EPISODE 294

[INTRODUCTION]

John Chang (JC): Get to understand the underlying drivers. Understand what is the fuel that is supporting any individual piece of real estate, or an individual market, and then be able to partner with the best people who understand that property, who understand that type of asset, because at the end of the day, property is very important, but even more important than the property are the people you're putting your money with. They have to be really high quality, they have to know what they're doing.

Announcer: Welcome to Elevate, the masterclass where we dissect the elements of exceptional achievement and lifestyle design with a focus on personal growth and real estate investing. Now, here's your host, Tyler Chesser.

[INTERVIEW]

Tyler Chesser (TC): Elevate nation, welcome back. This is Tyler Chesser. I'm so thankful to have you here. And I'm blessed and grateful to be sitting live at the Best Ever Conference with John Chang. John, how are you?

JC: Hey, doing fantastic.

TC: Thank you so much for being here. I'm excited about our conversation. I've been looking forward to this since we chatted in the hallway about an hour ago. What do you think?

JC: No, it's awesome. This is a great event. There are so many people here. So many investors, so active. I just really find it such an energizing crowd. It's a lot of fun.

TC: I do too. And you know, one of the things that you and I talked about while we were really talking about having this conversation was, you know, for investors really thinking long term, obviously, we have to drill into the specifics of what's happening in today's market. But you know, taking a step back and looking at a broader context, I'd like to be the focus of our conversation. But before we get there, why don't you talk a little bit about yourself and sort of your background? Because I think it lends itself well to not only the credibility of what you bring to the table for this conversation but helping people really understand who we're talking to today.

JC: Sure, sure. So I'm John Chang, and I lead the research services team for Marcus & Millichap which is a leading commercial real estate brokerage firm and financing firm. I've been in the industry for close to 30 years now and have been leading research for the organization. What we really try to do is gather all the data on the economy, on different types of commercial real estate, synthesize and put it together, translate it into something usable, and then share it with investors to help them make better-informed decisions.

TC: And I can tell you that what you bring to the market, what you bring to investors is tremendously valuable. Because we deal with a lot of complexity. In fact, you know, I think every day you know, there's headwinds or tailwinds. There are crosswinds and every single direction. And so while we're all most of us, and we were just talking about this, before the conversation, we're almost addicted to macroeconomics, and of course, microeconomics, and the patterns of how all of these things are really interrelated. But the thing that you bring to the market is clarity and helping people make clear decisions for the long term. And what I shared with you is that you know, listeners of Elevate are sophisticated, real estate investors who are looking to elevate their game to the next level.

TC: And so when you think about where we are today, I'd love to get your thoughts because, man, there's been a lot of market changes over the past 12 months. You know, not only from the inflation perspective, interest rates, everything that's happened as a result of the Federal Reserve's intervention in the market. But let's talk about how this really sort of can play into the longer-term perspective. Talk to me about your viewpoint on what's happened over the past 12 months. And how does this really fit into the larger perspective in the long term?

JC: Yeah, you know, as we closed out 2021 and went into 2022, there was so much investment activity. It was one of the most active periods in the history of commercial real estate. And then we had that inflationary spike. And the Federal Reserve responded with a series of significant rate increases. As they did that it really slowed the market down. And we saw the headwinds there, we saw investors trying to figure out how to make deals work when interest rates were going up 300 basis points in just two or three months. It was really a challenging cycle. And we're coming into the back half of that, but it's still present.

JC: And as we were talking about, there are so many challenges and so much noise out there that we're trying to deal with every day, from the media from the barrage of the financial markets, that as investors, we can lose sight of our long term strategy so we can lose sight of our goals. And what's going to be driving our investments as we look forward, you know, a few years, three years, five years, seven, ten years, whatever your hold period is. And if we lose sight of those long-term situations, we can miss out on the opportunities that are here today, that actually will play well into that future goal.

TC: So, that is a big challenge because you know, like many of our listeners who enjoy hearing your insights on the market, your analysis on the market, you know, from a day-to-day perspective, some of the takeaways may be very volatile, maybe up and down. There may be good news and maybe bad news. But when you take it from a broader perspective, how can investors be aware but not be impacted negatively by that noise in the short term and long term?

JC: Sure. You have to stay on top of it. You have to be aware, especially if you're trying to do a deal today, right? If you're trying to buy or sell real estate today, you have to know what the rates are, you have to understand what the loan ratios are, and how lenders are treating investors. You have to be aware of what cap rates are, what deals are trading at. But you also have to be cognizant of your exit strategy and figure out you know, if I'm buying multifamily, who is my tenant, why are they going to be living there and how long would they be living there and what does that tenant base look like in five years? If you're looking at retail, you're looking at who's leasing space in my retail center. If you're looking at you know, self-storage, you're looking at other dynamics. So, there's a wide range of factors you have to consider. But as you think about those, you want to be thinking not just what's there today, but what you can expect to be there in the future. And if that is a tailwind, if that's a positive factor that you can roll into your strategy, that's how you can make a very, very good return on that property.

TC: And real estate is a long game. You know, one of the things, again, that you and I talked about is, and this is a great reminder, for every listener, we're not day trading. You know, these are not penny stocks. This is a long game. And so the beautiful thing about that is you can weather the storm if you're playing that long game. But you know, one of the challenges that I know that many investors are running into today is really anticipating and projecting the future just because of the amount of volatility that we're seeing in today's market. I mean, obviously, the Federal Reserve has made tremendous moves over the past 12 months, perhaps they could be doing the same over the next 12 months, and where things will play out over the next three to five years in terms of, you know, the marketplace and yields and, you know, cap rates, and so forth. It's very murky to be able to project forward. So how can investors make those decisions and project forward where the market will be with all of these things considered?

JC: You bring up a good point about interest rates. You know, a year and a half ago, the 10-year treasury was about 0.5%. And if you go back into the early 80s, it was pushing 20%. And nobody can tell you where it's going to be in a year or two or five years. But what you can figure out are things like demographics, you can look at demographics, and you can see how many people are going to be what specific age. And we also know traditionally what the normal household formation ages are. So right now over the last few years, over the last 10 years or so we've seen this huge wave of demand for multifamily housing. And a lot of that is driven by the fact that the millennial generation, there are 72 million of them, the millennial generation is in their 30s which is a prime household formation age.

JC: What you also have to consider though, is that we had that pandemic. And what the pandemic did is it reset a lot of those numbers, a lot of those households combined, a lot of them deferred that household formation. And we saw a huge spike right after the pandemic. But because of the change in interest rates, because of the uncertainty that's come to the market, we know that again, a lot of households were deferred. So, we saw vacancies. At the beginning of 2021, vacancies were at a record low. They'd never been lower for apartments. And now they're up significantly from that level. And we're still forecasting them to climb in 2023. But what we have to consider is that household formation reignites, as we see those households opening up, and we see more people moving out on their own, the demand for housing will revive. And we're going to see that absorption grow positive. And even though we're delivering a record number of new apartment units this year, we should be able to absorb those and even more.

TC: So from a broader context. I mean, obviously, from a demographic standpoint, what you just mentioned in regards to multifamily and where things are moving, I think what you shared is extremely important to understand well, what are my occupants looking like today? And what are the trends looking like for the next five years? I'd love to take an even bigger step back and talk about just commercial real estate in general over the next five years, whether it comes down to demographics or trends, absorption development, where do you see things going over the next five years? And we can certainly dive into each asset class in particular, if you'd like. But what are your thoughts there?

JC: We, you know, pretty much across the board, we have some really good long-term tailwinds. Let me start with the one that's probably the most challenging and that's obviously office, right? Nobody's really sure what office demand is going to look like in six months or a year or even two or three or five years. We really had a behavioral change. And that's one of the other long-term drivers you have to monitor for - behavior change. And we saw that with working from home. Now, during the pandemic that was for health reasons, people stayed at home, and they worked from home, because it was potentially very dangerous to go to the office and be around other people and get sick. But now that's not the issue. It has become a lifestyle, it has become almost a benefit of certain jobs is to work from home. In other cases, it's some sort of a hybrid workspace and we don't know how that ultimately is going to shake out. Well, we do know is that office space in the urban core downtown office is having a real tough time of it. Suburban office space is doing better. It still has some questions but I do believe in conjunction with the demographics, that suburban office actually has some momentum, especially if there are amenities nearby, you know, restaurants, shopping and activities. If they're in that same neighborhood suburban area, then those office buildings may have some momentum as we move forward a little bit more.

TC: So if I were to follow up on a specific question there, thinking about office from the broader asset class perspective and then drilling down to say suburban office, you almost, it seems like you are saying there could be some compelling buying opportunities in that space as a result of potential, you know, investments that have the appropriate amenities and so forth based on where it is in that current market cycle. Is that fair?

JC: Yeah, you know, the cap rates on office are some of the highest out there because there's so much uncertainty. And as a result, there are buying opportunities. And, you know, I have to warn every investor, if you're going to look at these opportunities, it is challenging, you have to really understand the leases and the nature of office before you jump into that space. There are opportunities but I think that it's tied into the greater strengthening of the suburban areas that we've been seeing. Whether you're looking at apartments or retail or office, the suburban vacancy rates have outperformed the urban core over the last three years. And I think that's a trend that we can count on because of those demographics I talked about earlier. As people are moving into their 30s and into their 40s, for the millennial generation, they're moving into a suburban lifestyle. And because the labor force is so tight, because there is so many jobs, there's so much competition for employees, that the companies are going to have to move jobs to people rather than trying to make people move to jobs. And that means moving an office space closer to where somebody lives. And that's ultimately where I see that play now.

TC: That makes sense. So, now let's talk about some of the other commercial real estate asset classes. When you think about the next five years, you'd like to get to retail next? What do you see in there?

JC: Before we move on, actually, I will point out one of the subtypes of office that I think is going to do very well. And this is tied to a different age cohort, the baby boomer generation, which is aging into their 70s. The medical office is another property type that has some really good momentum going forward. The yield on those assets running around 8%, seven to eight and a half percent cap rates, and we're seeing a lot of momentum there.

JC: Shifting over to retail, retail has really outperformed. I mean, this is a property type that's been left for dead three times in the last 10 years, right? Everywhere, retail apocalypse that caught mainstream media. We thought it was going to get wiped out during the pandemic. But it didn't happen. The sector softened up. But it has strengthened and actually vacancy rate in retail today is about on par with what it was before the pandemic back in 2019. So the vacancy rates have tightened up. And when I meet with retailers, specifically, one of the things they're telling me is that they cannot find enough quality space. And yet, because of the reputation of retail, and because of the cost of capital for development these days, nobody is building retail. So there's a finite amount of supply. And it is not growing, and retailers are just chomping at the bit to take down space. So retail, especially neighborhood community, suburban retail is outperforming pretty much everybody's expectations, especially in growth markets. It is trading at cap rates as low as mid-five and as high as mid-eight in your weaker markets.

TC: So, I may have missed this. And maybe this is my own ignorance. But you're saying retail supply is not growing generally.

JC: It is growing very little. And most of the development is single tenant actually. So single tenant retail where you have, say a drugstore or a quick service restaurant or something like that, where they have a single tenant in no location, that is the majority of the development that's taking place in the retail sector because that is financed in a different way. There's a corporate background. So it's very different, but retail, in general, there's very little development. In fact, there's probably as much being torn down as is being built at any given time right now.

TC: *Hey, guys, I want to remind you to check out CF Capital. CF Capital is the premier boutique real estate investment firm in the Midwest and southeast region of the United States. We are a national real estate investment firm with a purpose. We provide property investment and asset management solutions to help passive investors maximize returns on high-value* *multifamily communities. But our investments go far beyond acquisitions, we invest in people. We are in the business of elevating communities and raising the bar for everyone within our ecosystem. CF Capital is a real estate investment firm focused on the acquisition and operation of multifamily assets. We confidently deliver tax-advantaged stable cash flow and capital appreciation with a margin of safety. By investing alongside our team, investors can preserve and grow their wealth without having to deal with tenants, termites, or toilets. Investors come and stay for the outsized returns we create in our deals while appreciating the ancillary opportunity to make a bigger impact that only CF Capital can provide. If you're an investor and want to invest with us, here's how to learn more about CF Capital at CFCapLLC.com or by simply clicking the link in the show notes of this episode. We will see you on the inside of this powerful community. So, let's elevate communities together.*

TC: So similar to the kind of work-from-home trend for office, like you said, the media basically created a zombie apocalypse for retail. And really the thought was, hey, Amazon and e-commerce is just destroying retail. Retail is dead. No, don't ever invest in retail. So what you're telling me is, that is not the case, at least that's the trend that you've seen and that's what you're projecting moving forward as well?

JC: You know, a lot of the e-commerce companies have opened physical brick-and-mortar retail locations because they need that brand, they need that visibility, they need that point of contact with their customers. So while a lot of companies started out as pure-play retail, they actually open stores so that they can engage their customers, that place where they can take returns, or pick up items that they may have ordered online. So that's an emerging trend, even the biggest retailers, say a Walmart or Target, they've invested heavily into the internet, but they use their local retail footprint, as a gym to connect with their customers, a place they get to return, a place to pick things up, and also even the warehouse product that is going to be delivered to their clients.

TC: Okay, now, let's talk about industrial because there's a little crossover when you're talking about some of that distribution, but obviously, industrial, you know, is an asset class in itself that has gained a lot of favor in particular, over the past five to ten years. And now what are you seeing moving forward in industrial real estate?

JC: Industrial has emerged as one of the top investment property types over the last five years or so. And part of that was e-commerce and part of that was just the logistics and supply chain issues that we faced over the last few years. And literally, they couldn't build it fast enough. But as where we're standing now, and looking forward, I think there's gonna be some changes in the industrial space that are going to affect investors. The first of which is that a lot of retailers that have built up their inventory during the pandemic have reduced the size of their inventories and they're in the process of paring those down, especially as they consider recession risks. In addition, supply chains have been ironed out. But we do see imports, especially those coming across the Pacific have been reduced. And we're not seeing as much flow through there.

JC: In addition, we have about 400 million square feet of industrial space that is expected to come online in 2023. That's a lot of space, it's a record level of construction. And that could be a bit of a challenge in some markets. I have to point out, the majority of that, about half of that construction is in just eight metros, right, So, 200 million square feet is going into eight cities, 200 million spread across the rest of the country. But you have to consider what are the drivers there. But over the long term, industrial may have a much better outlook, shipping, supply, logistics are going to be a major opportunity, a major issue.

JC: And one of the other things that we're monitoring is an emergence of reshoring and nearshoring that is going to have a significant effect on the industrial space. We're going to see more manufacturing coming back out of Asia and moving back to the United States or back to say Mexico or Canada, and they're going to truck those products in so they're not as reliant on very long supply chains that extend across the ocean. So as we look forward, say five years, we can see a lot more of the manufacturing of products that are being used in the United States coming in from Mexico instead of China. And we can see those ports of entry in Texas and Arizona and California doing very well as a result.

TC: So because of the fact that industrial has been so compelling over the past few years yields have gotten so compressed. Right, so moving forward, it seems like all the factors that you're describing are pointing towards increased occupancy rates and increased sort of growth in the future. Is that kind of what you're saying?

JC: Yeah, I think it does feel, it's looking really good. And it breaks into different categories right there, the very large facilities, you know, 100,000 square feet and larger that maybe at an intermodal hub or a port, then there are the smaller facilities that may be in a local market, maybe you know, just servicing the local city, I think those smaller industrial assets, especially the newer ones, you have to watch out for obsolescence with industrial space, that's a major issue they have to consider. But if you look at some of those smaller industrial properties that are serving the local market, those can do very, very well over the next few years.

TC: Okay, now let's talk about multifamily. What are you seeing moving forward in multifamily?

JC: So as I said earlier, you know, you had a rise in vacancy, you have record construction level, and those are things that are normally considered to be headwinds or challenges. It makes investors pause for a little bit. But when you look at the demographics, when you look at the long-term household formation trends, when you look at the growth potential, then it starts to look a lot better. You know, demand for housing, and household formation really got shut down by inflation. It weighed on consumer sentiment, and it really slowed down that household formation number, and that's why we saw that vacancy rate pop up in my opinion. So, looking forward, we could see that momentum pick up as consumer start, as sentiment starts to improve as people start to feel better about the economic climate.

JC: You know, maybe once we get past the fears of a recession, things can look a lot better. We see that household formation start to form. The other challenge is that the affordability of single-family homes, purchasing a home is just incredible. People talk about how much rents go up, you know, maybe 15%, 20%, 25% in a single year, but house prices went up 35%. In some markets, it was far more than that, it was 45%. So home prices have gone up dramatically. The higher interest rates have made it very, very unaffordable. The spread between the average rent, and the house payment on a median-priced home is now over $1,700. It's enormous. We're going to see a lot more demand for rental housing as we go forward.

TC: This is all great stuff. And really, when you dive into each asset class, I think it's extremely valuable to think about your perspective here. And now if we were to take us even further step back and just think about this from a larger context, how do you see today's market fitting into the broader context of the historical market cycle? I mean, give us a sense of where you think we are today.

JC: Sure, sure. You have to look back over time. I was just actually looking at this this morning. This sales activity over the last 20 years has grown dramatically. So in 2020, there were about 6500 transactions over two and a half million dollars for commercial real estate. If you look back at 2021, it was close to 50,000 transactions. In 2022, it came down from there a little bit. But my point is, that the momentum in the space is enormous. The amount of capital coming into commercial real estate is the greatest that's ever been. Now there are cycles, right? You have downturns. There was one in 2001. There was one of course, during the global financial crisis. That one was very severe, we had a liquidity crisis. You could not finance real estate for about a year. That was a huge challenge. It slowed activity way down. And prices also suffered. You had another setback during the pandemic when you couldn't even get an appraiser to go out to a property to appraise it, right? You couldn't get it signed off with the county. That slowed the transaction market down.

JC: So, there are times when things have challenges. There are setbacks. Right now we're dealing with what's happening with interest rates. But the thing is, is that when you look at this in the longer term, when you focus out a little bit farther ahead, and you realize if interest rates rise and fall, the market adapts, investors adapt, pricing adapts, and we're going to move through that cycle, we're gonna come out the other side, just like we did following the financial crisis, just like we have every other setback in the market. And the thing is, investors often move in a herd. They move to the sidelines, and everybody's looking around and going - no, I'm not going back in, I'm not going back until I see somebody else go back in. And that is when you want to be in.

JC: I remember talking to one major investor that we work with. During the pandemic, when everybody was shutting everything down. Nobody was doing business, everybody was, as they said, pencils down. Those guys said, no, we're not going to do that. They went out, they rented two private jets, and they put their acquisitions people on those jets. They flew around the country, and they bought deal after deal after deal. They got fantastic investments. And I talked to them lately and they say those are some of the best deals they made in the history of their company. And that's because they were taking action while everybody else was sitting on the sidelines. And that is an opportunity that's out there today.

JC: Don't go in willy-nilly. It's not that every deal out there is going to be great. You have to do your due diligence, you have to pay attention, you have to understand the asset, the market, the pricing but there are deals to be made today. And in six months or nine months, or whatever it is, when that herd comes back in, you're competing with everybody else for those same properties. And that's when they get bid up again. And that's when you miss out on those opportunities.

TC: That's a great tip. And I hope the listeners are listening very closely. Because you know, when others are fearful, you can get greedy when it makes sense, right? Do your due diligence, do your homework. When others are greedy, perhaps get a little fearful. And maybe of the past few years, we've seen a little bit of greediness across the market. And so it's interesting to understand that market sentiment and to be bold and move forward. But now I want to ask you just a few more questions before we wrap up here because I'm loving this conversation. First of all, I just really want to thank you again for taking some time to be with me. If you were to think about the industry as a whole, because through these type of market cycles, as you mentioned, individuals have to adapt and evolve. But overall, you also see the industry evolve. How are you seeing the industry evolve now as a commercial real estate investment, sort of asset class as a whole?

JC: Part of it is the investor pool. Part of it is who is investing in commercial real estate. That's become much more democratized. You know, years ago, it was just the most wealthy private investors, it was institutions, it was REITs. Today, there are a lot of ways for individuals to participate in commercial real estate. Yet private investors are completely underrepresented in this space. They have far too much money, in my opinion, invested in the stock market and other financial vehicles and not enough in commercial real estate. I think a lot of you - I can rant on this - (please) but I think a lot of the things that we are taught when we go into business school is to invest in the stock market and...

TC: It's go to school, get good grades, get a good job and invest in, you know, your 401k until you're 65, or then goodbye.

JC: But the thing is, the problem with that is it has an inherent problem. You put a bunch of money away into the stock market, right? Most of it is not generating a dividend, you move to retirement, and you hope your nest egg is big enough. You don't have cash flow from that investment. And you have this pile of wealth. And you say, well, how long am I going to live because I have to make this pile of wealth last as long as I'm alive. But I don't know how long I'm gonna live. I might live another five years, I might live another 50 years. And so calibrating to that is very difficult. The advantage of real estate is it's generating cash flow. It is paying you on a month-to-month basis and it allows you to have income throughout that entire retirement cycle. That is a huge advantage. And that's something that I think most investors or most people, in general, are missing out on.

TC: So what you've seen recently is that it's become more democratized. Do you anticipate that just further accelerating? Or what other evolutions are you anticipating within the industry?

JC: Well, you know, this event that we're at right now, Best Ever Conference is about that. It is something that our company Marcus & Millichap is trying to do on a daily basis. We're trying to educate people. That's my job. The root of my job is to educate investors on how to participate in commercial real estate. We're trying to move that needle but it is slow moving. Again, when you look in terms of the last 20 years, we're way ahead of where we were 20 years ago, but where we could be relative to the potential, I think that we have a long path ahead of us.

TC: I totally agree. You know, that's the interesting thing is that things move slowly, then all at once. Yeah, I think that's what we see, especially in this industry. But John, this has been so great. If you were to give the investors, the listeners here some tips for best positioning themselves for growth with all things considered over the next five years, what would you say to them?

JC: Invest in real estate. That's what I do - put my money where my mouth is. I figure if I can make money...

TC: What do you invest in?

JC: Right now I'm investing predominantly in single-family homes. It's been accessible to me and it's something I know very well. We also look at some retail funds. We're also looking at some multifamily funds. I believe in housing especially over the next 10 years with that demographic momentum that we have in front of us. But in terms of what I would recommend to investors, aside from investing in real estate, is really get to understand the underlying drivers. Understand what is the fuel that is supporting any individual piece of real estate, or an individual market, and then be able to partner with the best people who understand that property, who understand that type of asset, because at the end of the day, a property is very important, but even more important than the property are the people you're putting your money with. They have to be really high quality, they have to know what they're doing.

TC: Totally agree. You got to bet on the jockey and the horse. The jockey is almost as important if not more.

JC: I think the jockey is more important. I think there's always another piece of real estate but it's very, very hard to replicate knowledge, experience and seasoning, and understanding of the nuances of the market.

TC: Yeah, I love that. So invest in real estate. That's the takeaway. Anything else?

JC: No, I think that's pretty good. That's what I live by.

TC: Do it wisely and follow people like John Chang. John, where can the listeners find you and learn more from you and about what you do?

JC: Sure, you can follow me on LinkedIn, John T. Chang on LinkedIn. I post weekly videos there. But I also encourage you to come to our company website, MarcusMillichap.com. We just released our 2023 investment forecast books where we have individual analyses for 50 different markets in each publication, one each for multifamily, for retail, for office, for industrial, self-storage, hotels, pretty much you name it, we have an advisory investment forecast book for you that you can download for free. That's available on our website, MarcusMillichap.com

TC: We will put a link in the show notes as to where the listeners can find John and Marcus & Millichap. John, one of the best in the business, if not the best in the business. I just want to thank you again for being on the podcast. And thank you to the Best Ever crew for allowing us to do this live at the Best Ever Conference 2023 in Salt Lake City, Utah.

Elevate nation, I just want to thank you so much for listening. Until next time, talk to you soon.

[END OF INTERVIEW]

[OUTRO]

Announcer: Thank you for listening to Elevate. If you enjoyed this episode, be sure to rate, review, subscribe, and pay it forward by sharing with a friend. Most importantly, take this opportunity to elevate your results by taking immediate action on what you learned. For more, visit elevatepod.com.

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