PGIM

IPE REAL ASSETS WEBCAST

Why necessity retail continues to defy disruption



Brendan Maton:
Good afternoon, ladies and gentlemen. Welcome to the IPE channel. I'm Brendan Mason for IPE. Today we're concentrating on commercial real estate, specifically the retail sector, how much you as investors want to allocate to necessary consumer spending rather than discretionary, rather than other sectors. And we're also talking about those shops and stores people actually visit in real life rather than online purchases. Lots to discuss in a sector that continues to reconfigure itself. So let's introduce our panel. First up, Rory Morrison, head of European Core Strategies Real Estate at PGIM. Rory, welcome to IPE.

Rory Morrison:
Hello, Brendan. Thanks for having me on today.

Brendan Maton:
Tell us a bit about the strategies you oversee there.

Rory Morrison:
Yeah. So at a very high level, I have a pan-European role, so I'm somewhat country agnostic and all of the mandates that I oversee are diversified. So they're pretty much all sector agnostic as well. Where there is focus is in the risk appetite. So my area of specialism is the kind of core and core plus end of the spectrum. So generally the lower risk appetite within the real estate space.

Brendan Maton:
Okay. A little bit about the team. How big is it? Where are they based? What do they do?

Rory Morrison:
Well, so PGIM is a global investment manager, very large indeed with, as many of you probably know, one and a half trillion or thereabouts dollars of assets under management. Our real estate business is again a global business. I work in the European team where we have about 12 billion euros under management across equity and debt. And I think you'll hear a little bit from our debt colleagues, Matt, later on. But it's a broad team. We have over a hundred people in the various offices, investment teams, portfolio managers, as well as the operational specialists. So quite a broad team across Europe.

Brendan Maton:
Super. Why don't we introduce your colleague? You just mentioned him, Matt Crowther. Matt, welcome to our

Mathew Crowther:
Hi Brendan. Thank you.

Brendan Maton:
You're on the debt side. Tell us a bit about the day job.

Mathew Crowther:
Sure. Yeah. Look, I work alongside Rory here in our European office, but we essentially set up our own bank. So we raise private capital to lend to other people in the market. So other owners, operators of real estate in the European market.

Brendan Maton:
Lovely. And like Rory, I started the show saying we're talking about retail, especially necessity retail, but on the debt side, you cover the whole spectrum of real estate, not just retail.

Mathew Crowther:
That's absolutely right. And I think that's what I like about not being a bank or just a pure credit shop. We're alongside the real estate business part of that team that Rory's described. So we're sort of real estate experts first, but do the lending on top.

Brendan Maton:
Okay. Okay. Rory, I'm just going to make clear the point, the difference between you and Matt. You are taking on equity risk. You're at the bottom of the pile, so to speak. Hopefully you get richer rewards for that. Is that fair to say?

Rory Morrison:
Well, it varies. Risk adjusted is the key piece to that story in terms of how much risk investors are happy to take and the commensurate return that comes with that. But yes, generally the mandates and the clients that I'm representing are at that lower risk end of the spectrum, which means what in practical terms, more often than not stabilized assets with tenants in place, some kind of trading track record that we can due diligence. So that high occupancy focus helps drive long-term stable income returns, which are an important part of that core to core plus risk appetite. And in terms of the structures, the leverage that we'll use will tend to be at the lower end of the spectrum. So generally at or below 50% loan to value, if that helps frame that space.

Brendan Maton:
Yeah. Yeah. Good guide. Before anything else, we should introduce our third speaker who's been on screen with us for a few minutes now. It's Stefan Zimmerman. Stefan, welcome to IPE.

Stefan Zimmermann:
Thank you, Brendan.

Brendan Maton:
Now you head an interesting company. Stefan, tell the audience a bit more about Four Friends Investment.

Stefan Zimmermann:
Yeah. FourFI is effectively the family office of my business partner and myself. And we have three different sectors we are investing in and managing real estate, education and fitness, house and lifestyle. And I represent the part who is on the real estate side. And our biggest experience and largest experience is food anchored retail.

Brendan Maton:
Cool. You've got a rich experience in real estate. Stefan, say two words about that.

Stefan Zimmermann:
Well, actually I've started some close to 30 years ago and have also lived through one or the other crisis. Founded my first company back in 06 and ever since we have invested into European wide retail, roughly 30 billion together as partners throughout the different cycles, especially post global financial crisis. We went massively into food anchored retail, have been one of the first in that market and that ended up in buying in an opco property, also a supermarket retail chain in Germany, which was the fifth largest at point in time with some 36,000 employees where we restructured the operations and actually developed the real estate. So I know both sides, the operational part as well as the real estate side. Excellent.

Brendan Maton:
Super. This is great. It's usual IP format folks. So live webcast, IPE, PGIM, and I'm sure for friends investment, welcome interaction. So if you've got any questions for the panelists, fire them in and I'll put them to them over the course of the next 50 minutes or so. Stefan, necessity retail, let's start with the fundamentals of the sector. Give us some salient

Stefan Zimmermann:
Characteristics. Well, as I always say, necessity retail is effectively no retail because it's the translation of residential into the commercial market. Everyone needs it. Everyone needs to buy it. No matter how much money you are making, where you are living, you need to eat. Therefore, the market is huge. So in Germany or in Europe, in the U27, it's 3.6 trillion in total turnover of retail. Roughly 46% of that is spent for food. So the market is tremendously big in turnover and very resilient, which also shows that the largest retailers in the world, so if you take the top 20 retailers in the world, 65% out of those retailers are food retailers.

Brendan Maton:
Okay. Okay. They're a risk, Stefan. I'm sure a lot of people listening say, "Okay, this is kind of interesting." But I look at my high street, I think about shopping centers. They're very different from even 10 years ago. In many towns and cities, the high street is not as vibrant. Well, just make a comment about that.

Stefan Zimmermann:
Well, you can compare or you can't compare a high street or shopping center to a classical food retail box because the box is effectively the stage for the retailer to make the business. So the permanent CapEx investment which you normally face as a high street or shopping center investor is effectively taken by the tenant. So they are permanently investing into their stores because they have a huge competition ongoing. So you can rather compare that to a data center where the operator brings all the recs and the GPUs with them. So comparable to the food markets where all the shelves, all the cooling equipment and all the internal fit out is done by the tenants and you don't have to pay for that as a landlord, which makes it a super easy manageable asset in that respect and gives you long-term value and long-term cash flow.

Brendan Maton:
Yeah excellent. Rory, let me bring you in here and Matt, I'll come to you afterwards. This broad perception, I'm being a bit simplistic, a bit headline, but you can refine that in your answers. Retail generally, and Stefan's making a great point, he's distinguishing here between necessity retail and the high street, which contains lots of other types of discretionary spend. Retail, nevertheless, it feels a bit like office, a bit unloved, a bit out of fashion, certainly versus beds and sheds, some of the other sectors in retail. What are your thoughts, Rory?

Rory Morrison:
Yeah, you're right. We should differentiate. Retail is a very broad spectrum, lots of little micro pockets from luxury and shopping centers to high street retail warehousing, F&B, leisure. There's a broad spectrum there. And those parts of the retail space do operate very differently and they've had their moments. As Stefan was saying, he's been in the industry 30 years or so. I might be a bit more than that,
but we'll both have scars and many of those deeper scars were formed through a retail experience because e-commerce, COVID and other factors have hit that sector so hard and there's so much kind of fashion and trend and sensitivity in the way retailing works. It's had some very volatile moments. We should recognize those scars, but that shouldn't stop us from reconsidering. And as long as we do so in a lens that's relevant for today. Now, beds and sheds is, everyone's been talking about it, those pockets of growth, they've had a very strong run. There's lots of structural fundamentals as to why COVID drove the sheds story, just population growth is driving the bed story. But arguably some of those markets are so heavily demanded that pricing is no longer attractive and returns are hard to deliver. And that's where on a relative basis, retail starts to look interesting. And if you can do your diligence, understand those sub-sectors we were talking about a moment ago and find those pockets of resilience, find where there are opportunities for growth, that can make a really compelling story. Opportunities that are lighter on CapEx, as Stefan describes, whereas shopping centers and High Street, you can have some quite high CapEx, either direct landlord cost or incentives to give to your tenants to get them into those spaces. But five, 10, 15 years ago, diversified European portfolios would have 40% of their portfolio in retail. That's something like 10% today. So that's been a massive shift. So you can see why pricing has moved so far because that demand has just walked away from the sector. We're now seeing those allocations to retail growing. We are looking to do that as well ourselves. Some of that we've done in partnership with Stefan, which guess what is why he's with us on the call today. But that's building momentum and giving us opportunities. But that lens that you look through has to be picking up those factors that you really need in your portfolio. And we think there are pockets of opportunity today.

Brendan Maton:
Okay. I will explore those factors. And we've got a couple of examples, I think both from yourself and from Stefan. Matt, on the debt side.

Mathew Crowther:
Yeah, look, I think Rory's described what is a really unique buying opportunity, particularly for putting new capital to work or if we're financing people that are putting new capital to work and particularly on assets where now we can see how they've performed over the last 10 years. If they've survived COVID, if they've survived this shift towards e-commerce, they're very likely going to have some very resilient income profiles. I think the other key factor for us in Europe is just the sheer lack of new supply or development. These market shocks has been capital being taken out of the system. We see annual construction pipelines maybe replacing about one, one and a half percent of stock per annum, which is a 40 year low in Europe. So the threat of competition or new supply isn't coming, but actually from the debt side, I'm also supporting people who are supplying some of this brand new fit for purpose needs-based retail in the market, particularly think convenience grocery around public transport and other hubs in big cities and connobations. Often long leased and CPI linked or inflation linked leases also, which is great. So that provides a resilient income to pay my debt. So maybe just another way of looking at the opportunity.

Brendan Maton:
Yeah. And I guess from what you're saying, there'll be more of those, I'm going to call them greenfield, would they be greenfield? Are you speaking to the operator?

Mathew Crowther:
Yeah. And also urban regeneration as well, sometimes repurposing other assets in cities and towns for these purposes.

Brendan Maton:
Yeah. Yeah. Super. Okay. Stefan, let's return to you. You're looking at necessity retail. What are your top three criteria? You can't say location, location, location.

Stefan Zimmermann:
Damn, that has been the three. No. It's obviously in the first instance, the amount of sales space per capita. So that is especially true for the areas in the more rural sectors of Europe who are losing inhabitants in the future. So having said this, you can even invest into a shrinking city if you have the best location, which doesn't necessarily mean that you need to be in the prime heart of the city next to the church, but you should be very well accessible, you should be very good visible, or you should have a neighborhood around you, which includes all the pockets. So very dense East German prefab housing area, which has 30,000 flats and five minutes walking distance is a perfect location despite having only maybe 80% of purchase power because pockets walk and purses walk every day around the block. And the last one is, and that is something which is especially true in what all Matt said. How well does the current piece of real estate, the current space fits to the concept of the tenant? And that can go into both directions. If you are able to expand that space because it's too small, you have an additional value angle. If it's too small and you can't expand or you can only expand without then sufficient parking spaces, for example, you might lose a tenant in the future. And that is something which we are very intensively looking at. And especially when it comes to this per capita sales power, we have developed a special model to decide where's this one person going who lives in the middle of five minutes walking distance to little and five minutes walking distance to Aldi. And that comes down to region because certain regions have certain acceptance grades for certain tenants. So in the south of Germany, an Aldi is favored over Little and in Eastern Germany a Confluent is favored over Anetica. And that all flies into that model, into this valuation model. And then we know what is the potential turnover.

Brendan Maton:
Super. I liked everything you said there. We're going to come on to that point about expansion. And it's funny, you mentioned the biggest developers in the world. There's something to be said for distribution from existing boxes, this development where it's possible, but it does change that sense of online is one thing and physical is another. But let's park that though. That's where we're going folks. If you've got any questions, as I say, for Stefan Zimmerman or for Rory Morrison or Matt Crowther from PGM, just fire them in. We can take them any time. Actually, I'm going to stick with you, Stefan, and talk about what you have declared as your favorite topic, rental, growth, affordability.

Stefan Zimmermann:
Yeah. Well, starting with the first statement, I think, which Rory and Matt will probably sign off as well. The whole sector of grocery retail has rarely been touched because the lot size is so small. So it was much more interesting to

invest into a Prime Street, high street asset, which was like a hundred million instead of buying 30 smaller supermarkets for three million because it was underwriting intents and its management intents and so on and so forth. So having said this, the typical developer of such an asset is a mom and pop developer in the local neighborhood who has a very good relationship to the expansion guy of the tenant. And rents have never been calculated on affordability, but rather on, oh, that is a price for land, that was a construction cost. I give you two annual rents and profit and then actually we determine the rent from that.
That is point one which has already a substantial under rent, which also defines a substantial under-rent. The second is with indexation clauses in the leases which have holiday periods, thresholds and pass through periods, you also have another under rent because the retailers outperform inflation in relation to their turnover massively. So to give you an example, on the last 25 years, the Schwartz Group, which is the owner of Liel and Coughlin, had a turnover growth from 80 billion to 160 billion. So they doubled in size. And the rent actually increased lower than inflation. And if you look at rent to sales ratios, when someone started at 3.5%, 15 year later with a typical German indexation clause, he's at 3%. And then he renegotiates and because the typical owner is like a single one of mom and pop owner, gets super scared when the retailer complains. I always say you need to get worried if the retailer stops to complain because then he has real problems. As long as he is complaining it's super, you know that the business works very well. Then you have this fundamental under rent actually is structured over years. And what we clearly see is if you have the patience as an owner to keep those assets long term, there's situations where you can double the rent, but a 20, 30, 40% uplift is the normal situation for such assets after the lease has been terminated or ended.

Brendan Maton:
Right. I'm going to come onto ambit of strategies. Rory, you mentioned PGIM, large, Pan-European team, but I can't resist that statement of Stefan just letting it go without maybe Matt, any thoughts here if there's room, there's fundamental reasons why rental growth could be higher. Does that shine with you? Because I'm thinking about income streams and then turning into coupons.

Mathew Crowther:
No, absolutely. So we rely on the rent to pay our interest on our debt positions. And it's interesting because I think Stefan was talking about this idea of rent affordability and was also touching on this concept of retail and broader distribution. And so if you think about rental growth opportunities, take something maybe that's an unloved sector like retail warehouses, for example. And some of these retail warehouses may not have a grocery anchor within the asset themselves, but they may have a shadow anchor. Often there's a big grocery store nearby, which is kind of bringing footfall. But actually one thing we've found in this sector is that take logistics and inner city logistics distribution. We've seen what, eight to 10% rental growth per annum for the last five years in parts of the UK. So actual distribution rents, if you want to run a warehouse, is very expensive. But if you're a retailer, you're offering front of house, come and look at my goods, my washing machine or my TV, but actually using the back of house as quasi distribution into the suburbs, that can be quite affordable compared to where a logistics asset might be. So I think actually where rents have reset, that opportunity to be seen as a supply chain to suburbs and the comparative against where logistic rents have gone do allow that opportunity for rents to catch up. And I think retailers are starting to be aware of that in terms of their pricing and trying to capture this to get their goods out into the public.

Rory Morrison:
That growth, Matt, gives you headroom, right? So that makes those interest payments more affordable. For an equity investor, that's straight as a wash-through to our ability to distribute to our investors. So in what may be a low growth environment in Europe for the next few years, finding cash flows and income streams that have the potential to grow is a really exciting opportunity for sure.

Brendan Maton:
Yeah. Excellent. Good. This is what we want. Positivity. Positivity. Where can we find good opportunities? Rory, just talk to me about, because Stefan obviously majors in Germany, not sure if it's exclusive, but you're all of Western Europe. So just define the ambit of your strategies please.

Rory Morrison:
Yeah. And it's pretty unconstrained to be fair in terms of established Europe. It's got a kind of Western leaning at the moment. So the mandates that I oversee are invested in the UK, France, Germany, Italy, Spain, and the Netherlands. We have an ambition to lean into the Nordics, albeit that's a tricky market. A lot of local capital is quite competitive in that space, has tax advantages, et cetera. So it's not easy to break in. But UK, France, Germany are the largest, most liquid markets, maybe not the most transparent necessarily. It comes and goes a little, but that gives us opportunity. And I think what Stefan was talking about in terms of location quality, we're not talking macro, we're not necessarily talking countries. With a lot of these investments, we're talking cities and neighborhoods. And that's where these kind

of partnerships where we have a pan-European opportunity set and we can partner with local experts to get under the skin. There's no way that we as PGIM can have enough people in our team to be experts in every sub micro market around Europe. So we need to leverage relationships we have with teams like Stefan to help us filter those opportunities and really make the best stock picking decisions we can as a team.

Stefan Zimmermann:
Yeah. If I may add one point there. Please. The interesting part about investing into the sector is also the tenant base. So you have effectively the same covenant in the different countries. So if you go with the Schwartz Group or if you go over the Tesco or you go over Geronimo Montan, you have the same credibility, the same covenant, the same rating for each and every country, but obviously you get different return profiles per country. So Italy is much cheaper than Germany, actually. Poland is much cheaper than Germany. France is a bit more expensive than Germany. UK is much more expensive than Germany. But this is something which is super interesting because you can mix a portfolio, which obviously local knowledge already just mentioned, but still have an underlying undisputed tenant with an income profile that really helps you to match long-term returns. And actually also, as I used to say these days from the family office side, cash is king, right? So you can distribute capital, you can dividend stuff out instead of being rich on an exafile. So that's the interesting part.

Brendan Maton:
Yeah, yeah. Excellent. Yeah. Well, I mean, you're sounding like diversification, Stefan, that's what you're talking about. I'm going to come back to you, Rory, because we had three great selection criteria from Stefan, and they're going to ask you, you're in a different place, different strategy. We've established that. And these are your three criteria, Rory, when you make selections. And by all means, you may want to caveat and say in retail, across core equity, you decide.

Rory Morrison:
Yeah. Look, with a remit as wide in terms of sector and geography, I don't think there's one rule or three rules for that matter that work across markets. And I can give an example maybe, which is a way to avoid answering the question that relates to retail. So two investments that we've made recently for mandates. One was a retail warehouse park in Manchester, which is the second, third city in the UK, embedded within the urban infrastructure, a larger asset. So it was around 100 million pound investment in one deal, multiple tenants. And the retail warehouse concept, bigger boxes tends to be bulky goods, but that's moving now. And actually the demand in that asset is coming from retail, from food retail and from everything from the upper mid-market M&S type tenant profile to the discounters. And that's a reflection, I think, of the demand and the economic position that that part of Manchester is in. Now, that's very much a city you'd recognize, a city you'd probably want to visit, maybe you have if you're a sports fan of some sort, but it's embedded in the urban infrastructure of a leading city. And at the same time, there's another investment which ballpark is around 100 million, but maybe it's nine assets in regional German cities and towns, locations you probably haven't heard of and locations you probably won't ever visit. And those both offer very different but remarkably similar kind of risk return characteristics for those strategies. High initial income, opportunity for NOI growth, retail tenants who survived, as Matt was saying earlier, survived e-commerce, survived COVID, survived the cost of living crisis, survived this CVA environment in the UK where retailers can walk away from leases as part of a restructuring. And if those units have survived, that gives you a really good sense of their resilience. But at the same time, that cash flow has stability, good underpinnings, everyday needs, people shopping in those retail outlets daily, weekly. That's the same profile that we're getting from the food anchored retail portfolio in Germany, albeit the locations are completely different quality in a kind of filter. So I think it's really hard to make one rule. I think what is key is that the real estate is future-proof in that it will have a continuing demand from the retailer. And in order for that to work, you've got to have a continuing demand from the customer, from the wallet. And that's where those factors that Stefan brought in are so important to understand.

Brendan Maton:
Yeah. I'm remembering his first criteria, just effectiveness. Is this the one people go to regardless of the size of the town, the attractiveness of the town to visitors like you're saying about Manchester. Let's go to those regional German towns though, Stefan. I know what Rory is saying, but you've got an amazing fact for us, which is the percentage of Germans that live, is it three minutes walking from -

Stefan Zimmermann:
Yeah, three minutes walking. Yeah.

Brendan Maton:
Three? Yeah, we should have run a poll in this.

Stefan Zimmermann:
Yeah. So actually Germany is in Europe the most dense food retail conglomeration. So we have roughly 30,000 outlets because we are the inventor of discount retail, effectively food discount retailers Aldi and Little. And the normal business model of a food retailer is totally simple. They sell the yo-code three times before they have to pay it once. So it's more like a banking game. And that's why actually in these days where you get higher interest on your daily bank account, it's for them a much better business than actually in the low interest environment. However, actually 82% of the German population has a supermarket or a discounter in three minutes walking distance, which makes them to the best last mile logistics spot you can imagine. And we call that concept your friendly neighbor. And our strong conviction is that in the very near future, you will have this as a pickup location in a combination with the Amazon locker or the UPS locker next door, but you will also be able to have the Uber Eats delivering your dinner snack over there and you just pass by in the evening, you left your job and then actually you take the food home and then you say, "Oh well, I forgot the cucumber. I promised to my wife, you just jump in, you buy a cucumber, you get out and your parcels will be delivered there and it's not dependent anymore whether you're at home or not." So this is a huge revenue profile. Actually next obviously to the topics I just mentioned on the ESG side. So a typical supermarket, a typical Tesco or a typical has a need for electricity of roughly 15,000 households. Which means if you put solar power on the roof and you sell the electricity to your tenant, you have 12 to 15% unlevered return on the current electricity costs in Western Europe. So there are a lot of add-on factors next to the embedded rental growth, which we talked about where you can gain further momentum plus make the asset on the ESG side worth more as well.

Brendan Maton:
Yeah. Excellent. Excellent. Rory, I'm going to turn to you a few links further on in the chain from this analysis Stefan is giving us, which is returns. If we think about the IPE viewers today, they're going to get returns. And I'm always curious about how any asset manager breaks down returns where you see them coming from. So as Stefan's given us how it looks from the business, you tell us how it looks from a portfolio diversified.

Rory Morrison:
Sure, sure. And I think at a very simple level, there's income return and capital return. You can wait for capital return to come to you from a market perspective relying on capital markets or you can actively create capital return through asset management, improvement, tenant management, lease management, income growth, additional income, solar panels, et cetera. We very much take the view that that active approach is what helps to build resilience in portfolios and ensure that those investments are future-proof. Buy and hold is not a strategy, it's likely to be a disaster. So that capital return you can actively create, but I think more so right now in what are relatively challenging capital markets, that income growth story is so important in terms of driving that resilience. And that's why at this point in time, this kind of strategy is a really interesting fit for us and our clients because that kind of higher day one distribution, because arguably with a slightly under-loved sector, slightly underappreciated, misunderstood sector, those entry prices can be a little discounted. So you can get in at a slightly lower cost basis, which will give you a bit of a premium income return day one. If those rents are inherently below market because of the indexation lag that Stefan described, you've got some built-in upside that you can unlock in future quarters or future years. You can then do active asset management in terms of if some of the tenants aren't quite working so well in that location, if there's too little and they're a bit too close and they're kind of stealing each other's business, maybe you can bring someone else in to add competition. Maybe you can infill some additional space because some of these locations are underdeveloped in terms of zoning. So there's the opportunity to add more floor space or there's those additional income streams like ESG, electric car charging, et cetera, where there may be opportunities for incremental growth. That we believe is the most controllable way and most predictable way to drive those returns because you are more in control of the income profile because it's about your relationship with the tenants. It's about the underwriting you've done at entry. And then if the capital market gives us some yield shift, great. Then we're capitalizing a growing income stream and we're going to do better than we even expected in the first place. But that income driver, and that's particularly relevant for the core and core plus capital that I represent. I think in the value add space is a bit more of a blend and more reliance on the capital return side of things.
Maybe that's where some of Matt's borrowers are sitting more in that space. So I won't encroach on his story, but that's certainly from where the investor base I'm representing comes when it comes to return profile.

Brendan Maton:
Yeah. Excellent. I'm going to bring in Matt. Why not? And would you say you mentioned it earlier, Matt, it's a feature. It's not everything you do, but lending to developers, getting new stuff, Bill, you mentioned the paucity of development in recent decades, which itself is of interest. You say some more and then I want to bring in inflation again because we've talked about this affordability of growth rises, which is really interesting. And I want to then just link it to inflation generally. Matt, over to you.

Mathew Crowther:
Yeah, no, of course. And look, on the development side, I think Stefan was mentioning this, sometimes you get these smaller assets that are actually not done by very large institutional investors, more sort of small to medium enterprises that need funding. They're often getting maybe 20, 25 year pre-lets from a grocery anchor and they're putting up maybe anywhere from five to 15 million to develop this asset in and around Europe for these occupiers. But I think for us to get an institutional scale, we like to work with some of those partners that have a good pipeline. So they've got a good relationship with the retailer. They're maybe going to build 10 of these assets over the next three years and create this sort of institutional portfolio. From a risk perspective, we're not developing everything at once. We build one, two, they're stabilized, then we build three, four. So you're actually just creating this very core portfolio where we're getting security over time. And then maybe to link to your question, your thought around inflation, and I think maybe Stefan can weigh in on this, right? So particularly for those grocery anchored sort of assets where you have an inflation linked income, so maybe they're giving you a 20, 25 year lease inflation linked. Obviously affordability of rent is important, but I think as Stefan's flag, we're seeing their actual retail sales grow faster than the inflation linked on the income. So as a cost of their total sales, their rent is decreasing over time, which is not a bad place to be in terms of resilience of income in this sector.

Stefan Zimmermann:
Yeah. And actually it's undefeated by online sales because on the low margin business, the typical food retailer runs somewhere between a two and the max of a 5% EBITDA margin. So if you take that and you take only five euro delivery cost, it means you need to make a hundred euro net in turnover, so 120 euro in gross turnover purely to cover those five euro in logistic costs. And the average basket is more like 20. So it's a highly loss making business. We have seen all those hype companies, Gorilla and you name it, who came up through the COVID crisis and actually then disappeared shortly after. So from a business perspective, it's a high volume business with low margin, which is super protective on the online side, but which also actually helps through, as Mat just said, through the faster growth and inflation to decrease the affordability rates even further.

Rory Morrison:
And just to add to the inflation story, I think coming back to the question you asked me earlier about the pan-European scope, if we look across different country markets, we're not talking about the same inflation and it's not being driven by the same things necessarily. And the way the indexation works on leases will be different in terms of the contractual linkage to inflation. So I think it's important to recognize, again, one size doesn't fit all. You need that local knowledge. If we look around Europe post - COVID with when we saw energy price, oil price driven inflation across Europe where Germany suffered, particularly because of imported gas prices, French inflation was much lower because they have a very strong nuclear base and they import very little of their energy. So you've already got a step change there. We look at the economics of Europe right now and actually inflation in Spain and GDP growth, there's a lot more fundamental growth in the Spanish economy today than we're seeing in more Northern Germany.
So that'll have a different impact on the inflation that gets pegged in those leases. If we were looking, for example, at food anchored retail in Spain, you'd see a very different income profile because you're pegged to a different kind of inflation because of those local factors. So I just think it's worth stepping back and inflation isn't one thing for everyone in Europe. It's a much more regionally kind of diverse metric.

Brendan Maton:
Yeah, sure, sure, sure. And hopefully you work in your favor, but these are all good questions. I wanted to ask Matt, just keeping with the debt side, although appreciate for equity investors too, there is rents to be paid and that's an important source of income. But talk to me, Matt, on your side, how the cash flows work typically for this kind of debt, because we're going to have lots of maturing pension funds, long-term retirement income providers listening today. And yeah, I mean, they've always invested in real estate for something like this.

Mathew Crowther:
Yeah. Look, from the debt side, we're obviously charging an interest rate. So when we lend, we get an upfront fee and then we charge an ongoing interest rate, which is related to the risk. So it depends on often loan to value, how much capital you're putting in versus the value of the asset. Openly, we charge a margin over the risk-free rate. The risk-free rate is typically cash to think of Eurobor or Sonya, and our margins can be anywhere from 150, 200 basis points for sort of an investment grade, 50% LTV bond-like style of loan, up to maybe even high single digits or even low teens where we're providing development finance. So we can vary the return profile. Obviously at the lower risk end, what we want is most of our interest to be paid in full from the cash flow of the assets. So we'd be sweeping the income, the rental income, paying our interest, and then the surplus would go to the borrower. Maybe something higher risk like development. Actually, you might be accruing interest for a period of time until the income switches on, but there

maybe you're also reliant on the development profit sale of the asset to pay some of that accrued interest. So it can vary depending on the risk profile.

Brendan Maton:
Yeah, thanks. Nicely mentioned. I should have put this up earlier, folks. Contact details. Who'd you get in touch with at PGM Real Estate? I hope you can read it. It is rather small. There's one phone number because the tombstones... Now, Rory, your eyesight will be better than mine.

Rory Morrison:
Well, yeah, maybe.

Brendan Maton:
We've got addresses here.

Rory Morrison:
Yeah.

Brendan Maton:
So if you want to go and visit PGIM in Frankfurt or Zurich -

Rory Morrison:
You can come and bang on the door. There's a phone number. The other way, I guess, the simplest way would be to find Matt and myself on LinkedIn and then we can connect you with the right people.

Brendan Maton:
Yeah. Yeah. Yeah. If you or Matt aren't the right people right there. Let's leave this up anyway. It's quite a nice picture. I'm glad you spoke about cash flows, Matt. I'm going to ask a tough question.

Rory Morrison:
Not me.
Brendan Maton:
Someone's got to answer this. There you are. Now I'll leave it up to your conscious and your sense of collegiate togetherness. Capital appreciation for European real estate across the board here, not talking about retail, not talking about necessity retail, returns, capital appreciation has not been great since COVID. Prices haven't really recovered, and that's quite striking for whom real estate... Most of our audience is a minority part of the asset allocation. You hope it's quite reliable. How does that matter? So the specific question for you, Matt, is how does this fact matter on the debt side? And by all means say, Brendan, you're talking generally for us at PGIM, we are better than that.

Mathew Crowther:
Yeah. Look, for new lending, new opportunities, whether it's actually on the debt or equity side now, we actually think generally all real estate's probably about 20% below trend. We've got this quite incredible revaluation and I think certainly a generational opportunity to buy into real estate at this point, given where values have corrected actually where it looks in terms of value compared to maybe other asset classes, which there's more fuel going to other asset classes than real estate. I think real estate looks actually really quite interesting in terms of where the current valuation is. And then look on the debt side, I've got this ability not to take a hundred percent of risk. I can move my loan to value and take some element of equity buffer as well. So I think that's two components that are quite important to the analysis.

Brendan Maton:
Okay, good. Rory, did you want to skip that question?

Rory Morrison:
No, no, no. I'll take a bit of it.

Brendan Maton:
You'd look terrible now if you did skip it, wouldn't you?

Rory Morrison:
I would. Yeah. Thank you for stitching me up there. Look, I don't think it's as black and white as that. I think we've seen pockets of quite extraordinary value recovery post - COVID. We saw double digit returns in the core space. We then got knocked with the interest rates in 2022. We've then seen pockets that have recovered from there. Residential has performed pretty well. Offices have, as a wider sector, have dragged. Some of that is because secondary and tertiary office has performed so badly, but some of those prime offices, we continue to see some of the highest rents ever seen in major cities in Europe with new office leasing. So again, and I keep coming back to the comment I make, one size does not fit all, and there are definitely pockets of opportunity. There are pockets of mispricing, and there are good reasons and good cases to invest to deliver complimentary returns to existing portfolios of today's entry pricing. If there's further market volatility, that will bring more opportunity. Most of our mandates have some dry powder right now, so we're able to wait. We're able to grab those opportunities if we start to see owners in a stressed position because Matt and his colleagues are turning the screw on interest payments or whatever it is that causes that fragmentation. But market volatility creates opportunity. Somebody once said opportunity presents itself to the prepared mind. So that's why we're always looking and we're always listening and there will always be pockets of opportunity even in bumpy markets.

Brendan Maton:
Yeah.

Stefan Zimmermann:
So if your underwriting counts on interest rates rather than fundamentals, then this is a huge problem. And if you have, as a team, not enough experience to evaluate, then I would say one of the major factors why we see today so many very cool opportunities is because the education base, if you have a 10 year, 12 year strong cycle there, the market yields every underwriting mistake and every junior asset manager only knows one direction and doesn't know how to work things out and how to develop something and how to create zoning and how to talk to the tenants and how to reshuffle an asset, then you can have the cheapest and most patience capital in the world. You won't make money. If you have an experienced team and you combine the intelligence around the table and you listen and you look back into a time maybe prior to the global financial crisis, then you are able to do a proper underwriting and then you can still make mistakes, but actually the chance that you make money is much higher.

Brendan Maton:
Yeah. Excellent. Excellent. Speaking as an older person, I appreciate your appreciation of experience, Stefan. Thank you. We're going to wrap up two more questions actually. One, I'm going to start off with Matt, and I'm going to follow Stefan's point about stuff being bad and this bifurcation that you notice, which I quite like and I think makes a lot of sense to people. Rory, you mentioned about office. I've heard it from other real estate managers. Matt, you mentioned earlier about retail. You've got to pass this stuff and look at taking an aggregate figure doesn't tell you enough. So for you, Matt, specifically, talk to me about workouts, this kind of stuff when things go sour. I know one senior investor on the insurance side who says if I don't see a workout team for private debt, then I'm worried.

Mathew Crowther:
Yeah. And look, I think as I mentioned in the introduction, that's what I like about not being just a credit shop or not just a bank. That's what I enjoy about being part of a real estate house. So we always structure everything so that we can step in and take control of the asset if we need to. And I'm very happy to have Rory in the same office as me and his team in the event that we have to do that. But I think there's two things for me. So one is the quality of the borrower. So if we believe in the borrower and the partner we are working with, but the market's turned or there's been a Ukraine war or a COVID situation, if we still think they're very good at managing the asset and they're abiding by what they said they would, we'll continue to support them if it's a market movement. But if we lose confidence in that borrower, we've got that opportunity then to step in and take control of the asset and we will manage it as our own alongside our equity team. So yeah, a really important consideration there.

Brendan Maton:
Thank you. And now the last question, and this is a toughie, some might have said we should have started with this one. I'll ask you all to put the appeal of your strategy into a broader asset owner portfolio. Okay? So just to absolutely be clear on that, in the good old days when I was young, 60% equity, 30% fixed income, 10% real estate. You can call it a model portfolio, but I want you all to say in a way what people should be pushing aside in order to give space to give room for what you do. Now I'll start with you, Stefan, because you are a bit deeper, but that's still good. What do they push aside to make space for you?

Stefan Zimmermann:
Well, I can say actually in our family office, we have strongly weighted into real estate and went away from fixed income for one simple reason. We believe, and we know that this is not the common market opinion, that given the governmental debt across the Western world, we will see in the next five years a very unique situation. We will see high inflation but low interest rates because the GDP growth is not as high anymore and the only way to be able to pay interest on the high government debts will be reduction of central bank rates. But at the same moment, that will fuel private spending and consumer spending, which will then lead to inflation. So with those asset classes, which are highly inflation linked, residential is one, food anchored retailer is the second, might be some others, you are in a very good position because effectively your debt will be worth less and your rent will increase and you have a double whammy on your income profile. That's our theory.

Brendan Maton:
Yeah. Not sure double whammy is the right phrase. Double power.

Stefan Zimmermann:
Double power, double power. Double power.

Brendan Maton:
Yeah. Thank you. Excellent, excellent, excellent. Rory, you're next.

Rory Morrison:
Well, I'm just listening to what compliance might be saying in my ear right now, and forgive me for that, working for a global investment manager. I don't think they would want me to be expressing my views on the public fixed income markets or private equity or whatever. So that relative debate is more difficult for me to offer an opinion on, but what I can stand behind is I think Research we've done, research others have done continues to show that real estate is a stabilizer and a diversifier in portfolios. Indeed, cross-border real estate probably does an even better job of diversifying performance for investors. The income component continues to be strong and resilient, and I think the entry point is attractive and actually may get a little more attractive in the next couple of quarters with some market valuation adjustments on the back of the cost of capital changes that we've seen over the last 12 or 18 months. So, I would expect that long-term position of real estate to be five to 10% of investors' portfolios to continue. I particularly like the fact that real estate equity and real estate debt offer slightly different angles on the same underlying fundamentals. And I enjoy working in the same office as Matt. So, we get to talk about what is it. And at the end of the day, the same underlying bricks and mortar, just different ways of accessing it with different capital that has either different risk appetite, different timeline. But the key for me is the best way to avoid losses is keep control of your real estate from an equity perspective. The moment the bank steps in, you're going to lose money because it means you've got a problem and the bank's agenda is different from yours. They're worried about their mortgage, not the full equity stack. So buying real estate that has resilience, holding it in structures that are not over-leveraged and having that long-term view means you can keep control of that real estate and keep control of your value.

Brendan Maton:
Okay. I'm going to imagine that Matt is subject to the same compliance as you, Rory. So I'll ask you, Matt, just to pick up on that nice contrast, Rory said you're close to each other, but there's slight nuance. Talk about the nuance for real estate debt versus real estate equity. Sorry, I've squeezed you just to one side of the screen.

Mathew Crowther:
No, that's okay, Brendan. And look, openly from the real estate debt side, I think let's pick up on the trend of credit investors generally. There's been quite significant growth in credit and private credit, but I think people now see the value of diversifying their private credit book to include hard assets. So whether that's real estate or infrastructure. So we've seen this trend of this terminology, halo, hard asset, low obsolescence in the credit world. And I think people are realizing the value of that, whether that's real estate equity or debt. So I think that's probably just an angle I'd pick up on.

Brendan Maton:
Nice, nice. Thank you very much. Thank you all three. We're slightly overrun, so I will hastily remind the audience you can get in touch with PGIM. You can probably get in touch with For Friend Investment via LinkedIn, as Rory said, or via PGIM itself. It remains for me to thank our three speakers today. It's been hugely entertaining. First, Rory Morrison from PGIM. Thank you, Rory.

Rory Morrison:
Thanks, Brendan.

Brendan Maton:
Matt Crowther, your colleague on the debt side there at PGIM. Thank you, Mat.

Mathew Crowther:
Thanks Everyone

Brendan Maton:
And Four Friend Investment, Stefan Zimmerman there. Thank you, Stefan.

Stefan Zimmermann:
Thank you all.

Brendan Maton:
This webcast will be available both on IPE and Brightalk, our technology provider for the foreseeable future. So if you know colleagues, folk in the industry, send them a link, tell them to listen in. It'll be here whenever they're ready to listen. Hopefully see you guys back maybe in 27 next year, see how things have developed.

Stefan Zimmermann:
Thank you. Have a good day.

Brendan Maton:
This is Brenda Mayton for IP, wishing all of our viewers a good day.

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