The Weekly Take

Keep the Faith: Despite uncertainty, opportunity in real estate investment

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Spencer Levy
To the surprise of just about no one, Federal Reserve chair Jerome Powell came out of the board's June meeting announcing that the Fed was leaving interest rates unchanged after a series of 10 consecutive rate hikes. The Fed left the door open to more hikes, however, potentially as soon as its next meeting this month, so investors are still looking for clarity about the direction of monetary policy on the road ahead. On this episode, two leaders with prodigious experience in the global capital markets offer their views on how and where there might be opportunities in this current environment of uncertainty.

John Lee
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Spencer Levy
That's John Lee, Executive Vice President at PIMCO. John leads the team responsible for U.S. Commercial Real Estate Asset Management, holdings that John says have roughly quadrupled since 2009.

Chris Ludeman
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Spencer Levy
And that's CBRE’s own Chris Ludeman, Global President of Capital Markets, whose group has been an intermediary on trillions of dollars in global capital. We sat down at CBRE’s office in New York City at a time when it wasn't just economic uncertainty obscuring our view, but smoke from Canadian wildfires blanketing the Manhattan skyline as well. Coming up, the Fed pauses and we try to see through the haze in the capital markets. I'm Spencer Levy and that's right now on The Weekly Take.

Spencer Levy
Welcome to The Weekly Take. And this week we're going to be talking about the capital markets with our friends. John Lee. John, thanks for joining.

John Lee
Thank you, Spencer.

Spencer Levy

And welcome back to the show, my old friend, colleague, Chris Ludeman.

Chris Ludeman
Always good to be with you, Spencer.

Spencer Levy
Great to have you back. So, John, tell us a little bit about what is PIMCO's unique approach to the business. I'm not saying that there's a lot of capital providers out there, but there are many institutions out there that do similar things. Why is PIMCO different?

John Lee
We are active investors in all four quadrants of the real estate space. And what do I mean by four quadrants? That's really public, private, debt, and equity. So $195 billion across all of our various pools of capital through our various vehicles within PIMCO. We are a large and active private debt provider and buyer of private loans, and very active as a REIT investor, as well. The way I like to frame it is we navigate complex markets in order to deploy capital. And clearly in the markets today where we are, most of the cheapness is on the public side and we've been very active there, buying public CMBS, buying public REIT shares and the vehicles that hold those kinds of assets. Whereas right now we're a little bit more quiet on the private equity side.

Spencer Levy
And that angle, if I were to put it in my own terms, is not only can you do almost everything, but the intelligence you get from the different quadrants informs all of your decisions. Is that a fair way to put it?

John Lee
I think that's right. And that's one of the benefits of us being at scale. $195 billion of assets gives us a lot of insight into what's happening around the globe with all these trends.

Spencer Levy
John, thanks for giving us a great description of PIMCO and your approach. But let's shift now to the capital markets. Big picture, John, where are we?

John Lee
Well, I know people like to use the baseball analogy a lot, so maybe I'll just say that we're in early innings of whatever this is. It certainly feels like a big inflection point in the markets. We just lived through close to 15 years of one of the best bull runs that we've ever seen in modern real estate history. Those conditions feel like they've all completely changed. On its face, higher interest rates driven by higher inflation really changed the marketplace. But I would even say, if you look at all the conditions we talked about in the GFC and compare them against the conditions today, almost every major dimension is different. So then we were talking about basically zero interest rates. Obviously we have much higher interest rates now. We were talking about long, slow, close to jobless recovery, high unemployment. We have very low unemployment and every single month seems to print very strong job growth. And this pending recession, should it happen, has been the most discussed recession in the future, perhaps ever discussed. So every condition is perhaps exactly opposite, but we're kind of in the same place, which is the market is frozen, values feel like they're down, huge bid-ask spread, and very few transactions.

Spencer Levy

Chris, what's your perspective?

Chris Ludeman
My feeling today is that while that knife is falling and people are trying to determine when they're going to catch that falling knife, my sense is that values, and we can talk about each of the asset classes, I think cap rates are probably about where they're going to be. And I believe those cap rates will stay at those levels for a relatively extended period of time. By that, I mean, I think for the next four quarters, for sure, because I don't believe interest rates will come down any time soon. I know that we might see a reduction in the fourth quarter. I'd love to say that's going to happen. But the thing that is really in my mind gumming up our business is words like pause as opposed to stop. There's no clarity on when the Fed will in fact take their foot off the accelerator on interest rates. Pausing gives people uncertainty. It's better than raising again. But I'm not convinced that when this next Fed meeting comes out that we're not going to see another 25 basis point increase. And if I'm not certain about that and John's not certain about that, the market's not going to be certain about that.

John Lee
To what Chris was saying about the pause, markets and market participants like to transact when the waters are calm so they know exactly if they set sail in a direction, they feel like they can get to their destination, but it just doesn't feel that way right now. So in many ways, I think the discussion on investment committees that I'm sure is happening, happens with us is, hey, we got this great deal, this is 50 basis points wide or 10% cheap to where that deal was 12 months ago. We should love this deal at that level. The issue is not that it's cheaper. The question is how cheap is it against that deal in the future? It's not the opportunity cost of buying that apartment deal versus that industrial deal today. It's really the opportunity cost against some unknown thing in the future. And I think that is really what's holding things in the market from a transaction perspective on equity. Now, if you decide to go up the capital structure, you go to the more senior parts of the stack, then you say, okay, well as long as I've got capital, I can make what's a good risk adjusted return. And I'm not as worried about that 10 to 15 points on the margin of value, then that's a good place to strike. But for now, it feels more conceptual than actual. Everyone's waiting for that financing gap where they're going to plug in their 15 to 70% mezz. And trust me, we're looking for it. We got the money for it. We're ready to strike. And we see the early formation of that, but it hasn't quite been there yet the way that we want. So across the board, capital allocation is down. And if you look at the origination side, that's driven by sales activity, and sales activity is down. I don't know, Chris, what you think is going to happen volume wise, maybe comparing ‘21 to ‘23, but that's going to drive not just sales but also the lending side.

Chris Ludeman
I was having a conversation the other day about ‘21. It was such a outsized year for us and probably one that we’d never anticipate. That second half of ‘21 that continued into the first half of 2022. And the thing that I pause and think about, I'm using the word pause again. Will we ever see that latter half of ‘21, first half of ‘22 again in the next decade? Now, every time we think that won't happen, something causes an exuberance to happen in the space and what could happen in terms of volumes if prices really do reset in a material way, that could also create real opportunities to make money, and as John said, if people believe that all of a sudden those prices aren't going to get any lower. The other thing that John indicated is there’s these counterbalancing things in the market. Fundamentals are actually pretty good. And if you think about rent growth and in most asset classes, even trophy office, my hunch is after having been through six cycles at my

advanced age, there's going to be a unique money making opportunity that people haven't seen since the Great Recession.

John Lee
Yeah, that's our sense as well. I don't think it's going to look like the same factors going in as the GFC, but the idea of a basis reset certainly looms large in our mind. I would say that people were hopeful for a soft landing in real estate, generally, all up until I would say that as VBs, signature bank weekend, and then suddenly everyone's mood changed. Feels like everyone's now taking a step back, I'm sure, including the bank C-suite, the regulators overseeing those banks to say, you know what, maybe we shouldn’t allocate additional money to commercial real estate, and that's the fuel of the business. So if you have this big wave of maturities, no incremental lending, then what happens to the business? Maybe that's what causes the basis reset. I would just say as a general premise, if you want to be an opportunistic investor, you hope for the basis reset. That's a moment we're waiting for. The issue is that, what if that doesn't happen and then we're just grinding sideways for years and years and letting time and inflation take care of those issues. That's actually a harder market to make money in as an opportunistic investor. That would suggest go to the debt part of the structure and get your money there, better relative returns. I think that's probably on a lot of people's mind. That's certainly on our mind. And I would say at this point right now, just, we don't know if it's a pause or an increase or if you look at the SOFR curve, it all seems to suggest that rates are going to be falling dramatically from here. But the range of potential paths here on a go forward basis feels as wide and as dispersed as it's been in a long time.

Spencer Levy
Well, to touch on that from both a macro and micro perspective, I agree with you, John, from a macro perspective. But then from a micro perspective, I'm going to push back just a touch, because I think that what both you, John, and Chris, are expressing to me is maybe not peak, but close to peak pessimism in terms of where we are at the moment. And maybe it's apropos of the air outside, the opaqueness of it all. But if you take a look at our models, you take a look at the Fed's dot plot path. You take a look at where most of Wall Street believes interest rates are going to be in two years. We may be at the bottom today, but nevertheless, this pessimism seems to be preventing people from acting, notwithstanding the optimism of some economists and optimism of some modeling. Chris, how do you react to that?

Chris Ludeman
You're right about that, because no matter what one hand thinks and says there's the counterbalance or the other hand. When what I hear from many capital allocators, almost universally, we're moving into credit – that's the place to go for the reasons that John indicated. I am not hearing yet, we're going to balance credit and equity. So until that narrative starts to change and then that will change the mood in the market, the sentiment of the market, that will start to create more transactional volume. But at this point, I don't think we're going to see much real, meaningful, transactional volume increase until the first part of 2024. Now it's easier to get a credit deal done. The duration of how long it takes to go through the pipe is, you can say 60 to 90 days. Now things are taking longer because people don't know how to price the risk, but there's money out there to do it. But remember, in a sales business, it's a longer cycle. That's really 3 to 5 months to get deals closed. So if you now put that as that food is going through the snake, that you can almost project more activity, but it's going to take a while for it to be harvested. But I actually think business sentiment is surprisingly strong. Surprisingly strong. And you would think, gosh, business sentiment should be bad.

John Lee
But I think it goes to the operations of the real estate and what's happening at the asset level, versus what's happening in the capital markets. And you alluded to this. If you want to go into One Vandy or pick the best office asset in almost any major market, it’s still hard to get in there and you're paying all time high rents. But I think so much of what we view as the sentiment is driven by the people who control the capital and the assets, and now we actually have, for the most part, healthy NOIs, with growth, but because cap rates are expanding, values are falling, right? So you kind of end up, I guess, at least we’re at this point right now, with some of this basis reset. I don't know if we're going to have all of it just yet, but all these factors are just turned on their head for the moment. What I wonder is going forward off of the bottom, whenever that is, do asset values run aggressively? Do they trade sideways? They continue to leak down as people's expectations around rates and all of this and inflation change over time. You know, PIMCO's call is that inflation does continue to moderate here. But we recognize that all those things that were disinflationary trends, those largely feel behind us. At least the major disinflationary trends that informed the past 30, 40 years.

Spencer Levy
Let’s shift now to asset types. What asset types are you looking at today as, even though the market is down, not a lot is happening. But if you were to invest today, where would you go?

John Lee
So, I do think there's a lot of good news happening in real estate. I think the trends informing industrial still remain intact. I think the deglobalization, the nearshoring, friendshoring, all of that is going to drive positive trends and momentum there over a secular horizon, notwithstanding any near-term pricing changes. Multifamily rental product really around the globe, again, subject to any near-term pricing adjustments, near-term supply that needs to be absorbed. I think all that this material increase and interest rate, interest rate levels has done is just make for sale housing, the ability to buy a home, that much more unaffordable globally. So I think the rental housing story remains strong. But think about how much conversation I'm sure we've all had over the past month, two months, however many months, about artificial intelligence, the impact of AI on our businesses. I mean, that's going to fuel the need for data. Data centers is a place that we like as a secular trend.

Chris Ludeman
Think about, historically in the last as long as I can remember, if you look at the allocations to real estate, when I first got into the business, it was 2 to 3% of the big pension plans and now it kind of went out to 12 or 15%. But think about it in the quantum, how much of that, historically, had been aimed at office and big regional malls? So we've been dealing with the regional malls, so they're put them off to the side. Now, if you consider the allocations to real estate continue to stay high on a nominal dollar basis, and if office buildings per say, are getting a much, much, much smaller allocation to office, where is that money going to go? Yes, you can put more in credit, but it's going to go to other asset classes first and maybe second amongst them because you can do it and scale. Is anything resi and industrial. So that's going to be a counterbalancing fact that if you've got more money chasing those assets, it's going to create some downward pressure on yields. It just will. And if you've got rent growth, the question is how soon will that kick in? Now, you talk about data centers and you're absolutely right, with the consume, the amount of power that they require and how much is required for AI and everything else that's

happening with electric vehicles, you just keep adding the things that require data centers and power. The biggest issue we've got there is how long does it take to get the power to the asset? And then you start thinking about what the cost structure is to build those. So it's not about probably finding the right land that's got fiber there. It's actually getting the power generation right to the asset. And that could be, if you're talking Northern Virginia, that could be three to four years. And so how do those things get financed? Well, that's going to create some trading, I think, for the things that are already built, well leased with great credit. That's going to attract a lot of capital because those builders are going to need capital to build that next thing. And that's an unusual situation because in places like other asset classes, you're not building a lot of new hotels. The pipeline for new resi, new industrial, that's slowed dramatically because it's cheaper to buy today than it is to build. So again, there's all these things that are out there that won't last forever, but they're there now.

John Lee
Well, that's what I would say. The mid to long term picture remains healthy. I mean, we talked about even coming into this period of time that there really were not out of control supply issues really anywhere. Now, equity doesn't want to build a deal when they can buy a brand new deal cheaper and the debt capital isn't there. I mean, a lot of the construction financing was coming from regional banks. How much appetite do they have from here? I guess we will see. I would suspect very little. Maybe you'll have some debt funds, some non-bank lenders, step into the space. But what is their cost of capital, right? Their cost of capital may be high single digits into low double digits for your senior loan. So what does that mean the equity is going to require in terms of their return on investment? I think it just means that construction volume is going to be very low. So as we come out of this, the fundamentals will be even better. Things like housing are interesting because if you think about how much rent increases have been around the country, I think you're going to see major metro areas, and we already see it on the coasts. but even, you hear noise in the Texases and Floridas that you don't expect. Things like, even the mention of a word rent control start to come into the dialog. But at the end, politics is just people and people have their needs. And if rents start to move out of a place of comfort for where they're going to be, then you may see some of those things get implemented. But what does that mean for an asset you own? Unless it's actually directly impaired by rent control that actually makes your product that much more valuable, because I think it makes it harder to add more supply, right? So we may see that dynamic really across the globe.

Spencer Levy
John, the world's changing, right? COVID changed a lot of things. The capital markets are changing, and a lot of things. How far outside the major markets will you look today given some of these changes we're talking about?

John Lee
Well, there's a thing that they say at PIMCO, and I think this is just a bond trader comment, but there are no bad bonds, just bad prices. So it's always just a function of, what are you buying and can you find the value there, and how comfortable are you with the trade, right? I don't think we have hard and fast rules about, well, we're not going to go to this place because the population is of such a size. But what I would say is, these are demographic stories, right? These are places where people and jobs are moving in scale in a very consistent long wave that we can see going out into the future. That's really the story here. So then buying a large plot of land is really about matching that vision against the secular story and then finding the capital to match. The way that we deploy capital on the equity side is generally in these closed end fund vehicles. These are not forever life

vehicles. We can certainly pursue a portion of that kind of strategy. But I think the things that you guys were talking about as examples, these are certainly one generation deals, maybe two or three generation type deals. And if somebody has the right capital match and has a long vision and a long time frame, that's the right way to ultimately execute those kinds of deals. But, if we thought there was great value there, of course we would look at something like that.

Spencer Levy
Well I think the movement of people, demographics, labor that goes back to this company town concept, I think the number one issue that we're dealing with globally right now is the lack of labor. The demographic shifts of people from point A to point B, either from a market or within the market. So in today's market, when we're looking at the big picture, are there some asset types that are less attractive today than they were in a more deep labor environment? John, sticking with the labor concept, how do you look at your investment opportunities globally? How does labor and demographics play into that?

John Lee
We're always mapping two things. We are looking at what are the long term secular trends around population growth, labor movement, supportive government policies that foster economic growth, and then we match that against what's happening cyclically in a market. We're coming in this really interesting time because obviously we have mapped out ourselves what we view as these compelling secular trends around demographics and political environment and digital and sustainability. And then we have this downturn that we're working through right now that provides a really interesting entry point for capital allocation to play on those trends. If you think about how capital was getting allocated by all active participants, you are trying to buy into those trends, but at pricing that just, in retrospect, looks like it was quite high and perhaps priced to perfection. But now you're able to perhaps access those same trends and through various investments at a cyclical low point. And that's the right way, I think, to make money through a cycle. But, you know, those trends are really important. Mexico, we have a material size portfolio of industrial product there, and we're seeing the benefits of near-shoring, of deglobalization, both on the the user side, creating demand, but then on the capital side, looking to take advantage of that. I think we're in the early innings there and that's going to be a trend trade that plays out over a generation, perhaps much in the same way that the China growth and urbanization story played out over a generation. But that's what happens in these inflection points, is those trends shift, right? And now we're seeing that shift happen. We're seeing something similar in Poland. We have a sizable housing investment there. We're seeing significant movement of population into that particular market that's driven by geopolitical factors, right? And it's creating a lot of vibrancy in that market, particularly on the rental demand. And we're seeing it in not just the take up on leasing, but then also on the rent growth. So if you can map out these trends, we've got a global organization. We have 3,500 people throughout the globe, not just doing real estate, but really touching everything. And we can harness the power to really identify those secular trends and find the right place to deploy capital. That's our viewpoint, is how to make money and why scale matters in this business.

Spencer Levy
Well, thanks, John. So we're out of time, but I'd like to just ask a final question, Chris. Any final thoughts on today's discussion?

Chris Ludeman

Well, I think John said it at the top. If you think about what brought us into this difficult period of time, it's very different than what brought us into the GFC. And I actually find these times of displacement super educational. They're humbling, they're educational. And what they usually stimulate is more creativity, because we've had a problem in the capital markets today. We've got a lack of liquidity that has become quite profound. But now you see people creating creative structures to solve for a challenge in the market. And so we're going to get more sophisticated. We're creative people. And when you're working with companies like PIMCO and Allianz and hopefully companies like us, that we can collectively come up with a better idea or as to create a set of outcomes and solutions, that individually we couldn't do because we each bring something different to the table. What is one of our competitive advantages? I mean, if you think of the breadth and depth of our businesses and the data that we collect, if we harvest that data and then we decide how we're not just going to mine it, but how we can actualize that to create better solutions and we can be predictive. I'm telling you, it's going to be fun to watch. And I think the game is so different today than it was a decade ago. And I think the pace of change in our industry set will change more rapidly than we can possibly imagine. So that's going to cause people in our business, executives, to be more agile, be more creative, and not be set in their ways.

Spencer Levy
John, any final thoughts beyond that?

John Lee
I think this is an interesting time in the markets. I think clearly there's an inflection point happening here. Where we go from here, I think, is subject to lots of potential possibilities, but I view us as being ready and excited about the possibilities. And I think we will always have a role to play as a capital provider, as a liquidity provider in various parts of the capital structure. And I think it's going to turn out to be quite an interesting couple of years ahead of us.

Spencer Levy
Well, on behalf of The Weekly Take, I want to thank our, third or fourth time on the show, Chris Ludeman, our Global President, Capital Markets, CBRE. Great job. Thanks for coming back, Chris.

Chris Ludeman
Glad to be here.

Spencer Levy
And our friend John Lee, Executive Vice President at PIMCO. Also, terrific job. First time on the show, but hopefully not the last.

John Lee
All right. Thanks.

Spencer Levy
For more capital markets insights and related content, visit our website at CBRE.com/TheWeeklyTake. We invite you to use the “Talk to Us” feature to send your thoughts, questions and feedback directly with our team. We might follow up on what you tell us on a future episode, and we also hope you'll share this episode as well as subscribe rate and review us wherever you listen. In the weeks to come, we will span the globe for investing insights. We'll go to the mall with Macerich, a leading mixed-use developer. We'll

continue to explore the economy with CBRE’s top thought leaders and more. For now, thanks for joining us. I'm Spencer Levy. Be smart. Be safe. Be well.