Principal Asset Management

On the verge of a new cycle

Investors need to be nimble and adaptive to take advantage of value-added opportunities surfacing today

Loretta Clodfelter, Institutional Real Estate, Inc.'s editorial director, recently spoke with **Vance Voss,** managing director and portfolio manager, and **Russ Beecher,** managing director, from Principal Real Estate, the real estate investment team of Principal Asset Management, about their outlook for real estate investment this year and next. Following is an excerpt of that conversation.

What are your main observations regarding the current state of the U.S. commercial real estate market? Is now a good time to invest?

Russ Beecher: 2023 was a challenging year and a year of transition, with the Federal Reserve fighting inflation with the most aggressive rate-hiking cycle since the 1980s. That was alongside a lot of economic uncertainty regarding a potential recession, which has resulted in an environment with heavy price discovery and a very muted transaction market with asset values down, on average, approximately 15 percent. We believe repricing is largely complete, and we are on the verge of moving into a new cycle. We are entering a great period for real estate investing coming at us for structurally driven property types.

Vance Voss: On the space-market front, there are some interesting opportunities in structurally driven property types, such as industrial and multifamily. They've proven to be very resilient as the economy continues to grow, and while we think the pace of economic growth is going to slow, we still like the long-term fundamentals in multifamily and industrial. We think 2024 is an opportune time for investors. Given the reset in values that Russ highlighted, we believe 2024 is going to be a great year for investors to put capital back into the market.

What are the most structurally driven resilient property sectors today? Which sectors do you believe offer the greatest opportunity during the next few years?

Voss: We see three product types that have some strong resilient structural drivers. One is industrial. The industrial market today continues to benefit from supply-chain restructuring, onshoring and nearshoring of supply chains, which began during the pandemic and continue today, given the geopolitical risk in Europe and in the Middle East. We also like the continued growth and expansion of ecommerce in the United States. While stalwarts in the industrial sector have slowed their pace of new absorption of industrial buildings, we're seeing continued growth from traditional brick-and-mortar retailers, as they continue to build out their ecommerce capabilities. Also, from a product perspective, we like the multifamily sector. Continued increases in housing prices and increases in interest rates have forced many would-be home buyers into the rental market for longer periods of time, supporting longer-term multifamily demand.

Within both product types, the vacancy rates are starting to increase a bit, but they both remain well below their equilibrium vacancy ranges. Both product types are faced with some increased supply pipelines, but that supply pipeline, we think, is going to peak sometime in 2024 for both product types, and a significant reduction in those pipelines' deliveries for 2025 and 2026 bodes very well for investors in industrial and multifamily.

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The other sector I would highlight is data centers. The continued growth of AI data-storage needs for consumers and companies across the globe has really created significant opportunities in the data center product type. It's a sector that requires some unique capabilities, and it is important to partner with an investment manager who understands and has strong experience in that product type.

Russ, do you have anything to add here?

Beecher: As Vance mentioned, we remain bullish on the multifamily sector long term, but given the amount of new supply, coupled with a rise in operating expenses, we are starting to see downward pressure on NOIs. When you combine this with today's higher cost of capital, we are seeing value erosion and some signs of distress, particularly for those assets finishing up construction.

Let's dig in a little bit on the signs of distress in the multifamily market. What are you seeing, and what are the factors at play?

Beecher: The impacts I mentioned are occurring at the same time the sector is facing a significant wall of maturities, much of which is tied to new development that was financed with higher-leverage, floating-rate loans that are challenging to refinance without a significant equity injection in today's higher interest-rate environment. The distress has been evolving throughout 2023, and we anticipate the opportunity set to widen throughout 2024, making for an attractive opportunity to buy high-quality assets at a material discount to replacement cost.

What markets do you think could experience that greater degree of distress?

Beecher: We would equate the market to a stock picker's market today, with pockets of distress throughout the United States. California's Bay Area comes to mind when you think about the amount of new supply that has come online at the same time the market has experienced layoffs in the tech sector. Several of the Sun Belt markets, such as Phoenix; Austin; Nashville and Charlotte, N.C., have also seen a significant wave of new supply. Yet, we are long-term believers in the sector and in those high-growth markets, and thus, we're looking to take advantage of that opportunity.

On the supply-side pressures, do you anticipate that to begin to show relief? When and where might that happen?

Beecher: We do continue to have that long-term conviction about employment growth in these markets. When does that occur? We think it's going to be 2026 and beyond. These markets will be very well positioned for capitalizing on strong rent growth, going forward. A significant cause of that is we expect to continue to see new construction starts drop off dramatically, with these markets being very well positioned for rent growth as we enter 2026 and beyond.

Voss: In the multifamily market, for example, during the next 12 months to 24 months, the best opportunities will likely be in the distressed assets rather than new development, with borrowers becoming increasingly under pressure, given the prevalence of variable-rate loans for many borrowers. As the new supply pipeline starts to dampen and taper off, we think there will be an opportunity to be a first mover in 2025 or 2026 in developing new multifamily product, given the significant slowdown we expect to see in new deliveries starting in 2025. Being nimble and adaptive to the best relative value, whether it be in distressed value-added or ground-up development opportunities, will pay dividends for investors during the next few years.

How can investors take advantage of these distressed assets?

Voss: Investors with experienced staff and unique deal sourcing capabilities will be best suited to take advantage of these opportunities, whether that be distressed or value-added deals. For example, we think the multifamily sector – with a wall of maturities estimated to be nearly $1 trillion during the next four years – will offer some unique opportunities for investors. There will be some interesting opportunities in the industrial sector, as well. For example, we recently enacted an opportunity in Orange County, Calif., where there was an office owner with an office fund that had one asset left. We purchased the existing office buildings at a significant discount, given it was their last deal in the fund. We're demolishing that office project and building a state-of-the-art industrial building on that site.

We believe Orange County is arguably the most favored industrial market, with the best fundamentals in the United States. We're seeing some distress from other product types start to leach forward into redevelopments and unique opportunities that will benefit other product-type sectors as well.

Beecher: In our experience, these windows close relatively quickly. If you have dry powder, you need to be able to take advantage of those select or stressed opportunities today and position yourself to exit when capital values have recovered in the next three to five years.

You've both been through multiple economic cycles. What kind of final guidance would you offer investors as we go through 2024 and look ahead to 2025?

Beecher: My advice is to be nimble and take advantage of where you are seeing the best relative value. In both good times and bad, values tend to return to replacement cost. Specific to the multifamily sector, today we are seeing the opportunity to buy high-quality, multifamily assets at a discount to replacement value. That window will close quickly. So, investors need to be in a position to pivot and take advantage of development opportunities as they arise, given that the new supply pipeline is shutting down.

Voss: It's important to partner with proven investment managers who have demonstrated a strong track record during times of dislocation. We're entering a unique cycle right now, and values have declined in excess of 15 percent. To quote Warren Buffet, "Be greedy when others are fearful and fearful when others are greedy." There is a lot of uncertainty in the market now, and clouds are on the global economic horizon. Given the value declines we've already seen in the marketplace and the likelihood the Fed is going to start pivoting and reducing rates later this year, now is the time to start to opportunistically deploy capital into this new investment opportunity set while the uncertainty remains. I think 2024 is going to be a great vintage for investors to put capital to work and place it with a proven and trusted investment manager.

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ABOUT PRINCIPAL REAL ESTATE

Principal Real Estate is the dedicated real estate investment team of Principal Asset Management^{SM}. Our knowledge and expertise span the spectrum of public and private equity and debt. Our specialized market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximize opportunities and find the best relative value on behalf of our clients. Visit our website at **www.PrincipalAM.com/realestate**

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