

Privcap / Conversations

CORE REAL ESTATE

The Global Opportunity

Part of the PGIM Real Estate series of thought-leadership podcasts on excellence in institutional real estate investment

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PORTFOLIO & PERFORMANCE

CORE REAL ESTATE

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As real estate has grown into an important part of an institutional portfolio, the popularity of core real estate has surged. And yet the definition of core has morphed in recent years. In addition, outside of the U.S., notably in Europe and Asia, investors are eager to put capital in core assets but sometimes disagree on what constitutes core in these markets. To gain perspective, Privcap recently sat down with PGIM Real Estate's core portfolio managers for the U.S., Europe and Asia Pacific, respectively. The following is an edited transcript:

Privcap: Why don't we just start with the definition of core real estate. Frank Garcia, you invest in U.S. real estate. How has the meaning of core changed in your experience?

Frank Garcia, PGIM Real Estate: Core strategies have most of their assets invested in stabilized real estate. A majority - 80% or so - of the return comes from income from the properties. Most of the core strategies in the U.S. have fairly low leverage in the 20% to 30% range. And they're not taking a lot of risk on the non-core side. So they're not undertaking an inordinate amount of development within those investments.

For us, we define it very simply - at the time of acquisition, if the asset is 80% or more occupied, it's a core asset. However, if you go back to the 80s and 90s, office, industrial and retail were really considered core asset classes. Multifamily at that time really wasn't a core investment class, but has since developed into a truly core asset class. I think today if you're looking at just those four main food groups and calling them core, you're going to get left behind, especially with the pace of technological change that we're seeing. What was core yesterday may not be core tomorrow. A good example of that are malls.

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Malls had been seen as a fortress investment class. But with the headwinds of e-commerce, things are changing very quickly in that environment. And you could say now that most malls are probably not very core. The e-commerce and distribution channels are changing, having tremendous impacts on that asset class, especially if you look at the amount of capital it's going to take to keep those malls relevant and at a low cap rate.

Privcap: Let's move on to Europe. Thomas, what is viewed as core versus non-core there?

Thomas Kallenbrunnen, PGIM Real Estate: The funny thing about the definition of core real estate is that it's like a balloon, which means that it inflates and deflates with the cycle. So if you look at, say, the year 2010, right after the crisis, probably only very few trophy assets had been considered core, whereas much later in the cycle like we are today, the core definition has expanded a lot. So the question you always have to ask yourself when investing in this space is, what will remain core once there's a more normalized market. What does that mean for Europe? It means basically not going to those fringe markets,

but sticking to the more liquid and traditional markets, and maybe pursuing more non-traditional investments in those markets.

Privcap: Vincent Chew you oversee core investing across Asia. How is core there and how developed of a concept is it?

Vincent Chew, PGIM Real Estate: Leverage might be a little bit higher for a strategy in Asia, say up to 40% limit on a portfolio basis, where I think it would be lower in the U.S. Frank talked about 80% of returns coming out of income. In Asia we would say about 50% of that comes out of income, because there is a perception of stronger growth and capital appreciation. When you start really drilling down on structures in Asia, you start to see some wider differences between Asian core and European and U.S. core.

So for example, in Asia, Australia is probably the only market where you have tenants signing on to relatively long leases - 10 to 15 years like you may have in Europe and the U.S. In most markets in Asia we're talking about two-, three- or sometimes five-year leases. There is a view that there's risk with that, but there's also the abil-

ity to mark to market as rents increase and that ability to renew or to bring in new tenants at higher rents.

Kallenbrunnen: But maybe, as in so many cases in Asia, this constitutes leapfrogging. Because if you look at the trend for shorter lease durations, that's probably going to happen in the more mature markets as well. You definitely see it in Europe and I would imagine you see the same thing in the U.S. So maybe Asia is ahead of the curve.

Chew: You see a lot of this leapfrogging in logistics in China where, at a national level, they have jumped generations of logistics assets over the more mature markets because of technology and automation. We've seen massive facilities with a lot of automation being built and skipping over the infrastructure that might have been there 20 years ago.

GOING GLOBAL

Privcap: Let's talk about institutional investors and the way that they view and understand the core opportunity around the world. Frank, didn't it used to be the case that, especially among U.S. investors, when they invested at home, they tended to want core and when they invested abroad they wanted what was viewed as riskier or more opportunistic assets. Is that changing?

Frank Garcia: It has changed. A lot of data shows that global markets aren't as correlated as once thought. Because of that, U.S., European and Asian investors are finding that they increasingly want the diversification of core real estate globally. That's becoming more and more important, especially if you have a longer term horizon.

Transparency and Execution as Key Investment Criteria for Core

"The European ODCE index is a new instrument that creates transparency for Europe, the way it has been in the U.S. for decades. It allows an increasingly global investor base to enter the market in a transparent way by knowing the allocations, by knowing the positioning of the funds that are in this index."

–Thomas Kallenbrunnen, PGIM Real Estate

"Foreign investors who come to the U.S. and make direct investments often find that not having people on the ground here makes it much more difficult to be a successful investor. And the open-end core funds have become more popular because of that."

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Kallenbrunnen: Half jokingly, it's probably a combination of very human biases mixed with something very substantial. It's like you're a European soccer club and you're willing to take on that 15 year old Brazilian talent because you've seen him score so many goals. But you haven't seen him close enough to know all his weaknesses.

Whereas the homegrown talent, you know the weaknesses. So you're much more risk averse closer to home. The real estate allocation of many institutional investors in the past involved creating performance, it's much more about stability today. A globally diversified portfolio is more stable than just a regionally diversified portfolio. And that's why I think having the capability to operate in the core space on a global basis, plays so much more of a role today than it did five or 10 years ago.

LEARNING FROM THE U.S.

Privcap: PGIM Real Estate has been active for a long time in the U.S. What lessons are being applied to Europe and Asia that were learned in U.S. core?

Kallenbrunnen: When we're talking about European core strategies, the one thing the U.S. has proven is that open-end core funds have a liquidity mechanism that's proven crisis-resistant. Why? Because it's focused on protecting those people who want to stay in the fund over those who want to leave. U.S. open-end funds have been around since

the early 70s. In Europe we certainly want to provide U.S.-type liquidity mechanisms and providing for the long term through multiple cycles.

Garcia: The U.S. market has really matured over the years and the public real estate markets get a lot of the credit for bringing more transparency to private real estate. But being able to provide a high level of transparency and maintaining that fiduciary mindset is very important. On the issue of liquidity, we have to be a fiduciary for all of our investors - those that are in the queue to get out of the fund and those that want to stay in the fund. Direct real estate is inherently illiquid. And when we do hit those periods late in the cycle, you can go through periods of illiquidity you need to balance. Do we sell assets to redeem people out? How do we handle that? It is fairly delicate.

Privcap: Vincent, how has the Asia team benefited from the long tenure of PGIM Real Estate in the U.S. market?

Chew: One thing we're trying to learn from the U.S. is the direction of some of the sectors. Frank mentioned retail as a threat, and absolutely we see

those similar kinds of headwinds in Asian retail on a structural basis, but to a lesser degree. We can pick up on what's happening in other places and know what we're in for.

The alternative sectors in Asia are less developed. We can look to the U.S. and Europe for some direction on that. For example, self-storage is not really a core asset class in Asia. But it could be going in that direction and we've certainly seen it within U.S. funds. Student accommodation, again, not really something that you see as a core asset in Asia yet. So it's difficult sometimes to get a really good understanding of what pricing ought to be on something like that.

Kallenbrunnen: The important point here is the question of what core is. How do you define it? You want to have an element of negotiation power as the owner of an asset, right? You want to own assets and have a tenant base that actually wants to be in and willing to give you the growth you need in order to have a longterm sustainable strategy. The question you always have to ask yourself is, "Am I dependent on an operator?"

New Investors Rise in the East

"Regulatory changes have happened recently that have allowed Taiwanese, Japanese and Korean insurance companies to invest abroad. Those types of investors hadn't really participated that much in global real estate. Several of them are investing in real estate outside of their home countries for the first time."

–Vincent Chew, PGIM Real Estate

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Privcap: Thomas, there is a new index of European core called European ODCE Index. What is it and why is it important?

Kallenbrunnen: It's basically a copy-and-paste of the U.S. ODCE index, where only diversified funds are measured. It's an index for open-ended funds. Most of the older indices in Europe have a very broad constituency of multi-sector or single-usage types of funds. ODCE is a diversified index where you have to be in multiple asset classes in multiple countries. It's a new instrument that creates transparency for Europe, the way it has been in the U.S. for decades. It allows an increasingly global investor base to enter the market in a transparent way by knowing the allocations, by knowing the positioning of the funds that are in this index.

GLOBAL CASH FLOWS

Privcap: Vincent, PGIM Real Estate has the ability to track cash flows around the world into and out of real estate. What do today's cash flows tell us about the market?

Chew: We see investor interest in core Asia vehicles as predominantly coming from European and U.S. based institutions. That said, there absolutely are Asia-based investors that want a core exposure but they won't look towards a diversified, Asia Pacific open-ended core fund. There are some very large state pensions and sovereign wealth funds that will invest locally on their own or through separate accounts.

Privcap: Thomas, what are you learning from your vantage point in Europe?

Kallenbrunnen: U.S. investors are very interested in European core, but it's still the beginning of a trend. We're

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seeing the first Asian investors not just doing direct deals or joint ventures, but looking into diversified funds in Europe. But the interest is more about the evergreen nature of a fund rather than the core space. It's about deploying capital on a permanent basis and staying invested.

Garcia: I agree with that. Foreign investors who come to the U.S. and make direct investments often find that not having people on the ground here makes it much more difficult to be a successful investor. And the open-end core funds have become more popular because of that. Early in the cycle, we saw quite a bit of money coming out of the Netherlands as well as Switzerland. Now we're seeing pretty strong flows from Japan - investors looking for diversification as well as yield because of the low interest rate environment that they find themselves in. So we continue to see flows into the U.S. ■