PGIM Real Estate
Europe trends and opportunities

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Recently, Jonathan A. Schein, senior vice president, managing director of global business development at Institutional Real Estate, Inc, spoke with Raimondo Amabile of PGIM Real Estate. The following is an excerpt of that conversation.

Can you give us a quick overview of PGIM Real Estate’s Europe platform?

PGIM Real Estate has been acting as a fiduciary manager for institutional investors in Europe since 1982 and established one of the first dedicated real estate debt fund platforms in the region. Its European platform manages over $7 billion of assets, which is PGIM Real Estate’s second-largest regional exposure after the United States. Of this $7 billion, 80 percent is invested in core, core-plus and value-add equity strategies. The remainder is comprised of debt, where it provides mezzanine financing for development deals. Approximately 90 percent of the capital PGIM Real Estate manages for institutional investors is through discretionary funds, with the rest in separate accounts.

Which markets are you currently focusing on?

For the past five years, we have focused on the three major European markets — the UK, Germany and France. We are a country-based investment platform, so those are also the countries in which we have offices with people on the ground.

What types of investors find your offerings attractive?

When we first began to invest in Europe, we primarily acquired European property for our US-based clients. We soon moved into managing European investments for our European clients and now have a very diversified and global investor base that invests through our funds.

What is the current market environment in Europe and the UK?

Let’s look at the UK separately from continental Europe because, even before the EU referendum, they had a different dynamic. Before the referendum, the UK was following the United States in terms of market dynamic, value increase and rental increase. Since the referendum, however, there has been a lot of uncertainty in the market. Both transaction volumes and rental growth in London fell last year and, while there are still some active Chinese and Middle Eastern investors, the London market is slowing down across all asset classes. This is due to a combination of the EU referendum, decreased demand and additional supply, especially in the residential market. In summary, I would say that for London, we are in a wait-and-see mode. As such, we prefer to deploy capital through a mezzanine financing and preferred-equity strategy rather than taking an equity position in London and the UK.

What is the market climate on the continent?

Continental Europe is in an interesting situation. In most regions, we are seeing the occupier market improving, primarily because corporate sentiment is improving, but also because supply is still limited due to a lack of available financing for new development. Germany is leading the pack in terms of growth and value increase, and we also think Paris is an attractive investment opportunity. I am fairly bearish on Italy, as I am still uncertain about when, if ever, the growth story is going to happen.

Spain is a different story. Its economy is improving, and we are seeing some growth, but it feels like it still needs to be consolidated, and the capital market is ahead of the fundamentals of the economy. We have seen evidence of cap rate compression and value increase based on growth expectations but, if this growth doesn’t occur, there is likely to be some repricing in the market. From a pure capital market perspective, continental Europe still has a very positive spread between property and bond yields and, while QE will come to an end at some point, that is still years away. In short, we are very optimistic about our investment strategy in continental Europe.

What trends is this climate generating, and how is that influencing your investment strategy?

I would distinguish trends that are driven by capital and real estate markets from those happening independently but affecting the way investors are looking at real estate investment. The biggest trend in the capital markets is the low-yield environment, which is frustrating investors, even though there is a very
positive spread between property and bond yields. In fact, this is still one of the widest spreads we have ever observed in the market. Because of the low yields, however, investors are venturing out of CBD locations, which is a natural evolution of the market. But it is also something that needs to be looked at very carefully because non-CBD locations tend to become very illiquid when the market turns. I think the most interesting real estate trend is the lack of good quality supply and limited financing available for refurbishment of vacant buildings or new development — we are actively investing in this space, and we are finding very attractive opportunities. Another trend, which is related to a structural change in the way the new generation thinks about its mobility, is for-rent residential. Germany has always been a very big market for this — the third-largest after the United States and Japan — but we are now seeing this sector developing in places like the UK and Spain. The need for supply in these markets is creating opportunities for institutional investors to develop properties and hold them for long-term cash flow.

What independent trends do you see?

The penetration of technology, particularly e-commerce, into the lives of people is also affecting real estate. We continue to see strong rental growth across a number of logistics markets in Europe. E-commerce is also putting a lot of pressure on second-tier shopping malls, which are struggling to survive. Another secular trend is our ageing population. This is driving investment into other asset classes, such as senior housing, which are beginning to move out of the niche category and becoming institutional. There is also the change in office space demands by technology-based tenants, who want to be in the centre of the city rather than on suburban campuses. They need open space designed for interaction, which is a major change from how most office buildings are designed, and this is having an impact. This is not something that is going to happen; it is happening, and it is happening fast.

You’ve talked about opportunities, but what are the risks you are seeing?

The market is becoming binary. If you can deliver a prime product, whether it’s senior housing, other residential, retail or office, you will find growing demand. If you invest in the wrong product or are focusing on tier-two, midmarket quality assets, there is a risk of low demand. There are a few exceptions, however, to the idea that prime assets are the best opportunities. High-end London residential is struggling more than low-end because it has become too expensive. Logistics, on the other hand, is booming across the board. In the retail space, both the top and the bottom are doing well, but the middle is a no-go zone. I think we are going to see this middle space completely disappear in less than 10 years’ time.

What makes certain regions and sectors more interesting than others?

We are focusing on the major liquid markets — the top seven cities in Germany and Paris. These markets are very deep, and we still see a lot of value. A lack of supply is driving rental growth, and we have completed several transactions recently in this space. We like for-rent residential, especially in Germany, and we are also focusing on the retail sector. Logistics is attractive, but it is now a very competitive market priced to perfection. So, while we’d like more logistics in our portfolio, that is a challenge right now in Europe.

What makes PGIM Real Estate different from your competitors?

PGIM Real Estate is an interesting hybrid platform. We are part of the insurance company, Prudential Financial, Inc (PFI)*, which provides us with stability. But unlike a lot of insurance company–owned investment managers, we are not a traditional balance-sheet investor, and approximately 95 percent of our capital comes from third parties. Our investor base is very diversified — we have institutional investors, sovereign funds and, increasingly, high-net-worth investors from across the world. In addition, we have deep on-the-ground relationships that give us excellent access to new transaction opportunities. In fact, 85 percent of our acquisitions in the past four years were transacted off market. That has given us a competitive edge — and we are seeing proof of this as we begin to exit some of these properties with a very good return for our investors.

value-add, debt, securities and specialised investment strategies.

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