

## *The Retail-Office Performance Rotation: Implications for Investors*

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### Research

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The office and retail sectors of the U.S. commercial real estate market account for a significant share of the institutional investment universe. 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 two 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, but the retail sector has experienced relatively moderate cycles which, at times, 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 whose portfolios are 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.

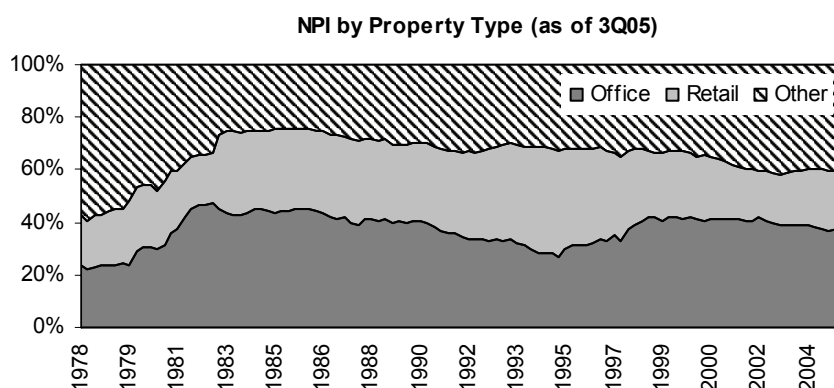
With the ongoing recovery in office market fundamentals gaining momentum and retail performance beginning to slow after years of strong gains, an impending rotation from retail toward office is clearly at hand. Total returns for the office sector of the NPI already have outpaced retail returns for two consecutive quarters, which, if history is any guide, suggests the office sector will outperform both retail and the overall NPI over the near to medium term. This report examines the retail-office performance rotation, the space and investment market dynamics responsible for this phenomenon, and some reasons why the next cycle might differ from past ones.

## 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% 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%, followed by retail, with an average share of about 28%.

**Exhibit 1** shows a breakdown of the NPI by property type (based on market value) over its entire history. 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 the robust gains and increased interest in the sector in recent years. Institutional investment in the retail sector peaked at more than 40% of the NPI in fourth-quarter 1994, and then declined steadily throughout the latter half of the 1990s and early 2000s, reaching a low of 17.4% in third-quarter 2002. While several factors contributed to the decline, the rapid growth of the U.S. REIT market precipitated a transfer of assets, particularly malls, from private to public ownership during the mid- to late '90s.

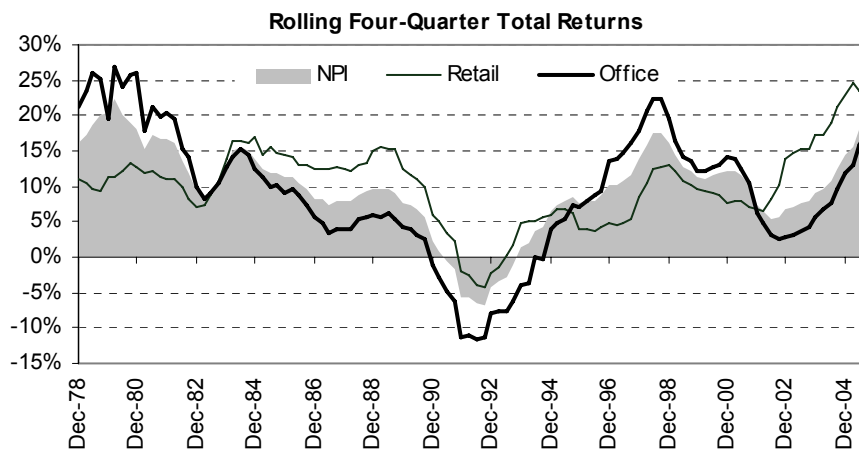
**Exhibit 1: Office and Retail as a Share of Institutional Investments**



Sources: NCREIF; Pramerica Real Estate Investors

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 **Exhibit 2** clearly shows, the amplitude of the office return cycle has been much greater. The early-'90s 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%, about 600 basis points lower than retail. At the peak of the late-'90s market recovery, office returns climbed to more than 22% on a trailing one-year basis, versus about 12% in the retail sector.

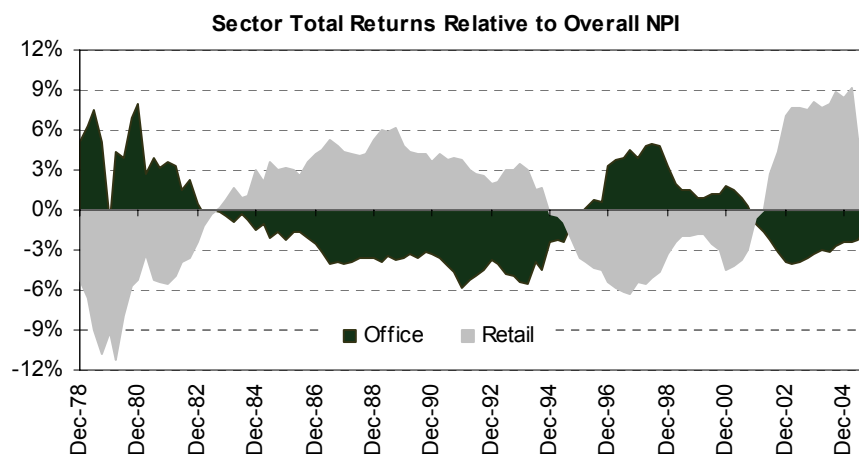
**Exhibit 2: Historical Returns Follow Similar Pattern**



Sources: NCREIF; Pramerica Real Estate Investors (quarterly data as of 3Q05)

While it may not be obvious from looking at the total returns for the two sectors and the overall NPI, the relative performance of the office and retail sub-indexes versus the NPI exhibit a distinct performance rotation pattern (see Exhibit 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-'80s building boom. However, as office space market fundamentals improved in the mid-'90s, 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 the NPI and the office sector over the second half of the decade and into the 2000s. Retail resumed its outperformance in late 2001, after the economy slipped into recession, and job losses and office vacancies soared. Over the last three years (through 3Q05), the retail sub-index of the NPI has delivered total compound annual returns of 19.5% versus 10.5% for the office sub-index and 13% for the NPI.

**Exhibit 3: Relative Performance Reveals Rotation**



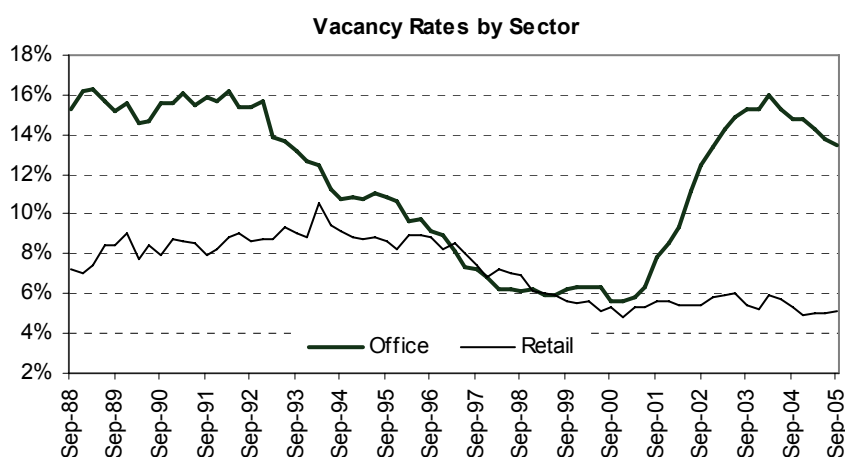
Sources: NCREIF; Pramerica Real Estate Investors

Recently, however, retail returns have moderated while office performance has improved. Although total returns for the office sub-index still lag the retail sector and the overall NPI on a trailing one-year basis, the office sector has outperformed retail in the past two quarters (2Q05 and 3Q05) and slightly outperformed the NPI in the most recent quarter.

### Space Market Cycles

The retail-office performance rotation derives partly from differences in the two sectors' space market cycles. These cycles differ dramatically in timing and magnitude due to the demand and supply dynamics in the two sectors. As **Exhibit 4** shows, the amplitude and volatility of the office vacancy cycle have both been much higher than in the retail sector.

**Exhibit 4: Contrasting Vacancy Cycles**



Sources: NCREIF; Pramerica Real Estate Investors

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.

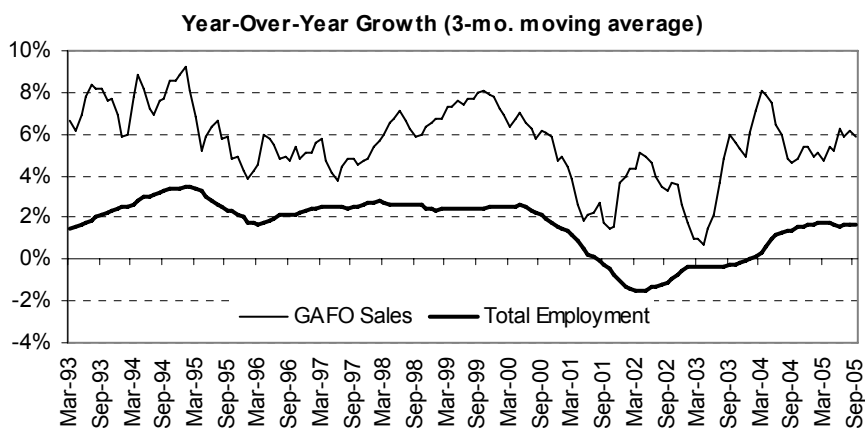
Retail demand is different, however. The more diverse consumer sector of the economy drives demand for retail space. As the past few years have made quite clear, consumer spending and sentiment can remain remarkably strong when the corporate sector is struggling. This is not to say that employment is unimportant to consumers. Rather, employment is one of several factors that determine consumer spending and, therefore, 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 can have a powerful offsetting effect that helps 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 main factors. Firstly, falling interest rates and strong home price appreciation created a wealth effect that, in the aggregate, more than offset the job losses. Refinancing volume during this period spiked to more than \$17 trillion. Although most of this money presumably was used to pay off existing mortgages, consumers likely spent some of the proceeds on goods and services. If we assume that just 5% 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 expenditures in 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% 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. Year-over-year GAFO<sup>1</sup> sales growth has averaged a nominal 5.6% since 1993, while job growth has averaged 1.6% per year (see Exhibit 5). The two series are not directly comparable and serve only as 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.<sup>2</sup> Powerful demographic forces, especially the many baby boomers who are in their prime earning and spending years, and other trends, such as outsourcing (or off-shoring) office jobs to lower-cost markets, make it unlikely that this disparity in growth rates will narrow much in the near to medium term.

**Exhibit 5: Retail Sales Growth vs. Employment Growth**



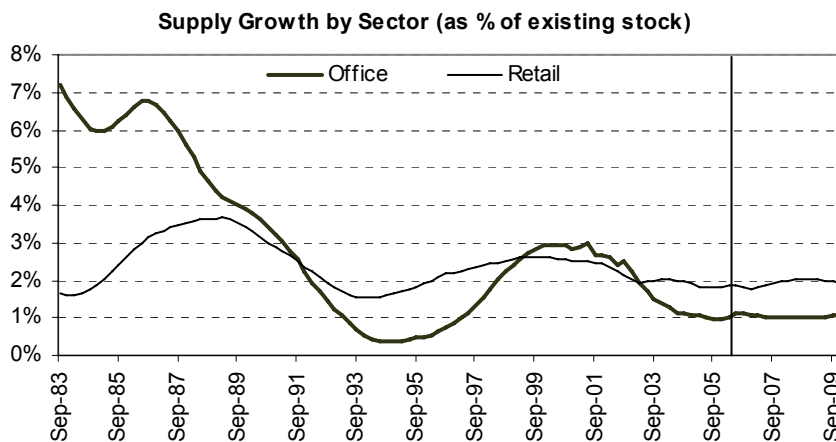
Sources: Census Bureau; BLS (Economy.com); Pramerica Real Estate Investors

<sup>1</sup> GAFO sales, a proxy for store-based retail sales, include general merchandise, apparel, furniture and other types of similar merchandise.

<sup>2</sup> With the U.S. population growing at about 0.8% per year and increasing numbers of echo boomers entering the workforce, total employment growth in the U.S. should average roughly 1.2% 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% per year.

Not surprisingly, perhaps, office supply growth has also been much more volatile than retail supply growth (see Exhibit 6). Over the longer term, average office and retail supply growth rates have not been radically different. For example, between 1Q83 and 3Q05, total office and retail stock in the U.S. grew at average annual rates of about 3% and 2.4%, respectively. However, as Exhibit 6 makes very clear, 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%-plus annual rate before the market crashed and new development largely ceased for nearly four years. Retail supply growth, in comparison, peaked at about 3.7% per year during the late 1980s and generally has remained within a fairly narrow band of 2% to 3% annually for the last decade or so.

**Exhibit 6: Moderate, Relatively Stable Retail Supply Growth**



Sources: Property and Portfolio Research; Pramerica Real Estate Investors

Several features of the retail market, beyond the sector’s more diverse demand base, may 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 (e.g., rent growth) less meaningful, it affords more opportunities than in other property sectors to recycle

space. Recycling unproductive space can satisfy considerable demand, from both retailers and investors, without increasing the retail stock.

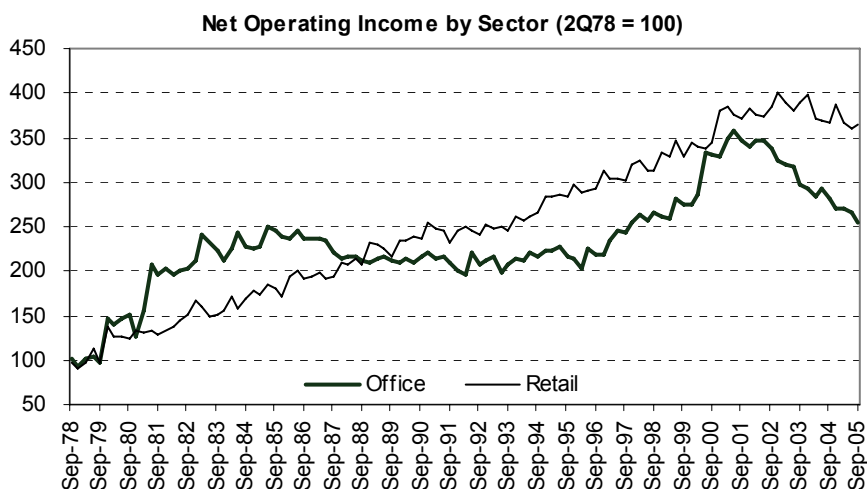
Lastly, retail development often requires more coordination between developers, tenants and communities than most other major property types, which helps keep new supply from expanding too quickly ahead of demand. Local authorities and community-based groups play an active role in planning and approving 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 and/or 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. **Exhibit 7** compares the quarterly growth in net operating income (NOI) for the office and retail sectors of the NPI. Both series 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 basically consistent with the vacancy cycle shown earlier.

**Exhibit 7: Pronounced Office Vacancy Cycle Produces Income Volatility**

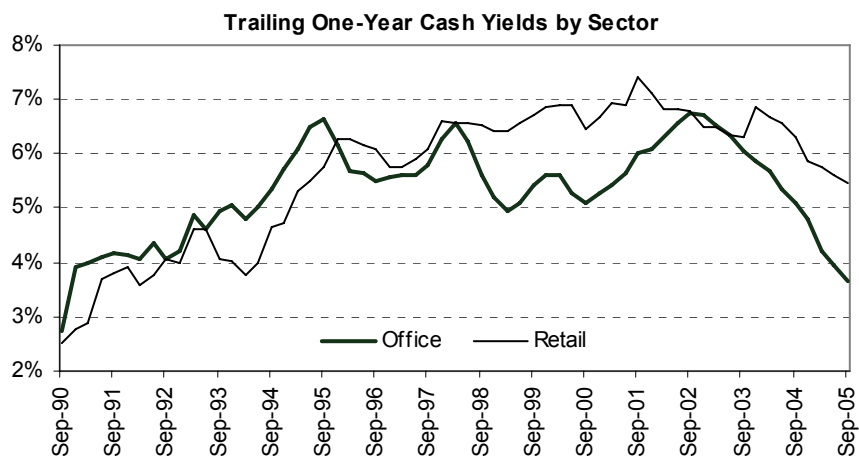


Sources: NCREIF; Pramerica Real Estate Investors

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 on a property's NOI of a downturn in demand for certain types of goods. 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 should afford some protection against any weakness in consumer spending. In addition, many of the anchors (in shopping centers, for example) have longer-term leases that mitigate downturns that may occur. 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 investment cycle. Not surprisingly, office cash yields have varied much more than retail yields (see Exhibit 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.

**Exhibit 8: Office Supply Cycle and Income Volatility Affect Cash Yields**



Sources: NCREIF; Pramerica Real Estate Investors

This feature of the office market is particularly relevant today. TIs and leasing commissions are not reflected in office or 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 **Exhibit 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 and likely will continue to weigh on income returns until vacancy rates decline further.

### **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, as **Exhibit 1** showed, institutional investors are still relatively underweight 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 sharply 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% to 5% 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 '90s will be fewer and farther 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 '90s, when companies were expanding rapidly in anticipation of future growth. Office rents have fallen sharply, however. According to Torto Wheaton Research, as of the end of third-quarter 2005, real office rents had declined to 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.

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