GLOBAL REAL ESTATE: INVESTMENT THEMES AND OPPORTUNITIES

At the global level, property performance tends to go hand in hand with economic activity. Growing optimism about the outlook for the global economy is feeding through into real estate markets, where investment transaction volume is rising. Global real estate returns are edging upwards, for now mainly driven by capitalization rate compression as investors effectively anticipate the next chapter of the recovery story: an upswing in occupier market performance.

When considering the outlook, we need to look beyond a simple overlay of macro-economic trends that explain broad movements in aggregate sector and regional occupier markets. Looking more closely, it becomes clear that individual real estate markets and sub-markets around the world have varying characteristics and are at different stages of their cycles. Identifying major trends and understanding how their impact varies across geographies, markets and sectors holds the key to outperforming in the next phase of the global real estate cycle.

In this paper, Prudential Real Estate Investors identifies four key themes that are shaping global property markets. These cover Strong Growth and High Development Activity in fast-growing developing markets; Early Recovery markets such as technology and energy corridor markets in the United States; Late Recovery markets that include government- and housing-led markets; and Challenges in the Retail Sector, which is being held back by indebted consumers and the growing impact of e-commerce.

As the lackluster environment of the past few years makes way for a brighter outlook, investors are positioning for growth. We expect higher returning value-add strategies to grow in prominence, aided by a general increase in risk appetite among investors and lenders. Taking our key themes into consideration, we believe the opportunities for investors seeking attractive risk-adjusted returns fall into three broad groupings: Taking on Risk to benefit from attractive non-core pricing and improved fundamentals; Buying into a Late Recovery in markets that have so far failed to participate in the upswing; and Capitalizing on Structural Shifts that exist as a result of the changing nature of real estate markets.
INVESTMENT THEMES: MARKETS AT DIFFERENT STAGES OF THE CYCLE

Local market characteristics continue to play a crucial role in determining property-level performance, but global occupier and investment markets are often highly integrated. In a number of major global markets, such as financial centres or prime shopping districts, the international nature of the occupier base means that sector composition is arguably more important than geographical definitions. Similarly, fast-growing developing markets in Asia and Latin America share certain characteristics, most notably a vulnerability to large supply pipelines. In developed markets in Europe and the United States, there are notable similarities – and differences – across markets, relating to activity among major occupier groups, such as finance and the public sector.

As a result, it is important for global investors to understand trends that transcend national boundaries. Here, we identify four key investment themes that we expect to shape the outlook in the next phase of the cycle and assess where their impact is likely to be felt.

THEME 1: STRONG GROWTH AND HIGH DEVELOPMENT ACTIVITY
Office and Retail in Fast-Growing Asian and Latin American Markets

Buoyed by strong rates of economic growth in recent years, developing markets in Asia and Latin America are at the forefront of the global occupier demand cycle, despite a recent slowdown. Office absorption continues to accelerate in a number of Asia’s fast-growing non-financial markets, including Jakarta and Kuala Lumpur, and remains strong in Beijing and Shanghai, albeit down from a previously ferocious pace, reflecting occupier concerns about China’s growth outlook. In these markets, rents have recovered from the damage inflicted by the global financial crisis and are now above previous peak levels (Exhibit 1).

As a result of an ongoing need to cater for a growing institutional occupier base, the supply pipeline in Asia’s developing markets is rising. Over the next three years, office central business districts (CBDs) in developing Asian markets will have to absorb more than 3 million square metres of new space – equivalent to an increase of about 8% per year. The recent experience of Latin America’s office markets acts as a warning. An early-cycle rental growth recovery stimulated building activity in Brazil, Chile and Mexico in the aftermath of the global financial crisis. Fast forward to the present day and vast swathes of office schemes are being delivered into slowing leasing markets, pushing vacancy rates well above average and choking off rental growth. Our long-term view on these markets remains positive, but the extent of supply growth is hampering the near-term outlook.

Similarly, in retail markets, there is a bright outlook for retail spending in developing Asia, Mexico and Central and Eastern European markets, where the retail offering is in need of modernisation to cater for a growing middle class. As with office markets, the supply pipeline is elevated, especially in Kuala Lumpur and China’s tier-1 cities. In both sectors, rather than an outright threat to the future of the markets, the level of supply implies winners and losers as older buildings are increasingly exposed to stiff competition from new schemes.
THEME 2: EARLY RECOVERY

Employment levels have risen well above pre-crisis peaks, and the growth in demand for office space has been strong in U.S. technology and energy corridor markets including Seattle, San Francisco, Houston, Austin, Dallas, Portland and Raleigh. Tight supply CBDs in relatively fast-growing Northern European markets such as Munich, Stockholm and London West End also continue to attract occupiers keen to secure addresses in prestigious locations. In both groups of early recovery markets, CBD rents are rising. Development activity is picking up in some U.S. markets that have high enough rents, but supply in European cities continues to be restricted by a lack of finance. Occupiers are now taking space in secondary buildings and non-CBD submarkets to meet requirements for modern space and large, efficient floorplates.

In the United States, apartment markets initially led the cycle, but the outlook points to a moderation in performance due to a supply response. Demand for apartments received a counter-cyclical boost from favourable demographics and housing market woes that, for a while, turned would-be buyers into renters. Lower unemployment boosts rental demand among young adults, but the housing ownership market is improving, while low vacancies and high rents are attracting developers to apartments. More recently, industrial markets have recorded strong demand, and they too are facing the prospect of supply responding to rising rents, although the outlook remains strong in tight supply, high population areas including New York, Miami, Southern California and the San Francisco Bay Area.
THEME 3: LATE RECOVERY

Despite the increase in global office-using employment, take-up of CBD office space outside of early recovery markets remains downbeat. In major developed markets, job creation is currently skewed towards lower value added services, rather than higher value added positions in banking and financial services. Among normally fast-growing global financial centres, the pattern of demand is inconsistent: employment and take-up are rising quickly in London City and New York, while leasing activity is more subdued in Frankfurt, Hong Kong and Tokyo. Competition for scarce CBD space in financial-led markets means that rents have risen from trough levels, but in most cases, prime rents are still some way below their pre-crisis peaks.

The group of late recovery markets also includes those with exposure to structural challenges in the global economy. Persistent weakness in a number of housing markets in the United States and peripheral Europe has weighed on occupier activity in cities such as Los Angeles, Miami, Phoenix, Madrid and Dublin. Sentiment is turning quickly in these cyclical markets, particularly in the United States, where the housing market outlook is improving. High public debt-to-GDP ratios in many countries have also impacted activity among increasingly frugal public sector occupiers, which is holding back space demand in markets such as Brussels, Paris and Washington DC. Rents in the much maligned eurozone periphery – where sentiment and growth are now slowly returning – also remain a long way below pre-crisis levels.

Our view is that the next phase of the cycle will increasingly favour late recovery markets, which generally have a limited supply of grade A space, low development pipelines and greater scope for rental growth from depressed levels. We continue to favour “high barrier” markets – those markets with a strong demand base in which natural constraints or planning restrictions limit supply – which typically outperform through the cycle. Second tier cities in the United States are expected to perform well, but in Europe the focus remains on core markets. Employment growth in Europe’s periphery is simply not strong enough to bear down on still elevated vacancy rates, although leading indicators show that occupier sentiment is noticeably improving. Over time, the emphasis for rental growth is likely to shift to non-CBD and suburban areas, where demand is rising due to a lack of availability in CBDs and there is rental “catch-up” potential.

THEME 4: CHALLENGES IN THE RETAIL SECTOR
Developed Retail Markets

Unusually, the retail sector – which normally leads a cyclical recovery – is lagging the broader upswing, held back by weak consumer activity in indebted western markets. Meanwhile, the growing impact of e-commerce is contributing to increased caution among retailers, which is affecting physical space demand, although some formats have been resilient. Lower-end, grocery-anchored schemes remain well-let, while demand among luxury retailers for flagship stores on major shopping streets has pushed prime rents up rapidly in low vacancy markets such as Manhattan, London and Paris.
Despite a number of headwinds, we anticipate a broader cyclical pick-up in retailer activity as we move towards 2015 – rising employment, stronger earnings growth and growing consumer confidence should give retail sales a welcome boost. Retailers are targeting expansion in major markets with scale and growth potential, most notably Germany and the United States. In addition, an ongoing lack of new supply in developed markets points to rental growth in well-located retail schemes. However, structural changes to retail markets mean that secondary and poorly-located schemes are at risk of being left behind, and the stark contrast between winners and losers is expected to continue.

**INVESTMENT OPPORTUNITIES: POSITIONING FOR GROWTH**

In order to understand the nature of opportunities in global real estate markets, we need to look at the investment themes in the context of global capital markets. Market liquidity is high and cross border capital flows are accelerating as investors look further afield for diversification and higher returns. Core assets in gateway cities – until recently the major focus of investor attention – look expensive as capitalization rates approach cyclical lows (Exhibit 2). In contrast, yield spreads on secondary assets and locations are wide: suburban office yields are only slightly below their 10-year average and still some way above their 2007 low point (Exhibit 3).

Meanwhile, the prospect of rising interest rates points to a need to target higher returns and growth potential, rather than safe income. Investors and lenders are turning their attention to cheaper-looking non-core markets that offer higher yields, improving occupier activity and rental growth “catch-up” potential.
There are structural opportunities too, also targeting higher growth, but with a focus on the changing nature of real estate markets. Structural change is mainly taking place in developing markets, where, for example, rising incomes and a growing middle class point to a need for an increased provision of retail and residential assets. In developed markets, there are fundamental changes to retail markets via the impact of e-commerce, and to debt markets via the impact of changing regulations, all implying ongoing opportunities for investors.

In summary, we believe that opportunities for investors to earn attractive risk-adjusted returns in today’s global real estate market fall into three broad groupings: “Taking on Risk”, “Buying into a Late Recovery” and “Structural Shifts”. These opportunities are summarised below and in Exhibit 4.

**OPPORTUNITY 1: TAKING ON RISK**

**Nature of Opportunity:** Taking on additional asset risk in early recovery markets to take advantage of a cyclical upswing in real estate fundamentals

**Target:** Developed Office Markets

Our leading indicators on sentiment point to stronger leasing activity in office markets and low yields on prime assets. This suggests that investors should look beyond the boundaries of a “buy-and-hold” core investment to earn higher returns. Yield spreads remain elevated in non-CBD and suburban markets in the United States and Europe, while lenders are becoming active in these markets again. Investors are able to follow occupiers that have to take sub-market space due to a lack of provision in CBDs, where vacancy rates are now below average.

Taking on leasing risk in North European CBDs and U.S. gateway cities, either through vacancy or short income, is increasingly attractive. We anticipate a further improvement in demand as higher-value added jobs are created, particularly in U.S. office markets. Meanwhile, there is still plenty of potential for rents, which are generally well below previous peaks, to “catch-up” in the cycle. As rents rise, we favour “high barrier” markets, which typically outperform in an upswing and have greater defence against a supply response. Repositioning and refurbishing secondary assets continues to look attractive in high barrier markets, given the lack of grade A space being completed.

**OPPORTUNITY 2: BUYING INTO A LATE RECOVERY**

**Nature of Opportunity:** Identifying underpriced core assets in capital-starved late recovery markets

**Target:** Eurozone Periphery, Second-Tier Cities in Europe and the United States

Opportunities in late recovery markets stem from differences in the growth outlook across countries and regions, exacerbated by patterns of investor and lender behaviour. Investors are starting to look beyond the narrow set of major cities that have dominated activity, but there is a broad group of late recovery markets that continue to suffer from a shortage of capital. Low pricing and an improving occupier outlook indicate a compelling investment
opportunity, particularly in markets that have under-capitalised domestic banking sectors.

Reflecting structural challenges and persistently sluggish economic activity across much of the continent, the bulk of late recovery markets are located in Europe, including core cities in the peripheral nations of Spain and Italy and eurozone laggards such as the Netherlands. The group also includes some second-tier cities in the United States – particularly those not driven by the finance, technology or energy sectors – and in smaller regional markets in faster-growing core European countries, where growth has been skewed towards major cities.

A lack of capital means that yield spreads in late recovery markets are elevated, while, at the same time, occupier demand is improving in line with better economic sentiment. Opportunities remain selective though, as availability in smaller office and secondary retail markets is often high. However, there is very little new space and prime rents are very low, which points to the prospect of a steep pick-up in rents and values, even if not to pre-crisis levels. Buildings have been starved of capital expenditure in recent years meaning the opportunity extends beyond a simple buy-and-hold strategy, especially in the retail sector. However, markets are starting to price in a recovery, and there are already hints that yields are compressing from elevated levels.

### OPPORTUNITY 3: STRUCTURAL SHIFTS

**Nature of Opportunity:** Capitalising on ongoing structural opportunities that exist as a result of the changing nature of real estate markets

**Target:** Developing Asia, Latin America, Debt Markets

Initially, developing markets led the global recovery, before recording a drop in performance linked to concerns about growth in China as well as the negative effects of a reversal in capital flows that accompanied expectations of tighter monetary policy and rising interest rates in the United States. A number of markets in Latin America continue to deal with domestic issues, particularly in Brazil where domestic imbalances are high, limiting the prospect for policy stimulus to boost growth.

On an absolute basis, compared to the United States and Europe, real estate returns in developing markets are still high, although oversupply in some office and retail markets as a result of the recent slowdown in growth limits the potential for cyclical investment opportunities. As a result, investors remain more focused on structural growth opportunities in these markets, developing assets in absence of local capital sources to meet the growing need for modern office and retail real estate assets to cater for a gradual transition to a more services-oriented economy and growing consumer class.

In developed markets, the retail sector is undergoing rapid changes as the way in which consumers and retailers interact is shifting constantly. Demand for traditional industrial facilities, such as plants and factories, is also increasing in the United States and Europe, linked to stronger domestic production activity and the return of previously “off-shored” manufacturing jobs. Changes to the physical environment can also bring about shifts in demand for real estate space: recent earthquakes in Japan highlighted the importance of seismic-proof logistics facilities, which are currently limited.
Meanwhile, debt markets continue to offer an interesting opportunity. While pricing and availability of debt is improving, the regulatory environment for banks, which provide about 50% of real estate debt in the United States and 75% in Europe, is toughening. Under the incoming Basel III framework, banks face a general requirement to hold higher levels of capital against their loan books and must apply a higher risk weighting to commercial real estate. The impact is to effectively restrict the amount of capital banks have available to lend, and we expect loan-to-value ratios to remain structurally lower than they were before the global financial crisis. An influx of secondary debt providers is closing the so-called “funding gap”, but we expect junior and mezzanine lenders to continue to play an important role in the United States, Europe and developed Asian markets of Australia and Japan.

CONCLUSION

The low-growth environment that has provided the backdrop for global real estate investment markets over the past few years is shifting, and investors are positioning for growth. While there are some notable downside risks – including slower growth in China and a bumpy exit from extensive policy stimulus packages in Europe and in the United States – on balance, we remain broadly confident about the outlook for the global economy and real estate markets. As we head towards 2015, we expect global GDP growth to gain momentum, underpinning a further increase in sentiment among real estate lenders and investors. Rising transaction volume and a broadening occupier market upswing should contribute to further improvements in investment performance.

In this paper we have identified a number of key themes that we expect to shape the outlook in real estate markets. Our view is that the best opportunities arise from considering these themes and distinguishing between their impact on different geographies, markets and sectors. Understanding when to take on more risk, where to buy into a late-cyclical recovery story and which markets are undergoing structural changes – and then positioning investment strategies accordingly – will likely play a fundamental role in determining investment performance as the cycle progresses.
Office Recovery
Office-using jobs are recovering, leading indicators point to rising absorption. Focus on late recovery, housing-led markets.

Mezzanine Debt
Debt markets are recovering, but still opportunities to originate new loans. Secondary assets becoming more attractive.

Secondary/Regional Markets
Yields remain elevated in capital-starved second-tier markets. Lending margins are falling and we expect better rental growth in smaller office markets and retail formats.

Core with income growth potential
Pipeline is low and demand for core assets remains strong. Look for asset management opportunities and rent catch-up potential for higher returns.

Peripheral Growth
Spain and Italy are growing, values are low and new supply is non-existent.

Affordable Housing
Strong demographics and rising middle class population.

Warehouse Demand
Demand rising in US and Mexico in line with the business cycle, pushing rents up. Possible supply response is a concern.

Retail Development
Retail assets in Latin America and Developing Asia to cater for a growing middle class.

Modern Logistics
Stronger global trade is fuelling export demand and need for modern logistics facilities.

Cyclical Pick-up in Core Markets
Economic growth has eased but we expect this to represent the low point, occupier sentiment is increasing in developed markets such as Tokyo.

Financing a broader recovery
Banks are coming back, but LTV ratios are still fairly low, so secondary debt sources are here to stay.

EXHIBIT 4: SUMMARY OF GLOBAL OPPORTUNITIES

Nature of Opportunity
- Taking on Risk
- Buying into a late recovery
- Structural Shifts
DISCLAIMER

These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person’s advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of Prudential Real Estate Investors is prohibited. Certain information contained herein has been obtained from sources that PREI® believes to be reliable as of the date presented; however, PREI cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PREI has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. Past performance is no guarantee or reliable indicator of future results. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PREI and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PREI or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: Key research team staff may be participating voting members of certain PREI fund and/or product investment committees with respect to decisions made on underlying investments or transactions. In addition, research personnel may receive incentive compensation based upon the overall performance of the organization itself and certain investment funds or products. At the date of issue, PREI and/or affiliates may be buying, selling, or holding significant positions in real estate, including publicly traded real estate securities. PREI affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PREI personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PREI’s clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part II of PIM’s Form ADV.

Prudential Investment Management is the primary asset management business of Prudential Financial, Inc. Prudential Real Estate Investors is Prudential Investment Management’s real estate investment advisory business and operates through Prudential Investment Management, Inc. (PIM), a registered investment advisor. Prudential, the Prudential logo and the Rock symbol are service marks of Prudential Financial, Inc. and its related entities, registered in many jurisdictions worldwide.