

Homeownership and Commercial Real Estate: Similar but Different

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Research

Manidipa Kapas, CFA
Director
U.S. Office
Tel 973.683.1674
dipa.kapas@prudential.com

Youguo Liang, PhD, CFA
Managing Director
U.S. Office
Tel 973.683.1765
youguo.liang@prudential.com

Pramerica Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

Tel +1 973.683.1745
Fax +1 973.734.1319
Web www.pramericarei.com
research.reports@pramericarei.com

Executive Summary

- Many people have the impression that owning their own home means that they should not consider investing in commercial real estate as well. However, from an individual investor's portfolio allocation perspective, homeownership is *not* a substitute for commercial real estate investment.
- Homeownership refers to real estate one buys and uses as one's own residence. Commercial real estate includes real properties such as office, retail, industrial and multifamily rental buildings that generate only financial gains (or losses) for the investor.
- Homeownership is mostly a consumption good and second, an investment asset, whereas commercial real estate is purely investment-driven.
- Homeownership and commercial real estate are on opposite ends of the income return continuum, with commercial real estate having a positive cash flow and homeownership having a negative carry. This normally leads to a much higher total return for commercial real estate.
- The demand drivers and supply cycles for homeownership and commercial real estate are mostly unrelated, resulting in only a modest return correlation.
- In contrast to homeownership, commercial real estate lends itself to the use of sophisticated investment strategies to capture value creation and enhance risk-adjusted returns, such as development forwards, mezzanine debt, private equity in operating entities and international investments.

Introduction

In the past decade, an unprecedented boom has occurred in homeownership. Today nearly 69% of U.S. households own homes, whereas about 63% did in 1996. The equity in one's

home is a substantial portion of the overall wealth of most homeowner households. For many homeowners, their house is their single largest investment. As a result, it is often thought that since most households already own a home, they do not need to also invest in commercial real estate.

This report examines the issue empirically from the point of view of individual investors who have the option of investing both in their residence and in commercial real estate. The results indicate that homeownership and commercial real estate have vastly different investment characteristics and fundamental attributes. Also, upturns and downturns in the residential home market are not necessarily harbingers of similar movements in the commercial real estate market. Hence, owning a home should not discourage investment in commercial real estate. They are not substitutes for each other and indeed complement each other in a diversified investment portfolio.

Homeownership generally refers to owning real estate property, single-family homes or condominium units, that someone buys and uses as a primary (or sometimes secondary) residence; it is first a consumption good and second, an investment asset. Commercial real estate, on the other hand, is property that is only intended to generate a return for its owner, both in terms of regular cash flows as well as value appreciation. Commercial real estate, therefore, is purely an investment asset. Even though homeowners are not only consumers but also investors in their homes, the investment aspects of homeownership are different from the investment characteristics of commercial real estate, as will be discussed below.

Rental apartment buildings are regarded as part of commercial real estate, since the owner is not a resident and is renting out the units for rental cash flows in the short term and for growth in value over a longer time horizon. Generally speaking, commercial real estate includes the following property types: office, retail, rental apartments, industrial, hotel, self-storage and senior housing.

An individual investor can potentially invest in commercial real estate via two ownership vehicles: indirect investment in properties via publicly traded real estate investment trusts (REITs) and direct investment through property transactions, property funds or private REITs. REITs are companies that own and most often actively manage income-generating commercial real estate.

Similar as Real Assets

Before we examine the disparities between homeownership and commercial real estate, let us consider some of their superficial similarities. First, both are substantial portions of the total investable universe, with U.S. residential homes valued at about \$20 trillion and investable U.S. commercial real estate at \$6 trillion. Second, both are real, or tangible, assets, and thus highly collateralizable. Both the home and commercial mortgage markets are large and well developed. Third, like other tangible investments, homeownership and commercial real estate can be effective hedges against inflation. Fourth, privately traded commercial real estate and residential homes have low return volatilities compared with stock and bond indexes.

Exhibit 1 shows the average annual return, standard deviation and return per unit of risk for some major U.S. and international benchmarks. The volatility of homeownership, measured by the standard deviation of the Freddie Mac home price index, is 3.4% and that of commercial real estate, measured by the standard deviation of the National Council of Real Estate Investment

Fiduciaries' Property Index (NPI), is 6.4%. The NPI tracks the unleveraged performance of U.S. commercial properties held by institutional investors and their advisers. This index, started in 1978, has the shortest history and thus determines the comparison period of 1978 to 2005.

Exhibit 1: Risk and Return Comparison, 1978-2005

	Avg. Return (% p.a.)	Std. Deviation (% p.a.)	Return per unit of risk
Real Estate Market			
Home Price Index	6.0	3.4	1.8
NCREIF Property Index	9.9	6.4	1.6
NAREIT Equity REIT Index	14.7	14.6	1.0
Stock and Bond Market Indexes			
S&P 500	13.1	15.6	0.8
Russell 2000	12.7	18.9	0.7
Lehman Bros. Aggregate Bond	8.7	7.6	1.2
Morgan Stanley EAFE Internat.	12.1	21.9	0.6
General Economic Indicators			
Inflation	4.2	3.1	
Gold Price	4.1	28.4	

Sources: Ibbotson; NCREIF; NAREIT; FHLMC; FNMA; Moody's Economy.com; Pramerica Real Estate Investors. Note: The home price index is the Freddie Mac Conventional Mortgage Home Price Index. It is based on single-unit residential houses only and does not include condominiums.

Publicly traded real estate, for which we use the NAREIT Equity REIT Index as a proxy, large capitalization stocks measured by the S&P 500, small capitalization stocks represented by the Russell 2000 and international stocks captured by Morgan Stanley's Europe, Asia and Far East (EAFE) Index all have volatilities much higher than private commercial real estate and residential homes. The NAREIT index, which is comprised of publicly traded REITs, has a volatility similar to stocks. As expected, bonds, proxied by the Lehman Brothers Aggregate Bond Index, have a much lower volatility than stocks. Inflation and the price of gold are shown for reference.

Dissimilar in Investment Characteristics

Despite some apparent parallels between commercial real estate investment and homeownership, the two are better characterized by their differences. Commercial real estate provides high current yields to investors, while homeownership has a substantial negative carry due to taxes and maintenance. Thus, the total return of commercial real estate is much higher than can be obtained from owner-occupied housing over the longer term. From a portfolio perspective, commercial real estate and homeownership have modest return correlations, the result of different demand and supply forces. Buying a home is driven by both consumption and investment considerations, but investing in commercial real estate is purely a financial exercise. As such, commercial real estate investment can be sophisticatedly engineered to provide a full spectrum of risk-return tradeoffs ranging from low risk and single-digit returns to high risk and high returns nearing 20%.

Consumption Good versus Investment Asset

Homeownership is both a consumption good and an investment asset. It mainly serves the housing needs of the occupants but is also an investment asset, with the potential for capital

gains appreciation, the ability to be leveraged and tax benefits to the owner. Homeownership is thus driven by investor sentiment and household consumption needs. The only goal of investment in commercial real estate is return generation and value creation.

Although consumption and investment considerations in homeownership are interrelated, their shares can be estimated. As shown in **Exhibit 1**, home prices appreciated about 6.0% per year since 1978. Assuming a conservative after-tax annual cost of carry of 2.5% for maintenance, utilities, property tax and insurance, the investment return on homeownership is about 3.5%. If an owner-occupied home were held solely for investment purposes, it would demand a return similar to the NPI over the same period, as both are private real estate investments without any financial leverage. The average return of the NPI from 1978 to 2005 was 9.9%, as shown in **Exhibit 1**. The difference between the NPI return of 9.9% and 3.5%, therefore, can be attributed to the imputed income return on homeownership, which consists of the consumption, socio-economic and psychological benefits derived from occupying one's own home.

Exhibit 2 shows that the investment benefit derived from homeownership is only 35% of the total opportunity return from investing in property. Rounding the numbers, one could conclude that homeownership is one-third driven by financial considerations and two-thirds by consumption needs. Alternatively stated, homeownership is one-third an investment asset and two-thirds a consumption good, whereas commercial real estate is 100% an investment asset. An imprecise interpretation of these numbers is that, from an investor's perspective, homeownership and commercial real estate investment have one-third similarity and two-thirds dissimilarity.

Appreciation return	6.0%
Negative carry	(2.5%)
Investment return	3.5%
Opportunity Return	9.9%
Investment Share	0.35
Consumption Share	0.65

Source: Pramerica Real Estate Investors Note: Appreciation return is based on the home price index; opportunity return is the total return from the NPI. Both are shown in Exhibit 1.

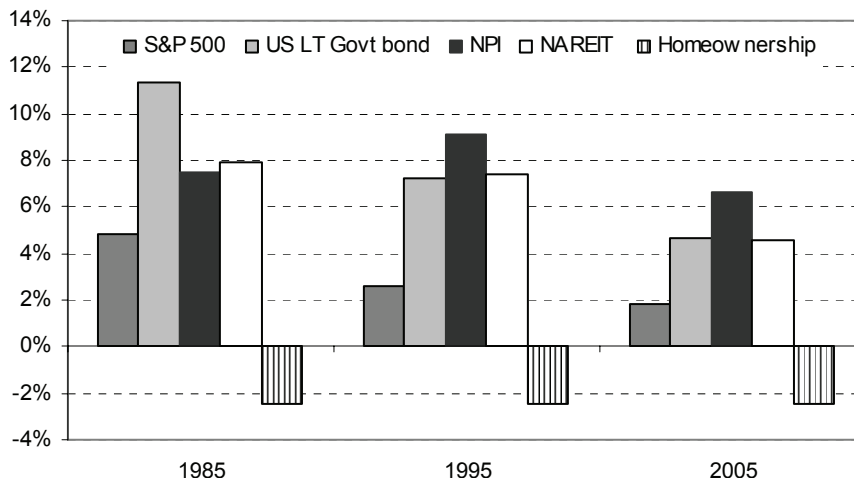
Negative Carry versus Positive Cash Flow

Income return is an important attribute of any investment asset. Homeownership is at one extreme end of the income return continuum of the investment universe. For commercial real estate, income return, or yield, is a large part of total return. The stable, predictable income comes from contractual leases. This cash flow characteristic means that commercial real estate is an attractive alternative to fixed income instruments for some investors. Homeownership, however, has an estimated negative carry of 2.5% of home price, prior to mortgage interest payments.

Exhibit 3 shows the current yields on different types of real estate assets, and stock and bond benchmarks. The chart shows that commercial real estate yields are high on a relative basis. Except for the high-interest-rate environment of the 1980s, private real estate yields were comparable to bond yields in the 1990s and exceed today's long-term government bond yields.

REIT yields also compare favorably with bond and stock yields. Homeownership, however, contrasts sharply with all other asset classes, as it has a negative carry, or current yield.

Exhibit 3: Yield Comparison of Investment Indexes



Sources: Ibbotson; Moody's Economy.com; NAREIT; NCREIF

Clearly, homeownership and commercial real estate are on opposite ends of the current yield spectrum. The difference in the current yield of commercial real estate and homeownership, of course, reflects the consumption value of owner-occupied homes.

Significant Return Differential

Historically, commercial real estate has yielded a much higher total return than homeownership, largely due to the lack of current return from a home. Exhibit 4 shows that the NPI has averaged a total return of 12.1% in the past 10 years compared with 7.4% for homeownership. REITs have had an even higher return, averaging 14.5% over the same time. REITs returned more than private real estate partly because REITs use debt, and the NPI measures property-level return free of any leverage. Both the NPI and NAREIT indexes outperform homeownership by a large margin, considering even longer periods of 15 or 20 years, or since 1978 (the start of the NPI).

Exhibit 4: Total Return Comparisons

	NAREIT Equity	NPI	Homeownership
1996	35.3%	10.3%	3.3%
1997	20.3%	13.9%	4.9%
1998	-17.5%	16.2%	5.1%
1999	-4.6%	11.4%	5.4%
2000	26.4%	12.3%	7.6%
2001	13.9%	7.3%	7.5%
2002	3.8%	6.7%	7.2%
2003	37.1%	9.0%	8.0%
2004	31.6%	14.5%	12.0%
2005	12.2%	20.1%	13.2%
10-Year Avg.	14.5%	12.1%	7.4%
15-Year Avg.	15.4%	8.2%	5.9%
20-Year Avg.	12.4%	8.0%	5.8%
1978-2005 Avg.	14.7%	9.9%	6.0%

Sources: Moody's Economy.com; NCREIF; NAREIT; Pramerica Real Estate Investors

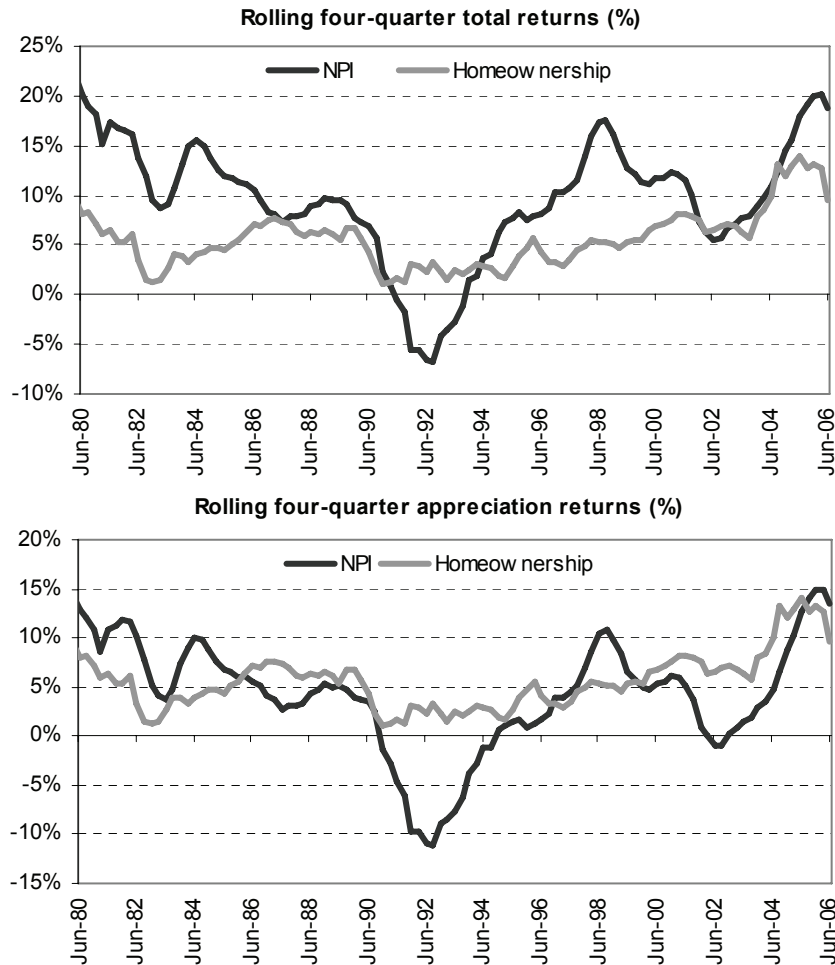
Modest Return Correlation

Exhibit 5 shows the rolling four-quarter total and appreciation returns for commercial real estate and for the home price index. The NPI and home prices have comparable average appreciation returns, whereas the total return of commercial real estate is much higher than homeownership due to the positive cash flow component. Moreover, homeownership and commercial real estate returns are not strongly correlated. For example, commercial property returns peaked in 1984 and then drifted downward until 1992, but no corresponding pattern occurred in residential homes. Another example is the strong peak in commercial real estate return in 1998 without any corresponding return behavior in residential homes.

To quantify the relationship, we calculate correlations between commercial real estate and the home price index from 1978 to 2Q06 using quarterly data to see whether both have a place in the same portfolio. The correlation between the NPI and homeownership is 0.39 based on total returns and 0.35 based on appreciation returns alone – a modest correlation from a portfolio perspective. The correlation between REITs and homeownership is even lower, at 0.11 calculated from total returns and 0.12 from appreciation returns alone. In terms of portfolio diversification, the modest correlations suggest that homeownership and commercial real estate investment are not substitutes for each other and, in fact, can be attractive complements.

This lack of correlation should not come as a surprise. The dynamics of the three (NAREIT, NPI and homeownership) are very different, resulting in a significant variation in the amplitude of their cycles. Homeowners do not have to sell, and the value of their property is less important in the short term. (If they must move, they can always rent if they do not like the sales price.) Investors view their investments less emotionally, have a shorter time horizon and are more apt to sell through different cycles. The charts below illustrate this point.

Exhibit 5: Lack of Strong Return Correlation



Sources: NAREIT; NCREIF; Moody's Economy.com; Ibbotson Note: NPI appreciation returns are calculated as (change in market value + partial sales)/beginning market value.

Different Fundamental Drivers

The lack of strong correlation between commercial real estate and homeownership returns reflects their different fundamental drivers. Today, some investors are concerned with the weakening of the residential real estate market and its implications for commercial real estate investing. The cooling of the residential market may not be a harbinger of a weakening commercial real estate market, since the two have different demand and supply cycles. In fact, currently, commercial real estate is experiencing favorable fundamentals such as low construction, healthy demand, improving occupancy and rising rents.

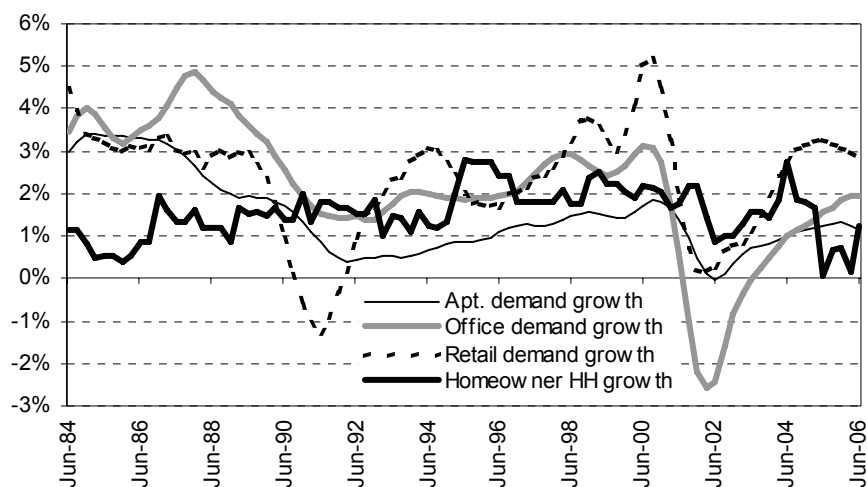
Affordability, household formation, the shifting distribution of household age cohorts and general employment all drive demand for homeownership. But commercial real estate demand is strongly linked to business employment and consumer spending, among other things. The supply of commercial space has always been much more volatile than that of owner-occupied homes. Since

office, retail and apartments are the largest sectors in the NPI, we focus on these sectors to highlight the demand and supply cycles of commercial real estate and owner-occupied housing.

Unrelated Demand Cycles

Exhibit 6 charts the annual growth rate in the number of households owning homes and demand for the three largest sectors of commercial real estate. It is obvious from the chart that growth in homeowner households is mostly unrelated to demand growth for commercial space.

Exhibit 6: Growth of Homeowner Households and Demand for Commercial Real Estate

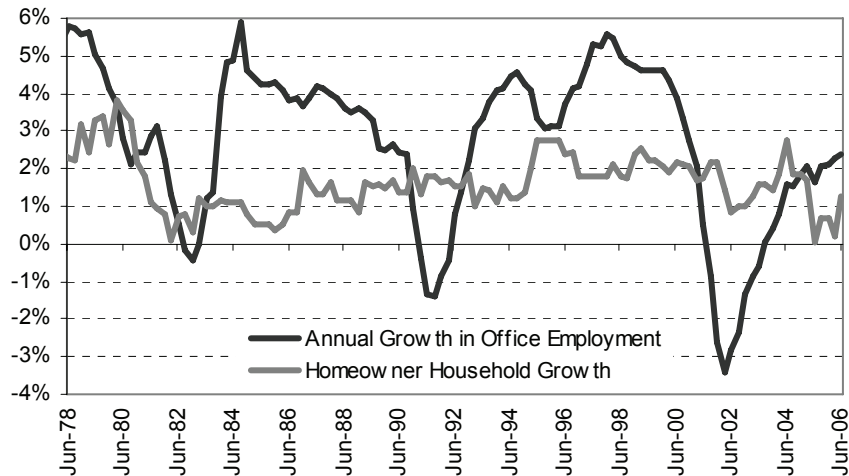


Sources: Moody's Economy.com; Pramerica Real Estate Investors

Financial and demographic factors play vital roles in homeownership demand. Housing demand is mainly driven by household formation and affordability, which in turn is driven by the home-price to household-income ratio and mortgage rates. In the past decade, growing housing affordability, bolstered by low mortgage rates, led to an unprecedented boom in home purchase and refinancing.

In contrast, office employment growth is the main demand driver of office space. Employment growth is, in turn, highly positively correlated with the business cycle. When the economy is expanding and adding jobs, office demand typically rises. **Exhibits 6** and **7** show that the precipitous drop in net absorption of office space at the start of the millennium was mainly a result of a downturn in office space demand caused by the weakening of broad economic forces. As the economy recovered, office job growth resumed, leading to office space demand growth. In general, the corporate sector of the economy drives demand for office and industrial properties.

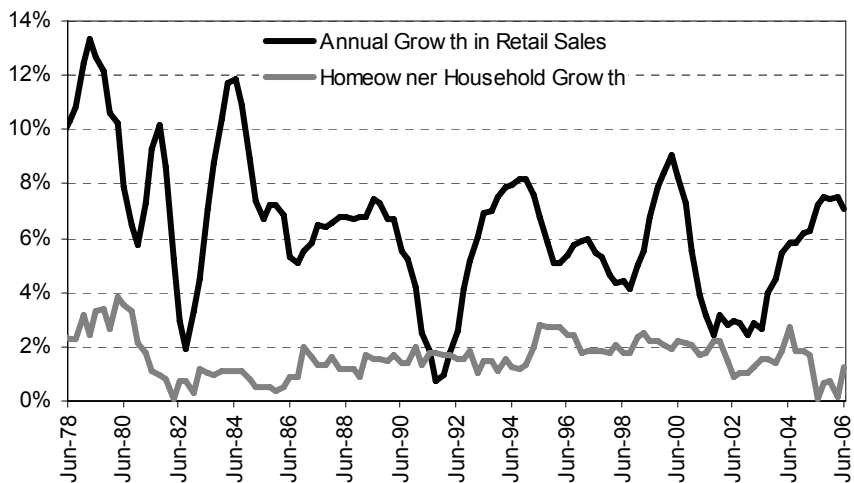
Exhibit 7: Employment is the Main Driver of Office Demand



Source: Moody's Economy.com

On the other hand, in the retail sector, which is the next largest property type in the NPI, space demand is driven by the consumer sector, which does not always mirror the corporate sector. Consumer spending on retail items is influenced not only by employment growth, but also by population growth, household earnings growth and the elasticity of consumption. Exhibits 6 and 8 map the close relationship between net absorption of retail space and growth in retail sales.

Exhibit 8: Retail Sales Drive Retail Demand

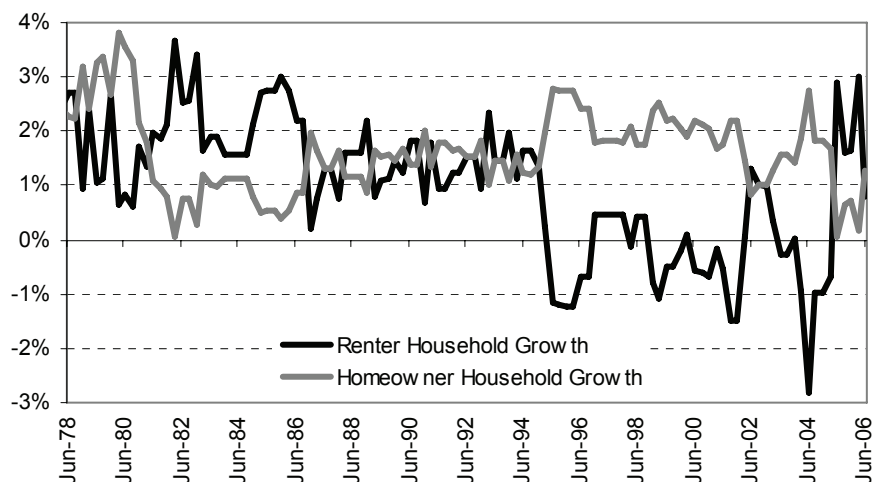


Source: Moody's Economy.com Note: The annual growth rate was calculated using a three-month moving average to smooth seasonal fluctuations.

Demand for rental apartments, however, by its nature, is closely affected by the single-family home sector but in a largely negative way. Rental apartments compete directly with owner-occupied housing, as shown in Exhibit 9 (versus Exhibit 6). Demand for rental housing depends on household formation, which depends on population growth and business cycles. When the economy is strong, many young people find jobs and leave home, which results in more household

formation. Also, in strong economies, immigration tends to rise. Rental demand also depends on the age distribution of households, as young people have a higher propensity to rent but are less likely to own. However, change in homeownership has the strongest impact on demand for rental housing, as each new homeowner means one less renter. Thus, demand for rental housing is mostly negatively related to demand for homeownership. The negatively related demand drivers for rental and ownership housing are not likely to lead to a strong positive return correlation between them.

Exhibit 9: Renter Household Growth is the Mirror Image of Homeowner Household Growth



Source: Moody's Economy.com

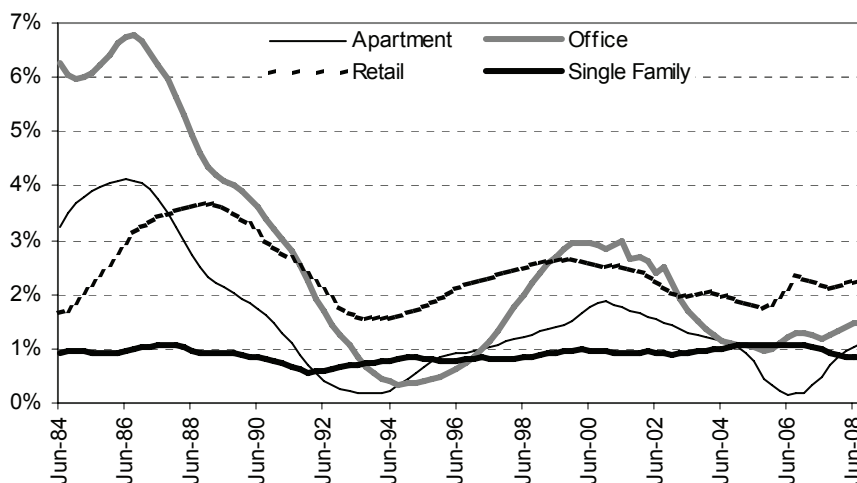
Unrelated Supply Cycles

The supply cycles of the homeownership market and commercial real estate have a marked dissimilarity. First, commercial real estate supply cycles are far more volatile than single-family homes (most owner-occupied homes in the U.S. are single family). Supply cycles in the commercial real estate arena are also much more pronounced. Second, the peaks and troughs of commercial real estate and residential homes are not aligned. As shown in **Exhibit 10**, the past five years have seen a boom in single-family home completions relative to stock, whereas offices and apartments have had serious declines in completions relative to stock. While supply growth for retail space was healthy over the past five years, no boom in retail construction occurred.

Simple versus Sophisticated Investment Strategies

Commercial real estate investment portfolios use many sophisticated investment strategies to deliberately target certain risk-return tradeoffs. For example, most real estate investment managers offer funds with core, value-added and absolute return strategies, with target returns ranging from 7% to nearly 20% in today's environment. Such value-enhancing and market-timing strategies are not the real goal of most homeowners. Some people do buy homes, renovate them and sell them for a profit in certain stages of the business cycle, but that is not a strategy pursued by most typical homeowners.

Exhibit 10: Supply Cycles, Completions Relative to Stock



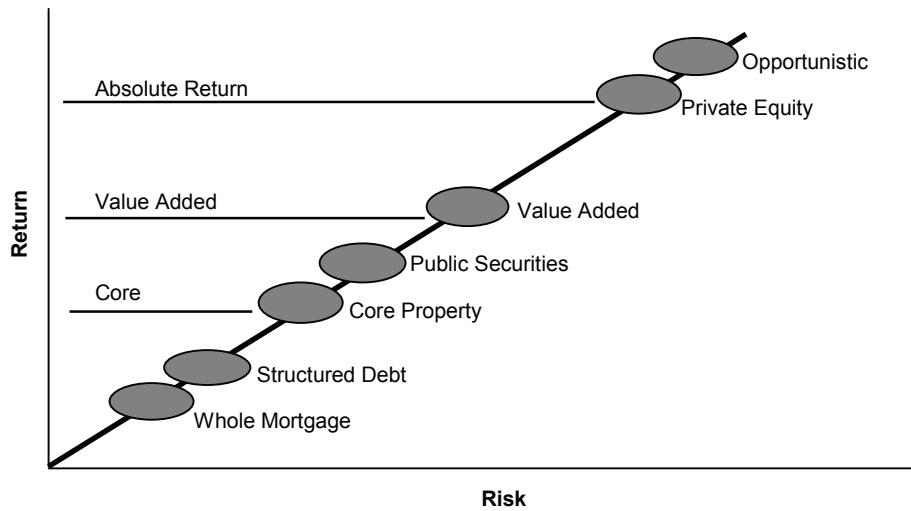
Sources: PPR; Moody's Economy.com

Exhibit 11 shows the full spectrum of investment strategies in commercial real estate. In the debt area, investors may own whole mortgages, different tranches of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDO). A core strategy refers to investing in stabilized, income-producing commercial properties with no or low financial leverage. In today's environment, expected returns are in the range of 7% to 8%. Value-added investment may be in the form of financial engineering, such as mezzanine debt, development forwards to capture the large value creation associated with development and redevelopment, and substantial operational improvements from large increases in income due to improving occupancy and rising rents. Expected returns for value-added investments range from 9% to 15%. Typical absolute return strategies are private equity investing in emerging companies and opportunistic acquisition of highly distressed assets with high leverage, with expected returns of 15% or more.

Investing internationally is another way to increase risk-adjusted returns. However, it carries the additional risk of adverse currency movements and complex regulatory and taxation issues. But international real estate investment also leads to far more diversification in a portfolio and exposes investors to growth and cyclical opportunities that are not available in the home market.

Such market timing and development or predevelopment strategies are not usually pursued with residential real estate. Regardless of market conditions, it is costly, in both monetary and nonmonetary terms, to sell one's house and move to an apartment temporarily to profit from price movements. Homeownership is thus somewhat restrictive as an investment asset.

Exhibit 11: Multiple Investment Strategies in Commercial Real Estate



Source: Pramerica Real Estate Investors

Conclusion

Intuitively, homeownership and commercial real estate would appear to have significant similarities. Both are tangible assets, large parts of the investment universe and can offer a hedge against inflation. However, they are marked more by disparities than by similarities in terms of current return, total return, demand drivers and supply cycles. Different fundamental drivers imply that upturns and downturns in the owner-occupied housing market and commercial real estate are not necessarily contemporaneous. Also, commercial real estate is a pure investment asset, whereas owner-occupied homes are both an investment asset and, far more importantly, a consumption good. The modest correlation between commercial real estate and homeownership, plus their different attributes, suggests that they are not substitutes for each other and, in fact, can be attractive complements in a diversified portfolio.

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