The Weekly Take

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Times Like These: H1 2021 Cap Rates Show Opportunities Across Property Types

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Spencer Levy

I'm Spencer Levy and this is the weekly take in our conversations. Each week we strive to present vivid snapshots of the commercial real estate world based on the unique perspectives of industry leaders. With the release of our most popular research publication of the year, we dig even deeper, armed with insights about the business from our 2021 first half US effort. On this episode, a pair of capital markets veterans help us make sense of the numbers.

Rod Vogel

We're active in over 40 US markets, and when you're in 40 different markets, you've got a good lens on what's going on in the US commercial real estate marketplace.

Spencer Levy

That's Rod Vogel, senior managing director of Principal Real Estate Investors based in Des Moines, Iowa. Broad heads of private equity real estate operations for the subsidiary of Principal Global Investors, which reaches from the US to a total of twenty eight countries worldwide with almost ninety six billion dollars in assets under management.

Paige Morgan

We're seeing more of the private buyers come to play and they're more yield driven, so they're willing to accept more of that risk in exchange for a higher yield where we really haven't seen the institutional capital move into that space.

Spencer Levy

And that's Paige Morgan, who was recently promoted to the position of executive vice president of Northwest Capital Markets for CBRE. Joining us from Portland, Oregon, Paige primarily covers office and industrial and has more than 15 years of experience as a capital markets broker. In a wide ranging discussion, we'll not only unpack the numbers, we'll also go beyond them, discussing risk asset classes and markets. Development and demand. That is, where investors are setting their sights right now and for the future. We may get a little wonky, but we'll also have some fun making music references and learning from our guests on career journeys as well. Coming up, a comprehensive look at the markets, CBRE brand new cap rates survey and more. That's right now on The Weekly Take. Welcome to the weekly take. So Rod, let's start big picture principle. Ninety six billion of assets under management. Assets all over the world. You could buy almost anything But why don’t you be a little bit more specific on what Principal is targeting today from an asset type perspective and how you see and values?

Rod Vogel

Sure. Well, you know, with the number of different clients and mandates we have, we're fortunate in that we have capital that'll buy core assets, value-add assets and opportunistic assets up. So up and down the risk spectrum. We're active in over 40 US markets. And when you're in 40 different markets, you've got a good lens on what's going on in the US commercial real estate marketplace specifically and not surprising to you and Paige. Our clients love multifamily and they love industrial. You know, for obvious reasons, the space market fundamentals are tremendous. There's awash in capital, as Paige can certainly attest to investors, not only ours, but almost everyone universally loves the two property types. That's the positive. The challenge is yields in those two property types are amongst the lowest -- well, they are the lowest I've ever seen in my 33 years with cap rates, certainly in the 3s for both property types. And I think I've seen an industrial deal go down sub three percent cap rate. So that's the challenge with those two property types. What it's forced us to do is a couple of things. One: broaden our array of property types that we're investing in and moving into some what we call niche property sectors, single family rental, manufactured housing, data centers and life sciences, to name a few. And those are four that we're actively investing in today. We're looking to underweight retail and office. We're selling there where we can and again, primarily focusing on the niche property types and industrial multifamily for our growth going forward.

Spencer Levy

Paige, Rod just gave a great overview of the markets, multifamily and industrial being tops of many, many investors lists. But yields are at historic lows. He didn't show as much love for office, but you cover office and industrials. How's the office market doing in the Pacific Northwest?

Paige Morgan

It's really a case of sort of the haves and the have nots. So if you're in an office market where you can see the long term growth drivers or where you can see the long term fundamentals, then you have good liquidity in that office space. Seattle is a great example of that. You know, the east side of Seattle really barely skipped a beat, just given the list of of credit companies that call that area home and continue to grow there. And also the lifescience factor is a clear driver of long term growth. So we're really seeing that liquidity in those markets with those prospects. And, you know, capital is trying to get ahead of that demand and absorption. And so it’s very clear to see that demand and absorption in industrial and multifamily and there are selecting the office markets where they can see it. In those markets where there's not as clear of a picture for for the growth. We're seeing more of the private buyers come to play and they're more yield driven. So they're willing to accept more of that risk in exchange for a higher yield where we really haven't seen the institutional capital move into that space.

Spencer Levy

You use the term noninstitutional capital, the private buyer. You also used the term the haves and have-nots. I want to be all positive here. but there are some have-nots out there. There are some office assets with short term weighted average lease terms in otherwise that are harder to trade. Talk a little bit about what makes a tradable office asset versus one that is maybe not tradable today.

Paige Morgan

Right, I think the not tradable is it's still depends. You're still really looking for data points in the market. So that's what's allowing investors to underwrite. So if you have leasing fundamentals where you can point to comparables or you have a sense of where the demand is going, those markets are more liquid. It's easier to underwrite. It's easier to trade. If you're in a market where you’re really not seeing much leasing activity, very little data to point to, hard to set market rents or we haven't seen much investment volume in those markets either. It's just a little unsettling for a lot of capital. But on the private side, they have other motivations. And so they're looking for opportunities where they can compete. It's difficult for them often to compete on those long term net lease products. So they're finding different opportunities where the bid list is thinner.

Spencer Levy

So we're here today not just to talk about different types of real estate and markets and values, we're talking about the cap rates survey by CBRE, which is historically been our number one most popular research piece produced. Rod, how do you use the cap rate survey information? What do you think about it and how does it influence your decision making on where to buy and what to buy?

Rod Vogel

It's widely read within our shop, Spencer. Your team has so much real time data on transactions, and I know they all people like Paige all contribute to the survey. So it's not an investor sentiment survey. It's real facts, as I call it. And so I put together a summarized version of that for our internal teams and for discussions with our clients and basically show them where cap rates are at by market, where we see discount rates are at by market. And a lot of that, again, is information that's coming from your team. So we find it tremendously helpful because we have to demonstrate to our clients -- what is a market yield. Right. And they don't necessarily like three caps and five point five on 11 IRRs. It's the market. And so we tell them, you know, this is the market. They have to determine, do they want to participate in it or not. But as I said, facts are facts and it's widely used by us, given just, again, the tremendous data gathering that you guys have the capabilities to put together. So very helpful. Thank you for doing it. I know it takes a lot of time.

Spencer Levy

With this episode we are going to put a link to our cap rates or raise all of you can read it. But Page, you're both a user of the survey -- a reader of it looking at different markets -- but you also give some of the data in the survey once you give us both sides of it as using it and actually providing your opinion on the values in your markets.

Paige Morgan

Right. It's always great for me when it comes out, because it's just really helpful to get perspective on a national level.We do connect with our colleagues often, but to actually be able to to digest the information and see it all presented together I think is always really interesting. I think at first blush, it's sort of surprising that the office was sort of flat. But I think when you really dig down, what was probably leading to a lot of that is just the kind of liquidity we did see was more in that long term net leased assets for the office space. So I think that is partially reflected in the survey, you know, in terms of contributing to it. As I mentioned, Portland unfortunately didn't have a ton of trades. But of course, our perspective just on where things are going was included. And I think that's been one of the real valuable lessons for brokers. And I think what our clients are constantly sort of enforcing to us is we need you guys to see where the puck is going, not where it's been. Right. So we really need to look forward to see the trends and see where things are heading if we're looking in the rearview mirror where we're missing value in perspective. So I think the cap rate survey for us as professionals in contributing to it, you know, always challenging ourselves to really be looking forward as that's where we all are trying to get to. The other piece that I just wanted to reflect on is that cap rate is just one measure of return. And I think when you're looking at these low rates in industrial and multifamily, people are getting kind of fixated on these low cap rates. But given the rent growth that we're seeing in some of those markets -- particularly industrial, just driven by this unprecedented level of demand -- that isn't always captured in the cap rate. Right. So that all in return is probably on par with maybe a little bit tighter, but on par with where principle was pre pandemic. But you have these other factors that are contributing to your return like growth and demand.

Spencer Levy

Let's go back to the industrial side for just a moment. And you mentioned you're seeing three caps. You saw two guys. I've seen a few two caps in the Inland Empire. I'm seeing Atlanta trading at sub four cap levels. Rod, how do you afford to buy that, given your cost of capital?

Rod Vogel

Yeah, that's a good question, Spencer. It reminds me of a song from the 1990s band No Mercy called *Where Do You Go*. And where we've chosen to go with our clients is into development of industrial and multifamily. The relative spread that you generate there, I mean, the unleveraged yields or IRRs during the time you start construction, when you lease it, you know, we're seeing those being 13 to 15 percent. So compare that to a five to six percent unleveraged IRR for core. You know, you can pick up a thousand basis points of return. And we've got so much experience at Principal, in development that the risks that you're taking are really more than compensated by that additional return that you're getting. Interesting stat for you, and this will surprise you about Spencer, but since 2001, when we started tracking our development activity, we've completed over almost 11 billion dollars worth of development deals. One hundred and eighty different transactions. And the performance of those deals on an unlevered basis was thirty one percent IRR from the time you started construction, tell you we leased it out. So our clients have been rewarded handsomely for taking on that risk and will continue to do it today. As we sit here looking at numbers just last week, we've got at Principal, for all of our different clients, a little over eight and a half billion dollars worth of construction underway in the United States. Over 80 percent of that is a combination of industrial and multifamily, not surprising. So our clients have really embraced development and they've been rewarded. And we hope that continues on with the eight billion dollars that we've got underway. This year, which obviously is not over yet, but we're on track to have our largest year ever in terms of new commitments to development at three billion dollars. So that's where we've gone. As the song says, we've gone to development. And again, I think we'll stay there is as long as the U.S. economy stays as strong as it is right now,

Spencer Levy

Or to quote The Doors, 'when the music's over, turn out the lights.' But the music is not over yet in the development space. And let me ask you just one more question, Rod. You mentioned your clients, which I presume you mean your capital clients, the clients who are providing capital for you. How do you build? Do you build direct or do you bring in operating partners?

Rod Vogel

Yeah, good question. Spencer, every one of our development deals is with a joint venture partner. We like having that partner there for local expertise to manage it day to day and, you know, obviously put in some capital. But one of the ways that we mitigate the risk is by having strong development partners in each one of our transactions.

Spencer Levy

Let's stay on the development theme now. Page, go to you. What kind of new building are you seeing in the Pacific Northwest?

Paige Morgan

We have a bit of a land constraint issue here, both in both markets. You know, just geographically up in Seattle and then in Portland, we have sort of urban growth boundaries that kind of prevent sprawling development. But what we're really starting to see is development moving outside of our traditional metropolitan areas. Just given the demand for big box industrial. We're sort of running out of room in our traditional submarkets, so we're seeing that development spread. And in some ways, you know, Portland and Seattle are getting closer, connected up and down I-5. But, you know, to Rod's point, we're seeing a ton of capital chasing development. I think even more so than a couple of years ago, just given the rent growth that we're seeing in industrial. It's almost -- you're de-risking it in a way as you're going to capture that rent growth as you're holding during that development period. There's really been a huge focus on trying to control those big land sites. But the other factor that's coming into play is we're seeing some of the big occupiers on the e-commerce side just buy some of those sites and developing those on their own.

Spencer Levy

A lot of people are building live, work, play developments with office, with retail. I know retail is an area that's a bit more challenged and multifamily office all together. Are we seeing a lot of mixed use going up in the Pacific Northwest?

Paige Morgan

We're not seeing a lot of it in the Pacific Northwest. We're not seeing a ton of speculative office development really at this point, or you are really just absorbing the pipeline. So we haven't seen too much in our markets.

Spencer Levy

What's your point of view on mixed use?

Rod Vogel

We've got a couple of projects going up. One in the San Francisco Bay Area, that has office, has some street level retail and apartments. So we like mixed use. We've historically done pretty well. These have been, again, maybe the primary urban markets like the Bay Area. To Paige's point, we're not seeing a lot of that around the country today. I mean, office vacancy rates generally are so high that doesn't make sense for more spec to be built in. Retail, as you mentioned, is essentially a four letter word. So it could be we anticipate there'll be more opportunities as the markets continue to strengthen for those two property types. But I think for good reasons, there's not a lot of that being. Built today.

Spencer Levy

I was just looking up on Google. The band that sang the song, Can You Take Me Higher? I don't know, Paige, if you know the band, but nevertheless, I don't think vacancies are going to get higher in office. As a matter of fact, we're seeing right now already a snapback in markets like New York, not San Fran has actually lagged a little bit because it was more tech heavy. But New York has seen a snapback or sublet levels have pulled back materially. We're seeing a lot more activity. So there's real activity in the city that never sleeps, which I think is a leading indicator for how the office market is going to perform elsewhere. What do you think, Paige?

Paige Morgan

Yeah, we're definitely starting to see more absorption, certainly in the Seattle market. And a lot of it is going first, as you mentioned, Spencer, to that sublease space just given there was a lot of high quality space that came on the market. And those landlords are happy to make a deal there. But it's good to see those fundamentals really starting to come back. And I think in Portland, like I mentioned, we had seen a lot of our supply get delivered kind of pre pandemic. And I feel like the noise around just leaving office entirely has died down significantly. And now that we've all been spending more time back in the office, we're realizing all the great things that come about when we're around each other.

Rod Vogel

Yeah, Paige, I think that's going to be one of the major drivers in demand -- is when companies start coming back into the office. As you noted, most of them talking next year. At Principal, we came back into the office after Labor Day. We've gone to kind of a flex work arrangement where employees are in Monday, Wednesday, Thursday, Tuesday and Friday can work remotely or they can be in the office all five days. My teams have found it great. to get back together. The interaction, right. The collaboration. So I'm very pleased with what we've seen in our own workforce. And after the first of the year, I think you'll really see that the office market strengthen as people do come back into the office. And I hope that doesn't get delayed further. But that's the key driver, I think, behind seeing some tangible net absorption for office.

Paige Morgan

And I think it's nice, as you mentioned, even though you've moved to a hybrid model, you're going to have all the people there at the same day. So it's not really going to lessen your demand for our need for the same amount of square footage. I think that's a consistent message that we've been hearing more and more as well.

Spencer Levy

Well, Rod, you use the term of your people are coming together, so that is a Beatles song. But I want to thank my producer for getting me the name of the Can You Get Me Higher by Creed. So we thank the people at Creed for writing the song that made it to today's episode. So let's now talk about post pandemic changes. We are seeing changes where there is a flight to quality and we're seeing that clearly and industrial multifamily. But Rod, you mentioned the alternatives, the data centers, the life sciences. And you were going after them because of fundamentals, because of yield. You're getting yields that are a little bit better. Tell us a little bit more about that.

Rod Vogel

A lot of it's driven by what we call our digital investment strategy, which, you know, has identified single family rental, certainly data centers, life science property types as those that we think will outperform over the next three to five years. We've made a concerted effort to make investments there. Last year launched a data center fund. Very successful capital raise and are now in the market. It's a value add slash opportunistic fund. So we're either developing data centers speculative or buying old centers that may need to be rehabbed. So, again, another higher octane strategy targeting net 20 percent returns. So we're excited about that. Single family rental, our strategy is going to be to build, rent and sell and take advantage of what we think is going to be, again, strong demographic forces. And surprising to me how low cap rates are and single family rental. I mean, they almost mirror multifamily. And probably for good reason, given the fundamentals. But we're probably more of a merchant investor in that segment. Not that we don't like it long term. Again, clients, the search for yield is such that I think we're going to build them, rent them and flip them. Lifesciences, again, like a lot just given the market dynamics. That's a property type where will more of a build to core approach We think long term again in the markets like Boston, San Francisco, Seattle, Raleigh, those life science markets have a lot of room to run and we think we'll offer some real compelling long term investment returns for our clients.

Spencer Levy

Now, the single family rental market, I'd like you just dig just a little bit deeper into exactly how you structure that Rod, because I think a lot of people think you buy a bunch of homes or build a bunch of homes and rent them up and get rid of them. But are you doing these all on one piece of land and are you keeping the fee interest in one person's hand or you have separate lots for each of the different homes?

Rod Vogel

Yeah, good question. There are different ways and avenues to participate. The first one you mentioned is the disparate home ownership approach where you buy a home in one of 50 different cities. That's not our strategy. It's certainly workable. Ours is more of let's go out and find some land again in a joint venture with a residential developer where we can assemble a site that can handle a hundred and fifty to maybe two hundred and twenty single family homes. These will be, you know, twelve hundred square feet or maybe eight hundred square feet. So really, it's a competitor to multifamily. Right. Except you get a garage, you get a small lawn. We think there'll be strong demand for that. There will be, you know, in essence be one tax parcel. We're not looking to sell to the renter. They're going to rent because that's what they want to do for mobility reasons, for affordability reasons. And so this is a build them out in a phase or two, rent them and then, you know, sell them as one single asset in the marketplace.

Spencer Levy

Well, to quote The Talking Heads here you are in a beautiful house and then you say, well, how did I get here? And people are getting there because there's great value in these rental homes, even though we have historically low interest rates and mortgage rates. But speaking of 'well, how did I get here?' I think, Page, you know, I say this with great pride. I've known you now for probably fifteen years, and you've been a tremendous success story for us, very proud of everything you've done. Just getting promoted again to EVP. If you don't mind, just telling our listeners for just a moment from the talking heads question, well, how did you get here and what tips would you give to people who want to be the next Paige Morgan?

Paige Morgan

Yeah, sure. Thank you so much. I was fortunate to grow up in a real estate family. My dad was a developer back east and my mom had a property management company that managed the project my dad's company built. So it was definitely the talk of the dinner table in my family. And I feel very fortunate that I was introduced to real estate. I wanted to be a developer. But then once I got into development, I realized there was just too many decisions. Too many meetings. It was just too slow. So I ended up transitioning over to the capital market side and that's been a great fit for just my interests, kind of that bringing together of marketing and finance and research and writing. And it's been an exciting career. My advice to others? I think real estate is really a business of perseverance. I hear that from developers. I hear that from the brokerage side -- like putting in your hard work and coming in with a good attitude, I mean, that's going to that's really going to get you far, I think, in this business. I think my other piece of advice would just be for me personally, I've gotten, you know, more bees with honey. Right. So I think just being approachable and doing what you say you're going to do and as you have these long career that really starts to pay back in the future as everybody remembers how they were treated early and they'll treat you with that same respect moving forward. So that would be my advice.

Spencer Levy

And Rod, you are and I say this, you know, with great pride as well. I mean, you're one of the true leaders of our industry leading one of the largest real estate investors in the world on the equity side. Big picture. How did you get here? And second, what piece of advice would you have people coming up who want to be the next Rod Vogel?

Rod Vogel

Well, thanks for those kind comments, Spencer. Appreciate it. I graduated from the University of Nebraska with a finance major and Principal, was looking for finance majors in the mid 80s. So I was lucky enough to get hired by what's truly a great company. started an asset management as an analyst, like most of our people do, and kind of got the million dollar education at Principal. We're very proud of the fact that we have many people that have been there twenty, twenty five, thirty years like myself. And so with that kind of continuity of people and process, you just really have a tremendous opportunity to grow and expand. Perseverance, as Paige mentioned, is important and patience is important because it's such a fast moving business with so many opportunities that you have to be patient. Unlike my days, there weren't as many as many real estate programs in colleges like there is today. So many of these young new hires have a pretty good real estate base to them by the time they show up, which gives them a leg up. And so my advice to them is, first of all, and this is the challenge with the millennials is be patient. You've got to put in your time. Good things will happen to you. Second thing I tell them is the way we're set up a Principal is you're assigned a specific geographic territory. When I started, it was Seattle, Portland and San Francisco. And I was told and taught, you got to learn those markets better than your home base of Des Moines, Iowa. So we really focus and teach them, you know, their particular market so they know streets. And if you mention the building, they'll know it. So we teach them. And that's one of the key things for their success. Lastly, you know, I've been talking to him right now and I really believe this. It's kind of an unusual and exciting opportunity for them. When Paige and I and you grew up in the industry, there was really four property types, right? Office, industrial retail, multifamily, student housing came along. And now we sit here today talking about single family rental data centers, manufactured housing, life science. I mean, there's now -- institutional investors are going to be investing in eight, nine, ten different property types. So they're at the forefront of an evolution of the US institutional real estate investment marketplace. So it's really exciting times.

Spencer Levy

So let's have a few more wrap up questions and I'll start with you. So we're still in the pandemic. But we are moving forward from a capital market standpoint. First, fundamentals are improving. What do you think are some of the lasting changes because of the pandemic in the office and industrial space from a capital markets perspective to how it might impact value?

Paige Morgan

I think that the impact of e-commerce can't be denied. I think that would be long standing. I think we've continued to see more and more money flow into real estate as an asset class. And I think that is building momentum throughout the pandemic. And I believe that's going to really keep yields compressed even if we see rates start to rise. I believe we're going to see that amount of capital trying to flow in with the limited opportunities is going to keep our yields low. So I'm pretty bullish on real estate as an asset class moving forward out of the pandemic. I think, you know, speaking about office, Rod and I were mentioning before, we've started to see investors turn back towards office just in that search for yield and frustrated by the lack of opportunities in industrial multifamily. So I don't see the office being out of favor as a longstanding result of the pandemic. I don't believe that that will happen. And, you know, there are good opportunities in that office investment market now. The spread between a five year lease deal for a seven to 10 year lease deal, I mean, one hundred 150 basis points. I mean, that's very significant. And then even when you're looking at the industrial deals that we're underwriting now, the risk of those deals is more significantly weighted towards the residual than it ever has been in the past versus office, where you're seeing a lot more of that return come back to you through cash flow. That's sort of the inverse of what we've seen in the past. So I think there's definitely opportunities for investors to pursue.

Rod Vogel

Spencer, we believe interest rates are going to stay low for quite a long time. The talks of inflation I think are overstated. At least our belief is a little bit of inflation in the system would be great, but I don't think it's going to be runaway such that you're going to see a big rise in U.S. interest rates, which in turn is going to allow cap rates to remain again at historically low nominal rates. So we're very bullish on the U.S. economy, the outlook for it going forward. So many different demand drivers, as we've talked about. That leads us to being very bullish with us commercial real estate investments. And our clients, both foreign and domestic, are viewing it the same way. And so I think you'll see even more out of the pandemic, more capital flow to real estate as a tangible asset. The stock market is richly priced, which I think also is contributing to investors interest in adding to their real estate exposure. Many of our clients are increasing their allocation to real estate as we sit here today, which bodes well long term for the market given, you know, there will be ample liquidity. The other changes from the pandemic is kind of what we talked about already. These niche property types, the alternative sectors probably would have happened but I don't know to the degree would have happened like it is today absent the pandemic. We do, as I said, remain optimistic about office. I do think there was going to be quite a bit more functionally obsolete buildings due to the pandemic and people and employees concerned about fit well and the air quality of buildings, et cetera, that I think there is going to be some of that stock that just has to be repurposed. And I think that's another advent of the pandemic.

Spencer Levy

Great. Well, no runaway inflation, no runaway interest rates. But Runaway by Del Shannon from nineteen sixty remains of the greatest songs ever written.

Rod Vogel

Classic.

Spencer Levy

Well with that I want to thank two of our terrific friends, starting with Rod Vogel, senior managing director from Principal Real Estate Investors. Rod, thank you for joining the show.

Rod Vogel

Thanks for having me, Spencer. Always great to be with you.

Spencer Levy

Great to be with you. Next time in person, next time at the Iowa State Fair.

Rod Vogel

It's a deal.

Spencer Levy

And another one of my great friends, Paige Morgan, newly promoted executive vice president, Northwest Capital Markets.

Paige Morgan

Well, thank you for having me. And, you know, I'd say you're one of the bright spots coming out of the pandemic, Spencer, that we're all looking for. I think your weekly take is incredible content and it's a great, great takeaway from the pandemic. So thanks again.

Spencer Levy

Thank you, Paige. Thank you, Rod. Thank you, listeners, for a deeper dove into our 2021 First Half US Cap Rate Survey. We'll feature a link on The Weekly Take home page. You'll be able to find the complete report with a wealth of data and investor insights at your fingertips, breakdowns by sector, class and region and custom searchability using a dynamic map tool. All that more will be posted on CBRE dot com slash The Weekly Take. As always, please share the show, subscribe rate and review us wherever you list. We'll be back next week with a Miami sound machine. That is a conversation about one of my favorite cities, its recent emergence as, all things, a tech hub. For now. I'm Spencer Levy. Be Smart. Be Safe. Be well.