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Emerging opportunities for core-plus

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Todd White,** managing director, portfolio management, with Principal Asset Management. Following is an excerpt of that conversation.

Where are we in the real estate cycle?

Looking through a capital markets lens from a private real estate equity perspective, commercial real estate values found a bottom in the early part of 2024, and the appraisal community was generally reflective of that by the end of the year. We believe we're at the beginning of the recovery phase of the cycle. The primary cause of the value-correction period we've lived through the past couple of years was the rapid increase in interest rates in response to higher inflation. In the past year, inflation has certainly eased, but not quite to the Federal Reserve's stated 2 percent target rate. But it was showing enough progress towards that goal in 2024 that the Fed paused interest rate cuts early in 2024 and began cutting in September. So, the primary headwind that caused the downturn in values seems to be abating. We're not seeing that turn to a significant tailwind yet, primarily because the long end of the yield curve has moved higher since the Federal Reserve began cutting short rates. At least the headwind of constant interest rate hikes seems to have passed.

There are market concerns the Trump administration's policies will be pro-inflationary. We share that concern and are currently monitoring developments with respect to tariffs, deportations and more stringent immigration policies, which may exert additional inflationary pressure. It does remain early in the process, and it will depend on how policies are enacted. Meanwhile, other policies – deregulation, energy policy, ending wars, government-efficiency initiatives – could be deflationary. Much remains to be seen as this year plays out. But we do believe that we'll see the Fed cut rates again in 2025, and we believe that could serve as a catalyst for the real estate value recovery.

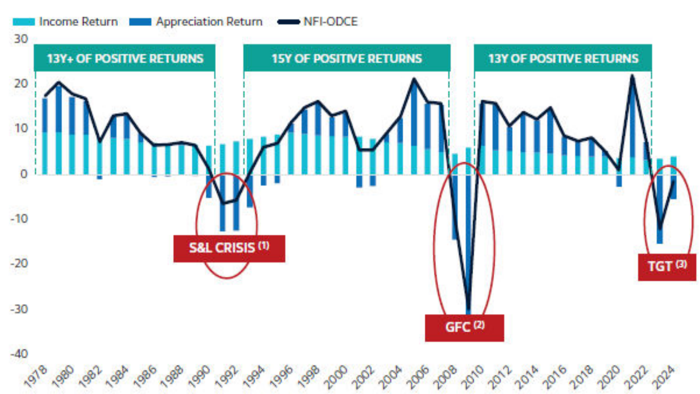
From a real estate fundamentals perspective, we believe vacancy rates have peaked in most markets and property types, or, in certain instances, we believe they will peak in 2025. We should see a declining amount of new supply delivering each quarter for at least the next four quarters, and probably a little longer than that because of the significant decline in new development starts during the past 12 to 18 months. Obviously, this can vary significantly by property type and market, but it is generally true across the country. Overall, improving fundamentals from a combination of stable demand and declining new supply should serve as another catalyst for value recovery.

What should investors expect in this part of the cycle?

Using history as our guide and assuming positive economic fundamentals, we would expect a long period of positive returns from the asset class as we start this recovery phase, which really started in the second half of 2024 when the NCREIF ODCE Index posted a positive total return in both the third and fourth quarters. In the past 47 years, there have only been six calendar years with a negative total return on the index, including 2024, and they have always occurred in two-year periods. Following those previous two corrections, the benchmark went on to post a 15-year and a 13-year period, respectively, where every calendar year had a positive total return, and the average annual return in those periods exceeded 11 percent. If interest rates stabilize, or move lower, and fundamentals continue to improve with less new supply, it seems reasonable to expect another long period of positive returns from the asset class starting in 2025.

Historical performance – NCREIF annual returns

U.S. properties, percentage, 1978–2024



Notes: (1) Savings and loan crisis, 1991–1992; (2) Global financial crisis, 2008–2009; (3) The great tightening, 2023–2024

NFI-ODCE = The NCREIF Fund Index (open-end diversified core equity). Indices are unmanaged and do not take into account fees, expenses and transaction costs, and it is not possible to invest in an index.

Sources: NCREIF, Principal Real Estate, October 2024. Past performance does not guarantee future results.

Why is core-plus an appropriate strategy right now?

The "plus" in core-plus typically comes from two sources: (1) executing lease-up or redevelopment/development asset strategies that produce higher returns, and (2) using more leverage – 35 percent to 50 percent would be typical, versus core funds at 20 percent to 30 percent. To the first point, less new supply during the next 12 to 18 months and expected improvement in fundamentals should support core-plus lease-up strategies. Development has been hard to justify the past two years, but it may make sense if fundamentals do improve and interest rates come down. With regard to leverage, core-plus tends to outperform when total returns from the properties are higher than the cost of debt. That has not been the case the past couple of years. Returns from the properties have been lower than the cost of debt, so the debt has been dilutive, but we see this changing in 2025, and leverage should be accretive again.

What property types and strategies are you focused on for new investment in 2025?

We believe data centers currently demonstrate the best fundamentals, and they remain at the top of our list for new investment. The national vacancy rate is approaching 1 percent, and the sector has experienced double-digit rent growth in the past year. Senior housing is also attractive, as it continues its strong recovery from the COVID-19 pandemic when it was dealt a tough hand. The bright side of that difficult period is that we have very little new supply hitting the market. Demographics continue to provide increasing demand every year, and that should set the sector up to do quite well. Retail is starting to interest us, as well. The strategy I work with had not invested in retail since 2016, until we closed on two Walmart-anchored centers in the fourth quarter of 2024 — at an 8.25 percent cap rate and a 50 percent discount to reproduction costs. National vacancy is around 4 percent for grocery-anchored, necessity-based retail, and it has been the best-performing major property type in the NCREIF Property Index over the past two years. Finally, our strategy also has a heavy allocation to industrial and residential. We continue to like those sectors, but because we already have a solid allocation as well as added policy concerns surrounding tariffs and their impacts to these sectors, we may not be as active with new investments in them this year.

Are there any geographic markets that stand out to you, positive or negative, for your investments this year?

We tend to favor higher-growth markets for the long term. To have strong fundamentals, you need to have strong demand, and to have strong demand, you typically need population and job growth. Some of the growth markets today are dealing with too much supply, especially in the residential and industrial sectors. We try to find growth markets that also have some supply barriers. South Florida markets probably best fit that description today, but pricing also factors in — and they appear fairly expensive right now. The gateway markets tend to be closer to average growth, but they do offer some supply barriers. Boston and New York feel the strongest of the gateway markets currently.

What risks are top of mind for you today?

We are cautiously optimistic about the outlook for the U.S. economy and real estate market, but we do see two primary risks. First, with the new Trump administration moving at a rapid speed on a wide range of policy issues, including tariffs, immigration and government spending reduction, these moves have already begun to impact both hard and soft economic data. At this point, an unforeseen policy misstep or an unintended consequence of those actions could be a risk. Another risk, which we've been focused on for a couple of years, is the Federal Reserve's interest rate policy. This year, that risk is equivalent on both sides, in that it could be a mistake to cut rates too soon and ignite inflation again. Or the risk could come in the form of holding rates too high for too long because inflation is not quite hitting their 2 percent target. In that case, interest-rate sensitive sectors, such as housing, could have ripple effects into the broader economy.

I will say, most of the risks are at the macro level and largely outside the real estate industry's control. There are always risks around certain property sectors and markets in real estate. But it does feel as though the events that could derail this recovery track would be those broader macro issues — the interest rate policy and the new administration's variety of policies.

Any final thoughts or words of wisdom?

2025 has potential to be a great vintage for a number of U.S. real estate strategies, in our opinion. The environment seems especially bright for core-plus strategies that emphasize income and income growth. We do not foresee widespread appreciation this year, but improving fundamentals and potentially lower interest rates as the year progresses could be excellent catalysts for the typical sources of the "plus" in a core-plus strategy.

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Principal Real Estate is the dedicated real estate investment team of Principal Asset Management℠. 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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