SPEAKING OF ALTERNATIVES

S1 EP10: Let's Talk Core Plus Real Estate Investing

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W: Speaking of Alternatives with Keshav Rajagopalan, Managing Director and Head of Product and Strategy at PGIM Multi-Asset Solutions. Real estate investing is something that a lot of investors can relate to in a more tangible way than other investments. Its features, including during durability, can make it more attractive and feel more accessible as a building block in a diverse portfolio. Core Plus strategies can add further to that diversification. Keshav explores the world of investing in Core Plus Real Estate with Darin Bright, Head of U.S. Core Plus Strategies at PGIM Real Estate.

KR: Today we're going to explore Core Plus Real Estate, and one of my first questions is going to be what exactly is Core Plus Real Estate? To introduce my guest, I'm very pleased to be joined by Darin Bright, Head of Core Plus Strategies at PGIM Real Estate. Thanks for joining us today, Darin.

DB: Thank you.

KR: Let's find out a little bit more about you. Talk to me about how you came to real estate, how you came to PGIM Asset Manager in general. What keeps you excited about what you do and keeps you in the game?

DB: Yes, I don't know exactly when real estate became a choice. I don't think it was as intentional as people think it is. I grew up in Chicago, so there's a deep history of real estate there. An awesome skyline. And when I was younger I definitely was interested in construction, my dad was in construction, so when I headed out to do my undergrad at Indiana University, the Kelley School of Business, they did have a real estate emphasis at that time. You could choose finance, insurance, and real estate, and I ended up leaning in towards something that was kind of more tangible and more personal. Over time, like I think it's actually super interesting to be in an asset class where the investment decisions you're making are based on where you live, where you spend money, where you work, what you work in, and so forth, and so it just became kind of a natural direction for me.

And then what I like the most going forward, I've been doing this for over 30 years now, is really just the relationships, I think. I know there are relationships in all in other asset classes, but the relationships you build in real estate are super important. You can't invest, develop, or operate an investment without a lot of people, so that interaction and relationship building over time is just a real bonus to the investment class.

KR: Well, it sounds like it's a little bit in your blood, but I definitely hear that tangibility point. Like you said, the people that come together to make everything in the build environment kind of happen must be fascinating. Let's talk a little bit about the opportunity set. So if you had a minute, what would you say, how would you convince me that there's a play here today or longer term as well?

DB: I would answer the question more broadly than just Core Plus, I think it's real estate in general at this time. Because as a firm across all the different strategies that we offer, we think now is a good time to be investing. It's the beginning of a new cycle and we think it's going to be an attractive, a vintage year to start investing. It likely will not be as supercharged as the returns that we delivered right after the global financial crisis where all capital was kind of in a vacuum at that time. The economic challenges that we encountered in the global financial crisis weren't the same as this time, but the vintage year still will be quite good.

So, real estate values across the different property types have reset, gone down by anywhere between 15 percent and you could argue 50 or 60 percent in the office sector. So therefore, yields today are the highest we've seen since post-GFC, and I think we compare real estate to other asset classes. Certainly, fixed income is starting to deliver at an appropriate rate and you're buying at what would be a pretty significant discount to replacement cost. That's kind of the first thing that rings the bell. Anyone who's investing in real estate obviously wants to buy below what it costs to build.

Then different than most downturns in real estate, you usually see like very weak fundamentals coming out of a downturn, in this case property fundamentals are quite strong. Occupancy and rents, we've seen some softness across property types, but still holding up versus what you saw in the global financial crisis. And even better, and which will be a tailwind, is supply. The supply has been shut down because interest rates are high. So, we think it all adds up to like this is the year to start getting ahead of the wave of what should be good, normalized returns going forward.

KR: It sounds like both the macro the environment, but then also an entry point piece here as well. Talk to me a little bit about the long term. When you talk to investors, how do they think about real estate in their portfolio? Then if you could dive a little deeper on the Core Plus point. Obviously, you manage Core Plus strategies at PGIM Real Estate, what does Core Plus in the real estate world do for an investor?

DB: I'll tackle the second question first. What is Core Plus? I've been at PGIM for 20 years now and in the business for over 30. I came to PGIM actually because at the time they were an investor of mine, so they have a long history of offering these open end funds and one of them is Core Plus, so I have a unique perspective on Core Plus. Because if you talk to investors or consultants today I think there's a level of confusion of what's Core Plus. There's a lot of variety here. I would say to a certain extent it's kind of like the "strategy du jour," as Jim Carey. It's become super popular since the global financial crisis.

Prior to the global financial crisis, I think that we had three or four competitors in the market space at that time. Today now there are probably like 50. You have a lot of sponsors that saw the opportunity come out of the global financial crisis because they offer a variety of what they call Core Plus, which could be debt or equity now. It could be even a single property sector vehicle, versus what our view is. It's like just really kind of a couple of clicks above core. So, what we think as Core Plus is really just income and growth fully diversified across property types in markets and it still priorities income, but probably not as much as you would find in a core strategy, but more appreciation.

So if you think about what core is today, we think it's kind of blue chip, stable income, fully diversified stabilized properties in the most liquid markets at a very low leverage level. But if you think about Core Plus, we think it's just kind of another couple of clicks above. It still offers that fairly good income stream, but now uses a moderate level of leverage and it looks to broaden kind of the investment target by both markets and by property types. And it's willing to take a little bit of additional risk, whether it be in terms of capital expenditures or vacancy to create more income and more value, so therefore, more appreciation for the investor.

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W: A major focus within real estate investing has been the office sector. Much attention has been paid to the transition to remote work by employees of large corporations and that has affected supply and demand within the sector.

KR: So if you are an investor looking at the space you really do have to look under the hood and understand what you're being exposed to. It sounds like for what you focus on in the Core Plus space it is a diversification element as well. Right? You're not just picking a single sector, but a sector that does come up in terms of food groups.

We like unpack a headline for each episode, I saw in the IPE Real Assets in their 2025 outlook for U.S. real estate. It asks a pretty simple question, but I think it's on every investor's mind, what do you do with office today? The article talks about just massive amount of debt refinancing in the year ahead, maturities are going to happen especially in the office sector. So how are you thinking about office, even just broadly as you kind of think about different market environments and the use office today, what's going to happen?

DB: My answer might not be exactly what you're expecting and I wish we could go to the next question really. So, it's kind of like the $3 trillion question, is what you always heard, because I think that's probably the size of the office sector in the U.S. today. So I'm talking from my home today, although I was supposed to be in the office because of a storm. So obviously highbred work is here. And actually two weeks ago the federal government mandated for employees to come back to the office. Right? So, what will that do? You continually hear announcements from corporations that it's like time to come back. Who would have thought of four years ago that we would be telling employees that they have to come back to the office. That was just normal.

So, the certainty around physical occupancy by tenant is super important for that sector, that's really kind of facing structural headwinds. And no other property type, there might be some headwinds today, but nothing like the office sector. But I've seen this before in different cycles for different reasons, office sector is not dead. You go back and look at like the global financial crisis or 9/11 or some of those really kind of flash events, there's always these discussions of like what's going to happen to the office, what's going to happen to high-rise office and then over time it comes back. But in this case, I'd say there is definitely, because of new technology, some structural headwinds to office that I don't think that you can ignore. So, it's all kind of really about supply and demand.

Post COVID there have been other sectors that have gone through this, and retail is one of them. Discretionary retail in malls, no one could walk into a mall and so they thought the mall was dead. The mall isn't dead, obviously, but grocery strip centers prevailed during that time and now retail sector has gone through a cleansing. I think now the vacancy rate for retail is best across all property types.

So office okay and I think it has hit a bottom, but I think also that the recovery will take a long time because new technology, corporations making movement to more affordable locations, people wanting to move to those locations and look for jobs. I think it's going to take tenants a long time to determine what is their optimal use of space. And because office leases are on the average five years, it may take three to five years to find out what is the stable income stream for that office building and during that time supply will have to be move out of the stock or repositioned, or you're already seeing some reformatting of certain office building.

I think tenants today are prioritizing highly amortized class double A, well located properties. And if the rent is too much they're just shrinking their tenant format, their size to actually fit that. So those buildings are already rebounding their vacancy levels several hundred basis points probably below kind of the average office vacancy level in the U.S.

For our strategy, our view for Core Plus is that, because I think we do expect to rebound, I think there could be some homerun opportunities at some point if you just think back at other cycles. But on a relative risk return basis for Core Plus that's trying to deliver income and then moderately level more appreciation than the core, I think office kind of ranks at the bottom of that because of the volatility of office and also the capital usage of office where you don't get a lot of reusability of the tenant improvements that you're spending there.

If you look at like the office sector in terms of performance over time, normal cycle is like seven years, you make all your money in office like in one year. So it really behooves you to buy office, improve it, and then sell it. The issue is that office was such a huge stock in terms of institutional real estate for such a long period of time, but now what's actually taken its place, I think office will rebound, it's going to have a cleansing, but at least for now it's probably not in our target zone for what we think as Core Plus today.

W: Effective investing strategies are largely about identifying and capitalizing on attractive opportunities in a timely manner. Critical trends affecting real estate include the rise of e-commerce and artificial intelligence, along with weighing such factors as price and volatility in various sectors.

KR: It sounds like one, obviously for the Core Plus strategies, it may be challenged. There may be other strategies obviously on the higher risk side that office does make sense.

DB: Absolutely.

KR: But then it does come down to the underwriting of a single asset. At some point not all office is also created equal and I'm sure some of these things are pretty attractive and then there are other ones that look very different. So, it comes down to the underwriting of a single asset.

DB: You're totally right. The space that we're in at Manhattan is so nice. Right? Brand new buildings and a great location in Hudson Yards. So, if you want that type of lower risk strategy, it's just too expensive and too low of a yield for Core Plus, but then if you want the others which you're uncertain about, you better require like a higher yield and it's too volatile and too uncertain at this time for Core Plus. I think Core Plus is kind of a best idea approach. Right now, I think on a relative return basis there are other opportunities that may be more attractive than reaching for that office today, but maybe 12 months for now it may be better.

KR: That's interesting. Well, office may be headwind. What are some of the tailwinds and opportunity sets that you're seeing. You mentioned alternative niche strategies. Talk just a little bit about what you're finding most interesting for that Core Plus income with moderate appreciation at the right kind of risk adjusted return. Where are you heading with the fund?

DB: Like I said, all things real estate from a macro perspective outside of maybe down the middle office, just because of the repricing there it's actually quite attractive. Right? And fundamentals have kind of held up the income growth, especially when you consider the lack of supply over the next two or three years.

If you look at the industrial sector, for example, you're seeing kind of new supply down 60 or 70 percent in multifamily traditional apartments. The same thing 50 percent plus or minus down. So eventually what we're looking at is a shut down in supply for new deliveries. And if you just look at housing along with the kind of long term shortage we have in housing, and especially affordable housing in the U.S., and then you kind of think about market by market where the growth is.

So, even though the sunbelt market is kind of oversupplied today, because that's kind of the easiest place to build, lenders are all over it. You saw a lot of migration. Like migration slows down and then you have an influx of new supply. That'll get burned off over time. And with the lack of new supply, because over the last two years with the rise in interest rates there have been no lenders willing to actually move forward with that, or equity sponsors. So now we think that there's a good opportunity in delivering that type of product in the next two years. Right? Because it takes about that long, at least to deliver like a garden apartment.

I think the tailwinds we talk about as a firm, as a Core Plus strategy, there's a couple really. It's demographics in the U.S. and then new technologies. If you look at new technologies, e-commerce is obviously one for technology. The adoption rate in the U.S., even when you compare it to Asian markets or European markets, is below. Right? I mean, it's spiking since COVID. It has leveled off a bit, but we expect the adoption rate to continue to grow, and as that grows, e-commerce sales grow. You need more industrial buildings to actually fill that. We think that there's still a really long way to go for industrial. Likewise, maybe even cold storage as kind of a niche property type. Because you're seeing more and more people, especially with the lifestyles that they have, get food delivered to their home, which then translates into needing more cold storage space. So as a firm we've kind of dipped into that.

As well, then you have from a technology perspective. You can have a conversation unless you talk about AI. Right? And I still think there's a long way to go to understand exactly the impact of AI on real estate. Everyone points to datacenters. Right? But there are other things too. There was just an announcement from the federal government having to do with pharmaceuticals and the discovery science. So not only do you have the demand side from a demographics of seniors that are growing that have a longer life expectancy and also supercharged to be involved in healthcare, but then you've got AI kind of supposedly delivering a roadmap that might be quicker to actually finding cancers.

There are a lot of tailwinds that have to do with kind of two segments of the population, baby boomers and millennials, that are the two largest and also wealthiest in the U.S., and how they consume real estate. And getting in front of whatever they consumer is smart in terms of real estate going forward. And that's the next cycle.

KR: So, we like to also get the pulse of what's happening via our distribution teams. So, we got a few questions that came up through our client facing professionals. And I know ESG has a different framing today than it may have had, but how do you think about ESG in a portfolio from a risk and opportunity perspective rather than a political perspective?

DB: Yes, you're right. We've been not struggling with ESG, but exploring how we can be good stewards regarding ESG. The prioritization of ESG has kind of gone up and down, and so forth. I think when investors ask about ESG it seems like they're only asking about E, you know the environmental, but I think they can also ask about the S and the G. And I think that PGIM, well, a lot of times you don't talk about this actually, and PGIM does a really great job in terms of the S and G, before I get to E.

From hiring a really good, diverse pool of talent, to the community level of social engagement that we do as a firm, but most importantly actually as a real estate investment manager, we are building and buying apartment and other housing formats around the country by the thousands. Right? And we are very involved in that community and actually delivering a product and actually hiring people and making that a really important community to live in. Right? So from the S and G point of view, we should be very proud of our involvement there.

When you focus on E, which I know everyone does, I think it's definitely a more complicated and complex discussion. But we do know as a developer and as an operator of real estate that we probably have one of the biggest impacts in terms of the environment than other asset classes out there. And we also do know that other countries around the world prioritize the ESG differently than others. That has changed over time especially here in the U.S. even by state, not just by country. So, we try to integrate the environmental process in everything that we do when we underwrite and identify a new investment with the two objectives.

One, we always say we want to do the right thing, but two, and most importantly, we want to make the right investment decision. So, it still has to make sense from an economic point of view for the fund. So, we're focusing on kind of the low hanging fruit always in terms of energy conservation, which may mean water and power, and then we go from there in terms of like other things that we can do to enhance the green rating of the fund. But most importantly, too, is because we have a diverse set of investors, is to always think about is that actually adding value to the fund?

W: As noted earlier, relationships are immensely important within the world of real estate investing and that can lead to greater local insights which can provide a critical competitive investment edge.

KR: So it comes down to the economics, but there is an investment thesis behind it, but you have to get to the economics. So, another one that I think where PGIM is differentiated is just the amount of local market knowledge we have. How does that filter into your investment decisions and how you think about the fund? Obviously, you're sitting in one location, but your team is spread around the United States. How is that local market knowledge tapped into?

DB: I go back to why I'm in this business. Actually, it is about local knowledge and local relationships. Actually, that's the best thing about real restate. It's that when people talk about like a certain corner of a certain markets you've been there. And it's actually so cool to see markets change over time. For example, in the sunbelt market, like Austin, Texas, Phoenix or whatever. Nashville, Tennessee. I mean, how those markets have changed over time is kind of a cool thing. We've been building relationships for a real long time. And I think actually that's kind of a special sauce that we bring to the table.

For us, in terms of local knowledge and how we're trying to underwrite and identify opportunities, it starts with our research group in terms of where we have a bottom up and even a top down approach. And we have research individuals that are assigned to each one of our strategies, right? So that we're constantly rethinking, because they're different in terms risk profiles. So it starts there, but like the execution at a local level is really through our asset management and transaction professionals. These individuals are experts in both property types and markets. They really understand the market when we look at a new investment.

And then from a transaction perspective, same thing. They're spread out over the country. We are highly dependent on the relationship building and the joint venture investments that we make, and those operators or developers are ones that we have repeat business with. We leverage those relationships and their opportunities to find investments. Real estate is a local business more than anything else, so it's important to have those relationships.

KR: That's great. Final question maybe to get some quick hits from you. Top three things you're focused on right now for the fund. Where are you kind of thinking about deploying capital? I know that's a broad question, but maybe kind of your three best ideas. As you said, this is a best ideas fund, so what are the three best ones right now?

DB: We kind of explored a little bit of this in terms of the portfolio of construction of our Core Plus strategy will change here in this next cycle. So, we are gravitating towards those primary property sectors, as well as what we've considered niche sectors which are primarily housing related, manufactured housing, single family rental, senior housing, and so forth. Then we'll be spending more time investing in that and divesting or not investing in the office or retail sectors. And retail is a great sector, we talked about that a little earlier, too, it's just that it doesn't provide enough juice actually for a Core Plus fund. Great income, low volatility, not a lot of upside, at least the kind of retail that we've historically invested in which has been grocery anchor.

So out of that, you know, the best idea for us right now is senior housing and so we're deep into trying to invest in that sector. And it's really the one that we have the highest level of conviction in going forward, certainly of all the kind of alternative living sectors. It's very complex because of the operating leverage and human resource operating need of that strategy, but I think it's going to be really someplace you need to actually invest in going forward. And it's pretty simple, although definitely a complicated place. There are three levels of housing, and you can actually incorporate all three of those within the community, the senior housing community.

It's independent living which is basically like any resident who could be living in their own home, but they're living independently in this community, and they have access to pretty good food and some other things, a pool and stuff like that too. Within the same community you have a progression from independent living to assisted living. Same thing, same housing, but you might need a little bit of additional care, and then as you age throughout that you go to memory care, which is kind of a full service. And you can have different communities that have all three or maybe just two – assisted living and memory care.

The reason why you invest in those today is pretty simple about supply and demand. Of all the property types today, supply being shut off in other sectors, there probably is no greater imbalance of supply and demand from a property type sector than senior housing today.

KR: Is that because COVID had an impact there too? I'm guessing just what happened in some of these different care facilities and then that kind of stunted the market for a little bit?

DB: If you think about demand you think about the baby boomers, right, and they call it the silver tsunami. Right? Sixty to 80 years old. In fact, the first baby boomer is turning 80 this year. The primary target for senior housing, plus or minus is in the middle 70s. So you're primary right in there. So, you've got 20 years of pretty good demand going forward. And then from a supply sector, as you said, the last four years for a number of reasons, including high interest rates, no new supply.

In fact, if you look at the supply stock of senior housing in the U.S., I think 80 percent of it is older than 15 years. So, it's an older stock that hasn't had any new supply in the last four years, and then you combine that with what happened during COVID where occupancy went down significantly. As a result, rents went down. Well, the last two years have been a strong recovery in senior housing. So, you've got fundamentals now improving quite strongly. You've got all the demand ahead of you and very little supply. So, we're really excited that that's going to be kind of a replacement for some other things, including office, in this next cycle.

KR: Well, Darin, thanks for the conversation. Obviously, your passion for this space is very evident, but it comes back to maybe something, again, in your blood, but the tangible nature that you also made it during this conversation was helpful. Three key takeaways for me just from our conversation, three things that sit out, one is, interesting entry point right now. Just based on where valuations are, I think real estate in general from a macro perspective seems to be a good opportunity set for investors today.

Two is, at the end of the day, the thesis is about supply and demand. So, while real estate as a sector is broad, you have to get down into the weeds of where there are supply and demand imbalances, and I think the examples that you kind of gave on senior housing just now is just that. And then three is just the relationship nature of this business. Everything is local and working with a partner with a longevity that PGIM has had in this space inures to investor's benefits because a lot of it is that long term relationship build.

Well, Darin, it's been a pleasure and thank you all for joining us on Speaking of Alternatives. Next month we'll be diving deep into portfolio construction and the use of alternatives in building resilient portfolios.

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