Fiducient Advisors, Nonprofit Investment Stewards Podcast
Episode 76, September 18, 2024

Real Estate Investing Trends with Rich Hill

Hello and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. It's always great to be joined by co -host, Devon Francis. Now I am nearly certain that all of you have been thinking about today's topic in one manner or another. What we're talking about not only impacts investments that you may professionally oversee, but it also impacts your personal net worth. Of course, I'm talking about your investments in real estate and wow, do we have an extraordinary expert as a guest today.

Devon, I hope you're doing well and may I ask you to introduce our guest. Of course. I'm great, Bob. I am so eager to learn from today's guest, as you said, on both the investing front as well as from a personal finance perspective. We are so thrilled to have Rich Hill from Cohen & Steers on the show today. Rich is head of real estate strategy and research. He has more than 20 years of experience in the real estate space. He's a senior vice president and he's responsible for identifying allocation opportunities in both listed and private real estate at Cohen & Steers.

which is one of the foremost global investment management firms. Prior to joining the firm, Rich was a managing director and head of commercial real estate research at Morgan Stanley, where he was responsible for public equity research, CRE debt strategy, and macro property research. Rich has a BS from Georgetown University and is based in New York. Rich, thank you so much for joining us. We're so happy you're here. Thanks for joining. Thanks for having me. This will be a blast.

So Rich, why don't you start by sharing your career path and your current role, how you got to where you are today? Sure, I'll try to give you the quick elevator pitch here. I grew up in a real estate family. My dad was a mall manager. I tell people that does not mean we own malls. That means he was one step up from a janitor. He managed malls from people that own malls. I had no desire to really get back into commercial real estate, but as luck would have it, when I joined

Bank of America, out of school, I joined the debt capital markets team and sort of the rest is history. I did that up until the GFC and reinvented myself as a research analyst. As you said, I'm Morgan Stanley. I joined Cohen & Steers about two years ago, almost to the day in a newly created role as head of research and strategy. I spend a lot of time speaking to institutional investors.

And when people think about commercial real estate, they typically think about big for -profit entities that own commercial real estate. But believe it or not, 30 % of private real estate is owned by foundations and endowments, many of which are nonprofits. So I spend a lot of time speaking to nonprofits.

Interesting. you know, given your expertise, how would you broadly describe or comment on the real estate investing landscape as it currently stands? Yeah, well, it's a great question to lead with. If you believe the media reports and there's probably been three to five written in the couple of minutes we've been speaking, it's Armageddon out there. What I would say is this correction feels very reasonable and very to be expected.

Yeah, when property valuations are down 20 to 30%, which we think they're generically down right now, that doesn't happen very often. It's only happened, call it one to two times previously. So this is the third time it's happened in several decades. But what's driving this is just an old school repricing of the right side of the balance sheet. It's higher financing costs. People ask me all the time, what do I think about this new normal environment? This isn't a new normal environment. We're going back to an old normal environment.

of higher inflation and higher interest rates. And as a result, commercial real estate's one of the first sectors that's been reacting to that. And guess what? Valuations are down 20 to 30. If you can explain something, it's less scary. If you can't explain something, it's really, really scary. So this is just all that's happening right now is interest rates are rising, risk premia is widening because of that, and it's moving valuations down. But I think this market's acting

very rationally, believe it or not, I'm sure we can unpack that. That's helpful, Rich. Now, many of our listeners and viewers, they're leaders at nonprofit organizations, or perhaps they sit on an investment committee overseeing an endowment foundation, that sort of thing. Curious now, what role you see real estate playing in a diversified investment portfolio for an endowment or foundation? Yeah. So look, I think over the past two to three years,

real estate's been a bad work because it's been one of the few sectors that's been under pressure at a time that the rest of the world seems to be rising in valuations. So I think a lot of people have started to say, well, am I supposed to have less real estate in my portfolio than I did previously? I think that's a fair question to be asking.

But we sort of push back on it a little bit because if you look through cycles and commercial real estate is a sicko classic class, but if you look through cycles, Bob, you nailed it. It's a great diversifier. It's one of the few asset classes that provides a stable stream of income. And guess what? It's a combination of income returns and capital returns. So we think about it as a great diversifier within portfolios. The big question we get, and I think it's the elephant in the room,

which is like, well, if you think commercial real estate such a great inflation hedge, why has it done so poorly over the past couple of years? And it really comes back down to this really scary word that doesn't, that we don't talk about a lot called stagflation. Stagflation is where growth is slowing and interest rates are spiking. That is sort of kryptonite for commercial real estate. The good news is it doesn't happen very often. The last time it happened was a scare in the first quarter of 05. And then prior to that, you have to go back to the 1970s.

But X, a stagflationary environment, which I think we're almost past this point, commercial real estate is a hedge against inflation. It does provide a stable income stream. So we really like it. And by the way, I get asked questions lot. Do you like listed or private real estate more? I just sort of reject the premise of the question. There's a home for both of them in our portfolio. And at some points in time, you're supposed to be overweight one versus other weight the other, underweight the other. But we can talk through that.

I think you nailed it. It's a great diversifier. And we do think the very best time to be owning commercial real estate is sort of in the aftermath of environments like today. So I would behoove, I think I'd behoove everyone to take a step back and say, guess what? Buy low, sell high. It's been a really bad period of time for commercial real estate. Those times don't last forever. Maybe we're starting to become into a better future for commercial real estate than we've seen over the past two to three years.

Yeah, that's helpful. We talked to our clients about the danger of extrapolation and right now a lot of that has been on, you know, people can look at the mag seven or some of the really exceptionally good performing areas and there's a danger to extrapolating that but there's a danger to extrapolating on the downside too, which I think is what you're getting at. So, so given

like a real uptick in market volatility recently. We're recording this in late summer and then lot of uncertainty around the economy and such. How are you assessing the risks and the opportunities? Yeah. So let's let's maybe step back and talk about what's happening with commercial real estate first, because I think it's under it's important to understand where we were, where we are and where we think we're going. first, Bob, we're big believers.

that listed reads are leading indicators in both downturns and recoveries. In 2022 listed reads were down 25%, pretty bad year for the sector. But since their lows in late October of 2023, they're up more than 33%. And here's a really interesting point. Over the past four months, they are the second best performing sector of the S &P. They're up almost 20%. The only sector that they're trailing is tech.

I sort of joke with people and say, how many people have that on their bingo card that real estate has been the second best performing sector of the S &P over the past four months? Not many people. So the List REIT market is telling you that there's a light at the end of the tunnel. So here's the way it works. List REITs trough about a year before private market valuations trough. We think we're in the beginning of the troughing process for private real estate.

it's going to occur somewhere between three Q of 24 and one Q of 25, somewhere around that three, three quarter time period. But there's an important point here, Bob, that I think people are, that people are maybe not fully appreciating. The distress markets peak on a lag relative to troughing the private real estate markets. So what does that mean? Well, the headlines that you're going to see over the next 18 to 24 months around about commercial real estate are going to be pretty bad, but that

doesn't mean that private valuations haven't already troughed or beginning to rise. Case in point, during the GFC, delinquencies peaked about a year to two years after private valuations troughed. So we actually think rising distress and rising delinquencies is a really positive sign for the commercial real estate market because it means we've moved through the grieving process and we're in the acceptance stage and lenders are finally willing to say, yeah, you know what?

There's an all clear signal here. Now I can begin selling my distressed properties. So we think the reward is really attractive here. The best returns come in the aftermath of environments like today. I'm gonna conclude your question with one important point. I promise I'm making fun of myself, not anyone that might be listening to this. Commercial real estate owners do a remarkably bad job of buying low and selling high. Everyone wants to buy everything when it feels really good and sell everything when it feels really bad.

You're sort of supposed to do the opposite. And I joke whenever my grandmother calls me and says, what do you think about the commercial real estate market? How bad is it? That's the time you're supposed to get really excited about it. So it's not puppy dogs and rainbows. There's going to be some really bad headlines, but we think that the worst is behind us. And we think property valuations are going to begin rising the next 12 months or so.

So I think that leads us quite well, thinking about bad feelings and bad headlines. We see really high office vacancy rates. Now there's growing concern over debt that many apartment landlords carry. So what sectors of real estate investing concern you, give you pause? What sectors are you excited about? Can you talk a little bit about the underlying breakdown of the real estate market? Yeah, really great question. I'm glad you asked it.

A lot of people think about the commercial real estate market as a singular asset class, but in reality, it's 18 different property types under this broad umbrella. And I sort of describe it as like a class of preschoolers. They sort of all move in different directions at different times. can behave differently in different markets. So what are we concerned about? Well, office, obviously.

I think everyone's read the headlines about how challenged office is right now. And all of those are true. Office valuations generically are down somewhere between 40 and 50 % right now. So it's been down a lot. But this isn't necessarily a COVID thing. We overbuilt office properties for almost two decades. And how people were beginning to work was changing prior to COVID. COVID just put that on overdrive, if you will.

I will make a point though that all offices not created equal. You can say, don't paint it with a broad brush, whatever cliche term you want to use. New cleaning green office is doing remarkably well. That's leasing up extremely well right now. Some high growth markets are doing quite well. And even believe it or not, some CBD central business district office is actually starting to defend really well and actually not have nearly as high vacancies. So office, of course.

I think you bring up a good point about multifamily. Multifamily is a remarkable asset class over the medium to long -term because we do not have enough housing in the United States. But it is facing some challenges right now. Number one, there is a tremendous amount of new supply of apartment buildings coming to market right now. But number two, and you mentioned this, there was a lot of people that entered the space to buy apartment buildings in 2020, 2021.

at peak valuations and finance it with short -term floating rate debt. The rubber has not met the road yet with that sort of debt, and that's going to start to occur over the next couple of years. So, aren't strong footing, but there is some distress that we think is likely to come out in the multifamily sector. The one other property type that we're probably out of consensus cautious on is industrial.

And industrial is everyone's favorite asset class. When I talk about industrial, just to be clear, I'm talking about warehouse buildings that are rented by people like Amazon. It has done really strong over the past

10 years or so. Why are we concerned about industrial? Not because it's a bad asset class, but the expectations for long -term growth are so high that we believe that can mean revert closer back to above trend inflation, but not nearly as high as it used to be. And that's going to pressure returns.

What do we like on the other side? The market views commercial real estate as an old economy asset class. But in fact, it's not. Around 60 % of listed market cap is what we refer to as next generation property types. What are those sectors? It's things like data centers and cell towers and seniors housing and single family rentals. These are all asset classes that are actually not very cyclical, have strong.

demand tailwinds, both near -term, medium -term, and long -term. And by the way, they're really hard to get exposure to in the private markets because they're big dollar price assets and they're very operationally intensive. So we tend to like to pick our spots in those next generation property types in the listed REIT sector. But you bring, just to come full circle, this is a market that's great for active management because you can figure out which of the 18 sectors work and which ones you want to avoid.

So Rich, can you talk a little bit about how anticipated changes and interest rates, and presumably that means a decline in interest rates, plays into your outlook for real estate? Yeah. commercial real estate's inherently a lepernastic class. What do I mean by that? Well, when someone buys a commercial real estate property, nine times out of 10, puts some level of debt on it, whether it's a 30 % LTV, 40 % LTV, or 50 % LTV, they usually finance that purchase.

So that means the availability of debt and the cost of debt really matters to level returns. As interest rates have gone up, its pressure returns lower and property valuations have to go down to offset that. So as interest rates begin to decline, it should have the offsetting impact to that. But let me make an important point. The market spends a lot of time focusing on the short end of the curve. What is the Federal Reserve going to do? But I'm actually a little bit more focused on

where are 10 year interest rates? And not only 10 year nominal interest rates, but what's actually most important for real estate is real rates. So it's nominal rates relative to inflation. Our long -term capital markets expectations have real rates declining to around 1 % or so versus, call it 2 % or so right now. That 1 % real rate environment is really conducive for owning commercial real estate because it means that inflation is slightly above average.

That's a good thing. And it means that inflation's in check with where nominal interest rates are. So as interest rates come down, that's going to be a tailwind for commercial real estate, both private and listed. And we think it's going to move the sector from sort of an out of favor sector over the past couple of years to much more of an in favor sector. And we think allocations will begin to rise.

Rich, what are some of the common misconceptions that real estate, to real estate investing that investment committee members may have at this point? And then I'll also, only because I think listeners always saying, and what about me? What are maybe some misconceptions and maybe a little bit on the outlook for housing in general? Yeah. So two main misconceptions that come up. First of all, office is a huge portion of the commercial real estate market. It's not. It's around 3 % of the market cap for listed REITs. So not to say it's trivial, but I spend way too much time talking about it relative to its importance in the listed REIT market. No offense to you asking questions. It's the right questions to be asking. But even in the private market, it's around 15 % or so. It's not 40 to 50%. The other portion of misconceptions comes from the debt market. I could spend

more time than you guys have and would even like to hear me talking about the debt markets, but two big things. Most core commercial real estate, and I include listed REITs in that, is not a highly levered asset class. Open -ended funds that own core commercial real estate are around 30 % levered. Listed REITs have around 35 % leverage. We all learned some real hard lessons from the GFC. so leverage is actually pretty prudent this cycle. The second point I would make to you about that, maybe one, two A and then two B,

is how important banks are. Banks are important, but you may have heard the stat that small banks finance 70 % of all commercial mortgages in the United States. That's a half truth. Small banks finance 70 % of loans held on bank balance sheets, but banks are only around 40 % market share. So small banks are only around 30 % market share in totality. We could talk offline about how this misconception came about, but there is a variety of different lenders.

Life insurance companies are having a field day right now. The CNBS market, commercial mortgage backed security market has bounced back. Big banks are actually lending again. So yes, small banks are working their way through their issues, but it's not the totality of the mortgage finance business. So housing, you bring up a really great point. First and foremost, we are under housed in the United States. There's a lot of reasons why we got there.

but there are more people looking for housing than availability of housing. And that is likely not going to change in the foreseeable future. So we need to build much, much more of it. The second point I would tell you is when people think about housing, they think about single family homes, but there's a big broad spectrum of housing. Everything from single family ownership to rentership to multifamily.

to manufactured housing, it's a big broad spectrum. And by the way, it's sort of all work together in totality for decades and decades and decades. But I think you're asking a question about what do we think about home prices? I think it's reasonable that home price appreciation begins to slow, but we do have an interesting dynamic here where people don't want to sell their homes because they can't move someplace else.

think about the statistic about where mortgage rates are from the vast majority of homeowners, I get it. You have a mortgage rate of three to four percent that's locked in for a long period of time. Why would you ever look to sell? So I don't think this is an environment like the GFC where you're suddenly going to see a collapse in the housing market. Could housing prices begin to slow in terms of their appreciation? Yeah, they begin to decline depending upon where things are, maybe a little bit. But I think this is a market that's actually on pretty strong footing, all things considered.

So Rich, as you look to the future, what trends or developments in the real estate sector do you think will be most influential over the next five to 10 years? I laugh because I'm still trying to figure out what's going to happen in the next six to 12 months, not in the next 10 to 15 years. But there are a couple of things that are atop of mind. First, I'll leave with positives, then I'll talk about maybe some negatives.

I think green energy is a real trend. So let me give you an example. Commercial real estate is actually maybe one of the biggest beneficiaries of solar power. If you think about where you're get solar power in the United States, it's all these building tops. You can go put solar power on the top of apartment buildings, storage facilities, industrial facilities, and there is a chance that at some point in the next 10 years,

these owners of commercial real estate could be making as much, if not more money off of solar power than they are renting out their buildings, depending upon what property type you have. And then you could sell it back to the grid. So that's an interesting point to just keep your sort of mind on because I do think it's something that people aren't really talking enough about. But the commercial real estate market always evolves. Do I think there's going to be wind reits in the future? Maybe. Do I think there's going to be solar power reits in the future?

I bet you there will be. So there's all these new trends coming in terms of like, how do we power our economy? And I think that commercial real estate will be a big beneficiary of that. On the negative, and one of the things I spend a lot of time on is climate risk. Climate risk, we can debate how significant it is. Some people say it's not significant. Some people say it is. I think the insurance companies are telling you it's very real. And that is impacting premiums.

can begin to play out, I do think climate risk will become a bigger focus for commercial real estate. That sounds like a negative, but think about all the other industries that might come about because of the greenification of buildings. And I say greenification of buildings because commercial real estate's one of the biggest...

they create significant emissions for the globe, for the world. And so the commercial real estate market will have to figure this out. So those are the two things that are really top of mind for me. Can we talk about AI? Sure. We can talk about all of that. But those are the two things that are on top of mind for me. Rich, I think we could go on and on. We could chase any one of these topics down in much greater detail. But we've covered a lot to this point. Is there anything that you'd like to add or underscore for our listeners?

Yeah, look, it comes back to the point I made at a beginning, which is how do you think about commercial real estate cycles? First and foremost, this is a generational decline in property prices. We don't see that very often. When this occurs, it does generally provide best in class vintage returns. So we think this is an opportunity to begin investing and building portfolios in commercial real estate at tomorrow's valuations.

The second point I would make to you is how you think about the sequencing. Listed rates have already bottomed. Listed rate market sort of tells you the future. Valuations are up 30%. It's telling you that market is bouncing back. We think private real estate valuations are in the process of troughing and we trough over the next several quarters. But let's be very clear. If you have me on 12 months from now and you say, Rich, I thought you said everything was okay. Look at all these headlines. Guess what? That's a lagging indicator.

the distressed markets are still working themselves out and it's going to continue to work themselves out for the next 12 to 24 months, maybe even a little bit longer than that. That doesn't mean you can't invest in commercial real estate. It just means you're supposed to avoid investing in distressed commercial real estate debt because that still has some ways to go. So hopefully that's a nice bow on our conversations, which I've really enjoyed. That's great. And you know, I think it's really important to underscore the importance of a long -term investment mindset.

And we talked about the role that real estate plays as a diversifier in a portfolio and we shouldn't try to time everything. We encourage our clients not to try to time everything. to your point, it's a good time for active management. So to have a manager who's doing the research and deciding which areas to overweight or underweight can help provide some comfort, I think.

So Rich, before we let you go, this conversation has been fascinating. We'd love to learn a little bit more about you on a personal note. So can you describe your ideal Saturday to us? So we should begin any discussion with the statement that I have four kids. So that keeps me extremely busy during the week. And I think my wife is a much better person than I am. What's my ideal Saturday night?

The ideal Saturday night is pretty simple. You get the kids to bed, or at least upstairs doing something else, and you cook a nice dinner. And if you're into wine, which I like to have a glass of wine every once in a while, I like that. It's one of my few zen moments, if you will, where you spend some time, quiet time with your wife, cook a nice dinner, maybe have a glass of wine. So that's my ideal Saturday night. Maybe that makes me a really big dork. I am a research analyst, so I come by it honestly.

But that's my ideal Saturday night. I think a lot of parents would say something similar. So you're not alone. Well, this has been really fascinating. We definitely appreciate your expertise. We appreciate your time. If folks want to learn more about either you or Cohen and Steers and the work that the firm does, where should they look? Yeah, you can go to our website. have a lot of it. We publish periodic insights on commercial real estate market. It's a nice little tab at the very beginning called Insights.

You can always reach out to me. My email is rhill@cohensteers.com. But feel free to reach out to myself or your sales representative. We're always happy to engage and debate the good, the bad, and the ugly about the commercial real estate market. Great, Rich. Well, thank you again. This has been excellent. Thank you. Thank you for having me. Rich, it's been just great having you on the show. And I'll just mention to our listeners,

That as we talked about in this episode episode volatility has shot up and with elections right around the corner there's probably a good bet you'll see a lot more movement for the remainder of the year and beyond if you haven't visited Fiducient's website in a while you should we have insights there where we update folks on our expectations for the markets in the economy for the balance of the year we have input on how markets historically performed during election years and a whole lot more so i'd say visit fiducientadvisors.com and then as always, feel free to reach out to me or to Devon on LinkedIn if you have any questions or just want to use this as a resource. So to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode.