PGIM REAL ESTATE

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U.S. Value-Add Real Estate: Capitalizing on Opportunities in the Next Cycle

Executive Summary

Despite ongoing market volatility, we believe the case for value-add real estate investment in the United States makes sense today due to five key factors.

1. U.S. real estate values have gone through a major correction. Values stabilized in all property types in late 2024, outside of the office sector, and are expected to rebound in the coming years.
2. There is a need for capital to develop new product or reposition and modernize existing and obsolete stock to meet evolving space needs.
3. Supply pipelines are thinning rapidly as high construction costs and lower property values are curtailing construction starts.
4. Today's low liquidity market environment, in conjunction with a healthy outlook for property fundamentals, offers an attractive entry point.
5. The value-add opportunity set is expanding to a new group of real estate sectors with elevated and increasing institutional capital interest.

Five Key Themes Supporting Value-Add Investing in the United States Today

1 Value Rebound
Rising values set to boost returns

2 Need for Capital
Changing space needs will require capital investment

3 Supply Slowdown
Limited supply pipelines for many property types and locations

4 Attractive Entry Point
Illiquidity and stressed capital structures despite healthy occupancy forecasts

5 Expanding Opportunity Set
Demand for alternative property types is rapidly rising

Part 1: Why Does U.S. Value-Add Make Sense Right Now?

We identify five factors that are among the most important in determining the nature and scale of the opportunity in U.S. value-add today.

1 Value Rebound

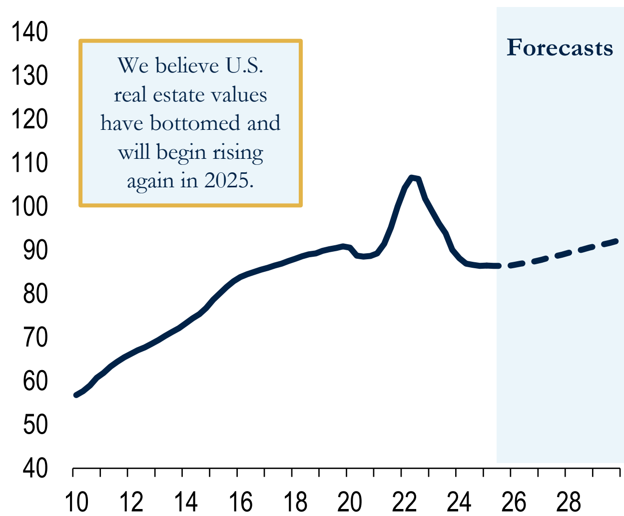
Rising values and falling borrowing rates are set to boost returns

U.S. commercial real estate values underwent a significant correction after peaking in mid-2022, driven by a spike in borrowing costs. Values are down by 19% peak to trough (**Exhibit 1**).

Values stopped falling in late 2024 across almost all sectors as short-term interest rates moved lower on the back of central bank policy easing. While office values are approaching their bottom, capital values were flat or up across all other property types in the second half of 2024 and into early 2025. Lower values limit downside risk for investors today as the yield repricing is already realized.

Exhibit 1: Values Set to Rise

U.S. Capital Values (Index, 2021 = 100)



Sources: NCREIF, CoStar, PGIM Real Estate. As of July 2025.
Forecasts are not guaranteed and may not be a reliable indicator of future results.

Defining Value-Add Real Estate

While style definitions in real estate are not set in stone, in contrast to income-driven, buy-and-hold core investments, a value-add portfolio will typically seek to generate capital value growth-driven returns over a limited period of time, based on most or all of the following factors:

- Improving the level, quality and durability of cash flows by active asset management, capex and development activities.
- Achieving a positive valuation effect by growing the income stream on a portfolio, improving its quality and risk profile to capture favorable yield shift and capturing upside from mispricing or market momentum.
- Taking on leasing risk and having exposure to non-income producing assets, such as developments or refurbishment projects.
- Investing in a broad range of real estate asset types from traditional lease-based real estate, to secondary markets and locations, to operational platforms that have a business aspect on top of owning the underlying real estate.

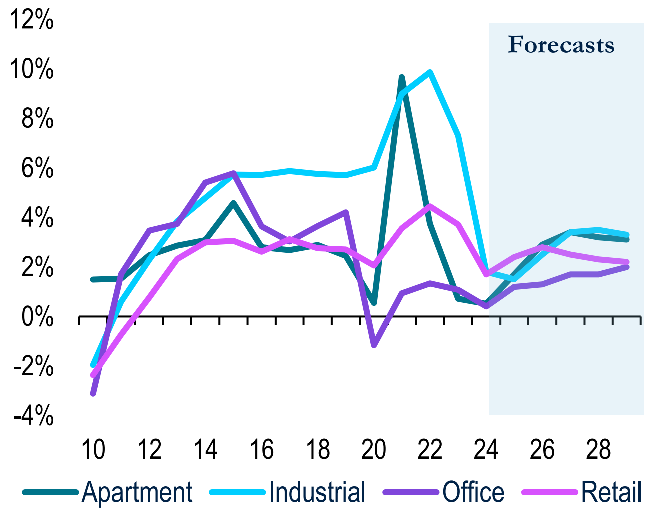
Meanwhile, there is plenty of opportunity for upside as the next real estate cycle gets underway. Values are expected to begin rising again, with parts of the commercial real estate market to rebound faster.

In the traditional sectors, an expected acceleration in rental growth beyond 2024-25 (**Exhibit 2**) will drive values higher.

Among nontraditional property types, rental growth is expected to be highest for data centers, senior housing facilities, single-family rentals and manufactured housing. All these property types will likely benefit from key structural demand drivers that will continue to influence real estate performance in the coming decade (as outlined on **page 8**).

Exhibit 2: Reacceleration in Rental Growth to Drive Values

Annual Asking Rent Growth



Sources: CoStar, PGIM Real Estate. As of July 2025.
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2 Need for Capital

Capital investment is needed to meet evolving space needs

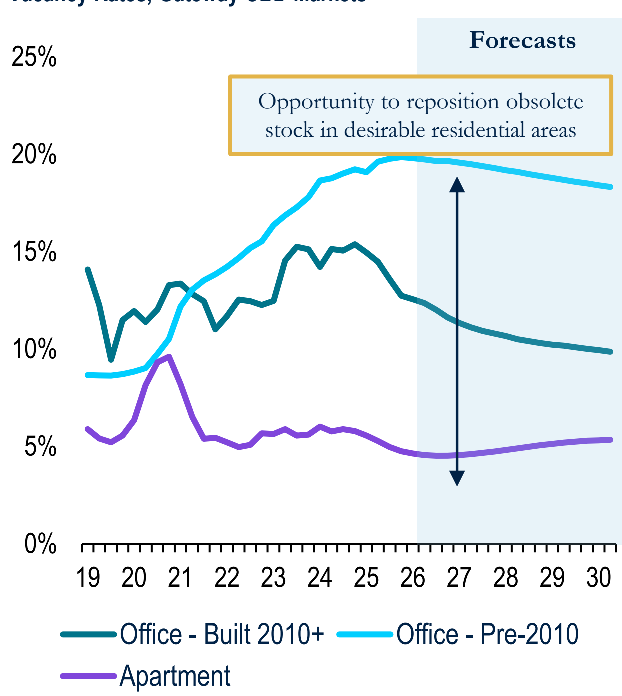
Investment will be required to modernize and repurpose existing stock to meet tenants' evolving needs. Value-add investors with significant expertise and liquidity will be well positioned to execute on these large capital improvement projects given a higher capital cost environment and complexities of modernizing property.

Currently, this need is no more evident than in the office sector. As a result of companies' recalibration of space requirements, a wide gulf has emerged in demand for older and newer vintages of office product, impacting relative vacancy rates (**Exhibit 3**).

Capital investment will be required to either reposition or modernize older stock. Apartment demand remains strong and local government incentives will increasingly offer residential conversion opportunities. Meanwhile, market conditions among newer office vintages are stronger and should improve further given little new supply.

Exhibit 3: Changing Space Needs Support Reinvestment

Vacancy Rates, Gateway CBD Markets



Sources: CoStar, PGIM Real Estate. As of July 2025.
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3 Supply Slowdown

Construction deliveries are projected to fall sharply in 2025 and beyond

New supply will be limited by factors such as higher construction costs and expensive development financing costs. This will impact supply deliveries for several years due to lags in the construction process and is already observable in new construction starts.

As shown in **Exhibit 4**, construction costs spiked in 2021 and 2022 along with broader inflation. While cost inflation has slowed, the level of construction costs remains elevated.

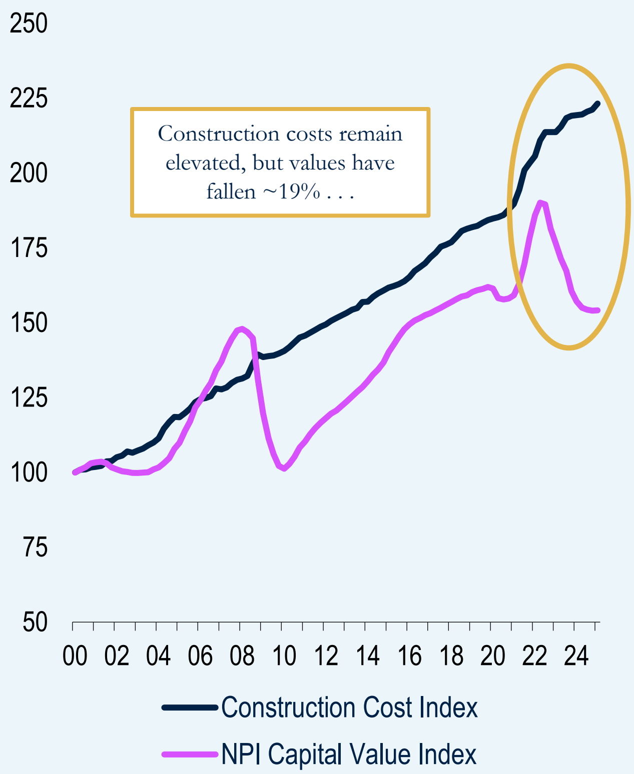
In contrast, property values dropped as interest rates spiked, creating a wide gap between construction costs and values. Combined with more expensive construction financing costs, development is now far more difficult to pencil.

A similar gap developed between values and construction costs during the GFC, which curtailed most construction activity (**Exhibit 5**).

The coming construction decline will be broad-based and evident across sectors like apartment and industrial, not just in parts of the market facing demand headwinds such as the office sector.

Exhibit 4: Higher Costs and Lower Values . . .

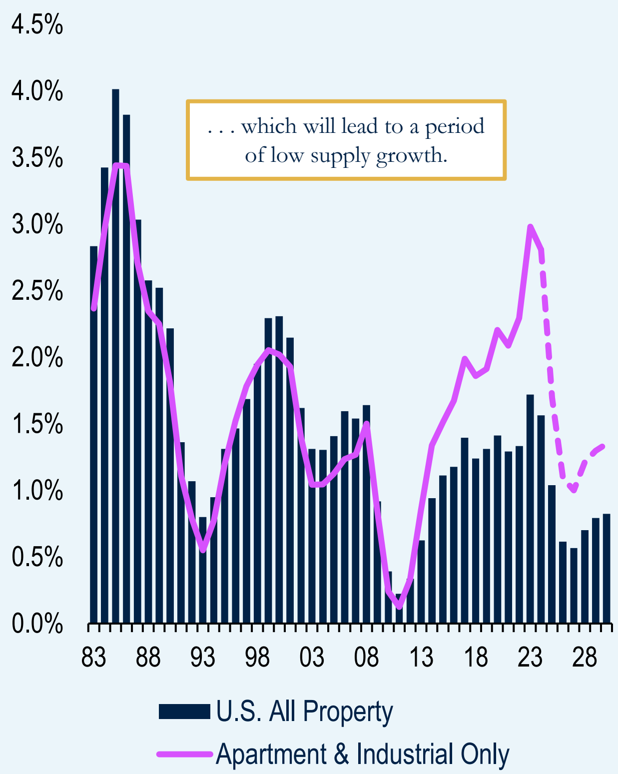
Construction Cost Index vs. CRE Capital Value Index (1Q 2000 = 100)



Sources: Moody's Analytics, NCREIF, PGIM Real Estate. As of July 2025.

Exhibit 5: . . . Mean Low Supply Growth Is Expected

Net Additions to Supply (% p.a.)



Sources: CoStar, PGIM Real Estate. As of July 2025.

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4

Attractive Entry Point

Illiquidity despite healthy outlook for fundamentals

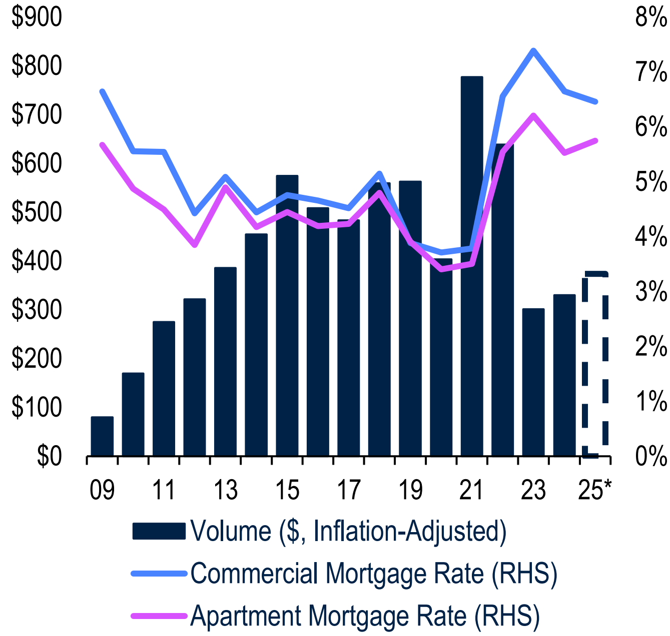
Liquidity remains low compared to the last cycle (**Exhibit 6**) but occupancy projections across many property types are at or above historical averages. This provides an entry point for value-add investors to take on lease-up risk through various strategies and identify mispriced risk in borrower capital stacks.

Value-add investors can take on lease-up risk through a variety of strategies (acquisitions, renovations, development, etc.) to target outsized returns. These strategies will be supported by the deceleration in supply growth and above-average projected occupancies across a range of sectors and markets over the next five years (**Exhibit 7**).

In the credit space, loans coming off low leverage are increasingly turning to alternative capital sources, while those with higher leverage seek flexible refinancing options. These opportunities provide attractive risk-return prospects given high base rates and a bottoming out of real estate values.

Exhibit 6: Activity Is Low, Lending Rates Are Higher

Annual U.S. CRE Transaction Volume ($ Billions) vs. Mortgage Rates



*2025 mortgage rates reflect data as of March 2025. Volume is a full-year forecast.
Source: Real Capital Analytics/MSCI, PGIM Real Estate. As of July 2025.
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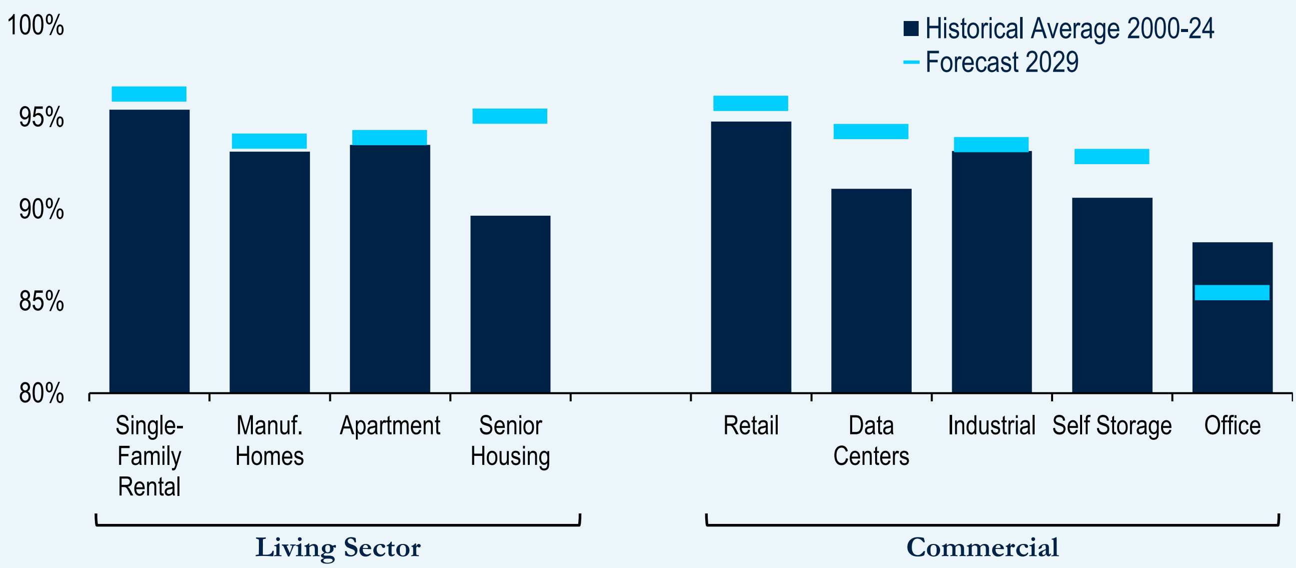
Exhibit 7: Occupancies to Be At or Above Historical Averages Across Property Types

Occupancy Rate by Property Type (Forecast vs. Historical Average)



Sources: CoStar, Green Street, PGIM Real Estate. As of July 2025.
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5 Expanding Opportunity Set

Strong investor interest and expected demand growth in alternative property types

Value-add investors will likely benefit from the growth of alternative property types both in terms of institutional investor interest and tenant demand. This includes manufactured housing, single-family rentals, self storage, student housing, senior housing and data centers, among others.

Exposure to alternative property types is swiftly rising in institutional investor portfolios, as seen in **Exhibit 8**. The increasing investor appetite for product in these sectors is improving liquidity relative to the traditional real estate sectors.

Additionally, there are several alternative property types with stronger tenant demand forecasts than traditional property types, as shown in **Exhibit 9**.

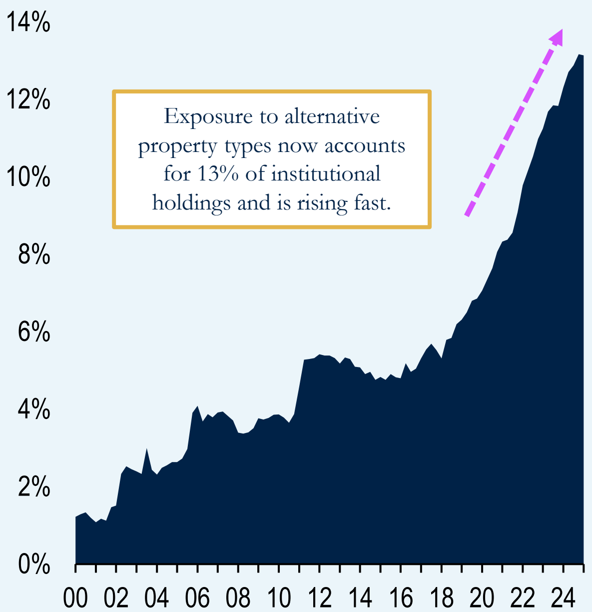
Key drivers of this demand include:

- Rapid growth in data usage in areas such as cloud computing and artificial intelligence;
- Aging populations, which supports senior housing demand; and
- Growth in middle-aged households, which supports single-family rental and self storage demand.

As a result, value-add investors can capitalize on this expanding opportunity set by either modernizing existing stock or developing new product to meet the needs of both tenants and investors.

Exhibit 8: Alternative Property Types Growing as Part of the Investment Market

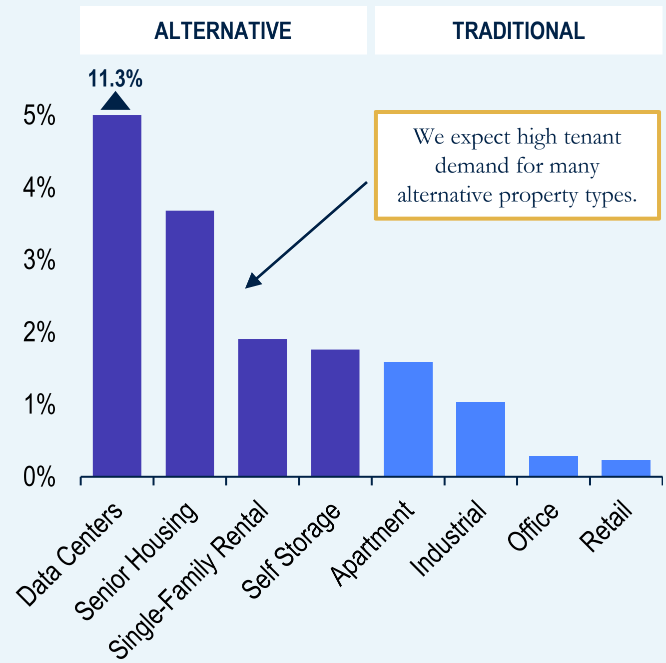
Alternative Property Sectors, % of Institutional Real Estate (NPI+ Index)



Sources: NCREIF, PGIM Real Estate. As of July 2025.

Exhibit 9: Faster Demand Growth Expected in Several Alternative Property Types

Projected Demand Growth (p.a., 2025-29)



Sources: Green Street, CoStar, PGIM Real Estate. As of July 2025.

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Part 2: Recognizing the Challenges

Aside from the typical risks value-add investors face – such as pricing, fluctuations in occupier demand and exposure to external shocks – we identify challenges that are specific to today's investment environment.

Challenge #1

Interest rates have come down, but are still higher than last cycle

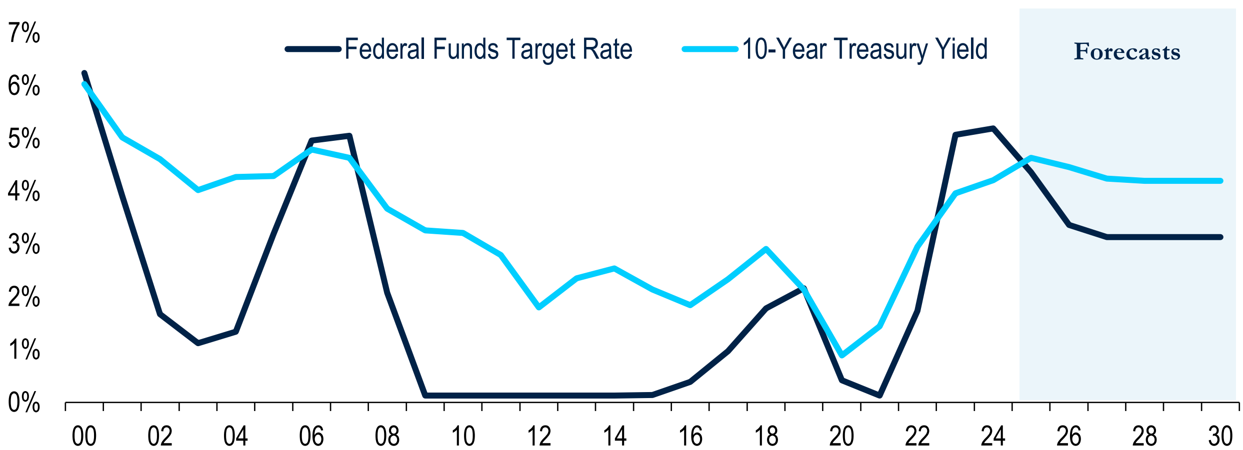
Short-term rates have started to fall, but long-term interest rates remain elevated compared to where they were in the last cycle. Forecasts are for long-term interest rates to remain near current levels (**Exhibit 10**).

WHAT THIS MEANS

The potential boost from leverage and for value growth from yield compression is lower than in the last cycle. **Returns are expected to predominantly be driven by income growth and cash flow durability, rather than market yield shift.**

Exhibit 10: Interest Rates to Remain Higher Than Last Cycle

Federal Funds Target Rate and 10-Year Treasury Yield



Sources: Oxford Economics, PGIM Real Estate. As of July 2025.

Forecasts are not guaranteed and may not be a reliable indicator of future results.

Challenge #2

Pockets of near-term supply overhang need to be absorbed

A significant amount of construction in the apartment and industrial sectors in recent years has pushed vacancies higher across many metros.

WHAT THIS MEANS

The slowdown in new supply may not generate strong rental growth immediately in some locations owing to elevated vacancies in certain markets and submarkets.

Additionally, even as vacancies and face rents improve, **investors will need to be realistic about the concessions required to maintain healthy occupancies as certain markets recover slower than others.**

Part 3: Capitalizing on Opportunities

Opportunities: Structural Versus Tactical Drivers

Broadly speaking, we split the opportunity set into structural and tactical groupings along sector lines, although geographical differences will play a role in portfolio allocation too. The following summarizes our views:

Structural Drivers

Investment conviction driven by basic needs and long-term structural themes that supports ongoing demand creation. Examples include:

- **Living and accommodation**: aging demographics, the need for affordable accommodations (**Exhibit 11**) and robust rental demand point toward an ongoing opportunity set across U.S. residential and living markets.
- **Logistics and supply chain**: rising online spending, a need for facilities that can drive customer fulfillment in urban areas and supply chain optimization are key drivers of logistics demand set to persist in the coming years.
- **Digital infrastructure**: demand for data centers is being driven by digital transformation, a shift to cloud computing and the development and adoption of artificial intelligence.

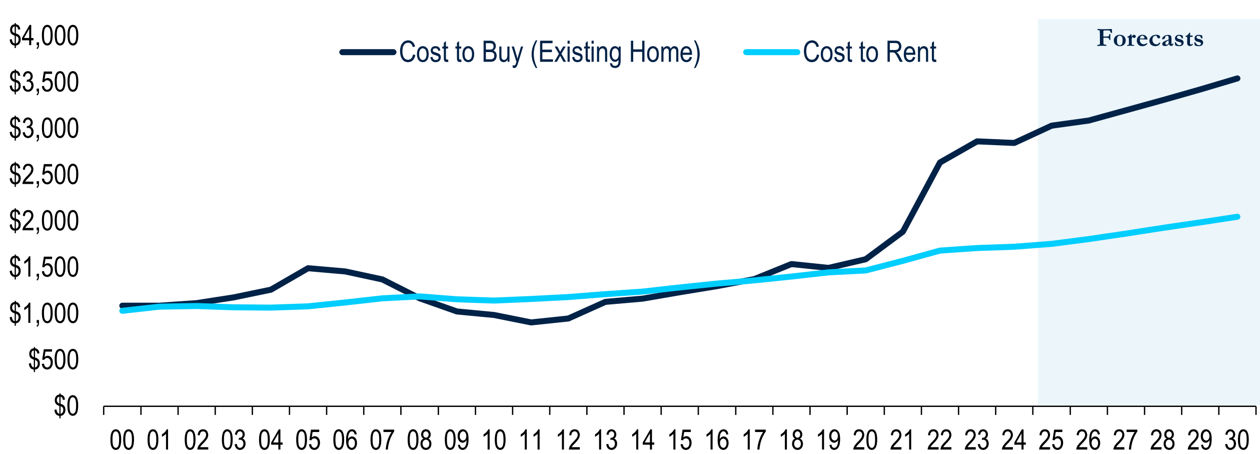
Tactical Drivers

Opportunities arising from near-term growth and market dislocation give rise to potential mispricing. Examples include:

- **Traditional income-generating sectors**: Office has a lack of liquidity in the face of demand headwinds from hybrid working, though certain segments of the market have been more resilient. There is potential for select retail opportunities given the continued lack of new supply that has buoyed fundamentals even as the share of retail sales made online continues to rise.

Exhibit 11: A Wide Gap Between the Cost to Own and Rent is Expected to Persist

Monthly Cost to Buy an Existing Home vs Monthly Cost to Rent an Apartment, United States



Sources: Oxford Economics, CoStar, PGIM Real Estate. As of July 2025.

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Building a Value-Add Portfolio for the Next Cycle

Here we assess how the different approaches to value-add investing affect portfolio allocation decisions relating to different sector and opportunity groups.

- **Development** strategies will likely focus on sectors with the strongest structural demand drivers, including the living and logistics sectors. Several alternative property types with structural tailwinds will also see more investor interest this cycle, including senior housing and single-family rentals. We expect value-add investors to benefit from strong exit liquidity for properties in these segments.

- Some areas in which **mispricing** is likely to be found include:

  1. Credit markets more generally, where some borrowers will continue to face stress from higher financing costs;
  2. Properties materially impacted by remote working that could rebound if back-to-office trends normalize further; and
  3. Properties facing headwinds from a retrenchment in technology sector hiring, which is historically very cyclical.

- **Active asset management** is effectively a key feature of all value-add investing. Yet with supply set to decelerate rapidly, investors have a unique opportunity to identify the best locations in currently oversupplied markets and assume leasing risk (through acquisitions, rehabs, development, etc.) to capture the rebound in occupancies expected in the coming years.

- Opportunities related to **institutionalization** are likely to continue in the living sector. This strategy is particularly notable in the manufactured housing space where many assets have historically been owned by small private landlords.

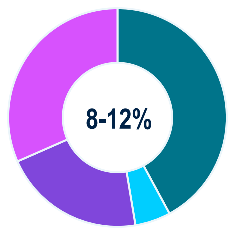
Sizing Up Different Approaches to Value-Add Investing

We identify five different value-add investment approaches in **Exhibit 12**, each with a different emphasis on how capital growth is generated and a different risk-return profile. Over the course of a cycle, a value-add portfolio would likely comprise elements of all of these.

Exhibit 12: Stylistic Target Return Range and Breakdown for Different Value-Add Investment Approaches

Mispricing

Opportunities linked to mispricing in the market, for example due to low liquidity or stressed capital structures.



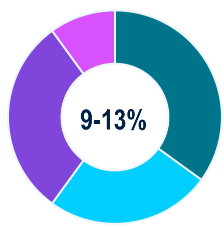
Key return driver(s): market performance plus yield shift.

Indicative target sectors: apartments, logistics, retail, office

Risk Level: Low-Medium

Active Asset Management

Taking on risk in under-managed or under-performing assets likely with vacancy or a challenging lease expiry profile.



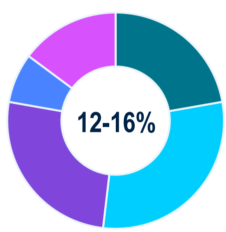
Key return driver(s): income growth via re-leasing and ERV reversion.

Indicative target sectors: living sectors, urban logistics, retail

Risk Level: Low-Medium

Institutionalize / Heavy Capex

Invest significant capex into outdated assets to institutional quality to drive modernization and meet latest building standards.



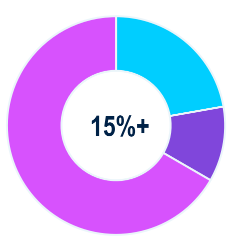
Key return driver(s): income growth and positive valuation effect.

Indicative target sectors: manufactured housing, office, senior housing, urban logistics

Risk Level: Medium

Development

Ground-up development of assets in market environment with declining construction activity.



Key return driver(s): valuation uplift and development profit.

Indicative target sectors: apartments, data centers, single-family rentals, senior housing, logistics

Risk Level: High

Income Return | Net Income Growth | Estimated Rental Value (ERV) Growth | Operational Gain | Valuation Effect

Note: Net Income Growth reflects the gain from asset management activity while ERV growth reflects the general boost to values from rising benchmark rents. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.
Source: PGIM Real Estate. As of July 2025.

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