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Key investment opportunities emerge from real estate downturn

By Prashant Mehra

PGIM Real Estate's Australian head Steve Bulloch anticipates more challenges to come for some assets in the country's commercial real estate market this year, as investors deal with easing valuations and higher-for-longer interest rates and the prospect of further write-downs. But for some sectors and specific assets, the opportunities are already emerging and 2024 could prove to be a good vintage.

The Australian unit of PGIM Real Estate, the global real estate asset manager with US$210 billion in AUM, is primarily focused on deals in the debt segment as well as the living and logistics sectors as it waits for the worldwide property downturn to bottom out.

While the market has been resilient so far, with lenders being accommodating despite the pressure on valuations, that could change in coming months, PGIM Real Estate's head of Australia and Asia Pacific debt Steve Bulloch tells *Investment Magazine*.

"The valuation cycle hasn't fully played out yet, so we think there'll definitely be some LVR (loan to value ratio) and ICR (interest cover ratio) breaches. Perhaps the banks will take the opportunity to require some more equity," he says.

Institutional investors in commercial property have weathered a tumultuous 18 months as interest rates have soared and demand in some subsectors faltered, resulting in uncertain valuations, poor income growth and a liquidity squeeze for some portfolio managers. The segment is set to post negative growth for the second year in a row.

Still, rental growth has remained strong in many segments, helping property managers tide over a difficult period.

The downturn has also proven beneficial in the form of the 'flight to quality', Bulloch says, which is playing out through better performance by higher-quality assets, particularly in beaten-down segments like office. "The trick is determining your own definition of quality because people will have different views, but ultimately the market will decide". Bulloch says.

"Everyone would prefer to buy the shiny, new asset but the real value may come from that really good, but less obvious, asset that still attracts tenants or the asset with good bones that you can fix, and at the end of the day, will attract a buyer at the right price," Bulloch says.

Investors though, are still discovering the bottom of the cap rate cycle and this is dictating the size of the equity opportunity at the moment.

"There's still a bit of a standoff between buyers and sellers that we think will play out this year but certainly while there is that standoff, the opportunity in the debt space is very appealing to us."

Attractive debt

Globally, PGIM Real Estate has been a keen player in private debt, with US$129 billion of its portfolio held in debt assets. In Australia too, debt makes up roughly half of its $3 billion assets under management in the country.

Bulloch says Australian debt occupies a dominant position in the real estate manager's pan-Asian strategy, given the opportunity to secure equity-like returns at a lower risk profile. He credits both structural and cyclical factors for the attractiveness of the country's high-yield debt opportunity.

"Australia has some very strong structural benefits like population growth and good quality borrowers. It is also a lender-friendly and a very transparent market."

In addition, increasing regulation of the country's banks will also open up a sustainable opportunity for non-banks to operate in the debt space, he said.

The investment case is bolstered by cyclical factors also at play at the moment, as peak rates result in strong risk-adjusted returns.

"Generally speaking, interest rates going up is bad for equity investing but quite helpful for debt investing, particularly for absolute return investors because they are suddenly much more competitive with the banks. With valuations coming off, with interest coverage tests potentially being difficult in the next 6 to 12 months, there will likely be an increasing funding gap," he said. A coming wave of debt maturities will also support this opportunity.

Focus on living

The asset manager has been active in the so-called 'living sector' across Asia Pacific, executing seven major residential transactions worth US$1 billion in the region over the last two years.

These include the development of two residential-for-rent projects in Brisbane and Sydney with about 300 smaller, more affordable apartments each, and an eventual portfolio target of 1,250 to 1,500 apartments.

PGIM Real Estate is focusing on the co-living format, which puts a greater emphasis on smaller, more affordable self-contained apartments, but still very well located and with high amenities, incorporating communal spaces such as co-working, libraries and event spaces.

It comes amid a burgeoning interest in the residential sector by institutional investors, partly driven by the turmoil in the traditional office and retail segments, and partly encouraged by the Albanese government's push to build more social and affordable housing as it looks to improve prospects for longer-term returns.

"The fundamentals of the residential market here are good – you have population growth, and you've got some significant supply constraints right now which makes it a good investment proposition," Bulloch said.

"Most people realise we do need some institutional support in the residential space and we're all trying hard to find the right way to access it. I would also say that people have discovered it is actually a really good, clean cash flow compared to some other forms of real estate." In addition to co-living, Bulloch said the retirement and land lease community space can both offer high-quality, yet affordable accommodation.

The real estate business, which forms part of PGIM, the investment management arm of global insurance giant Prudential Financial, has built up a diverse portfolio in Australia encompassing investments in office, retail, industrial, hospitality, and data centres, alongside the living sector exposures, since setting up in 2011.