Building for the Future: Real Estate Investing in 2024 and Beyond

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The storyline is changing

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Global real estate investors have endured a volatile market. In the past few years, talk of recession risk and various structural factors, primarily rising interest rates and rising bond yields, have fueled a somewhat downbeat sentiment toward global real estate. Permanently changing work and spending habits ended a years-long streak of robust performance across most subsectors, too. However, this is the year that story changes, according to PGIM Real Estate. Investors will need to prepare for a much greater level of selection than in years past.

In its paper, "Changing the Narrative: Constructing a New Portfolio for the Next Cycle", PGIM Real Estate posits that global real estate markets are about to hit a turning point—and the entry point for investors is now. It presents a large volume of research to back this view up, ranging from observations on the cyclical nature of property value and the drivers behind this, to a granular look at how the dynamics of investment opportunities can differ on a city-by-city basis. Many of the insights and ideas presented in this paper can be incorporated into investment processes today.

This Special Report contains highlights from the paper followed by an interview with PGIM Real Estate Global Head of Investment Research, Peter Hayes, PhD. Here you will find deeper thinking on some of the subjects raised in the paper, providing a fuller picture of how PGIM Real Estate expects the next few years to play out.

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About PGIM Real Estate

With US$206 billion in gross assets under management and administration*, PGIM Real Estate provides investors and borrowers access to a range of real estate equity, real estate debt, agriculture, and impact solutions across the risk-return spectrum.

For more information, please visit their website.

*AUM/AUA data as of March 31, 2024. NetAUM is $132B and AUA is $47B.

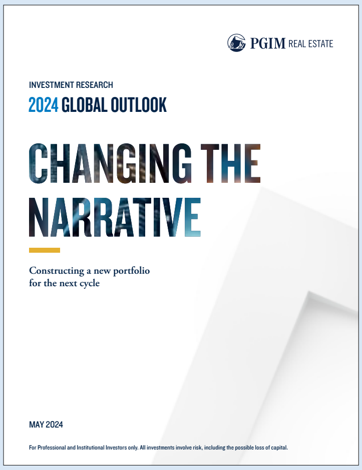
Peter Hayes, PhD
Global Head of Investment Research, PGIM Real Estate

Peter Hayes, PhD is the Global Head of Investment Research at PGIM Real Estate. He has a bachelor's degree in economics from University College, Swansea, a masters degree in macroeconomics from the University of Liverpool, and a doctorate in applied economics from the University of Sheffield.

Featured Paper from PGIM Real Estate:

Changing the Narrative:

Constructing a New Portfolio for the Next Cycle



View the full paper

Where do we go from here?

PGIM Real Estate's positive outlook on global real estate markets hinges on four factors:

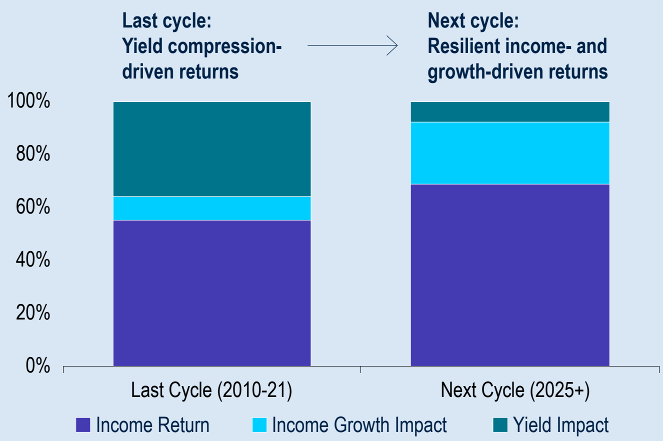
1. Impending interest rate cuts (although not to the level we have seen in the last decade or so)
2. The entering of a new phase in the real estate values cycle
3. The impact of higher interest rates now being factored into markets
4. Low supply mixed with economic resilience putting upward pressure on rent prices

PGIM Real Estate concludes that global values will hit a "trough" in the middle of 2024 before recovering soon afterward. Investors with a five-year or longer outlook can expect the highest returns if they enter markets around this trough, while investors with a timeline of up to three years will be better off moving into this market once the recovery is underway.

A tale of two cities

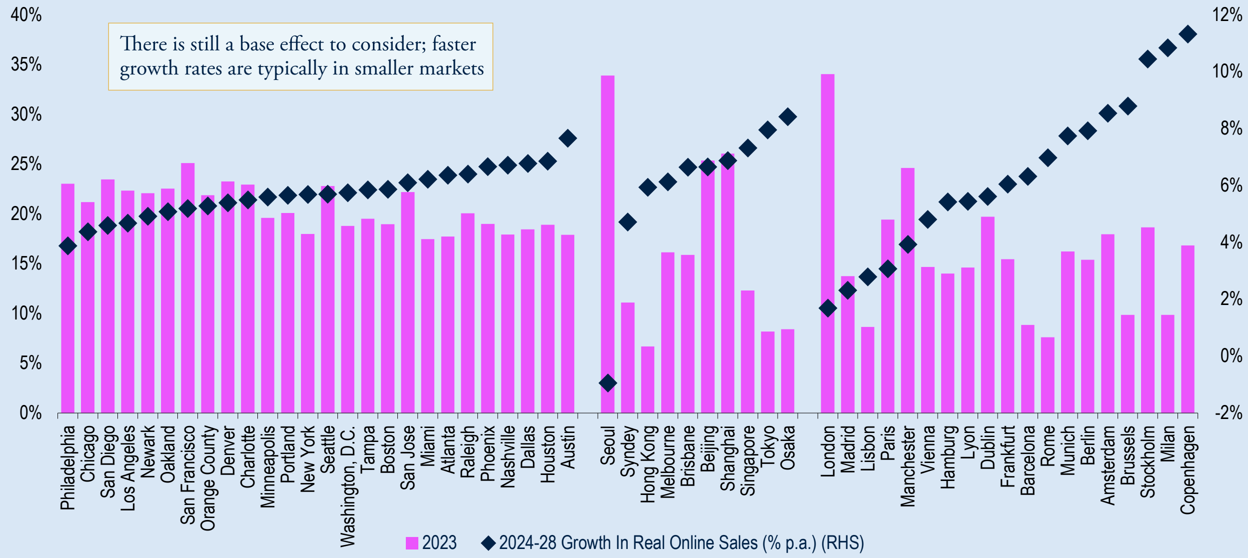
This recovery will contain many subtle dynamics that investors will have to incorporate into their positions. For example, the post-Global Financial Crisis focus on sectors is ending, heralding a return to the earlier focus on city-sector differences. And while productivity-driven cities will show higher but more cyclical (real) rental growth over time—cities classed as more employment-driven (typically with lower rental growth) should prove to be more resilient and will help the more defensively-minded investor.

Figure 1: Breakdown of MSCI Global All Property Total Returns



Note: Forecasts are not guaranteed and may not be a reliable indicator of future results.
Sources: MSCI, PGIM Real Estate. As of May 2024

Figure 2: Estimated city online penetration rates and forecasted growth in online sales



Note: Forecasts are not guaranteed and may not be a reliable indicator of future results.
Sources: Oxford Economics, PMA, PGIM Real Estate, As of May 2024

Construction work: Three portfolio strategies

PGIM Real Estate's paper outlines three strategies for building a portfolio:

Core

The Core approach is based on taking a defensive position in 2024 as real estate recovers, before reallocating to take on more growth in the years afterward. Striking this balance successfully will require good timing. Performance will be driven by strong income returns, as can be seen in Figure 1.

Value-Add

The Value-Add strategy eyes the funding gap created through a combination of maturing high interest and lower value loans, as well as the rising need for capital injections into aging property. Both city and sector selection are of prime importance. This strategy incorporates structural trends and tactical opportunities, both of which are covered in more detail in the paper.

Credit

For the Credit strategy, the paper highlights three drivers for returns in real estate debt markets: high interest income, lower Loan-to-Value attachment points, and attractive relative value versus corporate bonds. A key factor to consider within credit strategies, says PGIM Real Estate, is that deal volume will rise as interest rates fall.

Investment themes: Structural trends and tactical opportunities

The opportunities that PGIM Real Estate has identified are split into two categories: structural trends and tactical opportunities. They offer a real estate approach for investors related to each of these opportunities.

Structural trends

Structural trends include ideas driven by both the needs and long-term trends that help create demand. Drivers include changes in age and income demographics, the impact of increasing digitalization, and more resilient employment.

Tactical opportunities

Tactical opportunities consist of positions that take advantage of near-term growth, cyclical value trends, and market dislocation. Drivers include household spending on tourism, productivity gains in modern workplaces, and the growing funding gap.

The logistics driven by e-commerce come under the structural trend of digitalization. As the graph in Figure 2 shows, there are numerous opportunities when it comes to investing in the infrastructure that supports online retail.

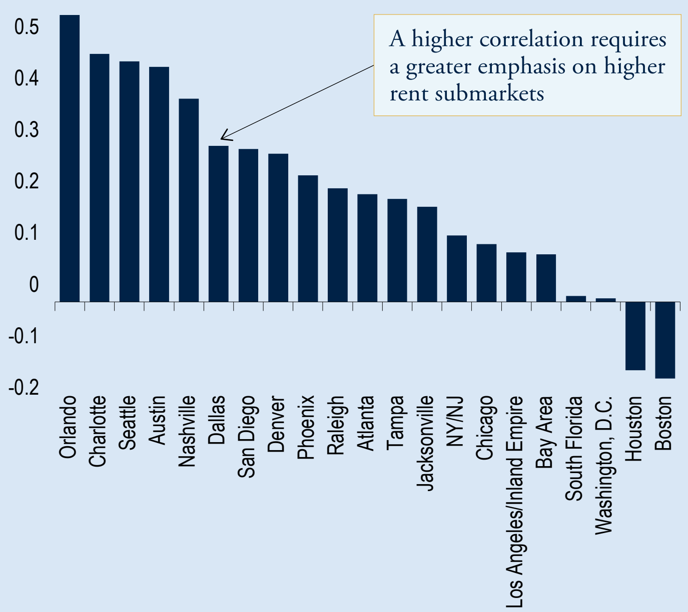
Geographical nuances

The analysis presented in PGIM Real Estate's paper highlights an important nuance to consider—that cities with low online sales and high growth potential such as Madrid and Sydney must be approached cautiously to avoid the risk of creating too much supply and overcapacity. Growth here will not necessarily follow the pattern seen in the UK and U.S.

PGIM Real Estate points out that in lower-density, non-coastal cities in the U.S., such as Nashville and Charlotte, higher rent submarkets have the potential to outperform other areas in the city. This stems from the different dynamics inherent in the higher- and lower-rent areas of these cities in relation to vacancy rates. The correlation between occupancy rates and rent levels in U.S. metro areas can be seen in Figure 3.

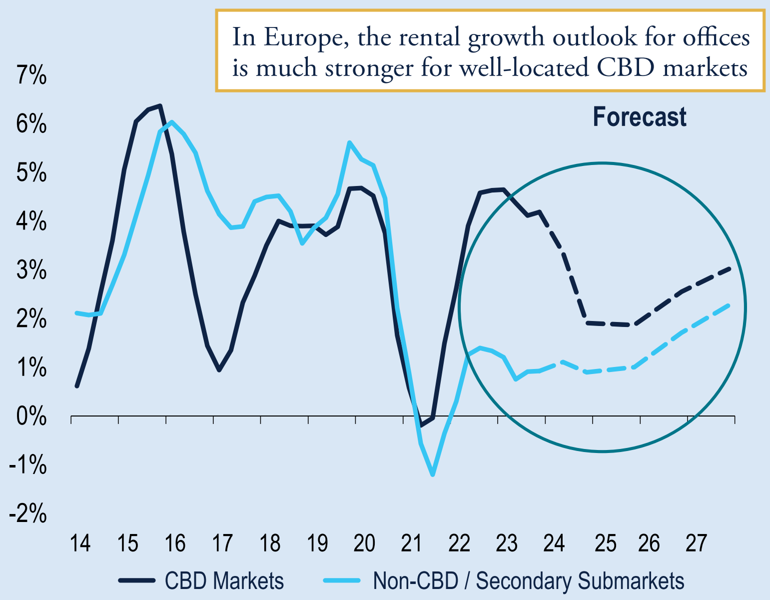
> **"The post-Global Financial Crisis focus on sectors is ending, heralding a return to the earlier focus on city-sector differences."**

Figure 3: Correlation of submarket occupancy rate and rent level by U.S. Metro Area



Source: CoStar, PGIM Real Estate. As of May 2024.

Figure 4: European office prime rental growth (%)



Notes: Forecasts are not guaranteed and may not be a reliable indicator of future results.
Source: Oxford Economics, PMA, Cushman & Wakefield, PGIM Real Estate. As of May 2024.

Identifying alternative opportunities

Within tactical opportunities, PGIM Real Estate's angle on modern workplaces proves particularly interesting. The common global theme is that rising vacancy levels are putting pressure on rental growth. However, when the situation is broken down to its constituent parts, plenty of opportunities reveal themselves.

For example, while vacancy rates in U.S. central business districts (CBDs) are rising, parts of Europe and Asia are seeing the opposite. This is down to economic, cultural, and legal differences. One of the starkest of these is the paper's argument that the adherence to environmental, social, and governance policies outside the U.S. is driving activity toward modern and efficient buildings located in CBDs rather than suburban areas. The effect of this flight to quality in Europe can be observed in Figure 4.

Mapping a clear route forward

Each of the drivers highlighted by PGIM Real Estate benefits from a similar level of analysis. Any investor involved in or keen to move into the real estate sector will take away from this paper an abundance of timely ideas and actions. Some of these include an entirely new framework with which to research cities as potential investment targets. Other readers will find the discussions on which sectors support defensive income streams and which sectors are more suited to growth-minded investors useful.

Further valuable discussion on some of these topics can be found in our interview with PGIM Real Estate's Global Head of Investment Research, Peter Hayes, PhD, found on page 10.

Ask the Expert Interview with PGIM Real Estate

The Real Estate Recovery: What it Means for Investors

Explore more thoughts on how real estate is likely to fare in the coming years with PGIM Real Estate's Global Head of Investment Research, Peter Hayes, PhD.

Interviewer
Gary Adams
Senior Investment Content Specialist, Savvy Investor

Peter Hayes, PhD
Global Head of Investment Research, PGIM Real Estate

How does the returns outlook for global real estate compare to past performance?

Peter Hayes, PhD: Our returns outlook is one that's not particularly volatile, but in aggregate it is set to be a lower returns one, especially if you look at the period just after the global financial crisis (around 2010-2016).

Our view is that over the next five years or so, returns will no longer be yield-driven—thanks to a higher interest rate environment. Instead, returns will be more about income and income growth.

We see 2024 as being a turning point. We are coming out of the worst of the downturn in real estate, and we're starting to see property values improve, and likely turning positive by the latter stages of this year.

Could you explain what your position is on interest rates?

Forecasts for the U.S. Consumer Price Index through to 2026 show that inflation is taking longer to come down. We do still see interest rates falling to the target range of 2% to 2.5% by about 2025.

If you look at the Federal Reserve's measure of global supply chain pressure, you can see that after understandably spiking during Covid-19, the easing of pressure has been the main reason for inflation coming down. But with that pressure now back to normal, it means that further falls in inflation must come from the demand side. Historically that is a tougher ask, but this is the "last leg" that central banks have been talking about.

For the past five years the focus has been on sectors. You say that selecting the correct cities and their submarkets will be a significant factor in driving performance during this cycle. Could you expand on this?

Sectors are still important, but the landscape has changed, and generating returns will require more knowledge and more effort from research teams.

We are now back to a world in which the returns on real estate depend more on the demand-supply dynamics at play. As differences in these dynamics grow—thanks to differing economic and political pressures both across and within cities—choosing the right market matters more than it has done for a long time. Understanding your local markets means having boots on the ground, it means understanding the importance of local knowledge and the value of effective asset management.

You shouldn't simply avoid markets where there is a high level of supply, however. Some of this supply might only be relevant to certain submarkets. You have to understand the impact this supply has, and of course what it means for pricing. Resilient income growth will come from understanding dynamics that go beyond the market veneer.

Identifying the cities that will have the most productivity gains is also vital for earning high returns. This is difficult because productivity proved so elusive during the previous cycle. But with job growth slowing, economic growth must increasingly come from productivity. We are coming out of an exceptionally long employment-driven cycle.

What is your approach toward emerging markets?

With real estate investing, there is no rule on which countries to invest in. After all, markets evolve as capital allocators seek new opportunities.

We view developing markets as both newly established or maturing markets within established countries. Examples include Busan in South Korea, Nashville in the U.S., or Dublin in Ireland, each having established or establishing themselves as major investment markets, and countries classed as emerging markets. Mexico, for example, is an interesting example. We invest in logistics along the Mexico-U.S. border and in doing so we get to know the country, the dynamics of the investor market, the legal structure, the market risks etc. In effect, you are better placed to consider logistics investing more broadly across Mexico. That doesn't mean you'd invest there; rather that you've already got a foot in the door, and you already understand the dynamics of the market.

Because real estate's returns relative to the economic environment will continue to improve, you will see more activity in emerging markets. But this is a long game. We can't predict where India will stand in 10 years' time. It's still a long way from attaining global capital market status achieved in advanced economies, for example according to the International Monetary Fund, but investors need to keep these opportunities in mind.

And then when it comes to emerging markets it is about understanding and pricing the risks such as capital market rules, the liquidity, the transparency of the market, the rule of law, etc. It is possible to generate high returns by targeting some of the fast-growing cities in places like India, but you have to be comfortable with risks of this sort.

Your paper talks about demand in different geographical markets. Can you talk about supply?

One big story that we've been tracking for several years is the trend decline in the net additions to stock. Major cities across the globe now have a lower-than-historically-average supply pipeline across all sectors, including office, retail, and multifamily. The only sector that bucks this trend is logistics, most notably in the U.S. and Europe. A major reason for this lower supply is the rising cost of construction. We track nominal input prices for steel, concrete, and timber, going back several decades. The prices for all these have increased significantly during that time. And this is before you even start thinking about the cost of construction itself, notably in terms of higher energy costs and wages, alongside the increased costs of land and challenges around planning permission.

To justify construction at these prices you need to have sufficiently high rents. What you have been seeing for several years now is that markets have been able to run a higher real rental growth before construction kicks in. So, in effect, despite GDP growth slowing over time, real rental growth has held up, and in some markets trended higher. And there's the upside risk that this story may be even stronger within a productivity-driven city.

How do the e-commerce growth and logistics themes play into the global real estate market? What specific opportunities do they present?

E-commerce growth continues to dominate the headlines. It drives demand for industrial and logistical spaces. And the logistics market isn't just about retail—it's also about distribution networks for business-to-business activity, to name just one example.

Our research shows that smaller cities have more potential for growth, because some of the bigger markets (such as Austin or Phoenix in the U.S.) are starting to look saturated. But remember that these smaller cities serve smaller markets, so it's important to really understand the nature of the investment opportunity. And even in bigger markets, especially within Europe, where e-commerce penetration rate forecasts have been pulled back a little, we're still looking at growth rates of 10% to 12%. Cities with strong household income growth and robust trade relationships will be the winners during this cycle.

Could you tell us more about the debt funding gap and what opportunities it might present for investors?

The debt funding gap comes from banks' reluctance to lend against real estate due to the market as well as regulatory pressure, and the fact that so much capital will have to be refinanced over the next four to five years.

Australia is an interesting case study. Banks there are creating buffers and not lending as much as they theoretically could because they are so nervous about the regulatory environment they operate in. This is why non-bank lending there has grown so quickly. We see major debt funding gaps in China, too. But this is something happening globally, not just in the Asia-Pacific region. And it is something that very obviously makes itself clear when coming out of a downturn. This growth in non-bank lending, especially in regions where regulations constrain traditional lending, is a huge opportunity for investors.

Savvy Investor Top Papers

Our Top Pick of Real Estate Papers

Real Estate Pricing: Short-Term View Needs Long-Term Perspective

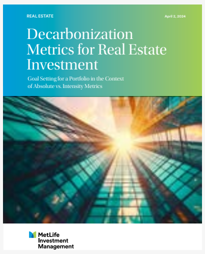
02/03/2024 | Invesco

One of the hottest questions posed by real estate investors today is "Where will cap rates eventually settle after they peak?" This question is difficult because it's flawed—cap rates don't settle; they are dynamic.

Q1 2024 Real Estate Global Trends and Tactics

07/05/2024 | Nuveen

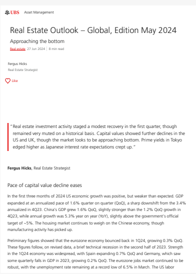
Discover the latest real estate market trends in our quarterly research report. Dive deeper into regional market and sector conditions to find out the tactics Nuveen incorporates into its investment decisions.



Decarbonization Metrics for Real Estate Investment

03/06/2024 | MetLife IM

The buildings sector is responsible for 39% of global emissions. While some industry sectors can adopt clear-cut best practices for achieving their decarbonization goals, real estate strategies require additional consideration.



Real Estate Outlook — Global, Edition May 2024

05/07/2024 | UBS AM

Two factors look necessary to spur investment in real estate. Interest rate cuts and confidence amongst investors that real estate values have bottomed out. Neither of these factors are currently in place, but they do not look far away.

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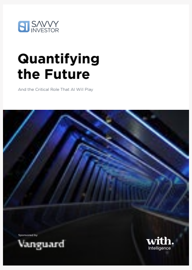

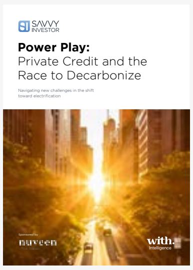

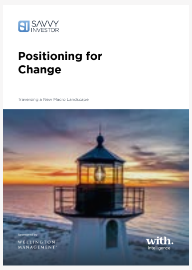

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