In This Report

The current U.S. cycle is the longest on record. While there are some reasons to be cautious, occupier momentum is positive, and investors remain active. Returns have slowed but the outlook is supported by the contained supply cycle and steady rental growth. Sunbelt markets are benefiting from favorable demographic trends, while investors are looking to non-core sectors such as senior housing for income growth potential. Debt strategies offer diversification and downside protection.

In terms of opportunities we highlight the following investment strategies:

- **Follow the Demographics**
  Markets with favorable demographics offer attractive returns potential, including office and apartment assets in the Sunbelt markets.

- **Senior Housing Tailwinds**
  Senior housing is set to benefit from ongoing demand growth, while supply is moderating. Elevated cap rates mean returns compare favorably to commercial sectors.

- **Debt Offers Downside Protection**
  Debt offers an attractive source of lower volatility, downside protection and diversification, while value-add debt strategies can generate attractive returns.
United States: Cyclical Expansion Continues

As the United States economic expansion nears the milestone of being the longest on record, the real estate cycle remains in the expansion phase, with steady total returns and balanced occupier fundamentals.

The baseline outlook remains positive, but the length of this economic and real estate cycle suggests a need for caution, especially as signs that the cycle may be nearing a peak are emerging. The end of 2018 brought a host of worries to light: selloffs in equity markets and tightening credit markets; concerns about slowing growth in China; Brexit; the U.S. government shutdown; and, uncertainty about U.S. trade policy.

Occupiers appear to be shrugging off these concerns – space absorption remains above average and rents are rising in most sectors – and capital markets and investors remain active, despite renewed uncertainty. Some indicators, including the nearly flat government bond yield curve and rising holdings of negative yielding bonds, suggest that investors are once again leaning toward a risk-off stance. To an extent, this sense of caution is helping to prolong the real estate cycle: real estate lenders remain conservative, keeping loan-to-value ratios low, and speculative construction is in check.

Business and consumer confidence levels have slipped from recent cyclical peaks in response to rising risk perceptions but remain consistent with ongoing economic expansion. While the outlook for GDP growth has slowed – Consensus Forecasts for 2019 and 2020 are in line with an estimated trend rate of approximately 2% to 2.5% – the Federal Reserve has signaled a pause in its rate increases, as inflationary pressure has eased.

Interest rates staying lower for longer than previously anticipated could further extend this real estate cycle. The gap between real estate cap rates and Treasuries remains historically tight but concerns about imminent cap rate expansion have eased since the Fed pause – although real estate is starting to look expensive relative to corporate and high-yield bonds.

Investor Appetite Increasingly Selective

Investors remain attracted to real estate, valuing its stable income return profile in today’s low interest rate, low return environment. Driven by ongoing capital inflows, real estate transaction volume increased 18% to $550 billion in 2018, a level broadly in line with that recorded in 2015 – the previous high point of the current cycle – and in 2007, just prior to the global financial crisis (see exhibit AM1).

Investors still have significant dry powder to invest, a legacy of the strong capital raising environment in recent years. Single asset sales volume remained elevated in 2018, while portfolio and entity-level deal volume grew rapidly, accounting for an above-average 36% of investment activity in the second half of the year – a sign that investors are looking to deploy capital quickly.

By sector, investors continue to view apartments as offering attractive risk-adjusted returns – the sector captured 31% of investment activity in 2018, slightly above its 10-year average. Drivers of apartment returns – in the form of significant regional population shifts – remain favorable, and occupancies tend to be more resilient in a downturn than other commercial sectors.
While the transformative effect of e-commerce continues to propel investor appetite for industrial properties, there are signs of improvement in demand for retail exposure. Driven by several large portfolio deals, retail transaction volume grew by 36% in 2018, perhaps signaling a bottom for the sector as investors seek potential mispricing for quality assets as the risk premium rises.

Office sector sales remained generally in line with 2017 levels. Transaction activity in gateway cities regained momentum, but investors continue to allocate more capital to secondary and tertiary cities that offer higher yields and more favorable near-term income growth potential.

**Steady Real Estate Returns**

Total returns for real estate have been relatively steady over the past two years, although the NCREIF All Property Total Return was 6.7% in 2018, down slightly from 7% recorded in 2017, reflecting much softer performance in the retail sector (see exhibit AM2).

Income returns remain stable, while occupier market fundamentals are still broadly supportive of values. Income growth continues to be boosted by rising employment and low supply, despite signs that economic growth is slowing. However, capital appreciation has dropped significantly, owing to a stabilization of yields, something not helped by weaker pricing trends in the out-of-favor retail sector.
By sector, industrial continues to outperform by a wide margin — boosted by strong rental growth and, unlike other sectors, some ongoing yield compression — while retail returns continue to slide. In 2018, retail total returns were just 2.2%, weighed down by declining capital values. Office and apartment returns have been comparatively stable in the 6% to 7% range since the end of 2016.

At a broad level, core real estate is now looking expensive compared to other financial assets. Despite a drop in bond yields since late 2018, yield spreads over both U.S. Treasuries and corporate bonds remain tight relative to their historical averages. As such, relative pricing suggests there is limited scope for further yield compression, pointing towards the slow pace of returns recorded in recent years continuing.

Conditions for investors to source and execute deals that meet target returns are becoming more challenging. Investors are increasingly looking for opportunities that offer higher yields, for example in non-gateway markets or non-traditional asset types, or that offer an attractive income growth potential to offset the impact of lower yields.
Occupier Markets on Solid Footing

Consistent with resilience of broader economic growth, occupier fundamentals remain balanced across most property types in the United States, providing continued support for occupancies and rents. Driven by ongoing employment growth in most parts of the country, tenant demand is set to expand further during 2019.

Occupancy is at, or close to, cyclical highs across most property types. While rents are still rising, rental growth looks to be past its peak, as supply growth is responding to tighter market fundamentals (see exhibit AM3). However, compared to typical real estate cycles, supply pressures remain at bay. Elevated construction costs still make it challenging to underwrite development projects, while construction lending has once again tightened.

Reflecting its increasing popularity with investors, the industrial sector offers the strongest income growth prospects. Occupier demand is benefiting from both a secular push – from the rising share of e-commerce in retail sales – and a cyclical push, from consumer spending tied to job growth and wage gains. Construction remains active, though commensurate with demand and, crucially, is restrained compared to prior cycles.

There are differences across markets. Low vacancy and persistently strong rental growth are driving increased speculative construction in coastal markets proximate to Los Angeles and New York, as well in national distribution hubs including Dallas and Atlanta. So far, new supply in these markets has been absorbed quickly, limiting the impact on vacancy.

Elsewhere, the supply chain continues to shift in response to consumer demand for faster delivery times, spurring new development in non-gateway industrial markets near large population centers including Denver, Nashville, and Baltimore. In these markets, the outlook remains positive, although additions to supply mean rental growth is set to ease back from its average of 6% per year, recorded since 2015.
Apartment market conditions remain balanced as annual completions have plateaued at just under 2% of stock since 2015. While homeownership rates have begun to edge higher, job and wage gains are generating new renter household formations, supporting steady net absorption in line with the pace of new construction. Supply remains focused on urban core submarkets – areas of cities that have high population density and, compared to suburban areas, a reliance on transit use – although construction is picking up in the suburbs.

Office absorption picked up slightly in 2018 in line with slightly faster job growth. Demand is expected to remain measured as tenants remain focused on gaining space efficiencies. Furthermore, much of the recent office demand is from highly space-efficient co-working firms, which are providing flexible options for smaller tenants, particularly in urban locations. Vacancies are now in line with or below their prior cycle lows and new office supply has been modest in most markets. Lenders remain particularly cautious towards office development, while higher construction costs are weighing on developer profit margins.

The retail sector continues to contend with the growth of e-commerce. While retail sales growth remains in line with its long-term trend, and consumer confidence is elevated, neither are translating into increased demand for retail space and vacancies have begun to move higher. There are differences across format, with malls and power centers experiencing the most significant headwinds – store closures have included even profitable retailers, leaving landlords facing expensive capex requirements to lease empty spaces.

In contrast, grocery-anchored retail continues to hold up comparatively well, despite the potentially destabilizing threat of rising online grocery shopping. Lifestyle and mixed-use centers have countered falling in-store sales by increasing their offer of service- and experience-based tenants – including restaurants, tutoring centers, salons, and fitness studios – that should be more resilient to e-commerce.
**Latin America**

**Uncertain Investment Environment**

Some of the political uncertainty that has overshadowed Latin America’s economic and real estate market outlook since 2016 has been lifted. While ongoing political turmoil means Venezuela remains a notable exception, major elections are now over in Brazil and Mexico, and a replacement free trade agreement with North America – the United States Mexico Canada Agreement (USMCA) – has been agreed in principle, removing a source of uncertainty.

However, markets are still trying to assess which of the policies promoted by the leaders of Brazil and Mexico during their respective elections will be enacted into law. The policy uncertainty is undoubtedly a key factor contributing to the dearth of transactions in Latin American property markets. In 2018, institutional transaction volume across the region totaled only $3.4 billion, down by 40% from 2017.

Yet occupier market conditions suggest that transaction volume should be stronger. While office vacancies remain elevated due to a large supply wave beginning in 2015, net absorption is positive in Mexico City, Sao Paulo, and Rio de Janeiro, pushing vacancies down and stabilizing rents. Industrial occupancy rates are near historic highs in Mexico, with strong tenant demand both in logistics-driven Mexico City and in manufacturing export-focused markets such as Monterrey and the Bajio region. Also in Mexico, international retailers continue to expand their presence, even as they trim store exposures in developed markets including the United States.

There are some signs that the trend of declining transaction volume – which has now gone on for seven years – may reverse. In early 2019, at least two large portfolios of industrial assets hit the market in Mexico. Policy interest rates appear to have peaked in Mexico and held steady in 2018 at less than half their 2016 levels in Brazil, removing some uncertainty about buyers’ access to accretive financing. And while neither of the two largest economies in Latin America are booming, they are both expanding fast enough to create tenant demand in both the business-driven office and industrial sectors, as well as the consumer-driven retail and housing sectors.

Despite these underlying economic conditions that would otherwise be supportive of rising deal activity, political uncertainty is likely to keep some investors on the sidelines. For starters, the USMCA may not have enough support in the U.S. Congress to be ratified. Meanwhile, both Mexico and Brazil have new leaders who ran on ambitious albeit very different platforms, and it is too early to tell which parts of those platforms will translate into policies that may support – or suppress – real estate demand.

**Investment Opportunities**

As core real estate returns have moderated, real estate investors are increasingly active at the edges of the risk spectrum – either in search of assets with a combination of higher income yields and growth potential, or retreating to perceived safety and downside protection offered by debt.

While investment remains active across all major sectors and markets, as the economic cycle goes on, growth stories are harder to come by. For this reason, while activity remains solid in gateway markets, investors seeking income growth potential will find better momentum in Sunbelt markets that benefit from faster population growth. Investors also continue to look outside core sectors for income growth potential. Senior housing provides a compelling investment opportunity offering higher yields and gathering demand over the next few years.
1. Follow the Demographics

Markets with favorable demographics offer attractive returns potential, including office and apartment assets in the Sunbelt markets.

In a late-cycle environment, in which growth opportunities are scarcer, a focus on markets with stronger demographic trends can help identify opportunities with attractive total return potential.

In commercial sectors, historically tight labor markets have made access to an expanding population base and growing labor force key considerations in current occupier location decisions. In the office sector, many employers, especially in the technology sector, are seeking employees with increasingly specialized skill sets – proxied by educational attainment among inhabitants. Young professionals are increasingly migrating to cities such as Seattle, Portland, Raleigh, and Austin – encouraging firms to locate in these cities. For tenants looking for industrial space, overall labor force growth is a key consideration.

Exhibit AM4 sets out a framework for assessing key demographic trends. Several of the fastest growing metropolitan areas have also seen notable gains in educational attainment levels this cycle, with an increasing share of their population having a college degree, including Denver, Raleigh-Durham, Portland, Seattle, and Austin.

Exhibit AM4: Analysis of Labor Force and Population Growth by City

Forecast Labor Force Growth by City (2019-23, % p.a.)

Forecast Population Growth and Historic Change in Educational Attainment by City


Change in Share of Population with a Bachelor’s Degree or Higher, 2011-18

Source: PGIM Real Estate. As of May 2019.
In the coming years, Sunbelt markets labor forces will grow faster than other parts of the United States (see exhibit AM5). In turn, the pace of absorption is set to be higher, supporting an income growth outlook that, on a relative basis, is stronger than it was in the past. Although supply has historically tended to be less constrained, limiting rental growth potential, given the tame supply cycle during this economic expansion, current momentum in many of these strong population-growth markets is expected to support solid rent growth over the next five years. Though generally lower supply constraints do tend to drive higher yields in these markets, the current ‘Sunbelt minus non-Sunbelt’ yield spread is above-average, pointing to attractive relative value – especially for those markets in which education attainment levels have risen.

**Exhibit AM5: Sunbelt vs. Non-Sunbelt – Demand, Rent Growth and Cap Rate Spreads**

**Absorption Growth (% p.a.)**

Sunbelt markets set to record strongest demand growth

**Rental Growth (% p.a.)**

Compared to the past, Sunbelt markets have a relatively favorable rental growth outlook, supported by low supply growth

**Cap Rate Spread: Sunbelt Minus Non-Sunbelt (Basis Points)**

Sunbelt markets are typically higher-yielding, and spread is still wider than historical average

Sources: CoStar, Axiometrics, NCREIF, PGIM Real Estate. As of May 2019.

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**2. Senior Housing Tailwinds**

Senior housing is set to benefit from ongoing demand growth, while supply is moderating. Elevated cap rates mean returns compare favorably to commercial sectors.

One of the most prominent opportunities for securing assets with attractive income growth potential is the senior housing sector. A modest wave of supply – which kept rental growth in check over the past few years – is now easing in response to softer fundamentals, while gathering demographic tailwinds point to further demand growth over the next decade (see exhibit AM6).

Occupancy and rental growth should improve across the sector, although there are differences between asset types. Assisted living facilities are needs-based and stand to benefit most from the aging population, while they are set to record substantial income growth as supply drops back and should offer greater resilience in a downturn.
Senior housing offers investors higher yields than other sectors. Currently, senior housing yields are 120 basis points higher than apartments, slightly above the long-term average. With higher yields and the potential for stronger rental growth and occupancy gains, senior housing returns are expected to continue to outperform mainstream commercial sectors in coming years.
3. Debt Offers Downside Protection

Debt offers an attractive source of lower volatility, downside protection and diversification, while value-add debt strategies can generate attractive returns.

Reflecting global trends, real estate debt in the United States is growing in popularity. Debt strategies offer a range of opportunities for real estate investors, from core mortgages that generate a low, stable coupon-driven return, all the way up to higher risk transitional and mezzanine loans, typically working in partnership with value-add and opportunistic real estate equity sponsors.

While debt offers downside protection and lower volatility compared to private and public equity positions, investors in the United States are also drawn to the diversification that debt offers relative to traditional private real estate investments. Over the past 20 years, the correlation between private equity real estate and core debt returns has been negative at -0.14 (see exhibit AM7).

Debt funds have raised $57.6 billion in the past three years, in line with the total raised in the six years from 2010 to 2015. While returns expectations have narrowed as more capital has entered the space, on a risk-adjusted basis, debt remains an attractive proposition for many investors.

Traditional 10-year real estate loans on stabilized properties provide an all-in yield of about 4.5%, roughly in line with current cap rates on core property. Debt providers focusing on value-add projects with no recourse are currently providing loans with coupons ranging from 5.5% to 6.0%, with the possibility of generating additional returns through modest fund-level leverage.

Exhibit AM7: Comparison of Returns Across Asset Classes

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Note: (1) Private Real Estate Debt is measured by Gilberto-Levy Index; (2) Private Real Estate is measured by NCREIF Property Index; (3) Public Real Estate is measured by FTSE NAREIT All Equity REITs; (4) Public Equities are measured by S&P 500; (5) Public Bonds are measured by Barclays U.S. Aggregate. No adjustments were made to account for liquidity. Private asset class returns may understate volatility versus public asset classes.

Sources: NCREIF, FTSE/NAREIT, Gilberto-Levy Index, Bloomberg, PGIM Real Estate. As of May 2019.
With real estate transactions activity still elevated, along with an increasing focus on value-add and opportunistic strategies among capital raised in recent years, demand for debt to fund new acquisitions looks set to remain high (see exhibit AM8).

Traditional debt lenders, including life insurance companies and banks, remain cautious. High volatility commercial real estate (HVCRE) regulations, despite being slightly relaxed in 2018, are still restrictive, requiring banks to hold more capital for more speculative real estate loans. Life insurance companies are keeping LTVs at 60%, versus the 66% to 68% that had prevailed during previous cycles.

Restricted lending activity among traditional sources of capital imply an ongoing opportunity for debt funds and other alternative capital providers to fill the funding gap.
**Global Map of Investment Opportunities**

**Nature of Opportunity**
- Late cycle growth
- Structural trends
- Debt strategies

**Senior Housing**
Ongoing demand growth and moderating supply point to further rental growth prospects. Elevated senior housing cap rates mean returns compare favorably to commercial sectors.

**Sunbelt Markets**
Office, apartment and logistics assets in Sunbelt markets benefit from favourable demographic trends, while offering relatively attractive cap rates.

**Supply-Constrained Markets**
Major logistics markets have low vacancy rates, while in low supply office markets, value-add strategies, including asset repositioning and development, offer a route to generating attractive rental income growth.

**Late Cycle Growth Potential**
Low vacancy office markets and logistics assets in Continental Europe are set to benefit from ongoing demand growth. Rents expected to rise in the short-term.

**Residential**
Residential assets offer a source of portfolio diversification, while its resilient income profile is attractive in uncertain market conditions.

**Living Sectors**
Living sector assets, including student housing, co-living and senior housing — are set to benefit from structural demand shifts.

**UK Recovery Play**
The UK market offers attractive relative pricing and is likely to outperform once Brexit uncertainty fades.

**Debt Strategies**
Debt lending offers lower volatility and more downside protection than equity investing. Opportunity set is growing due to regulatory pressure on traditional lenders.
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