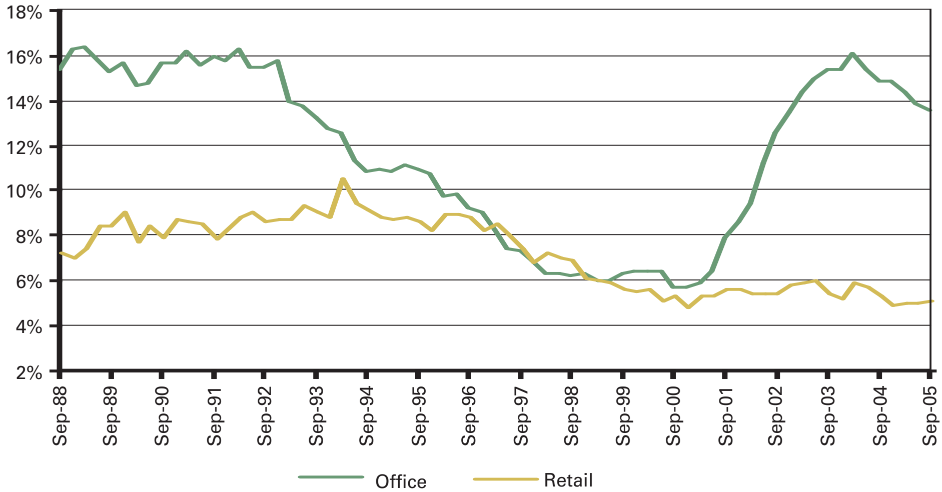
Sources: NCREIF; Prudential Real Estate Investors

The relative performance of the office and retail sub-indexes versus the NPI exhibits a distinct performance rotation pattern (Figure 3). Throughout most of the 1980s and early 1990s, retail property outperformed the overall NPI and the office sector, which suffered massive oversupply from the late 1980s building boom. However, as office space market fundamentals improved in the mid-1990s, the office sector rebounded strongly while retail struggled. Widespread tenant bankruptcies, excess supply, particularly of big-box retail space, and the e-commerce threat caused retail to underperform both the NPI and the office sector over the second half of the decade and into the 2000s. Retail resumed its outperformance in late 2001, as the economy slipped into recession, and job losses and office vacancies soared. Over the last three years (through the first quarter of 2006), the retail sub-index of the NPI has delivered total compound annual returns of 20.2 percent versus 13.2 percent for the office sub-index and 15.1 percent for the NPI. Recently, retail returns have moderated while office performance has improved. After outperforming the retail sub-index in three of the past four quarters, the office sub-index boasted a one-year total return of more than 20 percent as of the end of the first quarter of 2006, or about 150 basis points higher than the retail sub-index and slightly higher than the overall NPI.

SPACE MARKET CYCLES

The retail-office performance rotation derives partly from differences in the two sectors' space market cycles. These cycles

Figure 4: Contrasting vacancy cycles



Sources: NCREIF; Prudential Real Estate Investors

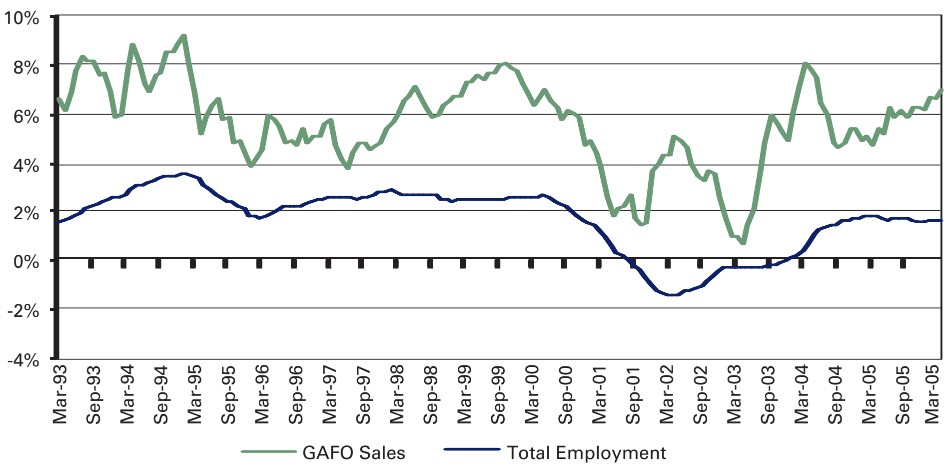
differ dramatically in timing and magnitude due to the demand and supply dynamics in the two sectors. As Figure 4 shows, the amplitude and volatility of the office vacancy cycle have been much higher than in the retail sector. The office vacancy cycle's higher volatility and amplitude stem partly from the sector's more concentrated demand base. The corporate sector of the economy, especially office employment, drives demand for office space, which is a function of headcount. When the economy is expanding and adding jobs, as it has recently, office demand typically rises, albeit with a lag. When the economy is contracting and shedding jobs, office demand usually suffers, also with a lag.

Retail demand is different, as the diverse consumer sector drives demand for retail space. As the past few years have demonstrated, consumer spending and sentiment can remain remarkably strong even as the corporate sector is struggling. This is not to say that employment is unimportant to consumers. Rather, employment is only one of several factors that determine consumer spending and the demand for retail space. Earnings growth and wealth—from a wide range of sources including financial assets and homes—also contribute to consumers' ability and willingness to spend.

The more diverse demand drivers for the retail sector reduce the volatility of retail demand. For example, the U.S. economy lost more than 2.6 million jobs between year-end 2000 and mid-year 2003. Office vacancy rates rose sharply as many companies slashed their workforces or disappeared altogether. However, consumer spending remained relatively robust due to two factors. Firstly, falling interest rates and strong home price appreciation created a wealth effect that, in the aggregate, more than offset the job losses. Home refinancing volume during this period spiked to more than $17 trillion. Although most of this money was used to pay off existing mortgages, consumers spent some of the proceeds on goods and services. If just 5 percent of the total refinancing volume returned to the economy in the form of consumer spending, the refinancing boom translates into roughly $857 billion in additional consumer spending over just two-and-a-half years. To put this figure into perspective, if the average office job pays about $40,000 per year, the 5 percent cash-out from refinancing activity amounts to the gross annual income from more than 21 million jobs, or nearly eight times the number of jobs lost during the recession. Secondly, the government implemented a series of tax cuts and rebates during this same time that also bolstered retail sales. Although the total impact is virtually impossible to calculate, consumers undoubtedly spent billions of dollars because of these tax changes.

The retail sector's more diverse demand base is one of several factors that contribute to the relatively high annual growth rate for store-based retail sales. The GAFO index is a proxy for store-based retail sales, including general merchandise, apparel, furniture and other types of similar merchandise. Year-over-year GAFO sales growth has averaged a nominal 5.5 percent since 1993, while job growth has

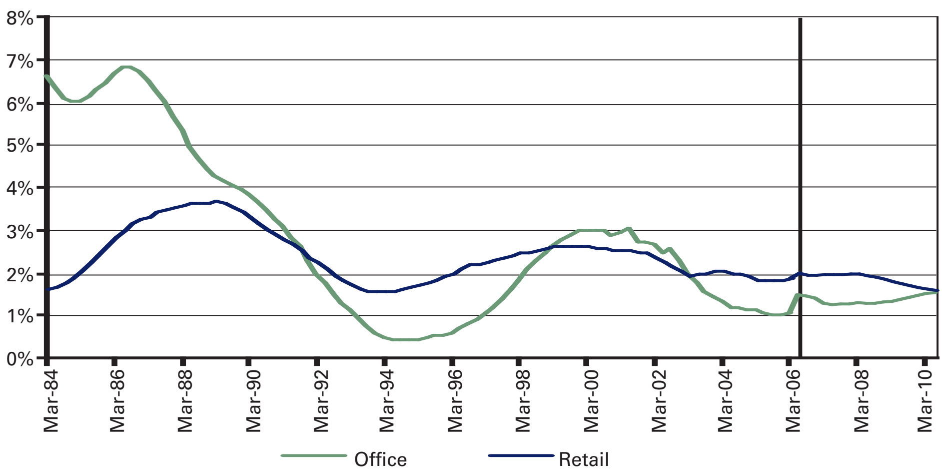
Figure 5: Retail sales growth vs. employment growth



Sources: Census Bureau; BLS (Economy.com); Prudential Real Estate Investors averaged 1.6 percent per year (Figure 5). The two series are not directly comparable, and serve only as rough proxies for demand growth for retail and office space. But it seems reasonable to expect that growth in demand for retail space should be a little higher, on average, than office demand, despite the fact that office employment growth should be a little higher than the total employment growth shown in Exhibit 5. (With the U.S. population growing at about 0.8 percent per year and increasing numbers of echo boomers entering the workforce, total employment growth should average roughly 1.2 percent per year over longer intervals. However, because most of the new jobs in today's economy involve office-using occupations, office employment growth, the key driver of office demand, should be a little higher, on average, or about 1.8 percent per year.) Powerful demographic forces, especially the many baby boomers who are in their prime earning and spending years, and other trends such as outsourcing (or offshoring) office jobs to lower-cost markets make it unlikely that this disparity in growth rates will narrow much in the near to medium term.

Not surprisingly, office supply growth has also been much more volatile than retail supply growth (Figure 6). Over the longer term, average office and retail supply growth rates have not been radically different. For example, between the first quarter of 1983 and the third quarter of 2005, total office and retail stock in the United States grew at average annual rates of about 3 percent and 2.4 percent,

Figure 6: Moderate, relatively stable retail supply growth



Sources: Property and Portfolio Research; Prudential Real Estate Investors respectively. However, as seen in Figure 6, retail supply growth has been much more stable. During the late 1980s construction boom, for example, U.S. office stock was growing at a 6 percent-plus annual rate before the market crashed and new development largely ceased for nearly four years. Retail supply growth, by comparison, peaked at about 3.7 percent per year during the late 1980s, and generally has remained within a fairly narrow band of 2 percent to 3 percent annually for the last decade or so.

Several features of the retail market, beyond the sector's more diverse demand base, also help explain the more moderate growth in retail stock. Perhaps the most obvious characteristic that distinguishes retail from the office sector is the diversity of formats. Most commercial properties are classified according to the quality of the improvements and their location in an urban or suburban area. Retail properties, however, also vary widely by format, depending on the design, use and, in some cases, tenancy of a property. This diversity has a smoothing effect on the retail supply cycle. Although certain formats go through periods of robust supply growth that can be just as extreme as the office supply cycle, such as malls in the 1980s, power centers in the 1990s and lifestyle centers today, the impact of a surge in supply of a particular format on the overall retail universe is usually fairly modest.

Retail space also suffers from a higher rate of obsolescence than office space. This is partly due to retailers experimenting with new formats to appeal to consumers' changing preferences and to differentiate themselves from their competitors. However, the retail industry does a particularly poor job of eliminating unproductive or obsolete space. Old retail space dies hard: shopping centers and malls can limp along for a surprisingly long time before the economics justify demolition or redevelopment. Although the persistently under-demolished state of the U.S. retail market probably inflates retail vacancy rates and can make other market metrics (for example, rent growth) less meaningful, it affords more opportunities than in other property sectors to easily recycle space. Recycling unproductive space can satisfy considerable demand, from both retailers and investors, without increasing the retail stock.

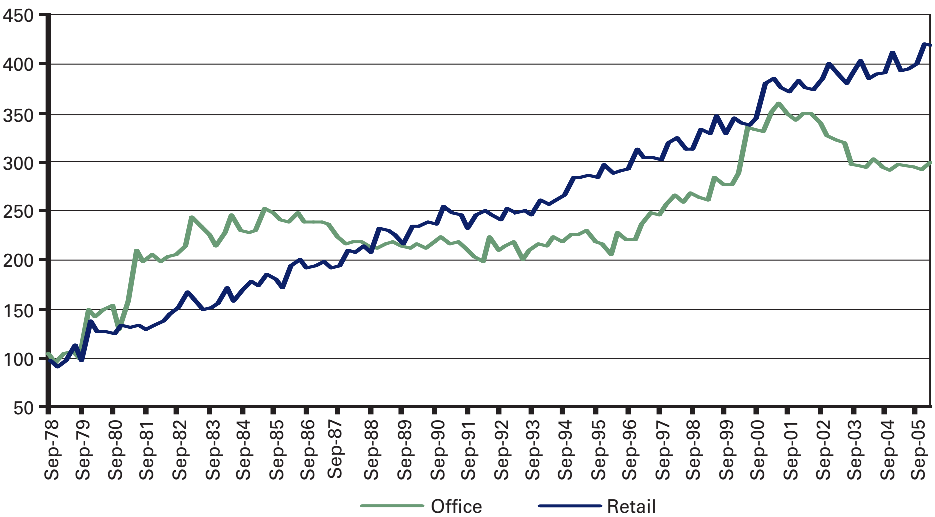
Lastly, retail development often requires more coordination between developers, tenants and communities than most other major property types, which helps keep new supply from expanding too quickly ahead of demand. Local authorities and community-based groups play an active role in planning and approving retail development that can be quite different from the roles they play in other types of commercial development. Wal-Mart, for example, continues to face strong opposition in many communities where the company would like to open stores.

Likewise, the closer relationship between retail tenants and the underlying real estate requires greater cooperation between developers, landlords and retailers. Unlike most types of commercial real estate, the success of a retail tenant often depends on the features of the real estate itself. Characteristics such as the quality and design of the improvements, the tenant mix, and the occupancy levels have a more direct and greater impact on the success of retail tenants than in most other types of commercial real estate. The income potential of an office space user, for example, generally does not depend on the location and design of the company's office space, or on the presence (or absence) of other tenants in the same building or complex. As a result, relatively few retail centers are developed or redeveloped on a purely speculative basis. Typically, a developer will secure an anchor tenant, usually one that will attract other retailers, before construction begins.

INCOME GROWTH PATTERNS

The more pronounced space market cycle in the office sector naturally produces higher volatility in office property income and, hence, in investment performance. Figure 7 compares the quarterly growth in net operating income (NOI) for the office and retail sectors of the NPI. Both series

Figure 7: Pronounced office vacancy cycle produces income volatility

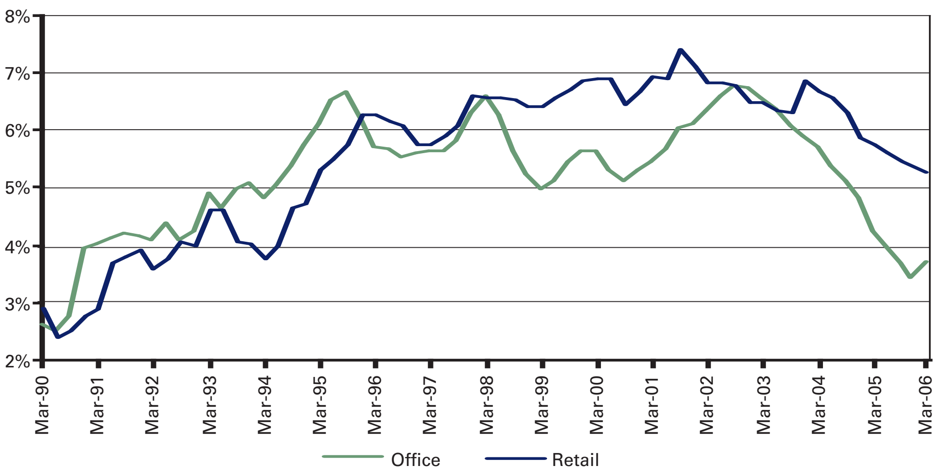


Sources: NCREIF; Prudential Real Estate Investors can be fairly volatile in the short term, but NOI growth in the office sector exhibits a distinct cyclical pattern over the longer term, which is consistent with the vacancy cycle shown earlier.

While space market cycle differences explain much of the variation in property income, the retail sector also benefits from defensive features that help guard against downturns in property income. For example, multi-tenant retail properties frequently offer a diversified tenant base that insulates property income from cyclical (or seasonal) downturns in consumer spending. Most shopping centers and malls have a broad range of retailers selling a wide array of discretionary and non-discretionary products. Consumer demand for different types of goods can vary dramatically by season or month, but a diverse tenant mix can greatly reduce the impact of a downturn in demand for certain types of goods on a property's NOI. In fact, this feature is one of several attributes that have attracted investors to grocery-anchored shopping centers in recent years. In theory, the non-discretionary nature of the anchor tenants' merchandise affords some protection against any weakness in consumer spending. In addition, many of the anchors have longer-term leases that mitigate downturns. This is obviously not true for all retail property types (such as malls, where the anchors pay very little), but it is true for power centers and shopping centers.

The office sector's more volatile supply and income cycles have important implications for investors in terms of the cash yields they can expect over the course of an

Figure 8: Office supply cycle and income volatility affect cash yields



Sources: NCREIF; Prudential Real Estate Investors investment cycle. Office cash yields have varied much more than retail yields (Figure 8). While this is largely due to the more pronounced income cycle, capital expenditures for tenant improvements (TIs) and leasing commissions exacerbate the effects of the office sector's higher income volatility. TIs and leasing commissions are prevalent in both the retail and office sectors. However, because the office demand and supply cycles are more severe, office landlords face greater variation in the pricing power they wield when negotiating with tenants. When office vacancies are high, as they are today, landlords must offer generous TI packages both to attract and to retain tenants. Moreover, TI packages for office space are larger than those for retail space, which means that not only do they constitute a greater potential expense in absolute terms, but they also can vary much more, further increasing the volatility of office yields. This feature of the office market is particularly relevant today. TIs and leasing commissions are not reflected in office and retail cap rates, which typically are based on a property's recurring earnings power. However, capital expenditures for these items can have a dramatic effect on cash yields. As Figure 8 shows, the combination of stable to rising office property values, falling income (due to higher vacancies and lower market rents) and increasing capital expenditures has already depressed office cash yields to very low levels.

THE CYCLE AHEAD

While recent returns for the retail and office sub-indexes of the NPI indicate the start of a new cycle during which the office sector will most likely outperform both retail and the overall NPI, the next cycle likely will be less dramatic than in the past for several reasons. First, institutional investors are still relatively underweighted in retail property compared with historical levels. Given the sector's relatively attractive cash yields and excellent performance in recent years, it seems unlikely that investors will dramatically reduce their retail holdings in the near term, particularly as the economy continues to expand.

Second, although retail performance has slowed as the outlook for the office sector has improved, the same forces fueling the office market recovery should also continue to support consumer spending while boosting consumer confidence. Retail sales are forecast to slow in the next year or two as rising interest rates take some of the momentum out of the housing market and increase consumers' debt burdens. However, total retail sales growth (including food services but excluding motor vehicles and parts) is expected to remain fairly robust, growing at about 4 percent to 5 percent per year. Demand for retail space should, therefore, remain fairly healthy as well.

Finally, the ongoing recovery in the U.S. office market will likely be more muted than in past cycles. Although office vacancies soared after 2001, the extraordinary liquidity in the real estate equity and debt markets prevented a repeat of the severely depressed investment market conditions that accompanied the early 1990s downturn. Without a sharp correction in office asset values, opportunities for the excess returns that drove the office sector's outperformance during the late 1990s will be fewer and further between in the current recovery cycle. Moreover, few economists expect employment growth in the current labor market recovery to reach the levels of the late 1990s. According to Torto Wheaton Research, real office rents reached a cyclical low in the third quarter of 2005 at roughly 1996 levels, and are forecast to rise only modestly over the next few years.

CLOSING THOUGHTS

The historical data from the NPI reveal a distinct pattern of rotating performance between the office and retail sectors relative to the overall NPI. Although the retail sub-index of the NPI has significantly outperformed the office sub-index in recent years, the U.S. real estate market has reached a turning point. As office vacancies decline, office rents rise, and retail sales slow from the torrid pace of recent years, the office sector should outperform retail for several years. However, while we expect the rotation pattern to continue, the outperformance may not be as large—or as apparent—as in the past. Retail fundamentals remain relatively strong and should continue to attract investors, even as retail sales growth slows. Office employment growth likely will not reach the levels seen during past recoveries.