Real Estate Debt: A Rising Asset Class
With Steve Bailey, Managing Director, Portfolio Manager for PGIM’s real estate debt strategies

David Snow, Privcap:
We’re joined today by Steve Bailey, portfolio manager of PGIM’s real estate debt strategies. Steve, how are you? Thanks for being here today.

Steve Bailey, PGIM Real Estate Debt Strategies:
I’m very well, thank you. Glad to be here.

Snow:
Let’s start at a 1,000-foot level. What is your approach to real estate debt and how have you structured this platform to succeed?

Bailey:
Inside Prudential, we have a very large investment management firm called PGIM. Inside that broad umbrella of investment management businesses, we have capabilities of both debt and equity. PGIM Real Estate Debt Strategies, is built to take advantage of those real estate debt and equity capabilities and to bring the best of the two.

So we have the fiduciary mindset, the investment expertise of the equity investor. And we’ve combined that with the origination platform and power of our debt capabilities inside PGIM.

Snow:
So let’s talk about how your group sources opportunities. You’re actually directly sourcing these investment opportunities, correct?

Bailey:
That is correct. We have a very large origination team that is in most major markets in the US. They produce a very large amount of deal flow for us to whittle through and match to strategies that we’re executing.

Snow:
Let’s talk about the growth of the real estate debt asset class. It is a burgeoning asset class, yet it’s one that maybe not every institutional investor fully understands. How do you define it? How do you define it as a distinct asset class that investors should consider?

Bailey:
Our definition and our business really operates in what we call the high-yield debt space. Then, our definition starts with essentially core-plus debt, which sits, risk and return-wise, just above CMBS or life company lending or bank lending—more commodity-like debt. And it goes all the way up,
risk and return-wise, to pure equity ownership including preferred equity and mezzanine-type lending. We can tailor strategies, risk and return-wise, that fit the specific needs of a portfolio.

**Snow:** So if an investor were to understand real estate debt as an alternative, let’s say to core equity how would they think about that? And how do the attributes compare to each other?

**Bailey:** When we say real estate debt, it can include a broad variety of types of investments, right. And so the way I think about the marketplace and what we do, is that there are some lower risk-lower returning strategies that are much more strategic and should be part of a long-term part of a portfolio. Perhaps part of that bucket of investments would be a replacement for core, although historically, the core equity replacement with debt has been more of a tactical move.

What we’re interested in doing though, is bringing to the marketplace – shedding light for the marketplace – on the opportunity to be more of a strategic, long-term investor in real estate debt and to have it be a permanent part of the portfolio. And some of the reasons that you might do that – and when I talk about long term and strategic, I’m mostly talking about core plus kinds of investment strategies but they’re income oriented. They’re low risk. They’re low volatility, and they have low correlation to real estate equity strategies as well as other major asset classes. So as a strategic part of a portfolio, these sorts of investments are meant to be income producing diversifiers in an institutional portfolio.

**Snow:** Can you give an example, on the one hand, of a type of real estate debt investment that’s maybe on the lower end of the risk-return spectrum? And another example, on the other end of the risk-return spectrum, of a more equity-like debt investment, if that’s the way one would characterize it?

**Bailey:** Sure. In our core-plus strategic approach to the market, we are looking at primarily bridge lending on stabilized assets as an alternative to a long-term, fixed-rate mortgage. We’re also looking at some lending on transitional assets. So, when you look at stable assets and light transitional kinds of assets, the cash flow from those is very predictable, very stable and, therefore, low risk.

At the other end of the risk-return spectrum, you see heavy transitional kinds of assets, [such as] historic industrial building in an urban core being converted to a multi-family building. Or you might see a development project with ground-up development and we could lend to those sorts of assets either through mezzanine or preferred equity kinds of investment—
subordinated investments. Or whole loan lending, where we are in essence taking the senior position and the mezzanine position in one investment.

Snow: Notwithstanding that investors should consider real estate debt as a long-term asset class, there was a great interest in it during the financial downturn, in which many investors looked at real estate debt as a way to dampen risk. Can you talk about how, tactically, real estate debt was used in that downturn and what the results were?

Bailey: The results were pretty good. We participated in that marketplace. Coming out of the financial crisis, the risk-return comparison of real estate debt to equity was very favorable. In our view, we were getting equity-like returns for taking very conservative debt risk. So, as a tactical move for our investors, it made perfect sense. Now, the opportunity was short-lived and it got arbitraged away fairly quickly.

Snow: As you speak to investors, do they sometimes wonder which bucket their allocation to real estate debt should come out of? Should it come out of fixed income? Should it come out of real estate? What do you think the right approach to that is?

Bailey: That is absolutely a challenge for the growth of our industry. The investors we speak to are often set up in a way where they’re different groups, their staffs are set up to be real estate or fixed income or alternatives. They have very defined strategies for what they do. Real estate debt often falls somewhere between those various strategies, so it is not a direct or easy link to—in some situations—a real estate group to do real estate debt or a fixed-income group to do real estate debt.

I think we need to be better about defining strategies and making sure that, at the top of these institutional investors, they understand the array of opportunities we can bring with real estate debt.

Snow: Newer asset classes tend to thrive as they become more transparent. Talk about how transparent the real estate debt asset class is currently and what challenges remain.

Bailey: What I defined as the high-yield part of the business lacks transparency. It is a challenge because many investors need to have solid benchmarks, very transparent ways of looking at the market comparison of different managers across strategies. And that’s hard to do right now. One thing that we are involved with, with some of our colleagues in the industry, is creating a benchmark—or a series of benchmarks—that address that transparency issue. I think it will take a few years, but if we want the asset class to be well accepted and to be more professionalized, then I think it’s an important step in that direction.
**Snow:** How do you think your kind of investing will be affected in a rising interest-rate environment?

**Bailey:** That's the trillion-dollar question. The hunt for yield across the globe has been so intense that we've seen, at least at some level...what we think is a warping of proper risk-adjusted returns. And some investors perhaps being too aggressive price-wise or structure-wise in trying to invest dollars they've raised that need to get put into the market. From our perspective, a rising interest-rate environment relieves some of that pressure, hopefully normalizes the market and gives us a return to a better risk-adjusted return with less competition that is behaving in a way that—in our opinion—might not be fully rational.