Economic Fundamentals and Warehouse Property Performance in Large U.S. Metropolitan Areas

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Property type and geographic region were the categories initially considered appropriate for diversification within the real estate asset class. Property type has remained applicable, while geographic region has not. The economic characteristics of metropolitan areas are now viewed as more relevant than their geographic location. Specifically, the metropolitan area's economic base and related economic specializations have been used to establish diversification categories.

Economic classification makes sense because metropolitan areas with similar roles in the global economy are comparable regardless of their geographic proximity. In the near term, their mix of industries partly determines economic growth at the metropolitan level, which influences real estate markets and performance at the property level. However, institutional investors require market intelligence that is useful over long-time horizons. Economic classifications developed from insights about the metropolitan area's economic base may not be pertinent for long-term analysis.

This research tests measures that indicate the economic fundamentals of metropolitan areas. Economic classifications based on these fundamentals should be more useful to institutional investors than economic base classifications because the fundamentals change more slowly over time than economic base. Furthermore, strong fundamentals can improve an area's economic base and help it sustain good performance over time.

The economic fundamentals include the area's economic importance (centrality), its economic diversity, and its flexibility and responsiveness to external economic forces (resilience). Economically important, diverse and resilient metropolitan areas also tend to be relatively stable. Metropolitan area classifications are established to test the influence of economic growth, development restrictiveness, stability, and economic fundamentals on property performance. Tests are applied to twenty-six (26) large U.S. metropolitan areas in the NCREIF database. Property performance is indicated by annualized total returns from 1985 to 1995 and from 1989 to 1995 for warehouse properties.

Most classifications do not create categories with statistically significant differences in warehouse property performance. Overall employment growth and wholesale sales growth do not create distinctive performance categories. Development restrictiveness measures give ambiguous results. Fundamental measures, individually applied, are not significant.

Several classifications, however, are significant. These are based on stability and a combination of stability and fundamental measures. The best classification is shown in Exhibit 1.

Warehouse properties in more stable metropolitan areas outperformed those properties in less stable metropolitan areas during the 1985-95 period. Results are not significant for the shorter period from 1989 to 1995. Warehouse properties in metropolitan areas with stronger economic fundamentals outperform warehouse properties in metropolitan areas with weaker fundamentals from 1985 to 1995. These results become less statistically significant during the 1989 to 1995 period.

In conclusion, the long-term stability and economic fundamentals of large metropolitan area appear to provide useful criteria for establishing real estate diversification categories, at least areas for relatively market-sensitive property types such as warehouse properties. These long-term influences should be more important than the indicators of real estate market conditions regularly monitored to suggest to institutional investors the near-term performance prospects of different metropolitan areas. Institutional investors who own equity real estate in the areas shown in Exhibit I are invited to contrast the historical returns of properties in these areas. Finding significant differences in returns among the three groups of metropolitan areas should encourage institutional investors to develop classifications constructed with stability, diversity, or other measures of economic fundamentals.

EXHIBIT I

Stability, Centrality, Diversity & Resilience

Stronger Fundamentals

A

Atlanta
Baltimore
Chicago
Los Angeles
Minneapolis
Oakland
Philadelphia
Seattle

Moderate

B

Anaheim
Boston
Cincinnati
Dallas
Denver
Houston
Memphis
Portland
St. Louis
Washington
Milwaukee
Orlando
Phoenix
Riverside
Sacramento
San Diego
San Jose

Weaker Fundamentals

C

Detroit