

# COVID-19 AND THE PUBLIC REAL ESTATE MARKETS

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During this period of global uncertainty, PGIM Real Estate is leveraging the breadth of its integrated global platform – closely monitoring public real estate market trends to capitalize on timely opportunities and assess the direction of the industry overall. PGIM Real Estate has approximately \$3 billion in public real estate assets under management through its Global Real Estate Securities division and is well-positioned through active management to benefit from the significant dispersion in sub-sector performance that is shifting daily within this volatile environment.

## Assessing the Global Implications

On the global scale, uncertainty around the duration of the economic shutdown and the shape of the recovery remain the main barriers to positive investor sentiment. REITs sold off by more than 28% during the first quarter of 2020, a drop that was similar in magnitude and speed to that of the global financial crisis but is more pronounced because of the closure of social gathering-oriented real estate in most parts of the world. Global REITs are currently trading at discounts of 20 to 60% to pre-crisis Net Asset Values (NAV). Additionally, formerly defensive property types such as assisted living have been negatively impacted by the virus, which is unique to this downturn. April rent collection, however, was stronger than expected for apartment REITs, office REITs, and net-lease REITs.

PGIM Real Estate anticipates that REIT earnings streams will be less negatively impacted than the broader equity market due to long-term lease durations in real estate and high credit quality tenants. Additionally, the composition of the REITs market has shifted over the past 15 years to be less economically cyclical and is instead largely driven by secular demand-based property types, such as cell towers, data centers, single family rentals, and manufactured housing. These sectors, which represent a significant portion of the investable REITs universe, were among the best performers in the first quarter of the year and will have muted negative earnings impact. Hotel, retail and senior housing REITs, on the other hand, were the worst performers of the quarter.

Real estate trends that were in place prior to the onset of COVID-19 are now accelerating. E-commerce and especially grocery e-commerce demand is accelerating at the expense of brick and mortar retail, as new adopters have been forced to bring their businesses online. Many will remain as long-term e-commerce participants, and asset value reductions in the retail space that were expected to occur over a five-year timeline will now likely occur in just 18 months. Mandated work from home in most parts of the developed world may lead to less demand for office space globally, as firms realize that portions of their business can work remotely without a loss in productivity. While these trends could be negative for the retail and office sector REITs, they are positive for others, including “last mile” industrial, data center, and cell tower REITs. Additionally, the trifecta of low interest rates, massive and quick government stimulus, and a lack of new supply due to the construction halt are setting REITs up to perform well in the recovery.

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## Capitalizing on Global Shifts in Sub-Sectors

There remains a strong opportunity in the REITs market for active managers, as volatility and dispersion have created alpha opportunities. With the heightened level of uncertainty in the market, PGIM Real Estate's information advantage, with real-time boots-on-the-ground information coming in from its private real estate asset management teams, is invaluable in determining the most likely impact on property values and on REIT NAVs.

PGIM Real Estate's Global Real Estate Securities business is balancing opportunities between those companies whose fundamentals will benefit or be less impacted in the current environment with value opportunities in the property types that have been most negatively impacted by the virus but will be relatively quick to recover. As a result, its funds are overweight in global last mile industrial, global affordable and mid-level priced housing, and cell tower REITs based on fundamentals and valuation. PGIM Real Estate is also overweight in gaming REITs, based on valuations that reflect draconian fundamental outcomes. Additionally, the firm is pursuing select opportunities in senior housing, student housing, hotel and restaurant-based net lease REITs.

## A Breakdown Across Regions

Regional return dispersion in the first quarter of 2020 was driven primarily by how far along each region was in its COVID-19 curve, as the Asian REITs market outperformed the European and U.S. REITs markets.

### United States

The U.S. REITs market was down approximately 26% at the end of the first quarter and underperformed the S&P 500 by approximately 900 basis points, which was driven by the country's essential shutdown of hotels, malls, and casinos. As of March 31, U.S. REITs were trading at a 21% discount to NAV, versus their long-term average of a 4% premium. NAVs are likely to be revised lower across most property types depending on the duration of the downturn. PGIM Real Estate has adjusted its own 10-year rental growth outlook for each REITs portfolio in the U.S., which now shows NAVs moving down by 17% on average and puts the overall U.S. REITs market at an approximate 5% discount to NAV (with core sectors at a 15% discount), with an expected upside of nearly 20% over the next 12 months.

In line with the global trend, COVID-19 has magnified several of the pre-existing themes in the U.S. real estate market. PGIM Real Estate has increased its underweight to retail and hotels, while increasing its overweight to the industrial and traditional and non-traditional multifamily sectors. Occupancy trends in these sectors are expected to hold stable, with the government stimulus allowing most tenants to continue to make rent payments.

In office, on the other hand, the fundamental outlook has deteriorated in both the near and long terms.

### Europe

Overall, the European REITs market is trading at a 25-30% discount to NAV. Across the continent, the German, Dutch, and French office markets are demonstrating strong relative value and appropriate market rents relative to the current supply and vacancy outlook. Paris remains a low vacancy market with a low supply of high-quality office space, which will support the market during the downturn and create an opportunity for a strong rebound as the economy recovers. The greatest shift in investor preference has been in the German residential market, where regulation risks that challenged the sector in 2019 have taken a backseat to the relative safety in cash flows during the COVID-19 outbreak.

In the UK, enclosed malls have collected between 25-40% of rents due for the month of April, while urban retail collections have been roughly 40%. Office has fared better, with 85% or more tenants paying on time, and discussions are occurring regarding deferrals for much of the remaining tenant base. There has been little disruption in logistics, given the tight vacancy in the market and the large pipeline of demand for space. There is also value in Central London office REITs, where supply growth has been limited over the past several years, as Brexit created an investment overhang in the sector and market rent growth has been relatively depressed.

### Asia Pacific

Across Asia Pacific, there has been significant underperformance in retail and hospitality REITs, where rent holidays have been announced by governments in Singapore, Japan, and Australia leading to uncertainty around cash flows for landlords. In Hong Kong, where PGIM Real Estate has an overweight position, residential development REITs were already trading at trough valuations prior to COVID-19. The earlier lockdown measures in Hong Kong have also led to limited downside to share prices. The scarcity of residential land in Hong Kong will support valuations moving forward, which—for the public real estate developers—are already at more than 50% below NAV.

In Australia, PGIM Real Estate's securities business remains overweight in logistics and has taken a value position in the residential space in anticipation of an economic rebound as the country's economy reopens. In Japan, there is value within the prime office and residential development REITs, and logistics REITs are expected to continue to show the best growth of any real estate sector. While retail and hospitality REITs are screening with dividend yields not seen before, the market is only months away from sharp dividend cuts as cash flow challenges intensify with retail closures.

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