PLRA Daily REIT Note
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I want to elaborate on a drive-by comment from today's weekly note. I think it's a risk that many REIT investors are thinking more about these days, but a tricky one to define:

> …replacement cost can also be a good tool for thinking about real estate from the bearish side — because it forces you to consider what really needs to replaced, and how much of current demand may be more discretionary than it looks. We've always had a "quality" bias in REITland, and in some property types, this has protected us from fallout at the lower end. But it can also lead us **to overimprove real estate on the way up, and take that "premium" demand for granted on the way down.**

As a simple example: if we take a market rate apartment portfolio and talk about a $100/month rent lift from renovating the kitchens, we're implicitly acknowledging that a new kitchen is discretionary, right? But if you come back a few years later in an environment like the current one, we're just pointing to low market vacancies and saying "well, there's nowhere else for tenants to go."

At the property level, we can still measure the premium directly (say, in a building with half the units done) and ask whether the "price" for a new kitchen has contracted to $50 or expanded to $150. But is that really how we're thinking about demand as REIT investors?

Maybe it sounds like I'm just finding an unnecessarily cute way to talk about trade-down behavior or hedonic adjustments, or some other more standard concept. Or maybe you're familiar with the sector-specific narratives about how various non-real estate businesses have slowly overpriced themselves into trouble — like **this column** today about the auto sector.

But we don't have enough of those debates in commercial real estate — and however you approach this subject, you're going to run into some fuzzy and subjective measurement problems. So just try out my framing, and see if it resonates. Rather than trying to decompose the current tenant base or in-place rents, think back to the pre-Covid years, and ask where the "premiumization" felt a little too easy at the time?

I can tell you where this resonates for me. Not with industrial or retail, where tenants have good measures of real estate productivity, and strong market incentives to maximize it. Not with self-storage, where the consumer psychographics are so unique that it's hard to define any component of what the median customer is paying for. (We could talk about the long-term "retailization" of storage with respect to locations and store design, but much of that is also sales & ops, and I don't think pricing is the best lens for any of it.)

The residential property types are where it starts to bug me, particularly in multifamily. I'm not calling new kitchens an "overimprovement," or even the best example of the problem. But I think we've gotten too comfortable applying stories about the entire housing market to the high end, and that's why an affordability perspective (like the **other column** I linked to) is worth considering. Yes, everyone needs a place to live, and yes, US housing is still drastically undersupplied. But it doesn't follow that the high end of the rental market can't be overpriced, or that rent/income ratios would be the only possible indicator.

And it's clear from my notes that I worry a lot about "premium" pricing in the office sector — where much of the sales pitch is still to the CEO's ego, even we grant that recruiting and employee preferences have been playing a greater role. I also worry about it with hotels, where the reduction in the service component of the offering implies that the true quality premium for the real estate component may be even more extended than it appears.

(It's no coincidence that these are two of the most capex-heavy sectors, where it's always been a challenge to define exactly what we're getting paid for. And in both cases, we can agree there's a segment of demand at the top that seems more or less positional, and indifferent to price — i.e. the price for the "best" is set by development costs and required yields. But we don't have a great idea of where that segment stops, or whether it's growing or shrinking.)

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