PGIM REAL ESTATE

4Q22

# Global Real Estate Securities Market Review

| | | | | | Annualized | | |
|---|---|---|---|---|---|---|---|
| **GRES Strategy Performance (%)** | **Inception Date** | **Fourth Quarter** | **1 Year** | **3 Year** | **5 Year** | **10 Year** | **Since Inception** |
| **Global Real Estate Strategy (gross)** | 1/31/2007 | 7.44 | -26.03 | -2.69 | 2.23 | 4.59 | 3.07 |
| **Global Real Estate Strategy (net)** | | 7.19 | -26.71 | -3.59 | 1.29 | 3.61 | 2.14 |
| FTSE EPRA/NAREIT Developed Index | | 6.85 | -25.09 | -4.93 | -0.23 | 2.99 | 1.18 |
| Variance (gross – benchmark) | | **0.59** | **-0.94** | **2.24** | **2.46** | **1.60** | **1.89** |
| | | | | | | | |
| **U.S. Real Estate Strategy (gross)** | 12/21/2010 | 5.40 | -26.53 | 1.84 | 6.81 | 8.30 | 9.17 |
| **U.S. Real Estate Strategy (net)** | | 5.14 | -27.26 | 0.83 | 5.75 | 7.09 | 7.91 |
| FTSE NAREIT Equity REIT Index | | 5.24 | -24.37 | -0.11 | 3.68 | 6.53 | 7.75 |
| Variance (gross – benchmark) | | **0.16** | **-2.16** | **1.95** | **3.13** | **1.77** | **1.42** |
| | | | | | | | |
| **Select Real Estate Strategy (gross)** | 8/1/2014 | 6.53 | -25.40 | 0.56 | 5.96 | -- | 6.58 |
| **Select Real Estate Strategy (net)** | | 6.26 | -26.15 | -0.47 | 4.86 | -- | 5.46 |
| FTSE EPRA/NAREIT Developed Index | | 6.85 | -25.09 | -4.93 | -0.23 | -- | 1.79 |
| Variance (gross – benchmark) | | **-0.32** | **-0.31** | **5.49** | **6.19** | **--** | **4.79** |
| | | | | | | | |
| **Real Estate Income Strategy (gross)** | 9/29/2014 | 8.44 | -15.21 | -1.43 | 3.50 | -- | 4.19 |
| **Real Estate Income Strategy (net)** | | 8.15 | -16.14 | -2.51 | 2.39 | -- | 3.06 |
| Blended Benchmark[1] | | 4.79 | -25.14 | -5.08 | -0.39 | -- | 1.52 |
| Variance (gross – benchmark) | | **3.65** | **9.93** | **3.65** | **3.89** | -- | **2.67** |

Source: PGIM Real Estate, Bloomberg. Performance based on gross returns for the period ended December 31, 2022 and does not include expenses or sales charges. If included, returns would be lower. Net performance shown is based on the mutual fund fee schedule. Past performance is not a guarantee or a reliable indicator of future results.

## Global Market Review

The macro backdrop for real estate investment trusts (REITs) in 2022 turned negative during the second quarter of 2022 as central banks acted swiftly and severely by raising interest rates to combat inflation. The raises caused investors to sell asset classes that they deemed interest-rate sensitive like bonds and real estate. Real estate and REITs, however, share both bond-like and equitylike characteristics with their high-income payouts but have the ability to grow earnings as rents increase over time. The sell-off of REITs globally totaled approximately 25%, with Europe getting hit the hardest, followed by the United States and then Asia, which was down only about 10% in U.S. dollar terms. The sell-off within REITS did not fully distinguish between strong real estate fundamentals and weak real estate fundamentals. Essentially, any REIT with a low cap rate and a high earnings multiple was sold off indiscriminately and with little regard for growth prospects. The sell-off also has created some great opportunities in property types whose growth is mispriced or undervalued — like shelter-related real estate and industrial real estate.

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The sell-off of REITs has also created a historically significant disconnect between private real estate pricing and public real estate pricing. Each time that we have seen discounts to private real estate of this magnitude within the REIT market, publicly traded REITs have outperformed private real estate on a three-year forward basis of 25 to 50%. In addition, when we have seen disconnects of this magnitude between private and public real estate, we have also seen significant M&A and consolidation activity once capital markets stabilize. In today's environment, we are focusing particularly on cross-border M&A activity, which we believe will be the first phase of consolidation. Given the remarkable strength of the U.S. dollar versus other currencies in 2022, we are finding companies whose share prices are down 25 to 35% and whose currencies are down 20 to 30%, both of which create tremendous opportunity for well-capitalized, strong-currency-denominated investors to acquire companies at generational discounts.

It is difficult to determine exactly where cap rates and net asset values (NAVs) sit today given the lack of transaction volume. However, when we try to reconcile the fact that some nontraded REITs marked their NAVs up more than 10% in 2022 — with a REIT market down 25 to 30% — we are puzzled. A closer look at the apples-to-apples portfolio composition of nontraded REITs that focus on high-quality Sunbelt apartments and infill industrial with listed REITs shows a similar disconnect in pricing, with those REITs down 25 to 30% in many cases, but the nontraded REITs up 10% or more. In short, we cannot attribute the difference to portfolio composition or property type. We believe that that disconnect will be resolved like it always has been historically, with public REITs rallying to help narrow the gap and private real estate prices declining to narrow the gap. As a result, we would expect money to flow out of private real estate into public real estate to eliminate this arbitrage opportunity.

In the first half of 2023, we are likely to get clarity on where interest rates and inflation stabilize and whether or not we have a recession or a soft landing or a less-likely stagflation scenario. Once the market gets more clarity on those factors, capital markets and risk premiums should stabilize, and we will see private capital flow into public markets and fairer pricing of real estate fundamentals and growth prospects.

We are currently finding our best opportunities in property companies with defensive demand characteristics like shelter, cold storage and healthcare. Plus, we like companies that have revenue growth at or above inflation but that trade at large discounts to NAV (i.e., mispriced growth — industrial, and manufactured housing and select global apartment and self-storage companies). In addition, we favor reopening themes in Asia like hotels.

We are focusing on companies with limited exposure to expense inflation or those with opportunities to show a deceleration in expense growth — like assisted living, cold storage and triple net lease.

Last, we are looking for the above characteristics combined with strong balance sheets with limited refinancing risk and attractive discounts to private market value.

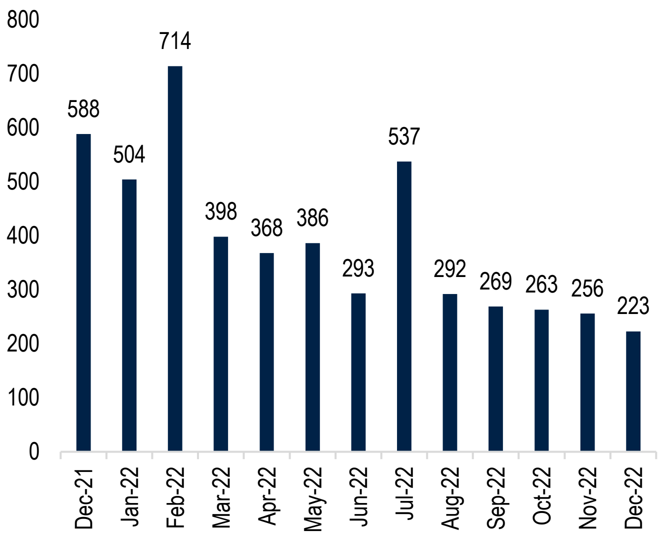
## United States

### Market Review

Despite the 5.2% drop in December 2022, the U.S. REIT market managed to post a 4.7% gain overall for the last quarter of 2022, lagging the broader, S&P 500's 7.5% gain. The year 2022 was a challenging one for REIT sentiment as the market witnessed a 240-basis-point increase in 10-year Treasury yield to 3.9% — a level not seen since 2010. In addition, growing fears of a Federal Reserve–induced recession tempered rental growth expectations for many property types. The higher cost of capital and lower growth outlooks negatively affected real estate values across the board, ultimately driving a 25.6% decline in the U.S. REIT market for the year, one of the worst years for REITs on record. The good news is that the REIT market has likely overcorrected at this point, trading at a 6.1% average implied cap rate, or roughly 260-basis-point spread to the 10-year note. Recent economic data suggest inflation pressures are easing, which should lead to more-limited and predictable actions by the Fed. We expect that the combination of a stabilizing interest rate environment, cheap valuation and relatively stable fundamentals will benefit REIT performance in 2023.

Despite recent signs of improvement in inflation data, the U.S. labor market remains quite strong, with roughly 740,000 jobs added during the fourth quarter and an unemployment rate of 3.5% at year-end. The resiliency of the U.S. labor market in the face of an unprecedented increase in borrowing costs has surprised most economists and enabled REIT fundamentals to remain better than expected. Overall occupancy levels remain high, and pricing power to push rents to record levels is evident in almost every sector. However, expense growth has been higher than expected for many sectors, limiting net-operating-income growth for lower-margin sectors.

**Monthly Gains (000) for Office-Using and Non-Office-Using Jobs[2]**

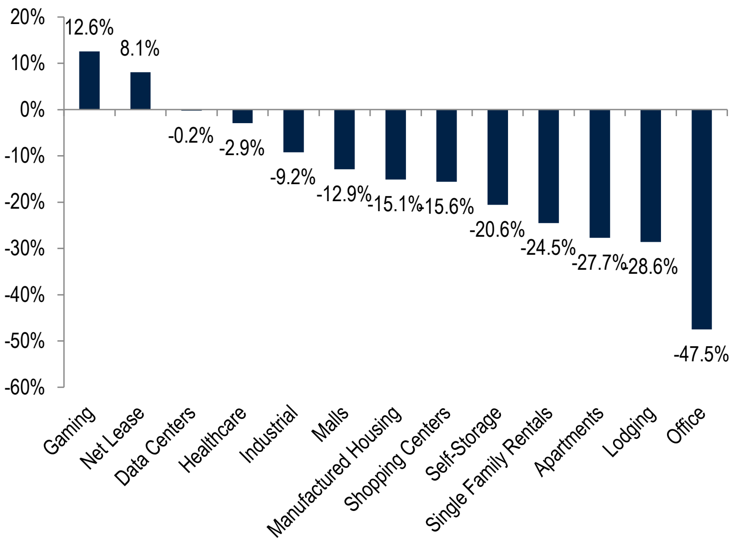



Fortunately, supply growth over the past cycle was well below long-term averages, as the combination of surging construction costs and pandemic uncertainty caused many projects to be shelved. As a result, most sectors within REITs are likely to maintain favorable pricing power even as demand eases. It's also important to point out the dramatic shift in the U.S. REIT landscape relative to prior recessions. Traditionally, economically sensitive sectors such as office, retail and lodging have witnessed a considerable drop in market cap relative to the U.S. REIT benchmark. Meanwhile, more-defensive sectors with secular demand support have grown dramatically in size, including data centers, healthcare and industrial.

The best-performing sector during the quarter was retail — at both the mall and shopping-center levels. Hopes of a soft landing for the economy helped drive performance for those consumer-sensitive sectors. We remain cautious on the mall sector, as foot traffic numbers recently eroded, and we believe the high-end consumer will continue to slow spending over the course of the year. Shopping centers also carry increased risk heading into 2023 given recent outperformance and lingering tenant bankruptcy risk.

The worst-performing sectors in during the quarter were storage and apartments. The storage sector posted a notably weak third-quarter earnings season, with extra space reducing guidance for the first time in many years. The sector is still expected to post the strongest revenue growth among REITs for 2022, but recent pricing power was not as robust as management's initial expectations, thereby raising doubt about the trajectory of 2023 growth and beyond. The apartment sector also suffered through a weaker-than-expected earnings season as the deceleration in rent growth from all-time highs was more pronounced than had been forecast. The shorter lease duration nature of both sectors leaves them vulnerable to downside surprises in rent growth. However, both sectors are supported by strong secular demand and will likely quickly rebound after rents reset from unprecedented levels of strength.

### U.S.-Sector Price/Net Asset Value[3]




## Market Outlook

The recent stability in rates — albeit early — and easing inflation pressure is very encouraging for REIT performance in 2023. The U.S. REIT market suffered a dramatic rerating in 2022 given a 26% price correction with minimal negative earnings revisions. REIT 2023 adjusted funds from operations' per-share estimates contracted only 3% from the beginning of 2022 — less than half the earnings reduction for the broader, S&P 500. Meanwhile, cash flow per-share multiples contracted by more than 2.5x the S&P 500. Barring a major economic contraction, we expect REIT fundamentals to remain steady for most property types given long lease durations, low supply risk and defensive and secular-based demand.

In addition, REIT balance sheets are in considerably better shape than during the global financial crisis. Most management teams took full advantage of the recent, historically low-interest-rate environment to lock in long-dated fixed debt costs. As result, most REITs are likely to be in positions of offense if private owners come under any distress because of the capital markets dislocation.

The current spread between REIT-implied valuations and private real estate appraised values is at a historically wide spread: at roughly 19% on an equally weighted basis. As rates stabilize, that valuation discrepancy is likely to lead to increased M&A opportunities for private-equity players looking to deploy capital toward the discounted REIT sector. We also expect large institutional investors to rotate their real estate allocations from private to public so as to take advantage of this arbitrage opportunity. The liquidity benefit of the publicly traded REIT structure has become abundantly clear in recent months and is a benefit that will likely have long-term implications for real estate allocations.

We continue to favor a barbell approach to our sector allocation by minimizing unintended factor exposure. We have added to our industrial overweight given reasonable valuation and significant embedded net-operating-income growth. Industrial REIT portfolios carry average rents 30 to 40% below market, thereby providing REITs with a strong cushion to continue posting above-average earnings growth as leases roll up to market even in the event of a slowdown in demand.

In addition, we remain positive on sectors with embedded occupancy upside and limited economic sensitivity, such as healthcare and cold storage. Both of those sectors were negatively affected by labor cost pressures in 2022, but we expect such pressure to moderate in 2023. In addition, occupancy overall remains roughly 400 to 600 basis points below pre-COVID levels, which should allow for significant top-line growth as trends continue to normalize.

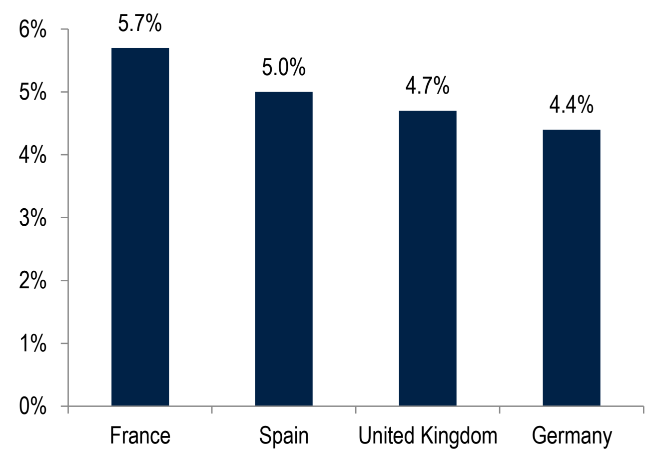
We remain cautious on lodging and retail because both sectors are more susceptible to a downturn in economic growth. And we remain cautious on office despite discounted valuations because we view the sector as only in the early stages of a multiyear secular headwind.

## Europe

## Market Review

The European REIT index bounced back in the fourth quarter of 2022 with a strong return of 13.9% (US dollar gross total return) on retreating bond yields after Europe had lagged far behind the other regions in the previous three quarters. Despite the fourth-quarter rebound, Europe's full-year total return of minus 40.9% meant that Europe still finished the year far behind other global regions. The significant U.S. dollar strength against both the euro and the pound during the first three quarters that depressed local currency returns — translated back into U.S. dollars — saw a sharp reversal in the fourth quarter, as both currencies notched up significant gains against the U.S. dollar.

### Europe-Sector Implied Cap Rates[4]




All European countries showed positive returns in the fourth quarter, but some of the worst performers up to the end of the third quarter saw the biggest rebounds in the fourth quarter. France was the best performer in the fourth quarter, with a 25.0% return, as its retail sector saw a strong recovery in investor interest after persistent underperformance the rest of the year. It was followed by Sweden, with a 24.3% return in the fourth quarter. Sweden was the worst-performing country in the previous three quarters due to investor concerns over high leverage and near-term refinancing needs in the sector. But despite its rebound in the fourth quarter, Sweden was the second-worst performer for the full year, with a minus 51.6% total return.

Sweden was narrowly edged out in last position by Germany, with a total return of minus 55.5% for the full-year period. Investors punished the share prices of German multifamily residential companies due to their very high levels of debt and rapidly rising interest costs that threatened their cash flows. All other major countries saw fourth-quarter returns below the European index total return of 13.9%. The UK (12.4%) and Switzerland (11.5%) were not far behind the index average, but Germany continued its lagging performance all year, with only a 6.0% fourth-quarter return.

### Market Outlook

The sharp sell-off in Europe in the first three quarters of 2022 opened up historically wide discounts to NAVs, but these discounts narrowed somewhat by Europe's fourth-quarter rebound. The outlook for the region, although somewhat improved, still contains multiple sources of potential risk. Threats from inflation, volatile energy prices and potential recession still cloud investment markets. Companies with weak balance sheets remain on very significant discounts to net and gross asset values, as refinancing costs have increased significantly; and these companies are still exposed to refinancing risk and falling cash flows. Cap rates have moved up in response to major upward moves in bond yields last year, but share prices are implying a still higher move in cap rates than we have seen so far in private markets. Despite significant central bank interest rate tightening this year across the region and initial indications that headline inflation has peaked, core inflation has still not been brought under control, and the outlook for demand is also weak under recessionary pressures. We retain a cautious outlook on the European region and a balanced portfolio structure.

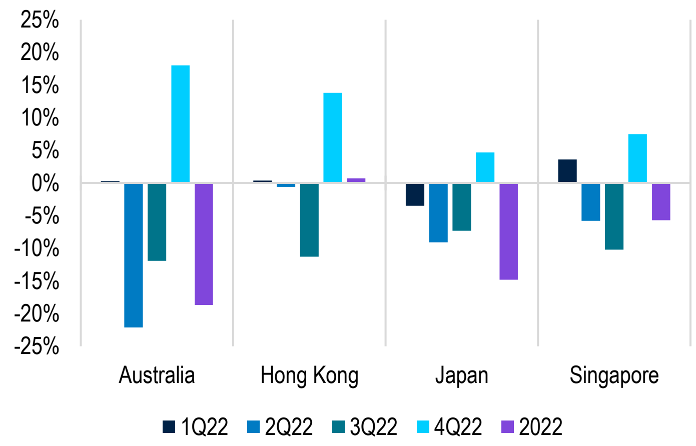
## Asia Pacific

### Market Review

Last year was a watershed for the Asian real estate equity market. The COVID-19 pandemic gradually evolved into an endemic, which prompted Australia, Japan and Singapore to successfully reopen at a measured pace. Hong Kong also reopened but at a more controlled pace. As a result, reopening names in retail and hospitality performed relatively better than names in other sectors. However, the macroeconomic environment was saddled by rising inflation and the consequence of central banks' raising interest rates to keep that inflation at bay. The raises triggered risk-off sentiment in the real estate equity market, which offset positive stock fundamentals.

All in all, the Asian real estate equity market lost 11.5%[5] in 2022 compared with a gain of 2.4% in the preceding year. Hong Kong managed to see marginal positive return for the year (0.7%), and Australia witnessed an 18.8% loss, followed by Japan (minus 14.9%) and Singapore (minus 5.8%). It is worth noting that foreign exchange volatility in 2022 played a meaningful part in U.S. dollar returns, as the yen depreciated by 13.9% in 2022, followed by the Australian dollar (minus 6.2%).

**FTSE EPRA/Nareit Developed Index Returns[6]**




Australia reopened its national border in February 2022 to fully vaccinated visa holders. The central bank raised the cash rate to 3.0% in December from 0.1% at the beginning of the year. Market impression is that the central bank is willing to wait for policy lags to play out rather than continue tightening until the full impact has been felt, by which time the hikes might be overdone. Unsurprisingly, the rate hikes led to significant price correction in A-REITs, with industrial and office witnessing the biggest declines. Retail names were more defensive for the year, supported by recovery of retail sales from reopening. Office faced the biggest headwinds emanating from concerns on leasing. JLL saw cap rate expansion of 19 to 25 basis points at the fourth quarter of 2022. Residential names were also under pressure, as home prices corrected by 7% from their peak in the first quarter of 2022 to November 2022.

Singapore lifted rules on indoor masking at most venues and eased quarantines for unvaccinated travelers in August, as the country dropped some of its last pandemic-era tightening after COVID-19 infections ebbed meaningfully. The relaxation benefited hospitality and retail — especially along the Orchard Road shopping district. For instance, prime retail malls such as 313@Somerset (owned by Lendlease Global Commercial REIT) saw about 100% occupancy, with positive rent reversion of 3.6% achieved. The Formula 1 Grand Prix night race also restarted, after a two-year hiatus, which boosted hotel occupancies and retail sales. The government announced fresh property cooling measures in September to ensure prudent borrowing and to moderate demand in the residential market in the face of rising interest rates and potential economic challenges ahead. In the transaction market, Link REIT emerged as the purchaser of Jurong Point and Swing By @ Thomson Plaza — two of Mercatus's four suburban retail mall assets in Singapore — for S$2.16 billion. The deal value was below the earlier reported indicative S$2.5-billion valuation; at a 6% discount to the latest appraised S$2.3-billion valuation at December 28, 2022, and a cap rate of 4.9%.

Japan fully reopened its borders to international travelers starting in October and without any COVID controls. Hotel names such as Invincible and Japan Hotel REIT recorded meaningful share price returns for the year, whereas others such as office and logistics lacked catalysts to see positive share price returns. Big three developers Mitsui Fudosan, Mitsubishi Estate and Sumitomo R&D announced their first half of fiscal year 2023 (April to September 2022) results in November. Pleasant surprise came from Mitsubishi Estate's share buyback of ¥100 billion (5.29% of shares outstanding). In terms of operating profit, both Mitsui Fudosan and Mitsubishi Estate outperformed, registering 30% and 27% year-over-year increases, respectively, whereas Sumitomo R&D recorded only 1.3% growth. In the final act of the year, the Bank of Japan surprised the market by expanding the band of its 10-year bond yield to about 0.5%, with far-reaching consequences for real estate, equities and bonds.

Hong Kong's performance in 2022 was affected by China's zero-COVID policy, which restricted mainland Chinese — the key drivers of Hong Kong commercial demand — from visiting Hong Kong. At the end of December, the government announced it would end physical-distancing measures, including limits on public gatherings, and it scrapped tests for inbound travelers. Notwithstanding, the equity market remained very much risk-off in 2022, and the muted performance is therefore not unexpected. On real estate, residential prices fell 16%[7] in 2022. Office rents dropped 0.9% in the year after falling 19% in 2020 and 5% in 2021. Hong Kong retail sales had recovered to 75 to 80% of 2018's level in the second half of 2022.

## Market Outlook

To say the least, 2022 was a challenging year, as the world faced a perfect storm of rising inflation and interest rates, underscored by the Russia–Ukraine conflict and COVID-disrupted supply chains that affected millions of lives. The pandemic had ushered in a period of unprecedented global monetary easing and stimulus. As a consequence, the world is now witnessing sustained and heightened fourth-quarter inflation the likes of which have not been seen for a generation. Equity and bond market volatility has become the norm, as markets vacillated between greater interest rate hike expectations induced by strong inflation data, against a slower pace of hikes when economic data revealed signs of weakening.

As global central banks converged on tighter monetary policy in the past 12 months, expectations are now solidifying of a mild U.S. recession that would put the brakes on further rate hike momentum, which presents an interesting dilemma: bad macroeconomic news could actually benefit real estate equity investments if interest rate hikes were to slow. In Asia Pacific, attention would squarely focus on how the Fed, the Bank of Japan and the People's Bank of China would move in the coming months.

We remain positive on the Australian self-storage and manufactured-housing sectors. Demographic and market consolidation trends provide structural tailwinds for those sectors. The Australian retail sector is also in recovery, as strong retail sales growth and inflation push up rents. As Hong Kong gradually moves out from the restrictive policies of the COVID era, we are positioned to benefit from the retail and residential sectors. Given rising interest rate pressure, we are underweight the Japanese developers but prefer names that exhibit strong shareholder returns with greater reopening exposure. We are neutral the JREITs but maintain a sizable overweight in hospitality names that benefit from tourism's reopening. In Singapore, we are overweight fund manager/landlord plays. For SREITs, we prefer diversified office/retail REITs and hospitality names that benefit from reopening. We also like large-cap industrial names with solid dividend growth underpinned by strong fundamentals.

Market focus now centers on the depth and scale of a potential U.S. recession as the Fed maintains interest rate hikes aimed at arresting domestic inflationary pressures. Recurrent COVID impacts, supply chain disruption, and continuation of the Russia–Ukraine conflict are other factors that continue to warrant concern. In Asia, reopening remains fraught with the risk of subsequent COVID wave impacts amid growing economic and social marginalization. The ways China manages its reopening pace as well as policies to support its housing market present major uncertainties for the country's economic outlook. For the rest of Asia, economic growth and monetary policy outlook remain dependent largely on Fed policy and global growth. On the flip side, a resilient U.S. economy could further stoke inflationary pressures and reaccelerate expectations of rate hikes. Within our individual sectors, a sharper rise in long-term real interest rates could negatively affect regional REIT valuations. In the events of setbacks on the geopolitical front, a potential U.S. recession and potential COVID-19 variants, risk appetite could remain in check heading into the year.

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Investors are advised to review the Investment Prospectus, Statement of Additional Information and other information related to specific strategies for further detail regarding the risks associated with investment in REITs and real estate securities.

The FTSE EPRA/NAREIT Real Estate Index Series reflects the stock performance of companies engaged in specific aspects of the of the major real estate markets/regions of the world - Americas, EMEA (Europe, Middle East and Africa) and Asia. The Index Series is designed to represent general trends in eligible listed real estate companies and REITS worldwide, covering Global, Developed and Emerging indices, as well the UK's AIM market. Relevant real estate activities are defined as the ownership, disposure and development of income-producing real estate. Dividends, using their exdividend dates, are used to calculate the Total Return Indices on the FTSE EPRA/NAREIT Global Real Estate Index Series. All dividends are applied as declared. "FTSE®" is a trademark of the London Stock Exchange Plc and The Financial Times Limited and is used by FTSE under license.

The S&P Global Property Index defines and measures the investable universe of publicly traded property companies. With more than 500 constituents from 36 countries, the index is ideal for a range of investing activities, including benchmarking active funds and setting the foundation for passive funds. The S&P Global Property divides into two subindices: S&P Developed Property and S&P Emerging Property.

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[1] Blended benchmark is 80% FTSE/EPRA NAREIT Developed Index/ 20% BofA Merrill Lynch 7 Const. REIT Preferred Securities Index.
[2] Bloomberg. As of December 31, 2022.
[3] PGIM Real Estate. As of December 31, 2022.
[4] Morgan Stanley, Citi. As of December 31, 2022.
[5] FTSE EPRA/NAREIT Developed Asia in USD Index as of December 31, 2021.
[6] Bloomberg. As of December 31, 2022.
[7] Centaline Property Centa-City Leading Index.