

The Weekly Take

Should I Stay or Should I Go: Timing Capital Deployment

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Spencer Levy

When it comes to visiting the state of Iowa, there's nothing quite like the state fair. But in the capital city of Des Moines, there is also the compelling attraction of one of the most notable investment management firms in the world. On this episode, we speak with leaders from Principal Asset Management for insights on real estate investing straight from their heartland headquarters.

Devin Chen

Having this broad perspective really gives us a better ability to assess relative value. How risk is being priced across this broad real estate universe just makes us all better investors.

Spencer Levy

That's Devin Chen, Principal Asset Management's Head of Private Equity Real Estate Portfolio Management, a total portfolio of approximately \$110 billion, a mix of public and private equity and debt.

Rich Hill

I'm often asked, do I like equity or debt, public or private more? I sort of reject the premise of the question. There's a home for all of them in the portfolio.

Spencer Levy

And that's Rich Hill, Principal Asset Management's Global Head of Real Estate Strategy and Research. Rich helps oversee that large portfolio and specifically the firm's focus on what they call the "Four Quadrants" of real estate, which we'll discuss in more detail. Coming up, insights and investment opportunities from Principal Asset Management, a 360-degree view through the four-quadrant lens. I'm Spencer Levy, and that's right now on The Weekly Take.

Spencer Levy

Welcome to The Weekly Take, and I'm delighted to have two of my friends from Principal Asset Management here today, starting with Devin Chen. Devin, great to see you. Thanks for coming out.

Devin Chen

Thanks for having me, Spencer. I'm a big fan of the show. Glad to be able to exchange some ideas with you today. It was great seeing you in Des Moines a couple of weeks ago.

Spencer Levy

Certainly was, Devin. And Rich Hill, great to have you on the show.

Rich Hill

Thanks for having me on, Spencer. Looking forward to our conversation.

Spencer Levy

By the way, do you know what the winning weight of the winning pig was at the Iowa State Fair? Anyone? Anyone? 1,244 pounds.

Rich Hill

So you already know, it was a loaded question.

Spencer Levy

Well, I knew what the answer was, because I was there, man. Next year, you're coming with me, as is Devin. All right, let's get rolling here, guys. Devin, we're recording this at the end of August. Just give me a big picture of, the elevator speech on what's going on in the markets today.

Devin Chen

We get a lot of questions around where we are in the cycle, and Rich, I'm sure, will weigh in here. I think we're still very much in the recovery phase of the commercial real estate market, especially if you define that by values, transaction volumes, they haven't quite returned to prior peak levels, but a lot of improvement. The important point is that the repricing phase is largely behind us. Prices have stabilized. We're seeing improvement across most of the market. Capital is available again. Transaction activity picking up. But we continue to believe this is going to be an uneven recovery and we expect performance is going to be driven a lot more by income growth this cycle than some of the broad cap rate compression we saw in the last cycle.

Rich Hill

I'm sure Devin is already rolling his eyes, given the rant I'm about to go on. We completely agree that we are in the recovery stage of the cycle. If you're looking at the NCREIF ODCE Index as an example, total returns have now increased for eight consecutive quarters. And if you go back and you look at prior recoveries, objects in motion stay in motion. But maybe the most interesting thing I would tell you is we think the list at market is sending us really positive indicators right now. Lists at REITs are up more than 15% per year to date, and they have actually moved from recovery into expansion because the total return index is now back above 2021 levels. And believe it or not, real estate is about the fifth-best sector of the S&P 500. No one's really talking about that. But I wanna make two quick points here, Spencer. We think recoveries are much longer than what the market believes. We think recoveries last around two years. We think expansions last around 12 years, and we think downturns last around a year and a half. So in totality, the commercial real estate cycle lasts around 16 years or so. It's driven by not just price returns but underappreciated income returns. So we think this cycle has a long way to run, but the headlines don't tell the whole story. We actually think headline returns are relatively muted, all things considered, but the top quartile of property types across markets are doing really, really well right now. The bottom quartile is not, and so the headline reflects the law of averages, but to Devin's point, this is a cycle for selectivity.

Spencer Levy

So, Rich, just so we're very clear, just list the Four Quadrants, please.

Rich Hill

Yeah, public and private, equity and debt. So that's private equity, public REITs, private CRE debt, and CMBS.

Spencer Levy

Why do you think about the market that way?

Rich Hill

There's a strategic and tactical reason why we think about the Four Quadrants. First of all, let me talk a little bit about the tactical. We are firm believers that the listed markets, both equity and debt, are leading indicators for the private market. They send signals, and they help us understand where the markets are going before the private markets know where they're going. So that's the first point. The second point, which we think is actually even more interesting, is that the Four Quadrants complement each other within a portfolio. I'm often asked, do I like equity or debt, public or private more? I sort of reject the premise of the question. There's a home for all of them in a portfolio, there are times in which you're supposed to be overweight private versus public, and times you're supposed to be overweight debt versus equity. And to maybe drive home this point, Spencer, the average performance spread across the Four Quadrants since 2017 has been 18.9 percentage points. Let me repeat that: 18.9 percentage points. What that really means is that there is a tremendous amount of alpha opportunity. If you know how to play valuations and you know how to anticipate cycles, you can move overweight, underweight, these various different quadrants and deliver significant alpha to your clients.

Spencer Levy

What I love about that comment, Rich, is it makes me think differently about how I'm going to frame a question I ask in every show. The question I ask in every Show is asset type versus market and submarket. I'm now going to add a nuance to that and they'll call it the Rich Hill nuance, which is structure. Because what you're saying is we can get the right asset, we can get the right submarket. But if you have the wrong structure, you're either leaving a lot on the table, or you're taking too much risk. Is that a fair way to put it?

Rich Hill

That's exactly right. And I'll give you just a real example. Everyone talks about the downturn in commercial real estate over the past several years. Well, if you were in private CRE credit, you actually feel pretty good because you probably delivered high single-digit, low double-digit returns, despite the drawdown in equity and revaluations.

Spencer Levy

And Devin, I know you run the private equity side, so you're primarily equity focused, but you're thinking about the whole capital stack every time. How do you see the why within the four quadrants, and how does that impact your investing decisions?

Devin Chen

Having this broad perspective really gives us a better ability to assess relative value. How risk is being priced across this broad real estate universe just makes us all better investors and it gets much more granular than that. We'll work with our debt team on how should we be structuring the loan on one of our assets in an equity fund. We will talk to Rich and the REIT team to understand. Well, gee, REIT prices are a little bit above NAV right now. But if you sort of drill down, you look at the main food groups, like multifamily, retail, non-mall retail, industrial, office, all trading well below NAV. What is that signaling? It really speaks, I

think, to the diversity of the real estate market today. Rich has a saying. What's the saying, Rich?

Rich Hill

And it's not our grandparents' commercial. Real estate market.

Devin Chen

Yeah, but I think it makes it even more important to understand these signals because they can speak to capital flows. And in this case, there's clearly a shift towards more alternative assets in the public markets. What does that mean for the private markets? It likely signals more capital flow into the alternative sectors over time. So it's just very important to understand this broader real estate universe and take all that data and focus on how we make our investment decisions with all this data.

Spencer Levy

We recently had a couple of episodes on secondaries, basically buying pieces of existing deals, as opposed to buying the entirety of the deal or lending to a specific deal. Is that on the table for Principal, or do you have reservations about that?

Devin Chen

It is on the table. Ultimately, we're relative value oriented. So if we feel like we can invest in an asset or even potentially a platform where we're getting paid well relative to the risk we're taking, we'll consider it. So that may be more passive structured investments as opposed to just a regular way of controlling equity investments. So it is something we're open to, Spence. We try to be flexible as an organization, and we have different pockets of capital that have different risk tolerances, but it is something we'll look at, and we are seeing more of those op keys in an environment like today.

Spencer Levy

So Rich's secondaries constitute a fifth quadrant or am I like pushing the hypo too far here?

Rich Hill

I think it's just a different way to execute on the quadrants. I wouldn't consider it to be a fifth quadrant. It's just a different way to execute, but I could be very wrong on that. And if it is a fifth quadrant, then I think that's extremely healthy for the commercial real estate market because it means there's ultimately more liquidity.

Spencer Levy

So, Rich, let's stick on one of the segments that you talked about before. We don't talk a lot about publicly traded REITs on this show, but since you mentioned it, I want to go there because let's face it, until recently, REITs have had a tough ride. They were trading below NAV. They were putting upward pressure on cap rates. Why have they turned a corner? Is it because data centers have done so well? Is it because offices have recovered? Is it both of those? What do you think is driving the REIT recovery?

Rich Hill

First of all, let's be clear. Around 70% of listed REIT market cap is in alternative sectors. Those are things like senior housing, data centers, and cell towers. And data centers have certainly gone really well. Data centers, despite all the headlines with AI, are still up 35% total return year to date. Second-best sector of the S&P 500. But I do think this recovery is fairly broad-based across the 18 different REIT sub-sectors that we track. And to me, it

comes back down to something really simple. The market is beginning to value predictable earnings and income-driven total returns again. I get questions all the time well, isn't this just driven by a rotation out of AI stocks into other sectors and my response is yeah That's sort of the point REITs underperforming over the last several years was a feature not a faw They are supposed to underperform when high-flying AI stocks are doing really well, but that doesn't always happen and as the market's starting to come back and be a little bit more disciplined now sort of old-school boring cash flows that REITs offer are beginning to become really attractive again. And I'll make one more point here, Spencer. No two cycles are the same, but sometimes they rhyme. And if you see what happened in the late 1990s with REITs when they underperformed given demand for dot-com and higher interest rates because of the Russian debt crisis and then outperformed in the early 2000s, even as the economy was in a recession and risk assets were pulling back, there are some real similarities to today versus then that we think markets should probably spend a little bit more time on.

Devin Chen

This is an area that Rich and I and our teams, we interact a lot just sort of discussing the signal from other areas of the market and when I look at the REIT market one of the things that stands out to me, I'm not the REIT expert, but you've got certain sectors like a lot of the traditional food groups – industrial, residential, even retail – actually trading below NAV and whereas you have healthcare that's trading well above NAV just sort of speaks to how diverse the asset class has become. Interestingly, main factor housing, which maybe we'll get into a bit, Spence, is one of our favorite sectors trading below NAV. So it's interesting to look at the signals that the public market is sending and compare that to what we see on the ground in the private markets.

Rich Hill

For the past three years, REITs have been highly correlated to interest rates. As real rates and nominal interest rates went up, REITs went down in valuation. And that makes a lot of sense, right? Because we've been in a weird environment over the past several years, which we would classify as stagflation. And stagflation is really challenging for real estate, both public and private. But what we've seen happen recently is those correlations to interest rate have really started to break down. And I think it speaks to what's becoming much more in focus. It's things like lending conditions, which are a huge tailwind for the real estate market right now. It's predictable earnings. It's income-driven total returns. That's a long way of saying, and I'm going to be super cliché here, but there's more to REITs than rates. And the market is beginning to put those other things in focus. So yeah, I mean, REITS are always going to volatile on a short-term basis because they are publicly traded stocks, but over the long term, we think there's a lot of other factors that drive their valuations, other than just near-term fluctuations in stocks and interest rates.

Spencer Levy

Oh, Rich, I'm going to steal your phrase there. There are more to REITs than rates. That's a very, very good way to look at it because I think a lot of people look at REITs as finance vehicles as much as they look at them as real estate holding vehicles. But when you really dig into them, they really do old real estate, and they really get income from that. But Devin, let's turn to the private markets now. One of the areas where Principal is one of the industry leaders is just being a partner to others in JV equity, in development. It's an area that's probably the higher-risk end of the market. But how does Principal see it, because I know you've still been active in that area?

Devin Chen

Well, to be clear, development, it's—I wouldn't say it's a broad area that this is for us right now, but we are doing so selectively, primarily in industrial and the data center space of course. We're not going to shy away from development where we think we can build to a yield on costs where we can achieve an attractive spread versus spot cap rates, particularly if it's pre-lease of course, but if we think that there's a very reasonable underwriting assumption that gets us to that type of yield premium. We'll make that investment. We have a lot of experience developing. We have in-house construction capabilities. We're generally not taking entitlement risk. Warehouse is much more straightforward to develop than data centers. So in the right markets, we'll actually be willing to take some spec risk on industrial development. We generally avoid that with data centers, and when it comes to partners, real estate's a local and operational business. If we're partnering with a developer, an operator, the goal is to leverage that local expertise, that operational expertise, that on-the-ground presence. But to be clear, we're not partnering to outsource judgment. Generally speaking, development—we will partner with developers because of how intense that day-to-day decision-making is. But we also have the capability to invest direct, if it makes sense.

Spencer Levy

Devin, you brought up the spread over cap rates for your yield on cost. And for people who are not aware, yield on cost means that you put in X amount of dollars into a project. What's the yield on the dollars you put into that project? And what is the spread over that number over what you might get if you bought an identical product next door? So A, did I describe it accurately, Devin? And B, what kind of spreads do you find attractive?

Devin Chen

Sure, you are describing it properly, Spencer, and, you know, the spread depends on, it's really a case-by-case decision. So, you know, if the property is pre-leased, we might be willing to accept a lower spread, maybe as tight as a hundred basis points. If it's a speculative project where you have to actually build it, take the construction risk, take a leasing risk, we may require a higher spread, 150, 200. It also depends on the subsector and the asset type as well. How liquid we think the project will ultimately be. So there's a lot of factors. There's no one-size-fits-all, but that spread can range anywhere from a hundred to 200 basis points.

Spencer Levy

So one of the topics we address regularly on The Weekly Take is market or sub-market versus asset type. Some clients say, you know, I'm not an industrial person, an office person, a self-storage person. I just want to buy the best sub-market, and I'll buy everything in it. Rich, how do you see it?

Rich Hill

Well, first of all, I'll be clear, obviously the holy grail is to pick the right property type and in the right market. We analyze rent growth projections over the next five and 10 years for every single property type across the top 50 markets. And there is a wide dispersion of rent growth projections. But what's really interesting about the analysis, Spencer, is when you start breaking it down into the submarkets, and there is just so much dispersion right now across markets, but when you start looking at the submarkets, there can be a market that someone says, hey, look, I don't think it's so great from a headline perspective, but you might look at that submarket and say, that's a really, really interesting submarket that's growing significantly for various different reasons. And if we could buy in that submarket and get a really good price because the overall market doesn't look that good, that's where we're spending a lot of time with Devin's team.

Devin Chen

This is something that—it's sort of a constant dialogue between the profiling managers and the research team, which as a team, they're providing that top-down analysis and we'll get into individual markets. As profiling managers, we try to turn that framework right into investment decisions. And it's a very iterative process to be clear. Research informs us what to look for. And I think the profiler managers, through the transactions and opy results we see, we can test those inputs specifically on this question. To reach this point, both matter, right? But I'd say probably asset matters more right now just because we're in a period of this unusually high dispersion and, you know, there are going to be markets where headline maybe supply looks concerning, but the right submarket or asset can outperform. We recently made an investment in Phoenix. Phoenix, a lot of supply, multifamily, but we felt like our submarket was really well positioned in the asset. Had a lot of upside to it, given our cost basis. And there are also strong markets where, let's say, take retail, for example, a strong market, but if you have a retail asset that's in the wrong location or it doesn't have the right tenant mix, it just won't generate enough foot traffic. So you need the right market framework, but the final investment decision really gets to, I think, the granular sub-market and asset level.

Spencer Levy

Not to get too granular, but even when you get down to the sub market level, how much does asset variation, asset amenitization, asset differentiation change your return profile?

Devin Chen

It can change it tremendously. The property next door can have a very different risk-return profile. The way I would describe our approach is, you know, when we're, when we're looking at these assets, we're asking ourselves, number one, is there a durable and growing demand for the asset? Second, we ask ourselves, is it in a defensible supply position, whether that comes from land constraints, entitlements, power availability these days. Obviously, we want to get in at a cost basis that leaves us some margin for safety. And then fourth, is there an ability to grow NOI, just do mark to market, which means your in-place rent versus market rents. Is there an embedded gain there? All these will help us drive NOI. And then the last point would just be capital structure. It's got to be a capital structure that fits the business plan. The best asset can still be a bad investment if it's over-leveraged and has to refinance in the loan environment. So this is all to say, it's not only the market, the sub-market, it is down to the block whether, you know, mid-block, corner of the block, ultimately the quality really matters in terms of your ability to ultimately create value for our investors.

Spencer Levy

So Rich, Devin opened the door to asset type when he gave a plug for manufactured housing. I will say that I've seen a market shift in investor preference in the last year, really, where I would say in the past 10 years prior to this year, industrial and multifamily were probably the two preferred asset types. And maybe they still are. But I've seen office and retail, in many cases, not only a catch-up, but a step ahead of them. How do you see the different asset types today, Rich?

Rich Hill

Maybe I can touch upon industrial and multifamily, because you led with that. I would say those are the two asset types where we think that you need to have the most selectivity. In industrial, I think everyone understands that there's a significant mark-to-market opportunity over the next two, three, four, maybe even five years, as in-place rents are

below market rents. But if you start looking at what asking rents are doing, they've already sort of normalized. And so you have to be really selective about what property types and what markets you're owning that you're getting long-term asking rent growth to support where cap rates are. But I think the more interesting asset class right now is actually residential, or maybe even what we would characterize as living. And I'll start off with this, Spencer. You've heard all the time, I'm sure there's been a story written about it in the couple of minutes we've been talking about how the U.S. is under-housed by, pick your number, 5 million, 7 million, 8 million homes. That is mathematically true, but we actually think it might be the wrong debate. We think we have a housing mismatch more than we have an undersupply of housing. That means that we've built a lot of houses of certain types in some markets and not enough houses of other types in other markets. You don't solve an 8 million undersupply problem by building 8 million homes in a singular market. So what does that lead us to do? Well, I do think we're very selective on class A apartments, especially in some of the prior high-growth markets. That's not to suggest that we won't recommend to the PM team that they should buy it, but they have to buy it at the right basis, and they have to underwrite the right rent growth projections. And if they can do that, Class A apartments can be a really attractive investment alternative. But there's maybe even some opportunities to do light value add and some higher quality Class B. But more importantly, when we think about living, we try to think about it holistically and look across the spectrum, whether it be Class A apartments, whether it's built-to-rent or manufactured housing or senior housing or even student housing in selective markets. If you take a holistic view to living, we actually think there's a real opportunity to add some value and not be siloed into buying Class A when, in fact, there's nothing wrong with Class A, but if the growth isn't attractive enough relative to cap rates, then your long-term return potential could just be underwhelming. Maybe that comes across as a little out of consensus because what I'm saying is we're not generically bullish. I'm class A, like I think a lot of people were over the past five to 10 years. We just think it requires a lot more precision than it did previously. And if you look at the rentership asset class across all of the various different pillars, that is a very, very attractive and high conviction opportunity for us.

Spencer Levy

Let's stay on housing for a moment – or living as you've put it, Rich, and I like that term. Devin, how do you see it? How are you investing in the sector today?

Devin Chen

I would say the categories that we focus on, obviously apartments, student housing as well, manufactured housing, senior housing, and I'd even include age-restricted housing. We view that as a distinct opportunity set. If you were to tell me like force rank where we're allocating, apartments would probably receive the largest allocation followed by manufactured housing. Then age-restricted senior housing and then student housing kind of round out the allocation. But each for different reasons, apartments, large allocation, if for no other reason, it just, it offers the deepest and most liquid opportunity set, there's simply more opportunities to find relative value. But to Rich's point, we're really selective. We take more of a rifle-shot approach to apartments tactically these days. You want to focus on situations where we can really buy at a compelling basis below replacement cost. Manufactured housing, it's one of the most supply-constrained sectors in the entire real estate universe. And we think affordability continues to support that long-term demand, so that's one of our highest-conviction ideas, is that manufactured housing has been very active the past 12-18 months. Age-restricted housing, I mentioned. I think the demographic tailwinds are quite attractive. I think that's well-documented, and unlike senior housing, you don't have the same level of operational complexity. So you're getting exposure to that

aging population without taking as much operating risk. I put senior housing after that, arguably has the strongest outright supply-demand outlook, Spence, in the entire housing universe, but the challenge is operational execution really matters and pricing's moved quite a bit already. You've had a lot of investors coming into the sector recently, so not as attractive as maybe it was a year ago. And then student housing, we still find opportunities there, but really selective for us. It comes down to the quality of the university, which means its enrollment trends is a key factor, various new supply and just proximity to campus. It's probably one of those sectors where asset selection tends to matter even more than just broader sector allocation.

Spencer Levy

I want our listeners to emphasize a point that Devin made there a moment ago about the supply constraints of manufactured housing. So much of what we talk about, we're talking about sectors, markets. Let's get real simple here. It's supply and demand, and the supply of manufactured housing. They aren't building more of it because a lot of people don't want more manufactured housing in their backyard. It's the same reason why we love industrial outdoor storage. People don't want it in their backyard. It has now become one of the hottest subsectors. And so now let me—which leads me to the next one where

Devin Chen

Can I add one thing?

Spencer Levy

Sure, sure.

Devin Chen

I rank ordered those sectors, but it's a dynamic thing as you know.

Spencer Levy

Yeah.

Devin Chen

And pricing changes as the market changes, those rankings could very well adjust as well. But just where we sit here today, that's how I rank them.

Spencer Levy

I was going to get the data centers now because there's clearly been a shift in the political headwinds which I think is going to create supply constraints. Given what's happening out there, given the broader demand for data centers, how do you see it, Devin?

Devin Chen

So first, we are still very constructive on the data center opportunity, but it's gotten much more complex as you're alluding to. We made our first data center investment about 20 years ago. It was a project in Dallas, Texas. So we've had a lot of experience. We've seen the sector evolve over the years and really explode the last few years. You know, I mentioned the opportunities become more complex, especially like on the supply side. Power is increasingly becoming the main headwind for new development, right? With grid capacity, but it's not just grid capacity. It's—there is some growing community opposition and we've had the well-publicized moratorium in New York, the audit requirements in Texas. So tremendous political scrutiny as well. And then the rules and engagement with utilities, they're ever changing and requiring more and more capital. I think, look, all that said, the sector remains very, very strong from a demand standpoint and, Spence, I mean,

there's essentially no vacancy market. The current vacancy as of the end of June in the U.S. was about 1%, but, you know, the execution risk has risen, and you really need to know what you're doing. And it's not just about signing a lease and building a structure, right? You have to know how to navigate local communities, understand the potential opposition. Deal with the utilities, understand the political dynamics. And so, as an investor, I think risk management is critical with data centers. You gotta make sure you have a path to power, that you structure your leases appropriately, and sometimes doing a powered shell deal might make more sense than, and leave some potential profits on the table versus doing what we call a turnkey larger project. Give yourself more liquidity on the item. So there's a lot to think through. But this is a sector that's got very, very powerful supply demand dynamics and we're still constructive.

Spencer Levy

But in the sector, as I mentioned, Rich, a few minutes ago, there has been a market shift in what CBRE's own economists think are going to be the best sectors going forward. Last year, it was, or for the last several years, it was multifamily and industrial. Now it's shifted to office and retail. Do you agree?

Rich Hill

First of all, I want to be clear. We tried not to redline any, any sector. I would argue that there's opportunities and risks across all the various different property techs. There are great opportunities in the residential and logistics sector right now. Do I think last cycle's winners are going to be next cycle's winners? That usually doesn't play out. And so what I would also argue is, yeah, do I think institutional investors are under allocated to retail and office? Sure. But I think, I think Spencer, in many cases, we talk about these things in too broad of a brush. I'll give retail as an example right now. There's 115,000 open-air shopping centers across the United States. We've done a deep-dive analysis of those 115,000 shopping centers by GLA and put a REIT wrapper around it, which basically says, look, we think the REIT demographics are indicative of the type of property that an institutional investor would buy. And believe it or not, only five to ten percent of that 115,000 are institutional quality. So yeah, we like retail a lot. And I'm advocating to our PM teams that we take a harder look at it. But I don't think you can go out there and just buy every single open-air shopping center just because you're underallocated to it and the fundamentals look good, and supply versus demand is finally back in favor of the landlord. You have to be a little bit selective. Office is a fascinating asset class. And we have the luxury of Principal Asset Management for thinking about this on a global scale. And we had the luxury of thinking about it in public versus private, equity versus debt. I think there's some real reasons to believe office fundamentals in the United States are bottoming and beginning to improve. And by the way, we might see better opportunities to buy select office in some European markets where there's more barriers to entry and we actually know what the cap X is. So I just come back, and I say, you know, economists like myself tend to make these big statements because we have to, but the devil's in the details. And I think there's opportunities and risks across all these property types.

Spencer Levy

Well, one of the beauties of Principal, Devin, is that they have all these different pockets of capital that do all these different things. Now, I recognize that you lead the private equity effort. You're not on the debt side of the house, but you do have a big debt side of the house. And so is it fair to say that when an opportunity comes in, you look at the opportunity, but you then select which bucket you're going to put your capital in. Maybe you put in equity, maybe you put in debt, maybe you put in mezz. But generally speaking,

Principal would not play in multiple areas of the capital stack. They'll just pick one. Is that a fair way to put it?

Devin Chen

That is a fair way to put it. We generally are going to pick our spot in the capital structure. We're not gonna lend to ourselves, if you will. So if we're in the equity, we're generally not gonna be in the debt and vice versa. So that's right. We do try to look at these opportunities in a holistic way, meaning what is the best way to invest in the asset? And that could be, like you said, equity, it could be debt, it could be something in between. One of the areas of the market that we are very focused on right now is PCLs, Participating in Construction Loans. It's a bit of a hybrid of debt versus equity. We've been deploying capital into this segment of the market in both our equity and our debt strategies. And it's essentially providing a construction loan where you're providing a bit more advance, a bit, more leverage. And where the benefit to the borrower is they don't have to go to a traditional senior lender and subordinate debt lender to counterparties to get the money. The, the financing, we will provide it one-stop shop solution. Uh, in exchange for that, we get a piece of the equity upside. Um, we feel like that's its great relative value and something that we've been doing. So it's never black and white. It's, it's always a discussion and a lot of debate, but yeah, we're, we're active across the stack.

Spencer Levy

Correct me if I'm wrong. PCL stands for Participating Construction Loan. First time we've heard about that product on the show. At the risk of every developer in America giving you a call tomorrow, Devin, which is probably not a risk, it's probably what you want, that sounds like a very interesting structure. Just tell us a little bit more about that. How deep in the capital stack do you go? And again, I'm sure every deal is different. Are you getting 5%, 10% of the equity? How do you typically structure these deals?

Devin Chen

Every deal is different, you're right, Spencer. The advance rates can range anywhere from 60 to 80, 85%, depending on the nature of the asset and how we do the lease-up risk and the development risk. So it's a wide range, but typically the structure includes a current component to the loan, a current coupon. And the rest of your return is based on the ultimate residual value that the sponsor is able to generate. So we get a percentage of that. So I probably can't go into specific details around how pricey it really depends, but I will say that when we look at it on a blended basis, overall the returns compare attractively to your typical equity investment or your typical debt investment, and this is where it just. Being creative and offering a solution to borrowers or counterparties has helped us identify a segment market that is essentially pricing attractively.

Spencer Levy

So, from a sentiment standpoint, Devin, you've got all these different buckets of capital. Give me your sense of, where is investor sentiment today? Where is it strong? Where do you think there's still some cracks?

Devin Chen

Redemption queues still exist in the broader open end fund universe. I think it's an important data point because it's meaningful in that it signals a shift from whether you're playing defense to whether you are playing offense. We manage two open end funds, core core plus. They cleared their redemption queues about 20 months ago. And today the conversation is increasingly about how efficiently can we deploy that inbound capital. To be clear, that liquidity—it doesn't create any pressure for us to deploy. I think of it as giving

us optionality, right? We remain very selective, but we can act when the right opportunities emerge at today's reset value. The other element to this, Spencer, is just it also reinforces, I think, investor confidence in valuations. If a fund can generate liquidity, satisfy redemption requests, attract new capital and all the time maintain performance, that's a meaningful evidence that its marks and strategy have credibility. I think one thing we are seeing that's really evolved from our clients. So there was a time when a lot of it was around macro questions and Rich should weigh in here. Industries are no longer waiting for uncertainty to disappear. They're more asking us, how do I invest through it? We still hear the questions about raids and tariffs, I'm geobloat risk, but more questions at the asset sector level. And we're essentially also seeing some investors consider moving up the risk spectrum from, say, core to core plus or value add because they want differentiated returns, but they're also very focused on downside protection. They wanna know what that looks like. How much more leverage are we talking? How much more value add lease up risk am I taking, development risk? So we'll get a lot of questions around what that it looks like to assess how much risk they're willing to take to get some incremental return

Rich Hill

I think investors recognize the world is unusually complex, but they're trying to control what they can control, and we think that's maximizing that operating income growth coming full circle. But to Devin's other point, I also think investors are beginning to recognize commercial real estate is not a monolithic asset class. There's core, there's core plus, there is value and optimistic. When I look at the ecosystem and when I speak to investors, I think core AUM is beginning to consolidate in the managers that are producing the best returns relative to the benchmark, I do think investors are moving out from core to core plus selectively to add alpha because you can probably generate 200 to 300 basis points, higher returns in core plus versus core. And I think investors recognize that in an early cycle environment, you're historically rewarded for moving out to value at an opportunistic. But manager selection really matters when you move out the risk spectrum because there's outperforming funds in bad vintages and there's underperforming in good vintages. So we spend a tremendous amount of time on the strategy side of my role, thinking about where we're supposed to be playing as Principal Asset Management, but also helping guide our investors as to how they should think about their portfolios holistically and how they optimize their portfolios.

Spencer Levy

Just give me the next three, four years. How do you see the market cycle playing out?

Rich Hill

First of all, we're pretty transparent that we don't think this is gonna be a V-shaped recovery, like prior cycles. If you're assuming 10-year annualized total returns on unlevered basis are going to be 12 to 15%, I think that's gonna be hard. So what we're advising investors is capital returns are gonna be relatively muted for all the reasons Devin mentioned. They will start to improve, but really the driver of this is net operating income growth. And maybe I'll leave you with this, Spencer. Dispersion in returns has always existed in the commercial real estate market, but investors have forgotten about it because it doesn't matter in a market where there's a broad-based expansion where everyone's making money. It doesn't really matter in a broad-based downturn where everyone is losing money, and the last recovery that we saw was a V-shaped recovery post the GFC where you were rewarded for taking risk. So, in fact, Spencer, I think we're going back to the early 1990s where this is just blocking and tackling, picking the right property type in the right market. And if you can do that. It leads me to be, like, really bullish about this

opportunity set. So I've been told I'm bullish, pragmatic, and bearish all on the same day of meetings, and I'll take that as a compliment.

Devin Chen

One thing I'll add to that, Spencer, is one very important aspect of our investment process is we always want to look at how the asset's going to perform in various states of the world. So we will stress it. Will it be durable in a downside scenario, but also not leave out the upside because the upside that convexity matters as well. So it's getting those base case assumptions right, but it's also stressing it, looking at how it does in various states in the world.

Spencer Levy

Well with that, what a fantastic conversation with Devin and Rich today.

Rich Hill

Spencer, thanks for having me. Really enjoyed it.

Spencer Levy

And Rich, great to have you as well.

Rich Hill

We'll always accept your invite, Spencer. Thanks for having me.

Spencer Levy

Thank you Rich and Devin, next time at Des Moines and we're gonna hit the state fair this year, okay?

Devin Chen

Sounds good, we'll do it.

Spencer Levy

Thanks to our guests from Principal, we got a lot more from the Heartland and beyond. Check out our website at CBRE.com/TheWeeklyTake or visit the episode archive on your favorite podcast destination. And make sure to join us again in the weeks to come as we bring home perspectives on the commercial real estate market in Brazil and visit other markets, sectors and timely issues across the industry. Thanks for tuning in, I'm Spencer Levy. Be smart. Be safe. Be well.