The Weekly Take

Ready For It?: KKR on capital's reviving interest in real estate

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Spencer Levy
As the first quarter of 2024 draws to a close, the capital markets may be thawing. There's a sense that investors may be ready to test fire some of the dry powder they've been holding through the past 18 months of uncertainty. On this episode, we get a sense of the prevailing winds with a pair of major players in the capital markets.

Roger Morales
We are in a deleveraging cycle and over time we should expect and will see more sellers have pressure, either because they have redemption issues or because they have debt issues or they have to buy interest rate caps. Which should force more trades.

Spencer Levy
That's Roger Morales, Head of Commercial Real Estate Acquisitions for KKR and one of the founders of the real estate platform for this global investor. Roger is responsible for all ends of the business, including acquisitions, portfolio management and fundraising.

Kevin Aussef
I think we're in a better world today than we were last year this time. What's been missing in the market is conviction from investors.

Spencer Levy
And that's Kevin Aussef, America's President of Investment Properties for CBRE. Kevin oversees a sales business with verticals for office, retail, multifamily, industrial and specialty practices. Coming up, a conversation recorded at the recent CBRE Investor Symposium in Arizona on the state of deal flow with investment leaders from two of the biggest players in the world of commercial real estate. I'm Spencer Levy, and that's right now on the Weekly Take.

Spencer Levy
Welcome to the Weekly Take. I'm here with Roger Morales. Roger, always great to see you.

Roger Morales
You too, buddy. Thanks for having me.

Spencer Levy
Great to have you. And another great friend of mine, Kevin Aussef. Kevin, thanks for coming out.

Kevin Aussef
Good to be here. Thank you.

Spencer Levy
Great to have you. Well, let's just start big picture. Roger, just in a nutshell. How would you describe the capital markets today in commercial real estate?

Roger Morales
We're definitely sitting in a world where the macro is pretty uncertain. The path of interest rates is uncertain. The path of the economy is uncertain. I would say, in fairness, it is more certain than last year. But still, there's a fair amount of uncertainty. I think people are still a little bit on edge in trying to figure out how to express themselves in new investment opportunities, how to manage their portfolios, and how to think about exits in this world that we're all tasked with figuring out.

Spencer Levy
So, Kevin, if I were to summarize Roger's statements in a couple of words – still uncertain, but maybe slightly more certain than last year. What's your point of view?

Kevin Aussef
I agree, I think we're in a better world today than we were last year this time. What's been missing in the market is conviction from investors. And I think the Fed has done a really good job at keeping everybody in suspense. And that conviction is what has been driving the market for the last ten years, until we saw the interest rates go up as fast as an elevator. Looking at the overall market, we've seen activity start to pick up this year in comparison to last year. Pricing is tightening more today than it was probably 6 or 7 months ago, but it will take a while for it to sort out.

Spencer Levy
Well, Kevin, you're the president of the largest group of investment sales professionals in the world. What's the mood among our team? Among our brokers?

Kevin Aussef
There is more optimism. We just got back from NMHC, which is a multi-family conference in San Diego. Lots of dry powder on the sidelines. I think generally people are more optimistic. It varies if you're an office or a retail or data centers or self-storage. But, generally speaking, I think the mood and the sentiment is more positive today than it was a year ago this time.

Roger Morales
So I might even add that, what I'm hearing is that there's a lot of investors that didn't participate in the market last year, they didn't invest capital, and so going through our business and not doing anything for 12 months can create a little bit of deployment pressure. So I think there is that element that's causing folks to think about how to get back in the market. There is slightly less uncertainty than there was last year and compelling people to think about how to get money to work.

Spencer Levy
And one of the things I heard today – because I've been meeting with all of our brokers today as well – is that, I think last year it was almost impossible to get equity bids and certainly very difficult to get debt. But I think the average size of the deal is now beginning

to get larger – in part for what you're saying, Roger – that people are coming back into the market. Do you see that as well, Kevin?

Kevin Aussef
Yeah. And better pools are expanding where we would get one or two offers. Now you're back to getting five or six or seven. I think there is still a gap between the bid and the ask, but it is tightening.

Roger Morales
I think a lot of that comes back to the availability of capital and the availability of capital and credit. Right. Every time you start a new year that provider in the insurance business get new allocations and they're eager to get their you're up and running and going to the availability of capital – of that capital is more abundant on the front end of the year. And of course, what we've seen is that the CMBS market has woken up in 2024 – is functioning, deals are getting done, spreads are compressing, risk is clearing through the capital structure – which of course enables more and more transactions and allows investors to do larger deals if the credit side of the equation is.

Spencer Levy
Roger, KKR has lots of different buckets of capital. Have you changed the way you're underwriting today – given the changes in the capital markets environment – to be more focused on cash flow then on the capital markets gains, or are you still using the same basic discipline?

Roger Morales
Listen, I think we are in a deleveraging cycle. And so, it is true that prices have come down materially from the peak, but we're also in a world where transaction volume is a fraction of what it was. So, yes there's deleveraging pressure. Yes, values are coming down. But transaction values are down and so prices are not unhinged at the moment. Right. I think everybody wants to talk about the stress, but that's not the world we're living in – as a wholesale matter right now. That may manifest itself in the next six months, in the next nine months, if the macro changes or if there are more people that are forced to trade, thereby driving up force in transaction volumes. But it's not. And so what is a focus area for us at the moment is looking at all the redemption pressure that a lot of equity investors have. We've been gravitating towards buying very high quality assets at big discount to replacement cost up the quality chain, taking little execution risk at the asset level – and those are all the positives. The negatives are that interest rates are up a lot and unfortunately, when you underwrite those types of transactions – even though you're buying assets at a discount to replacement cost – you're getting very minimal current cash yield. Right. So you're buying high quality assets – making the bet that supply is coming down which leads to better fundamental performance in ‘25 and ‘26 – but there's a healthy amount of the return that's being derived from the residual, irrespective of the fact that it's in high quality collateral. So cash yields are down, admittedly. Quality of asset is up, execution risk is down. And that's one of the places that we're very focused on right now, playing up in quality.

Kevin Aussef
Is that a longer term hold then – strategy?

Roger Morales
Yes and no. We buy core plus assets – add value, add returns – in the opportunity funds and we're trying to continue to buy quality in the lower return vehicles. And again a lot of

that is on offer by virtue of the fact that there's a good number of equity investors in commercial real estate that are facing redemption pressure, they're forced to trade, and those lower cost of capital investors are the ones that are facing that pressure, and they're not there to also buy. So we're trying to sort of sweep in with higher return capital and buy those assets at outsized returns.

Spencer Levy
Let's talk about the cost of capital for just a moment – just using very general terms. Core capital's typically high single digits, core plus maybe low double digits, value add mid-teens, and opportunistic around 18% to 22% ballpark. Have those numbers changed in today's market? Are you expecting a higher return for that same capital?

Roger Morales
I think what's happened is that the expected returns have not changed. But to my point earlier, the quality, the collateral, and the amount of risk that you need to take is better. Right. Because again, that lower cost of capital – investors facing redemption pressure and they're not buying as actively as they were in 2021, assuming they run an Odyssey index fund or they run a non-traded REIT. So that's really the dynamic. Again we're trying to create core plus assets and earn value add returns up the quality spectrum.

Kevin Aussef
That's a great point. We've heard for years that you make your money on the buy. And to go and buy these assets below replacement cost – you didn't have these opportunities a few years ago. So, getting some of these quality assets if you have the right capital structure – hold them a little bit longer – you're not necessarily counting on rate compression to create value, but you're getting an asset that's unique in the market. That selection has expanded tremendously over the last couple of years. Three, four years ago there wasn't that much on the market. So you're sort of compromising your way through transactions, whereas now you can be a little bit more picky.

Spencer Levy
What I think has also happened in the last decade or more, is the diversity of institutional quality, real estate, has expanded. I think it's fair to say that self-storage, which is an area that KKR is investing in. Data centers were not considered institutional – and I know, am I even going to say this word, but I, because I know you're not a big fan – retail was not institutional quality for a long time. Roger and I have had this debate before. And so, but now that's coming back too. And so, I think it's actually a better world for investors in the sense that you have this greater diversity of asset types. I'll go one step further. I think there's a better diversity of market too. Do you see it that way, Roger?

Roger Morales
We really focus on institutional quality assets in the top 15 markets. Just value the liquidity that's associated with those assets when you're selling to your next buyer and we just think you get outsized growth. The opportunity for outsized outcomes, off the page outcomes, is better with those sorts of assets. So we stick, like I said, to the top 15 markets, and that's how we run the investment.

Spencer Levy
Even in self-storage? Even in industrial?

Roger Morales

Even in self-storage and even in industrial, we stick to the primary markets. Now we may, for example, in industrial, we may step out a little bit and focus on port oriented markets like Richmond or Savannah, which is a play in the southeast in Atlanta. But we really try and stick to the top 15 markets and the same is true with industrial. We're focused on net migration patterns in the US and where there's outsized job creation opportunities. We don't go into the tertiary markets.

Spencer Levy
Gavin, you mentioned the big five asset classes is your primary responsibility. But how do you see some of these operational real estate asset classes – smaller asset classes versus the big four today?

Kevin Aussef
Data centers is unique. I haven't seen anything like it in my career, where it has been such great tailwinds for data centers and so much demand. Self-storage – I think to your point – they kind of follow rooftops. So that's a little bit different. But I think data centers, just given the demand in the market, you're seeing capital willing to take lower returns to be in that asset class. And that's with AI. You look at the drivers for data centers to the extent that you can get power. It makes sense to a data center. And I think both on the debt and equity side, people are willing to take lower yields to be in a safer asset class.

Spencer Levy
So while we're on data centers, while we're on data – that the big theme of our conference here today, big thing we talked about this morning internally, and we'll be talking about externally – is just data. What we are doing with it today and where we're going. Can you give our listeners a snapshot of where CBRE Capital Markets is with our data aggregation and where we think we're going?

Kevin Aussef
Well, I'll give you some numbers. These are round numbers. At the peak, we were taking 6000 properties to the market. We would launch 6000 listings a year into the market. And those 6000 listings generated 300,000 confidentiality agreements. So you do the quick math, it's 50 acres per property. That's a peak at a market. Today we anticipate taking about 4000 properties to market this year, which is down by, call it, a third. But here's the interesting part: The demand side. We think that those 4000 properties would generate about 120,000 confidentiality agreements – so it's about 30 per property versus 50 per property. Or that's down by 60% and there lies the gap between buyer and seller expectation where there's more supply and there's less demand and as intermediaries we essentially sit at the intersection of supply and demand. So that's what we're seeing. We're fortunate to have the technology to be able to track all of that. So we track preferences, geographic orientation, product, and we can break that down by any given product or market. But when you look at it holistically, it is a new baseline for us. And it's at the levels of 2016, 2017 when we go back and look at data to see when was the last time we did generate 120- or 130,000 CAs. It goes back. You have to go back almost seven years.

Spencer Levy
So, Roger, when Kevin mentioned those statistics, it reminds me of where I started my career in the mid 90s in New York City real estate, and we were buying office buildings – and again that's another word we can talk about at great length – for 100 bucks a foot in New York City, in downtown Manhattan, even in Midtown, there were some that were available at those levels because the bidder pools were so small. Because we were a private organization, we were getting money from high net worth individuals, and those

seem to be the nature of the buyers. And they bought some of the best real estate imaginable for a song at that point. I see similar opportunities today. If you can get the assets at fair market value, good assets, fair market value, good submarkets. Do you see this as that kind of intergenerational opportunity today or is it going to be, still be, much more of a sharpshooter investment market?

Roger Morales
I think in this spot market, I don't think that that is on offer for the reasons I said earlier – even though we're in the deleveraging cycle, transaction volumes are down and so pricing is not unhinged – particularly for smaller transactions. Having said that, we are a deleveraging cycle and over time we should expect and we'll see more sellers have pressure either because they have redemption issues or they have debt issues, or they have to buy interest rate caps, or they're out of reserves to protect investments in their fund, or they have to fund a development pipeline, which should force more trades. And if and when that happens – which again we have not seen as a matter, like a wholesale matter right now – then you've got four sellers potentially overwhelms the number of buyers and you should see more distressed activity with significant value created on the buy. So that's what I would say about deals that are marketed, and particularly for people who are selling smaller transactions. I do think you are in a market where investors need liquidity. Right. We are in a deleveraging cycle. And so it really is all about, in my opinion, how you manufacture a deal off market vis-a-vis relationships, talking to counterparties who are comfortable to trade in size, if they feel like their buyer can bring certainty to the equation and deliver a deal where the seller is not taking execution risk. I do think more of that is happening and I think increasingly more of that will happen and that's where we're spending a lot of our time. But again, in the smaller transaction game – deals that are being brought to market by intermediaries – I think those feel quite well bid to me at the moment with a lot of CA activity and a lot of investor interest – again in the top 15 markets in the US for asset classes that are performing.

Spencer Levy
To Rogers point, Kevin, this seems to be a little bit of a positive change. What do I mean by this? I think that if we were having this conversation six months ago sitting in this chair, we would have said that a disproportionate number of our bidders were high net worth individuals, private capital, maybe some sovereign wealth – people that were not traditional institutional investors. It feels like the institutions are coming back.

Kevin Aussef
Depends on the product. Not for office, but depends on the product. For multifamily. We can't say retail property that had 14 or 15 institutional buyers at the table.

Spencer Levy
Grocery anchored?

Kevin Aussef
Grocery anchored. So it depends on the product where you see high net worth versus family office or institutions. But I've often thought about if I were running a family office, you know, what would I do? I think I would buy a lot of apartments. I think I would buy as many apartment buildings as I could that are below replacement cost in areas that maybe were oversupply, such as the market we're in right now in Phoenix or Austin. You look at the secular trends for multifamily over time, especially given that supply has peaked, there'll be generational wealth created in multifamily. And I think on office – speaking on generational opportunities – James Millon, who runs our debt business, he is convinced that buying

office buildings is a generational opportunity that we will never see. There’s properties that were selling for four or $500 bucks a foot, selling for $150 bucks a foot. We just sold a property in Denver – 400,000 plus square feet for $40 bucks a foot – an office building, in Denver. That's unheard of.

Roger Morales
The only thing I would add, Kevin, is I feel like we're in a very bifurcated market. If you've got an A quality asset in an asset class that is performing, that’s well bid. In a primary market or in a growth market in the Sunbelt, that's also well bid. But the bid activity and interest falls off sharply when you go into less attractive secondary markets and tertiary markets, and you start to step away from assets that are A in quality. And I do think that the investors are discerning right now. There's a lot of liquidity for the right properties. And there's, in my opinion, a lack of liquidity for assets of lesser quality and lesser locations, which, of course, you know, that's not the case when capital is flowing and the debt markets are functioning on all cylinders and you can capitalize things cheaply. Secondary tertiary markets benefit cap rates compressed between A's and B's – that's not the market we're in right now in my opinion.

Spencer Levy
Roger I know you've invested in SFR, a single family rental, for quite some time now. I'm very bullish on that market. When you're looking at single family rental as an investment class, are you saying with those top 15 markets as well, just doing in the suburban areas, or do we go further afield?

Roger Morales
No, we're staying in those top 15 markets focused on suburban areas that have the right access to jobs. Downtowns or areas where people work in the right schools and that sort of thing.

Spencer Levy
Is that market holding up today? Because I know you've the same interest rate pressures there as you do in commercial.

Roger Morales
One hundred percent. It is holding up. Rents are up mid-to-high single digits and a lot of it comes down to the cost of renting relative to the cost of owning, which is a very, very significant discount in favor of renting as the cost of ownership is very, very expensive and people are effectively locked out of buying. Not to mention the fact that there's not enough housing inventory, single family homes to buy.

Spencer Levy
Well, I can say this both mathematically – looking at the Case Shiller Home Price Index – but also anecdotally for me because I was on Zillow today just looking at the price of houses in Florida and the rental difference is staggering.

Roger Morales
It's 40%, 30%, 40%, 50% depending on –

Spencer Levy
It’s that much cheaper to rent today than it is to buy. Now, given the secular shift today, Kevin, how much of our business do you think is going to shift if people are going to be renting more versus buying more in the housing sector?

Kevin Aussef
Those are benefits on the positive side ledger for multifamily. But there are some negatives with multifamily. One is the supply issue that we talked about. Second is the cost of operation has gone up significantly, especially in the coastal markets when you have some markets that are also softer. Accounts receivable for multifamily have been increasing. People are not paying their rents on time. There’s evictions, there's collection issues, there's fraud. Utilities are going up. So you have some headwinds there. But I think on the demand side equation, it is much more difficult for people to buy a home today than it was two, three years ago. But as I said, I think the secular tailwinds for multifamily – if you get past the next two or three years – could be very beneficial.

Roger Morales
Yeah, I agree, Kevin, I think it's really two things. It's the discount to homeownership, which we've already talked about, which is pretty compelling, but also the discount to replacement cost, which is also very, very compelling. And those are very different concepts, although both are supportive of multifamily and renting. And one of the things we focus on a lot internally is what are new development rents? If you're buying at a 40% discount to replacement cost? In theory, reds have, like, a lot of room to run before it's economic for a developer to go out and build that new building at a 6.5% yield on costs or a 7% yield on costs. So a lot of the analytics we're running internally is focused on the discount to homeownership, the discount to replacement cost, and at exit, what is our discount to replacement cost if we trend our basis up and what are replacement cost rents at exit – again to understand whether or not we're insulated at our point of exit. And the only thing I'd say – just to go back to the thing that you brought up, Spencer – this idea of replacement cost and really having a refined point of view is a big deal today, because supply pipelines are going down and effectively going dormant for the most part across asset classes once you get through the second half of this year. And so as investors, we all have to develop a real point of view around whether you're willing to bet on buying assets at a big discount to replacement cost, whether replacement cost is defensible, and if it is, does that set up well for owners of assets to enjoy outsized growth in ‘25, ‘26 and 2027, when in theory, we should be catching up on supply because pipelines take a while to activate. And we're spending a lot of time internally looking at the cost of construction, historically, the cost of labor historically and today, speaking to GCs, looking at the construction industry in the U.S. – underlying construction data. Looking at how much infrastructure spend is a percent of total construction in the U.S.. Okay. Looking at manufacturing capacity and how that's ballooned as a proportion of construction spend in the US, and quite honestly, looking at how commercial real estate as a proportion of construction projects in the U.S. has declined over time. And so, really, if you deconstruct construction activity in the US, you become self-aware of the fact that even though we're obsessed with commercial real estate construction, it is a declining piece of the puzzle in that there are other parts of the economy that are not as cyclical, and it will continue to build, and that it's, in our opinion, less likely that construction costs come down, even though they increased rapidly in 2021, ‘22. And if you develop that view, then you're actively investing behind that thesis across sectors in high quality assets.

Spencer Levy
But here's the other thing – and this is more of a general statement – that historically putting cost aside – which is like putting that 800 pound elephant aside – the best time to build is at the bottom of the market because you're going to have the best product coming out when we're done. So even though the cost is so high, I still think there's a case to be

made for new construction today, for the right assets, in the right submarkets. You have a point of view on that, Kevin?

Kevin Aussef
Yeah. I mean, to the extent that you have a construction loan available and, you know, what do you think a construction loan would – I mean, it's got to be 10%.

Spencer Levy
10%. 15%.

Kevin Aussef
Right. So on 10%. I mean, I don't know how you pencil that right now. I mean, you'd have to get the dirt for free. Even that may be challenge. But I think it will change. I mean, over time it will change. But it is – when you look at it from a cyclical perspective – it does make sense.

Roger Morales
Well, let's break it down. The cost of labor that's bid in a construction project, that's now going down. The cost of materials is plus or minus 5%, depending on the material or the trades or whatever. The cost of debt is up materially, like multiples. And so therefore what is seemingly pretty material moves in land prices are getting offset by the cost of construction. And most other key components of building a building, like I said, are not going down. And so, you know, it’s tough.

Spencer Levy
It's tough. But let me ask just one big picture question before we wrap up. And I say this with real pride. I remember when you and Ralph started the business at KKR, started from essentially zero, and now you are one of the major institutional investors in the space in the course of, what, 12 years or so, 12, 14 years. What were some of the secrets to your success of growth?

Roger Morales
So thank you. First of all, thanks for saying that, Spencer. Today we're sitting at $65 billion of AUM. We've got a business in the US, with business in Europe, and we're in Asia. And of course we're up and down the capital structure. We're in credit with the dominant franchise and we're in the equity side of the capital structure again with a dominant franchise. The keys, I would say, are, number one, defining your strategy. And in our case, it's a thematic approach to investing where we think we have differentiation by virtue of what we do in the commercial real estate sector, by virtue of the fact that we have a credit business, by virtue of the fact that we're attached to KKR with a lot of information, edge, etc. – overtime deciding what differentiators we wanted to bolt on to the business and building them out. Right. And again, in our case, was building out the credit business to complement the equity business in real estate, in our case, was developing all the relationships internally to extract the information across industry groups, etc. that KKR has to offer. And then, lastly, was the decision that we made to add operating capability to what is obviously a very well heeled and information rich alternatives asset manager. And so in response to you is to be deliberate about your strategy, to be deliberate and to invest behind your differentiation, and to play to those strengths and not to get distracted away from them. To be deliberate about defining them, don't get distracted, and then go execute.

Spencer Levy

Kevin, you're speaking now not just to our brokers, but to the market. What are your words of advice over how to handle a 2024, 2025 markets?

Kevin Aussef
Well, I was reading Warren Buffett's annual letter to investors and he was reminiscing about his partner who passed away, Charlie Munger. And he was saying that in 1965, Charlie gave him some advice that has shaped everything that he's done. And, I'm paraphrasing, but he said that right after acquiring Berkshire, Charlie told them that now that you've acquired Berkshire, you don't want to go out and look for a similar business. Like, you can't replace what just happened again. So don't waste your time on that. And the advice he gave him, he said, think about buying wonderful businesses at fair prices versus buying fair businesses at wonderful prices. And I think we can all kind of heed that advice. You know, as we're talking about investment, the opportunity in the market right now is to buy some wonderful properties and pursue some wonderful strategies, and you can get them at pretty fair prices as opposed to the – you know, we were so focused on the yield and driving value and extracting value and all that. And I think when I read that, it resonated with me, just given the market that we're in.

Spencer Levy
Any final thoughts?

Roger Morales
Our strategy is to buy high quality assets at fair prices, which is why we focus on the asset classes that we focus on. We focus on the cities that we focus on. And to your point, Spencer, it's almost impossible to get us to focus away from that because we just think that the opportunity for growth, the outcomes, the liquidity is just better. So we certainly subscribe to that theory. The only thing I'd say is that we are in an uncertain world. And notwithstanding that, I do think that we believe that there are interesting transactions to do where you can buy very high quality assets at a discount to replacement cost. And so the approach that we're taking is to hedge against some of the uncertainty by pacing and just being deliberate about how much capital you want to invest in the year and pacing your way throughout the course of the year so that if any one of these uncertainties comes about in a way that's highly unexpected, you're sort of legging your way in through the year and not getting ahead of your skis. And part of that goes to another concept, which is that, I believe in the world that we're in – where transaction volumes are low – most investors, when they transact they are buying the forward curve. Right. Because it's either in your financing or it's in your exit cap assumption. And so that’s just another reason why pacing throughout the course of the year, as you deploy capital in an uncertain world, I think is the best strategy. It's the way to hedge against things that we can't forecast or foresee. And I think it keeps us sane and that's what we're doing.

Spencer Levy
Well, on behalf of the Weekly Take, two of my really great friends in this business, Roger Morales, Head of Commercial Real Estate, KKR. Roger, great seeing you. Thanks for coming out.

Roger Morales
Thanks.

Spencer Levy
And Kevin Aussef, America's President Investment Property, CBRE. Kevin, thanks so much for coming out.

Kevin Aussef
Thanks for having us.

Spencer Levy
For more investment insights and related content, please check out our website cbre.com/TheWeeklyTake. We'll be back with more views on the capital markets and deep dives with other leading global investors and developers, including a stopover with some first class guests in the hotel sector – a topic we haven't covered in a while. So I'm looking forward to that conversation and lots more. Next week we'll sit down with big thinker Ben Nemtin, a popular keynote speaker and the bestselling author of “What Do You Want to Do Before You Die?” and we'll delve into the unique insights and stories he shares with corporate leaders around the world. For now, we hope you'll share this episode as well as subscribe, rate, and review us wherever you listen. Thanks for joining us, I'm Spencer Levy. Be smart. Be safe. Be well.