June 2019

Real Estate

Core Real Estate for U.S. Insurers

MetLife Investment Management

Introduction

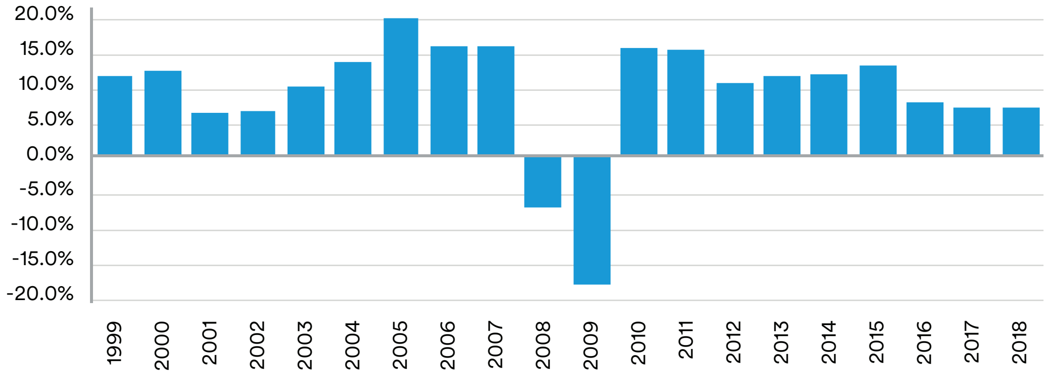
Commercial real estate was once viewed as a niche investment sector, but after several decades of evolution it has emerged as a fully mature asset class. In recent decades liquidity has improved, transparency has risen, and core real estate's investor base has broadened substantially. Joint ventures, private funds, and public companies draw capital from sources both foreign and domestic. These new vehicles and their investors play an important role in today's real estate capital markets, but the sector's oldest and most experienced investors remain at its core. Many of these investors can be found among the ranks of the nation's most established insurance companies.

Core real estate equity, with returns composed of both income and appreciation, offers insurers a mix of benefits difficult to replicate with other asset classes. The sector has consistently produced positive total returns historically, and its risk-adjusted returns are among the highest of any major asset class. If held directly, it offers significant short- and long-term tax advantages. It acts as a strong portfolio diversifier, exhibiting relatively low historical correlations with other sectors, and fits well into portfolios organized around asset liability matching strategies. Its perpetual life and discretionary hold periods also make it effective at defeasing medium and long-term liabilities. The sector's challenges lie primarily in the expertise necessary to execute individual transactions, manage national portfolios, and navigate insurance company portfolio frameworks. For those insurers with the expertise to address these challenges, we believe the rewards of an allocation to core real estate equity can be great.

Historical Performance

Core real estate equity has historically offered attractive total returns. During the period from 1999 – 2018, the sector produced positive total returns in 18 out of 20 years, and an average total return of 8.78%.[1] Total returns were negative only twice, in 2008 and 2009 during the Great Financial Crisis (Exhibit 1). The consistency of the sector's historical performance is driven largely by its reliance on in-place income. During the 20-year period from 1999 – 2018 approximately 73% of the sector's total returns were derived from income. The remaining 27% came from appreciation, which was itself partially driven by expectations of future income growth. In addition to providing consistently strong absolute returns the sector's reliable flow of income also contributes to attractive risk-adjusted returns.

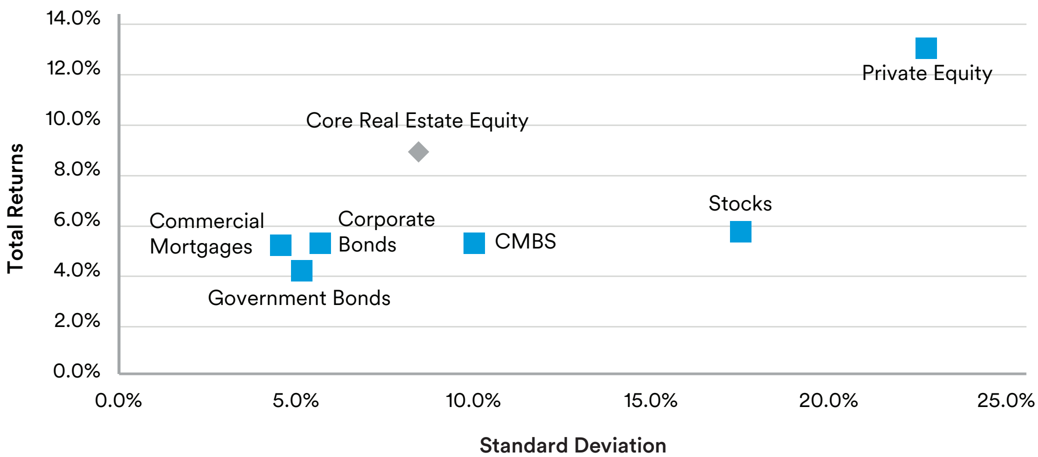
Exhibit 1 | Core Real Estate Equity Total Returns



Source: MIM, NCREIF.

Core real estate exhibits one of the highest total returns and lowest standard deviations of any major asset class. The sector has historically exhibited substantially lower volatility than other equity asset classes such as stocks and private equity and has outperformed the former (Exhibit 2). While more volatile than bonds core real estate equity has also exhibited substantially stronger total returns and experienced fewer years of negative returns. Only commercial mortgages can boast lower volatility and fewer years of negative returns, but at the cost of lower total returns during positive years. We believe core real estate equity's combination of high total returns and moderate volatility allow it to effectively straddle the low and moderate risk buckets in a multi-asset class portfolio. Its greatest contribution to such a portfolio, however, may lie in its diversification benefits.

Exhibit 2 | Annual Total Returns and Standard Deviation by Major Asset Class



Sources: MIM, Moody's, Bloomberg, NCREIF, Gillibert-Levy, Barclays, Cambridge Associates.

Diversification

In addition to consistently attractive absolute and risk-adjusted returns, core real estate equity can act as a strong diversifier in a multi-asset class portfolio. Over the last two decades the sector has exhibited relatively weak correlations with commercial mortgages, CMBS, stocks, bonds, and private equity investments (Exhibit 3). Its average correlation with these sectors is only 0.09, the weakest cross-sector correlation exhibited by any major asset class excluding commercial mortgages, and its strongest correlation with any single asset class measures only 0.34.

Exhibit 3 | Correlation of Total Returns by Major Asset Class (1998 - 2018)

	Core RE	CMLs	CMBS	Corp. Bonds	Gov. Bonds	Stocks	Private Equity
Core RE	1.00	0.21	-0.09	0.15	-0.28	0.09	0.34
CMLs		1.00	-0.09	-0.07	-0.09	-0.06	0.15
CMBS			1.00	0.34	0.86	-0.14	0.06
Corp. Bonds				1.00	0.06	0.22	-0.20
Gov. Bonds					1.00	-0.78	-0.57
Stocks						1.00	0.64
Private Equity							1.00

Sources: MIM, Moody's, Bloomberg, NCREIF, Gillibert-Levy, Barclays, Cambridge Associates.

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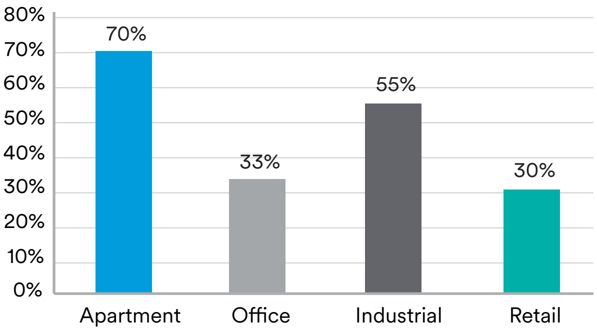
It is also possible to construct highly diverse portfolios within the real estate sector itself. Real estate demand is driven less by aggregate economic growth than by specific components of that growth. Labor market conditions, demographics, and consumer spending all fuel real estate demand across property types. As a result, industry concentration, demographic composition, and wage levels can all have a substantial impact on the fortunes of individual property types and markets.

The four major property types are each driven by different economic and demographic trends. The office sector is heavily driven by job growth in office-using employment sectors. The apartment sector is driven by a combination of job growth and the shape of demographic trends. The retail sector is fueled by consumer spending and its tenants and formats constantly adapt to changes in consumer behavior. Formerly driven chiefly by trade, the industrial sector is now heavily driven by consumer spending and population distribution. Depending on the outlook for these and other drivers the income growth each property type is able to achieve in a given period can vary significantly (Exhibit 4). During the current cycle the apartment and industrial sectors have been the standouts. The apartment sector has benefited from strong cyclical demand growth generated by the Millennial Generation, while the industrial sector has benefited from structural changes in demand associated with the rise of e-commerce.

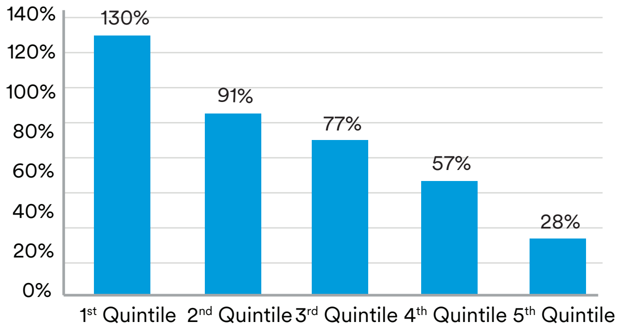
Within the individual property types, performance can also vary greatly. The U.S. economy is highly decentralized relative to other developed markets, and the nation's tradition of local control results in a lack of consistency between zoning and land use laws at the metro level. With each metropolitan area driven by different industries and demographic drivers, real estate demand growth can vary substantially, as can the development community's ability to respond to that demand with new construction. The result is often a significant variance in income growth between different markets even within the same property type (Exhibit 5). During the current cycle markets with stronger job growth in the fields of science, technology, engineering, and mathematics registered the highest income growth. Not far off were those markets that boasted stronger population growth driven by diverse economies and lower costs of living.

Exhibit 4 | NOI Growth by Property Type (2010-2018)



Source: MIM, NCREIF.

Exhibit 5 | Apartment NOI Growth by Market



Source: MIM, NCREIF.

The sector's potential diversification benefits do not end at the asset level. Particularly in the nation's largest markets workers are employed in a host of different industries. Multi-tenant office buildings are the norm, apartment complexes are home to residents across a wide array of professions, and retail centers mix apparel, services, and dining and entertainment options too numerous to mention. As a result, asset level incomes are often highly resilient and high levels of vacancy in seasoned core assets are rare even in times of slow economic growth.

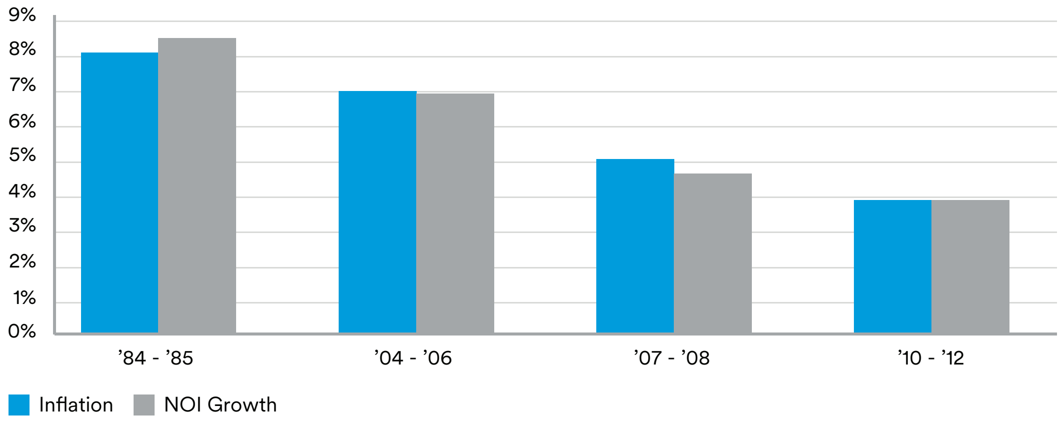
The diversification benefits of core real estate equity also extend to the capital sources that typically invest in the sector. A typical real estate transaction can take from 30 – 90 days to complete. As a result, core real estate has historically been viewed as an illiquid asset class and carried an appropriate yield premium. We believe this view, however, fails to account for the role that individual capital sources play in determining sector-wide liquidity. The fixed-income and corporate equity markets are dominated by relative value buyers that can shift in and out of individual sectors based on current market conditions. By contrast, the majority of real estate capital is sourced from either long term, relatively static allocations, or from investors focused solely on the real estate sector. As a result, core real estate equity held directly offers liquidity throughout the economic cycle that is less heavily impacted by short term conditions. For investors seeking to diversify their portfolios by asset class, to invest in a sector which is itself diversified, or to diversify their sources of liquidity, core real estate can be a highly attractive option.

Asset Liability Matching

Core real estate provides investors following an Asset Liability Matching ("ALM") strategy with an effective tool for defeasing a wide range of medium and long-term liabilities. The time necessary to acquire, improve, and dispose of direct real estate could leave it ill-suited to match short term liabilities. The perpetual life of real estate assets, however, means that they can be matched to liabilities of five, ten, or thirty years, or of any period beyond or in between.

In addition to flexibility in matching the duration of liabilities, real estate equity also offers the opportunity for enhanced yield potential over time and acts as a strong hedge against inflation. The rolling nature of commercial real estate leases, which range from three to twenty years depending on property type and market, allow space to be repriced on a regular basis. Market rents, the price of that space, are driven by a combination of inflation and supply and demand fundamentals. When fundamentals are in balance, rents and net operating incomes rise at roughly the pace of inflation and exceed that pace when demand is greater than supply. During the last two decades growth in net operating income has outpaced inflation by 132 bps annually as demand has consistently outpaced supply during periods of economic expansion.[2] During the brief periods when supply and demand have been in balance net operating income growth has roughly equaled the pace of inflation (Exhibit 6).[3] As a result, core real estate equity can not only be used to match liabilities of varying lengths, it can also offer the ability to maintain or enhance real yields over that time.

Exhibit 6 | Inflation Spikes During Balanced RE Conditions



Source: MIM, Moody's Analytics, NCREIF.

Tax Advantages

For insurers that own real estate assets directly the tax advantages can be significant. Direct holders of real estate assets can reduce taxable income by depreciating the cost of existing improvements and ongoing capital expenditures. For office, retail, and industrial assets this depreciation can be taken on a 39-year basis, for multifamily assets it can be taken on a 27.5-year basis, and for certain building systems it can be assessed at an even faster rate.4 At the standard corporate tax rate of 21%, a core multifamily asset purchased at the end of 2018 could be expected to yield an after-tax income return of approximately 3.23% before depreciation. Once depreciation deductions are used to reduce taxable income, however, the after-tax income return would rise to 3.76% on a cash basis.5 The result is that while depreciation reduces net investment income, it actually produces a higher level of after-tax cash flow than its pre-tax income return would suggest. That after-tax income return also has the potential to rise substantially over time.

As depreciation deductions are taken the asset's book value will decline and as its leases are renewed, or its rents contractually increased, net operating income will rise. The result is that by year five the after-tax income return on book value will likely have grown to 4.45%, by year ten to 6.40%, and by year fifteen to 8.94%.6 As impressive as these returns are it should be noted that they are calculated on a nominal basis and as a result do not reflect the additional benefits depreciation offers via deferred taxation. Deferred taxes on net operating income can be reinvested to generate additional income, and long-term inflation will reduce the impact of those taxes when depreciation is recaptured in the future. As such, the impact on portfolio level returns is likely to be even greater than our asset level income returns suggest.

The tax benefits of core real estate also extend to the point of sale. In addition to strong income returns investors receive the benefit of appreciation driven by net operating income growth and changes in capital market conditions. For those who are holding real estate assets at book value unrecognized gains can grow to be substantial over time. The recognition of these gains through disposition can be used to offset losses elsewhere in the portfolio, bringing stability to portfolio level returns during volatile periods. From 1998 – 2018 core real estate achieved an annual appreciation return of 2.29%. If that rate continued for the next ten years the asset would offer not only an income return on book value of 6.40% in year ten, it would likely also carry an unrealized gain equal to 25.45% of its original purchase price. A potential side

benefit of this unrealized gain is the ability to cushion potential declines in market value during the hold period. If real estate assets are held directly, and thus at book value, the decline in market value required to result in an impairment would need to be in excess of 25.45%. As a result, directly held real estate equity generally exhibits lower statutory capital volatility than equity investments in other asset classes.

Risk Based Capital Requirements

One of the persistent questions that insurers face when considering an investment in core real estate is its likely impact on risk-based capital ("RBC"). At present (June 2019) real estate equity held as an investment by life insurers carries a capital charge of 15% of carrying or book value while joint ventures and funds carry a charge of 23% of book value.[7] Since real estate is categorized with bonds in the C1 portion of the life insurer covariance formula it also receives a relatively small covariance adjustment, despite its strong diversification benefits. There are, however, efforts underway to lower RBC charges for real estate investments that may produce results in the near future. Though not a focus of current efforts the sector's diversification benefits would also suggest that a future reassignment within the covariance formula may be appropriate. For now, though, the existing RBC framework can present challenges at first glance. A deeper analysis paints a more complex but encouraging picture.

Directly held real estate and real estate fund investments have strengths and weaknesses within RBC and ALM frameworks that can affect how the two interact. Risk based capital charges are based on book value for directly held assets and fair value ("market value") for funds. As a result, one approach may be more attractive than the other depending on an insurer's goals. Take for example, an insurer primarily concerned with keeping RBC charges low. The capital charge on direct real estate is higher than that of high yield NAIC 4 bonds, but that may be only temporary. As an investment's book value declines through depreciation so too does its effective RBC charge. While initially a newly acquired multifamily asset would require an RBC charge of 15% before the covariance adjustment that same asset would require a charge of around only 11% in year ten, not far off from an NAIC 4 bond, but likely with a higher return on book value and potentially significant unrealized gains.

The potential downside of direct ownership will depend on the basis by which a given insurer runs their ALM strategy. If an insurer chooses to match liabilities against book value the number of policies they can match against a given real estate asset will decline over time as its book value depreciates. We would not recommend this approach as it fails to recognize the true cash flow that is likely to be achieved upon disposition, but for those that choose to pursue it an investment in a fund may be more attractive. Since fund investments are carried at market value the amount of liabilities they can be matched against is likely to grow over time as net operating income growth drives appreciation.

In addition to potentially offering the ability to match a larger amount of liabilities fund investments can also result in more stable periodic returns. Since fund investments are carried at market value appreciation is booked as it is recognized, regardless of whether or not the asset has been sold. While this does not allow for the retention of unrealized gains to balance portfolio losses it does reduce the likelihood of large gains being recognized in any individual quarter. Doing so in a directly held portfolio of real estate assets will likely require a managed sales program that would need to be balanced against individual asset performance and prevailing market conditions that may suggest a sale at an earlier or later date.

Investment Vehicles

The decision on whether to invest in core real estate through a fund or direct ownership will rest on a number of different considerations that extend beyond RBC and ALM. Unlike fund investments, direct ownership offers insurers the ability to craft portfolio strategy, maintain operational control of assets, direct additional capital investment, and make acquisition and disposition decisions. By contrast, investments in comingled funds cede the decision-making authority in these areas to fund managers. In return, funds offer a host of potential benefits.

Fund structures often provide insurers with access to greater diversification of assets, strategies, and markets, as well as the ability to utilize leverage. The size of individual core real estate assets can, however, make it difficult to construct a diversified portfolio within the sector without a significant allocation. As of the fourth quarter of 2018 assets in the NCREIF Fund Index – Open End Diversified Core Equity (“ODCE”) recorded an average market value of approximately $104 million.[8] While many core assets can be acquired for lower amounts this figure illustrates the limits to which even relatively large allocations can be used to construct diversified portfolios. Investing in a fund solves this problem by providing the investor with a relative share of each asset in the fund. As a result, investors are able to acquire access to a much higher degree of diversification with a far smaller commitment.

In addition to diversifying across property types and markets funds often enjoy a greater flexibility in the use of leverage and modest exposure to non-core investments. Core-plus investments involving properties in lease-up, value-add projects that may call for large capital investment or asset repositioning strategies, and ground-up development of new core assets can all enhance returns. The ODCE funds also employ a modest level of leverage comprised of asset and fund level debt. In the fourth quarter of 2018 the ODCE reported a leverage ratio of 21.5%.[9] Likely as a result of these advantages the index has consistently outperformed unlevered core real estate in recent years. In 2018 the ODCE recorded a total return of 8.35% compared to 6.90% for unlevered core real estate.

Required Expertise

Core real estate equity offers insurers numerous benefits, but that does not mean that they are easy to access. Real estate assets are asset management intensive, requiring specialized investment, operational, and legal expertise spread across multiple teams. Despite significant advances in information transparency the sector also remains heavily relationship oriented, and experienced players will enjoy advantages over new entrants in access to market information and deal pipelines. While the analysis of global, national, and regional trends remains crucial to developing portfolio level strategies, we believe superior asset selection can often only be achieved with extensive local knowledge. This places investors with a local presence and years of in market experience at a significant advantage to those who lack it.

While these challenges can be overcome with a significant investment of time, capital, and human resources, we believe that investors seeking greater access to the sector today would be best served by selecting an experienced advisor. We believe that advisors with experienced teams, research-driven strategies, and extensive regional networks are best positioned to meet the challenges of successfully investing in the sector. For insurers, we would also recommend giving preference to advisors with extensive experience in managing insurance company portfolios, particularly in the case of direct ownership.

Conclusion

Core real estate equity offers insurers a multitude of benefits. The sector has historically produced attractive absolute and risk-adjusted returns while acting as a strong diversifier in multi-asset class portfolios. It can serve multiple roles in asset liability matching strategies and offers significant tax advantages for those hoping to produce strong after-tax income returns or manage portfolio level gains and losses. It does not come without its challenges, including higher RBC charges than many other asset classes. Deeper analysis reveals that this challenge can be greatly reduced with time, but those first entering the sector face significant execution challenges as well. Real estate remains a relationship driven asset class where local knowledge can be as essential as analysis of macro trends. We believe that all of these challenges can be met in partnership with an experienced advisor attuned to the goals and needs specific to insurance companies. We believe that those insurers that choose to make an allocation to the sector will soon recognize its benefits and join the many other insurers that have long been counted among its largest and most important investors.

Endnotes

1 National Council of Real Estate Investment Fiduciaries. The figure shown represents unlevered returns for operating assets in the NFI-ODCE Index from 1998 – 2018.

2 National Council of Real Estate Investment Fiduciaries, Moody's Analytics. The Consumer Price Index is used as a proxy for inflation. During the period from 1998 – 2018 net operating income growth of core real estate assets rose at an annual rate of 3.49% compared to annual inflation of 2.17%.

3 Ibid.

4 Neither MetLife Investment Management nor any of its employees provide tax or legal advice and all investors should consult with their own tax or legal professionals to evaluate their individual circumstances.

5 Assumes a year one stabilized cap rate of 4.12%, improvement value equal to 70% of purchase price, a standard corporate tax rate of 21%, no capital expenditures in the first year, and a depreciable life of 27.5 years calculated on a straight-line basis. These examples are for illustrative purposes only and not intended to represent actual historic (or future expected) performance of any actual property or portfolio. The analysis is based off of U.S. national aggregate figures for the multi family real estate market. These figures will vary depending on the specific attributes of individual properties and the markets they are located in. There is no guarantee the assumptions used by the authors in this analysis are correct and actual future performance may differ dramatically from that illustrated herein. Past performance does not guarantee similar future results.

6 Assumes net operating income growth of 3.50% per year, consistent with annual net operating income growth for core U.S. real estate from 1998 – 2018. These examples are for illustrative purposes only and not intended to represent actual historic (or future expected) performance of any actual property or portfolio. The analysis is based off of U.S. national aggregate figures for the multi family real estate market. These figures will vary depending on the specific attributes of individual properties and the markets they are located in. There is no guarantee the assumptions used by the authors in this analysis are correct and actual future performance may differ dramatically from that illustrated herein. Past performance does not guarantee similar future results.

7 National Association of Insurance Commissioners.

8 National Council of Real Estate Investment Fiduciaries.

9 Ibid.

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About MetLife Investment Management

MetLife Investment Management (MIM)[1] leverages its size, scale and deep asset sector relationships to seek attractive, long-term investment opportunities for our institutional customer base. MIM provides investment management services in asset sectors including, but not limited to, fixed income, index strategies, private debt, real estate and structured finance.

Our investment methodology is based on a disciplined in-house credit research and underwriting process which leverages the deep expertise of our seasoned investment teams. Institutional investors can have access to MIM's in-house investment capabilities, including deal originations, asset acquisition, rigorous portfolio monitoring, proprietary risk analytics and risk management. Our expansive global footprint, with strong capabilities in key markets, makes us well positioned to serve our clients' investment needs.

For more information, visit:
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[1] MetLife Investment Management ("MIM") is MetLife, Inc.'s institutional management business and the marketing name for the following affiliates that provide investment management services: Metropolitan Life Insurance Company, MetLife Investment Advisors, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), Logan Circle Partners, L.P. and Logan Circle Partners I LLC.

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