PGIM REAL ESTATE

INVESTMENT RESEARCH | MARCH 2025

REGIONAL INSIGHTS

As it stands, the news flow is generating record-high policy uncertainty, amplifying risks to the economic outlook. Even without decisions being finalized, uncertainty hurts sentiment, and the longer that continues, the more it weighs on activity.

But with real estate fundamentals holding up – ongoing employment growth, low unemployment rates and inflation and interest rates trending down, and all largely in a world with limited supply – how much at risk is the real estate recovery?

That question lies at the heart of our latest insights, which are again trying to better understand how resilient the real estate outlook is. In PGIM Real Estate's latest Regional Insights, our research teams focus on the following themes and opportunities:

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- Interest Rates Are Higher. What Happens to Real Estate Values Now?
- How Does Productivity Impact Real Estate Returns?

6 | EUROPE

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UNITED STATES INSIGHTS

Key Themes

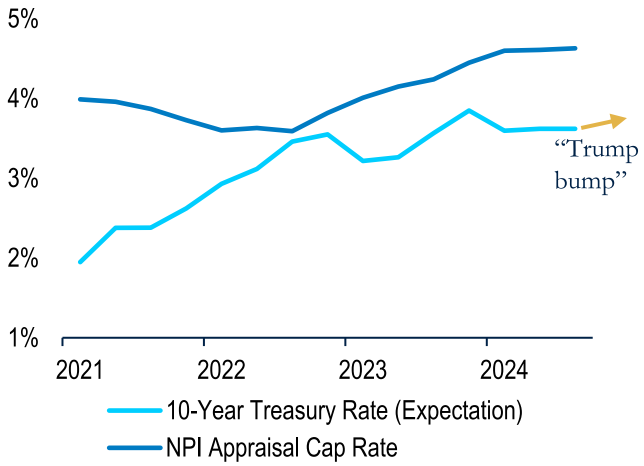
- Interest Rates Are Higher. What Happens to Real Estate Values Now?
- How Does Productivity Impact Real Estate Returns?

Interest Rates Are Higher. What Happens to Real Estate Values Now?

It is too early to evaluate the flood of policy proposals of the Trump administration, but one thing is clear: long-term interest rate expectations have risen. Despite this, we maintain our conviction that real estate remains fairly valued today.

Exhibit 1: Another Unhelpful Push on Cap Rates

NPI Appraisal Cap Rates vs. Three-Year Ahead 10-Year Treasury Yield Expectation*



Here is how our valuation math works, using the apartment sector as an example:

To start, we estimate where we expect long-term interest rate expectations, aka the risk-free rate, to settle over the long term. We then compare that with current appraisal cap rates, as illustrated in **Exhibit 1**.

The gap returned to comfortable levels in 2024, which coincided with the end of the period of property value declines (outside of the office sector).

The yellow upward pointing arrow is an acknowledgement that it's too early to precisely estimate the magnitude of how interest rate expectations have risen. But a ~50 basis point increase is consistent with other indicators such as current Treasury yields and the recent increase in the estimated term premium.

*Note: 10-Year Treasury yield expectation is based on the median expected 10-Year Treasury yield three years ahead of the year in which the forecast was made. Data is unavailable prior to 2009. For years prior to 2009, we use the median expected 10-Year Treasury yield over the next 10 years and interpolate the data across quarters. Both data series come from the Survey of Professional Forecasters.
Sources: Federal Reserve Bank of Philadelphia, NCREIF, PGIM Real Estate. As of March 2025.

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Yet one reason interest rates expectations are higher is higher nominal economic growth expectations, as illustrated in **Exhibit 2**. The dotted yellow line is our pre-November economic growth assumption, and the bars show our new assumption. On average, this is about 40 basis points higher per year of economic growth.

So if the economy is growing at a relatively strong pace and real estate supply growth is constrained by higher interest rates (and potentially higher material costs due to tariffs), that should translate to higher real estate income growth.

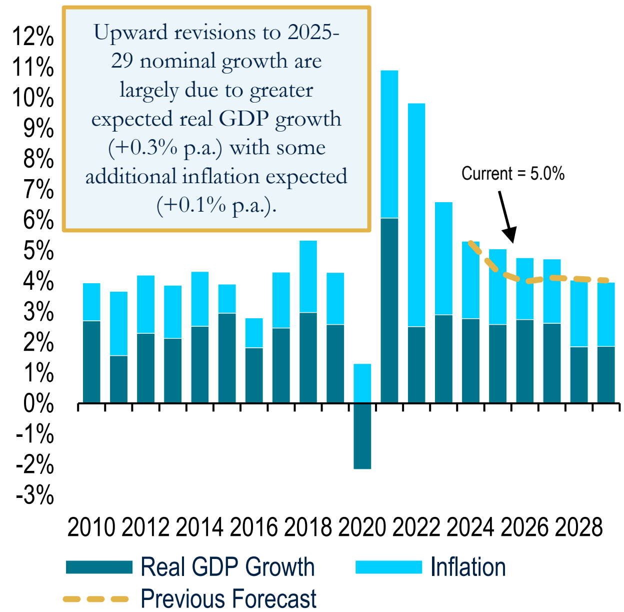
Exhibit 3 puts the pieces together, again using the apartment sector as an example.

Our model starts with long-term bond yield expectations, which we now estimate at 4.0%. Based on our historical estimate of the risk premium for apartments and longer-term rental growth, our model indicates a yield of 5.25%, representing fair value pricing for the sector on a longer-term basis, roughly 25 basis points above current yields.

Near-term rental growth expectations get us comfortable with this gap. We expect rent growth to be about 100 basis points above our long-term assumptions over the next five years. That is enough to offset the negative impact of higher interest rates.

Exhibit 2: Economic Growth Expectations Are Higher

Annual U.S. Nominal GDP Growth



Sources: Oxford Economics, PGIM Real Estate. As of March 2025.
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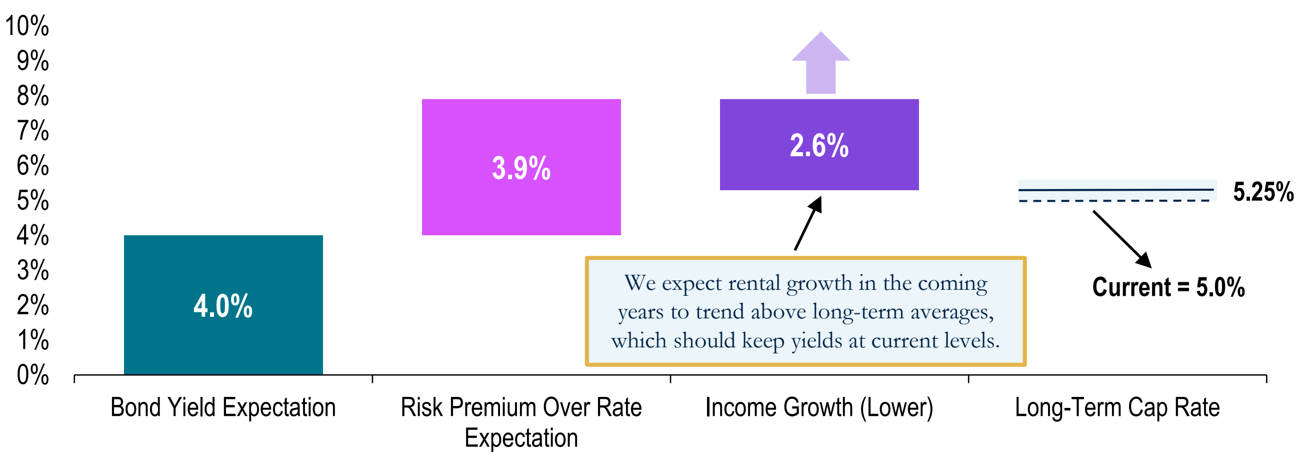
Exhibit 3: Cap Rates Don't Need to Move Up

Long-Term Yield Analysis (Apartment)



Sources: Philadelphia Federal Reserve, Oxford Economics, NCREIF, CoStar, PGIM Real Estate. As of March 2025.
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How Does Productivity Impact Relative Real Estate Returns?

A coming shift in the composition of U.S. economic growth has significant implications for relative real estate market performance. If we are moving toward an economy driven mostly by productivity, the outlook is brighter for some of the laggard markets of the last cycle.

As seen in **Exhibit 4**, forecasts point to a pick-up in productivity growth that will be the primary driver of U.S. real GDP growth. This is in large contrast to the previous cycle (2010-24), where productivity growth was low and employment growth drove economic gains.

Moving forward, slower population growth and an aging labor force will require firms to invest in technology and equipment to boost the productivity of the existing labor force.

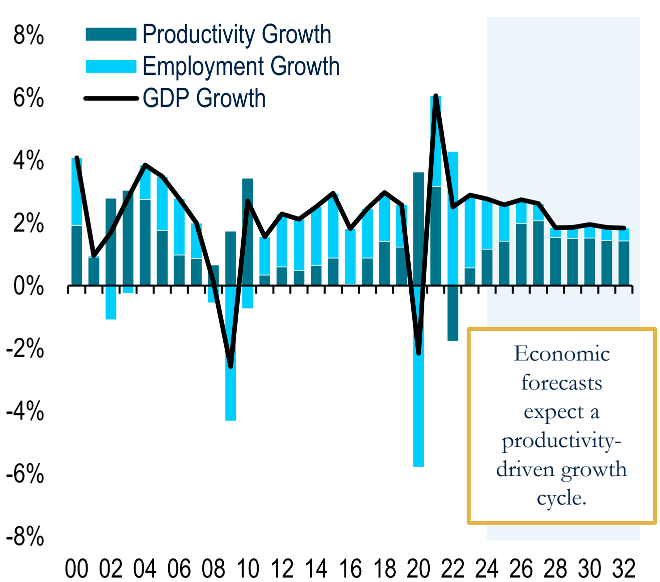
Why does this matter? History tells us that the relative real estate returns of markets vary depending on the rate of productivity growth in the economy. In **Exhibit 5**, we calculate the correlation of U.S. productivity growth to relative metro-level returns across all property types.

The markets whose relative returns are positively correlated with U.S. productivity growth are largely a group of markets that are both economies driven more by productivity growth and are also markets with higher rental rates, including New York, Boston, San Diego and San Francisco.

As productivity growth increases, these higher cost markets benefit as tenants experience less cost pressures. Higher productivity growth enables tenants to afford the higher rents in these markets and boosts relative real estate returns.

Exhibit 4: Shifting U.S. Economic Growth Drivers

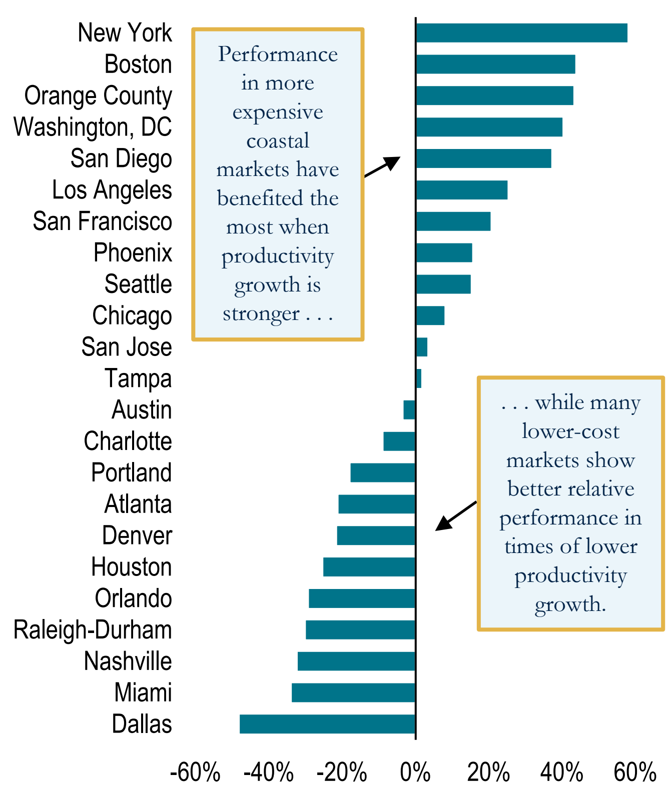
Productivity, Employment and Real GDP Growth (% p.a.)



Sources: Oxford Economics, PGIM Real Estate. As of March 2025.

Exhibit 5: The Productivity Cycle Impacts Relative Market Returns

Correlation of Relative Total Returns With U.S. Productivity Growth, 1981-2019*



*Note: In this analysis, Productivity Growth is lagged by 2 years.
Sources: Oxford Economics, NCREIF, PGIM Real Estate. As of March 2025.

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Alternatively, markets that perform better on a relative basis in an employment-driven economic environment include many markets across the southern United States, including Dallas, Miami, Nashville, Raleigh Orlando and Atlanta, most of which have primarily employment growth-driven economies.

We can see these relationships more clearly for two specific metros in **Exhibit 6**. Whereas historically relative returns in Washington, DC have risen and fallen along with overall U.S. productivity growth, Atlanta shows the exact opposite trend. Should forecasts prove to be right regarding the sustained increase in productivity growth, expect a boost to real estate returns in the Washington, DC area.

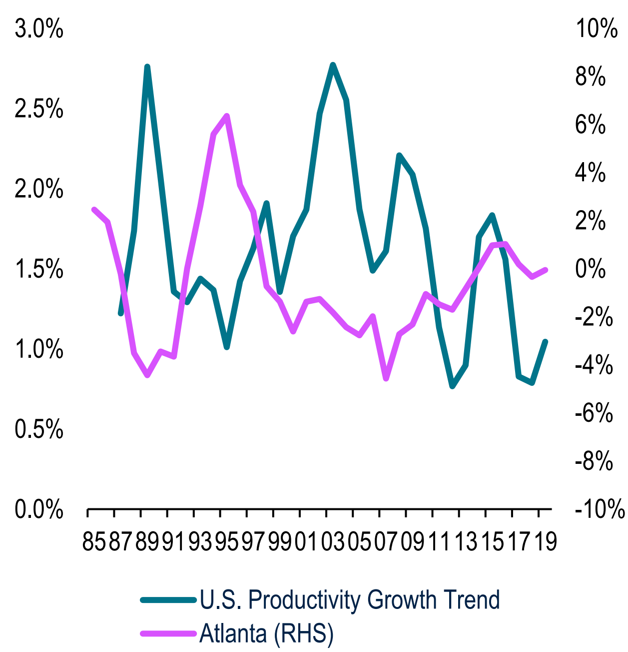
The impact from productivity growth is not the only factor that will drive relative real estate performance. Still, we expect that an overemphasis on the historical performance of markets in an employment-driven cycle will be misleading. The same real estate markets that lagged over the past decade will benefit from the coming productivity-driven cycle.

Exhibit 6: Differing Relationships With Productivity Growth

U.S. Productivity Growth vs. Relative Total Returns by Market (3-year m.a.)*

Washington, D.C.: Correlation = +0.40

Atlanta: Correlation = -0.21



*Note: In this analysis, productivity growth is lagged by 2 years.
Sources: NCREIF, PGIM Real Estate. As of March 2025.

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INVESTMENT RESEARCH | MARCH 2025

EUROPE INSIGHTS

Key Themes

- Have Higher Government Bond Yields Changed the Real Estate Outlook?
- What Does an Analysis of Affordability Mean for Office Rental Growth Forecasts?

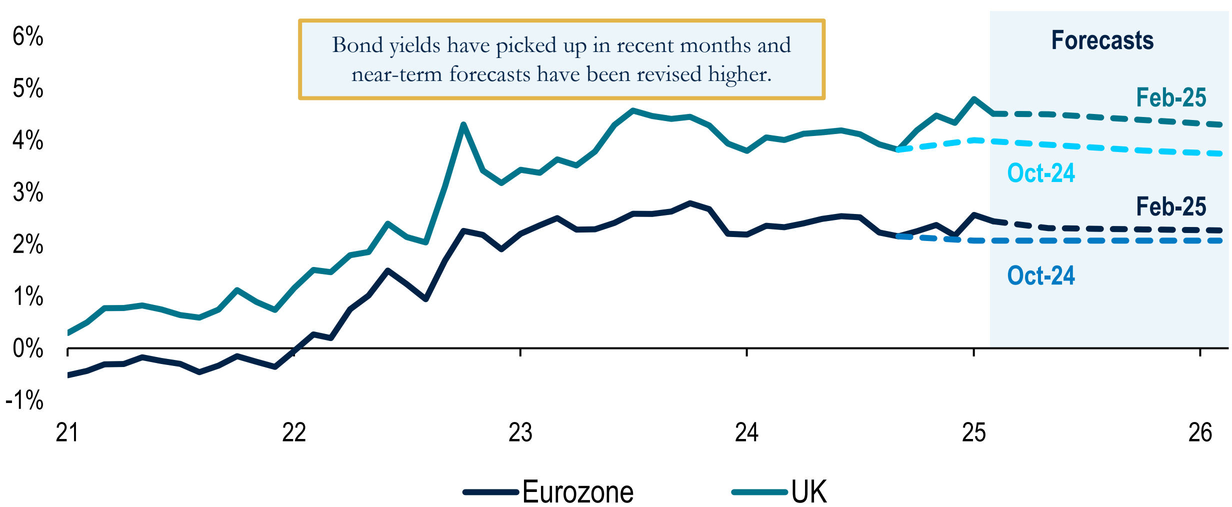
Have Higher Government Bond Yields Changed the Real Estate Outlook?

Real estate is a capital-intensive industry and the recent headline-grabbing rise in 10-year government bond yields and upward shift in near-term forecasts has understandably caused concern among investors (**Exhibit 1**). Higher risk-free rates matter, but the question is has the outlook really changed that much?

In aggregate, our answer is not very much – real estate yields in Europe tend to move closely with expectations about where bond yields will be in years to come (**Exhibit 2**, next page), rather than with often volatile movements in short-term market pricing. Yields have already risen a lot to reflect the transition to a higher interest rate environment than during the last cycle.

Exhibit 1: Government Bond Yields and Near-Term Forecasts Have Risen

10-Year Government Bond Yields (%)



Sources: Bloomberg, Consensus Economics, PGIM Real Estate. As of March 2025.

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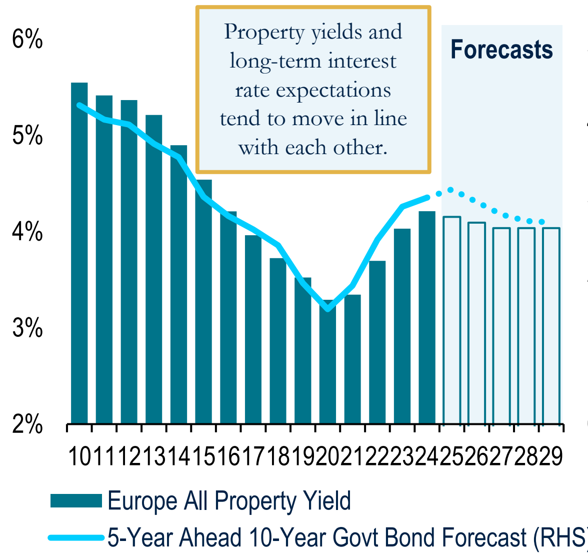
Our view of where bond yields will settle in the longer term across Europe – driven by factors such as demographics and productivity that affect potential rates of economic growth across the region – hasn't really changed. We see the recent pick-up in bond yields as temporary and don't see a need for any major adjustment to our forecasts for yields or real estate pricing as a result.

Real estate market participants are looking through recent bond market volatility too. Since October 2024, lending margins have fallen and, for the first time in several years, there has been some compression of prime yields (**Exhibit 3**). What we are seeing though are differences emerge between the eurozone and the UK.

Short-term reference lending rates i.e. 5-year swaps, have been falling in the eurozone, so all-in real estate debt costs have moved lower and are more clearly accretive to returns in leveraged transactions. We expect this to support a recovery in liquidity and investment volume from low levels through 2025.

Exhibit 2: Long-Term Bond Yield Expectations are What Matter for Real Estate Pricing

Five-Year Ahead Consensus Bond Yield Forecasts and Property Yields – Europe (%)

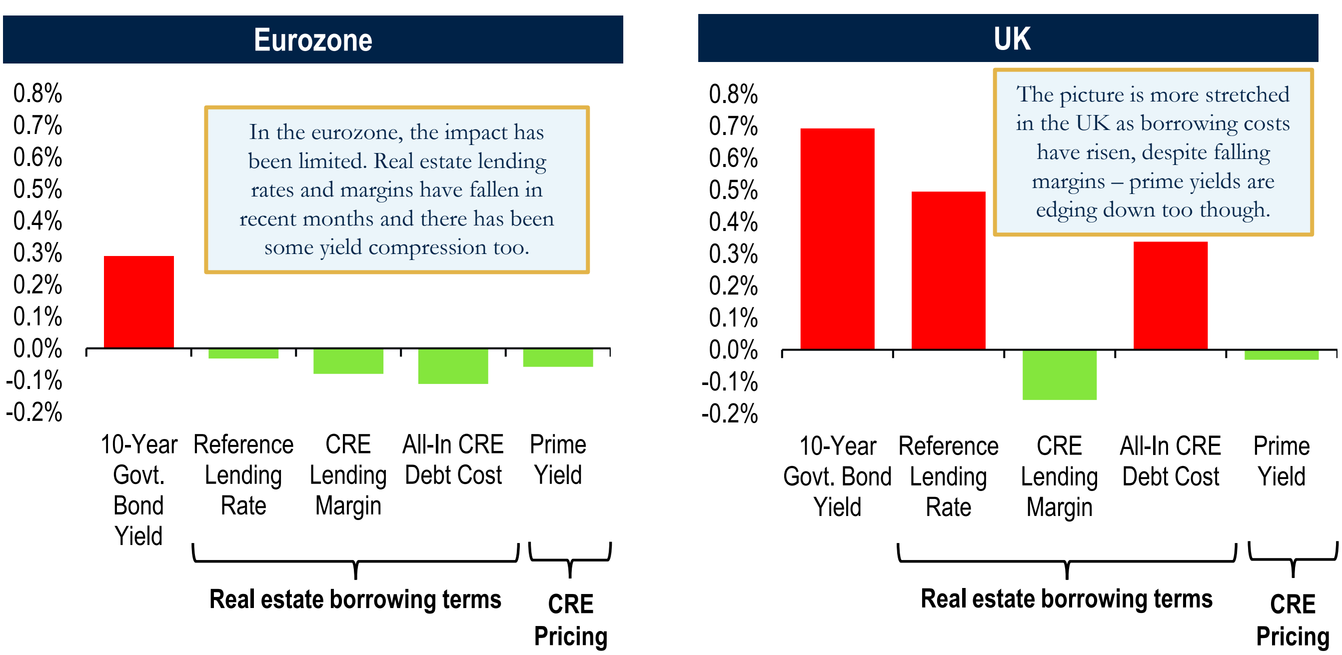


Forecasts are not guaranteed and may not be a reliable indicator of future results.

Sources: Consensus Economics, Oxford Economics, PMA, Cushman & Wakefield, PGIM Real Estate. As of March 2025.

Exhibit 3: Real Estate Lending Margins and Yields Moving Lower

Change in Borrowing Costs and Real Estate Yields Since October 2024 (%)



Sources: Bloomberg, Consensus Economics, Chatham Financial, CBRE, PGIM Real Estate. As of March 2025.

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The story is more stretched in the UK where inflation is stickier and swap rates have moved higher in recent months. All-in debt costs are both rising and at levels that are not clearly accretive to returns as they are above prime yield levels. The absence of a positive leverage effect means we see bigger risks around the liquidity story – and the therefore pricing outlook – in the UK in the coming months.

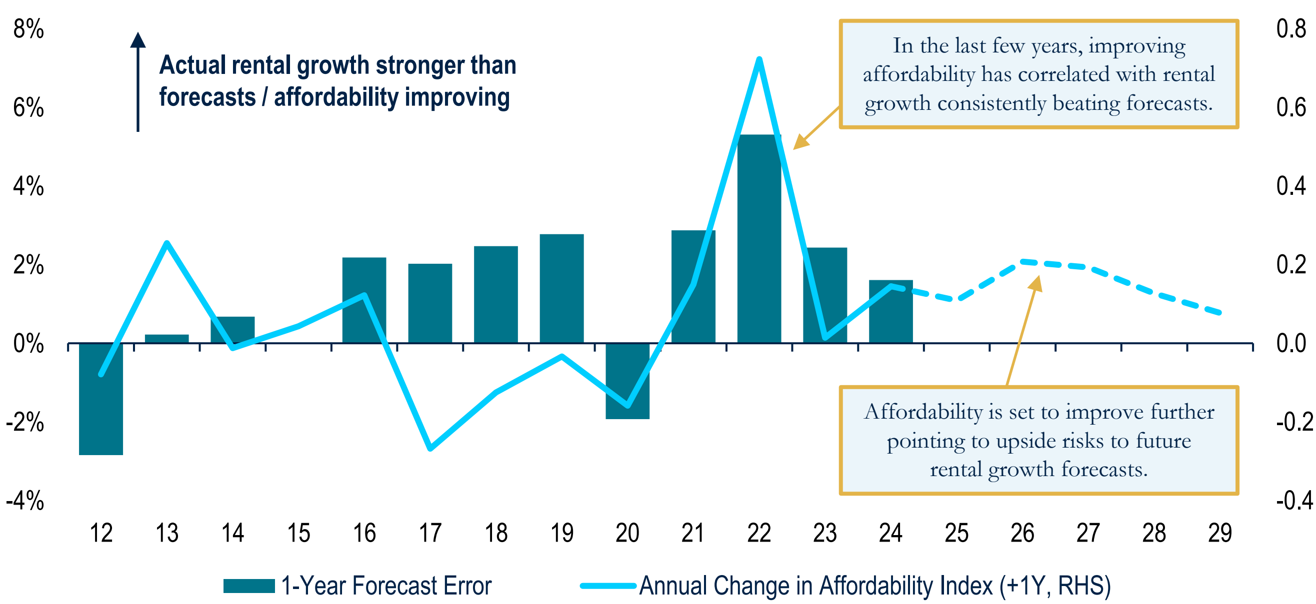
What Does an Analysis of Affordability Mean for Office Rental Growth Forecasts?

Offices have been out of favor with investors due to occupier headwinds from hybrid working but affordability has improved and points to upside risks to rental growth forecasts in the coming years.

Through the last cycle, office rental growth was repeatedly underpredicted, in part reflecting lower supply and higher employment growth outcomes than expected. In recent years improvements in our measure of tenant affordability – which compares economic activity per unit of occupied real estate space to headline rents – have started to play a role in explaining forecast errors too (**Exhibit 4**).

Exhibit 4: Affordability Has Explained Forecast Errors in Recent Years

Annual Office Rental Growth Forecast Error (%) and Change in Affordability (Normalized)



Sources: PMA, Oxford Economics, PGIM Real Estate. As of March 2025.

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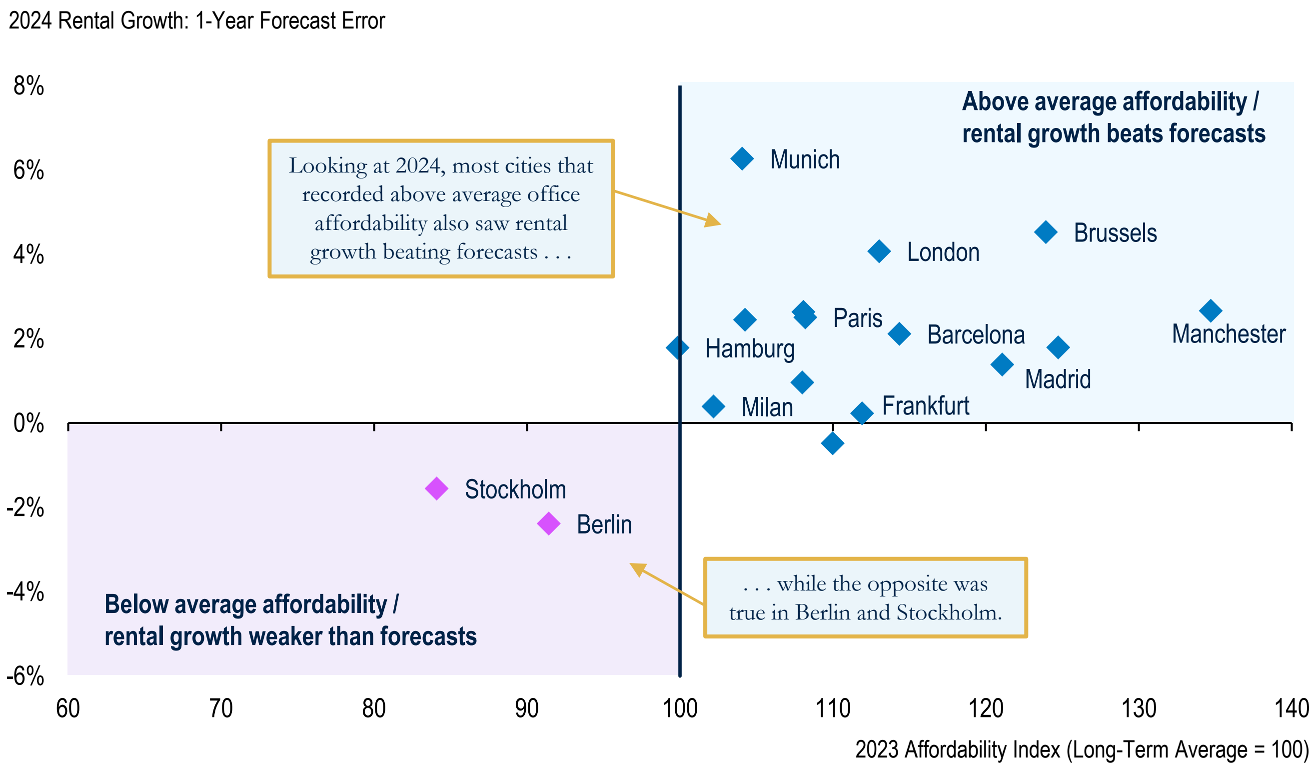
Our affordability index can be a helpful predicative tool when it comes to assessing city rental growth. Most cities that recorded an above average affordability score in 2023 went on to record stronger-than-expected rental growth in 2024 (**Exhibit 5**).

Exhibit 5: Affordability Can be A Helpful Predicative Tool For Cities

Office Rental Growth Forecast Error Versus Previous Year Affordability Index by Major City – 2024



Sources: PMA, Oxford Economics, PGIM Real Estate. As of March 2025.

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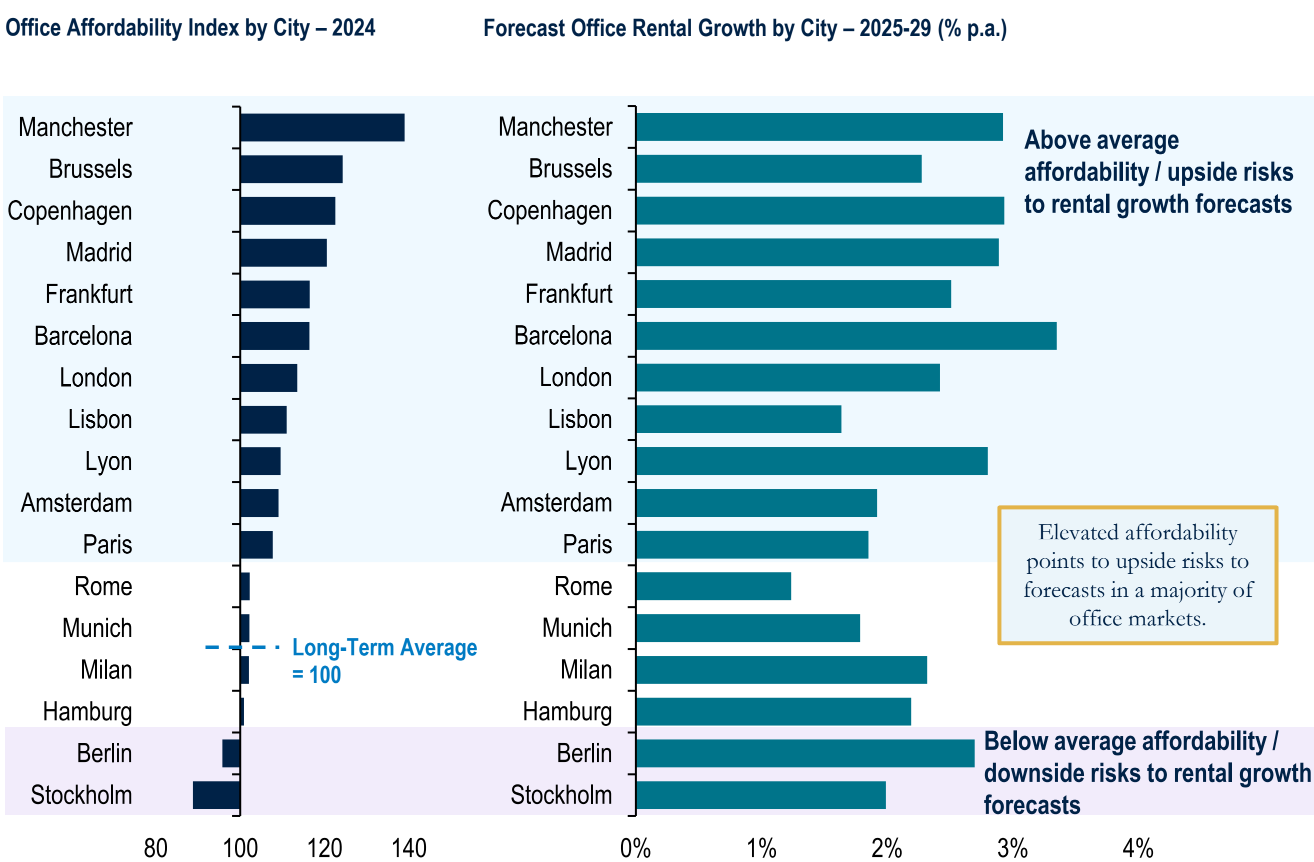
In turn, we can look at where there might be upside and downside risks to forecasts for rental growth in major markets in the coming years. Generally speaking, we are seeing elevated affordability and upside risks to the outlook in second-tier markets like Manchester, Brussels and Copenhagen, along with faster-growing Barcelona and Madrid in Spain, and major financial hubs like London, Paris and Frankfurt (**Exhibit 6**).

In contrast, affordability continues to look stretched in Berlin and Stockholm and points to a risk of rents underperforming expectations in the coming years.

Exhibit 6: There Are Upside Risks to Rental Growth in Many Office Markets



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PGIM REAL ESTATE

INVESTMENT RESEARCH | MARCH 2025

ASIA PACIFIC INSIGHTS

Key Themes

- Does Infill Development Help Support the Rental Growth Outlook?
- Are Forecasters Ignoring the Importance of Infill Development?

Does Infill Development Help Support the Rental Growth Outlook?

The recent bout of economic and geopolitical uncertainty has given rise to a fear that the economic outlook across Asia is set to be downgraded and with that real estate. And yet reading across from GDP or employment growth forecasts to rental growth isn't perfect – even when development pipelines are low.

Exhibit 1 plots employment and rental growth for the 10 major investment cities across the region. Ignoring the outliers of 2008 and 2020, its clear there is a pretty good fit between the two variables. From this, employment forecasts point to real rental growth for prime commercial real estate of around 1.5% per year for the next five years, slightly lower than the 20-year history. Here a weaker employment outlook translates into lower rental growth.

And yet, what works so well for the region does not work so well for the city. If instead we compare employment growth against real rental growth on a city-by-city basis, it is clear there is, in effect, no common relationship across the cities (**Exhibit 2**).

Exhibit 1: Why Employment Growth Gets so Much Attention

City Employment Growth and Prime Commercial Real Rental Growth, 2001-29 (% p.a.)*

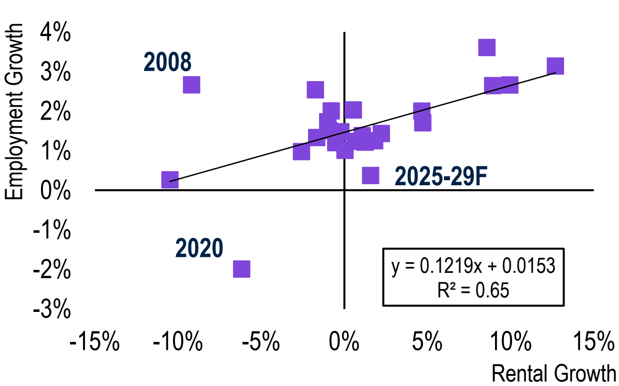
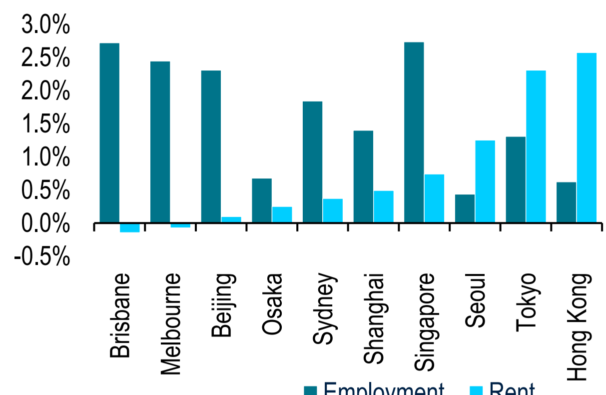


Exhibit 2: Why Employment Growth Should *Not* Get so Much Attention

City Employment Growth and Prime Commercial Real Rental Growth, 2001-24 (% p.a.)*



*Note: For Beijing, Brisbane, Hong Kong, Melbourne, Osaka, Tokyo, Seoul, Shanghai, Singapore and Sydney.

Sources: Oxford Economics, JLL, PMA, PGIM Real Estate. As of March 2025. **Forecasts are not guaranteed and may not be a reliable indicator of future results.**

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Why is this? The simple reason is aggregation bias – the regional view averages out city differences. Linking economics to rental growth should at least hold at the city level. But even here there are problems For one, even when taking the supply-side into account, it is unclear why the link from economics to rental growth varies so much across cities. And that makes analyzing and forecasting rental growth problematic.

One reason for these differences is down to the shapes of the cities themselves. In particular, the degree of infill development – defined as how much of a city is built up and occupied – each has.

According to a recent World Bank Group Report[1], cities with high levels of infill development are those in which occupiers compete for limited space to take advantage of location-specific productivity gains. In real estate terms, this translates into real rental growth.

In effect, the higher is the infill development the more intense the competition for space is and the stronger the pass-through from economic growth to rental growth. **Exhibit 3** plots the link between the rent to employment ratio and infill density.

What this means is that by taking infill development into account we are better able to explain how economics feed into rental growth and in effect the differing significance of changes in the economics.

But there is another factor to consider. This transmission from economics to rental growth changes over time - in line with changes in infill development. As **Exhibit 4** shows, over the next 5 years the transmission from employment to rental growth is set to increase in Brisbane, Melbourne, Sydney, Beijing, Shanghai and Singapore; elsewhere it is set to weaken. As such, in these cities the higher level of infill developments supports a stronger rental outlook than is currently forecast.

This means changes to the economic outlook will now have a time varying element, rendering historical patterns increasingly misleading unless explicitly taken into account. Levels of and changes to infill development now add a new dimension to how we might now think of the longer-term occupier dynamics of cities.

Exhibit 3: Infill Development Affects How Employment Impacts Rents

City Infill Development* and Prime Commercial Real Rent: Employment Growth Ratio, 2001-24 (% p.a.)

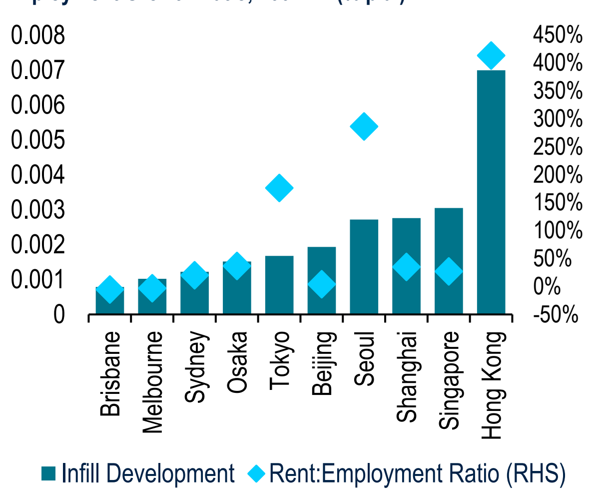
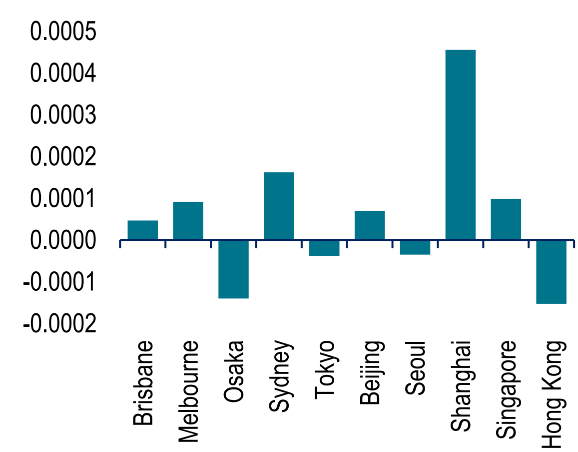


Exhibit 4: Cities Continue to Change

Expected Change in City Infill Development 2020 vs. 2030 * (Persons Per Sq Meter)



*Note: Where infill development is how many people occupy per square meter of a city's floorspace.
Sources: World Bank Group, JLL, PMA, Oxford Economics, PGIM Real Estate. As of March 2025.
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[1] Pancakes to Pyramids, City Form to Promote Sustainable Growth, World Bank Group, 2021.

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Are Forecasters Ignoring the Importance of Infill Development?

Alongside numerous economic and political risks to the outlook, the major investment markets are also vulnerable to an expected decline in employment growth, thanks in large part to aging demographics. Singapore and Seoul, for instance, are expected to post falling employment over the coming years. From an occupied space perspective, at the extreme, this points to an outright decline in the need for real estate.

That said, consensus economic forecasts point to an expected pick-up in productivity growth (as is currently being recorded in the United States). A bigger role for productivity makes existing buildings more valuable to occupiers and investors alike: more output is produced per square meter of occupied space. Even taking into account the employment outlook, the GDP growth story does not look so bad (**Exhibit 5**).

Nonetheless the outlook for rental growth is somewhat different. There is a clear disconnect between the GDP and rental outlook but one that can be explained given current market conditions – for instance, we know there is solid employment growth outlook for Australia (not shown) and of ongoing struggles in China (**Exhibit 6**). But of course this does not mean the forecasts will be proven right. They are afterall error prone.

One source of forecast error can be through the role of infill development measured in terms of how many people there are per square meter of a city's entire floorspace. As we argue in the previous insight, cities with high levels of infill development are those in which occupiers compete for limited space to take advantage of location-specific productivity gains. In real estate this translates into rental growth[2].

Exhibit 5: Productivity Growth Set to Overtake Employment in Driving GDP

City Employment, Productivity and Real GDP Growth Forecasts, 2025-29 (% p.a.)

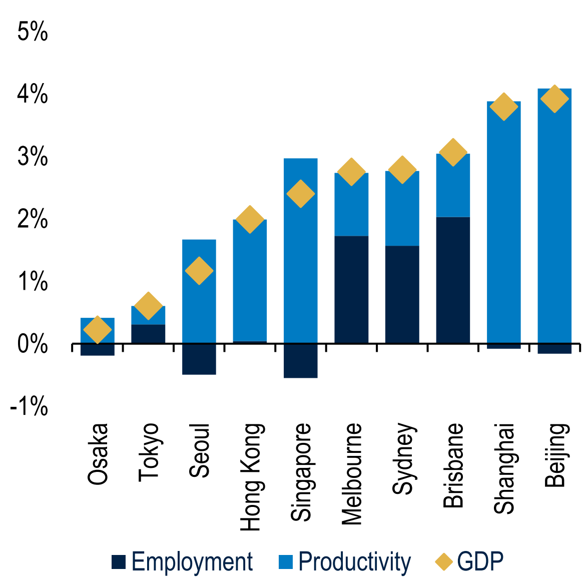
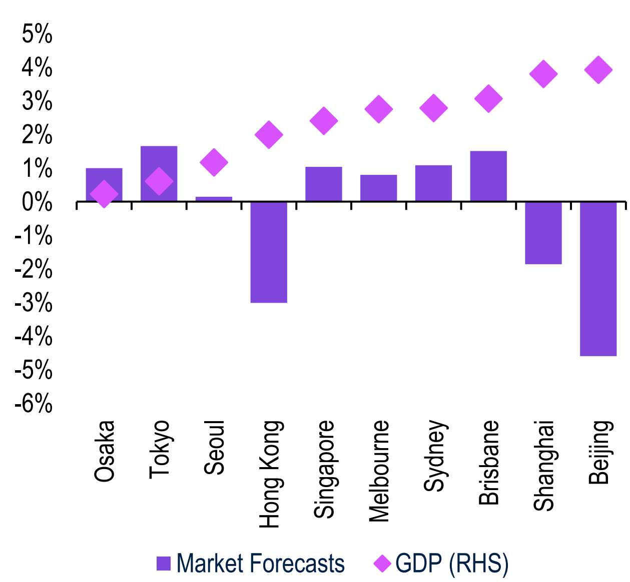


Exhibit 6: Economic and Rental Growth Forecasts Are Not Clearly Aligned

Market-Based City Commercial Prime Real Rental Growth Forecasts vs. GDP Growth, 2025-29 (% p.a.)



Sources: Oxford Economics, JLL, PMA, PGIM Real Estate. As of March 2025.
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[2] Pancakes to Pyramids, City Form to Promote Sustainable Growth, World Bank Group, 2021.

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In other words, the higher a city's level of infill development, the stronger the pass-through from economic growth to rental growth. If forecasters miss this tension, then it is possible, even when taking all of the economics into account that rental growth is being over-estimated in low infill developed cities and underestimated in high infill developed cities.

To explore this, **Exhibit 7** plots the link between city infill development and commercial real rental growth. While not perfect – Osaka and Tokyo are clear outliers suggesting more is going on here[3] – the fit is not bad at supporting the link between economics and real estate.

So are forecasters missing this link? **Exhibit 8** plots one-year ahead forecast errors for the office market. The larger the error, the greater the average difference is between actual real rental growth and forecast – and supports the idea, albeit not perfectly, that the higher the infill development of a city, the higher the forecast error. This would suggest forecasters are not taking infill development into account.

For our given sample, market-based forecasts have underestimated real office rental growth. The errors for Melbourne, Sydney, Osaka, Beijing, Singapore and Hong Kong for instance point to a pattern in which the higher is infill development the greater is the forecast error.

Exhibit 7*: Infill Development Also Affects the Feedthrough From GDP Growth to Rents

City Infill Development and Prime Commercial Real Rent to GDP Growth Ratio, 2001-24 (% p.a.)**

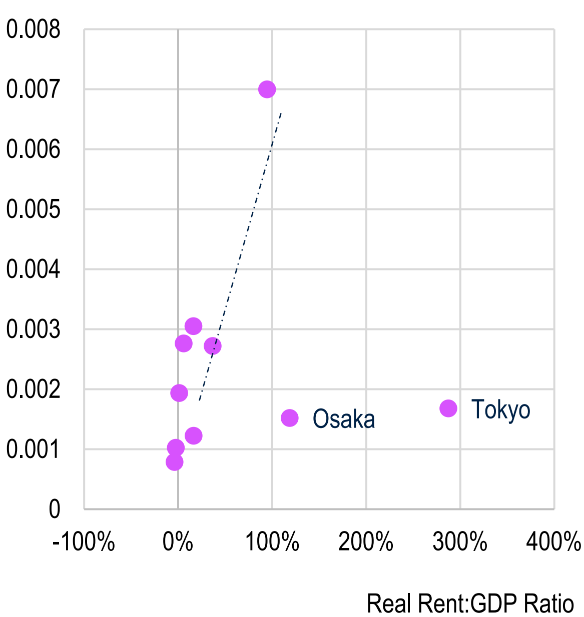

Exhibit 8: Forecast Errors Are Generally Larger in Higher Infill Developed Cities

Infill Development and Average 1-Year Ahead Forecast Errors for Real Rental Growth (% p.a.), Prime Office Markets, 2011-24**

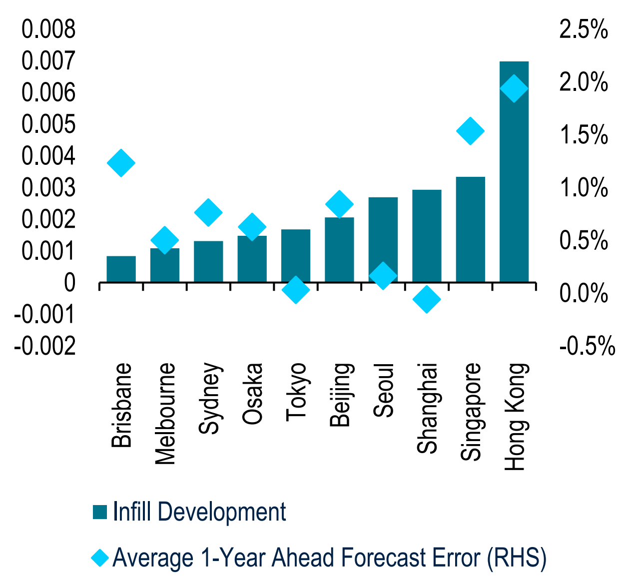

*Exhibit 7 cities: Beijing, Brisbane, Hong Kong, Melbourne, Osaka, Seoul, Shanghai, Singapore, Sydney and Tokyo.
** Infill development measured by how many people per square meter of a city's entire floorspace.
Sources: Oxford Economics, JLL, PMA, PGIM Real Estate. As of March 2025.

[3] Evidence supports the notion that the occupier markets of Tokyo, for instance, are driven more by export revenues linked to the value of the yen on foreign exchange markets – boosting occupier affordability – than Tokyo GDP growth.

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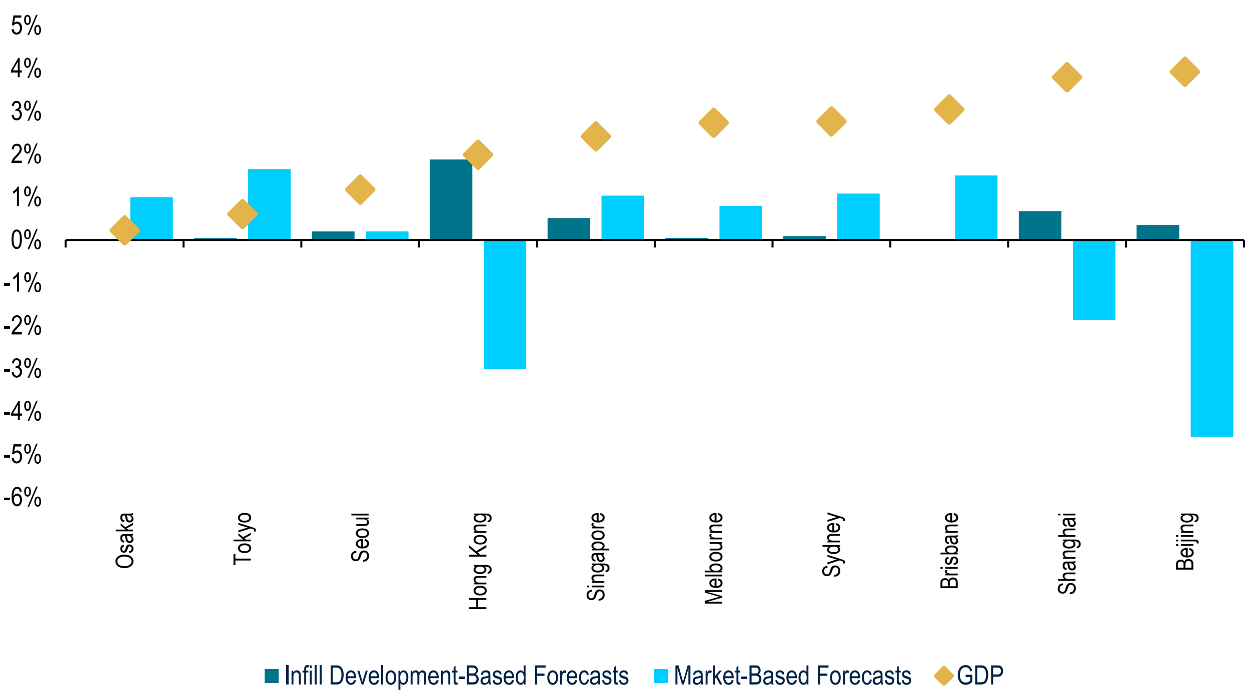
So what does this mean? **Exhibit 9** compares market-based rental growth forecasts for prime commercial real estate for the major 10 investment markets against the simple rental growth outlook based on GDP growth and levels of infill development.

The comparison is interesting. The infill development-based forecasts, whilst naïve – with demand tracked by GDP growth and infill development capturing the supply side – present a more subdued outlook than the market-based numbers – unless you happen to be Hong Kong, Shanghai or Beijing. More generally, infill development means real rental growth is expected to be stronger in high-density over low-density locations, but there is no narrative as such.

We have more work to do in this direction, but we also have another variable to consider when evaluating the risks to forecasts – signs that forecasters are missing the role infill development plays. And with that we have another reminder to not get carried away with headline economic numbers.

Exhibit 9: Forecasters Might be Ignoring How Infill Development Matters for a Market's Outlook

Infill Development-Based City Commercial vs. Market-Based Real Rental Growth and Real GDP Growth Forecasts, 2025-29 (% p.a.)



Sources: PGIM Real Estate. As of March 2025.

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INVESTMENT RESEARCH | MARCH 2025

MEXICO INSIGHTS

Key Themes

- What Does Tariff Uncertainty Mean for Industrial Investment in Mexico?
- Which Markets Benefit Most From Higher Productivity?

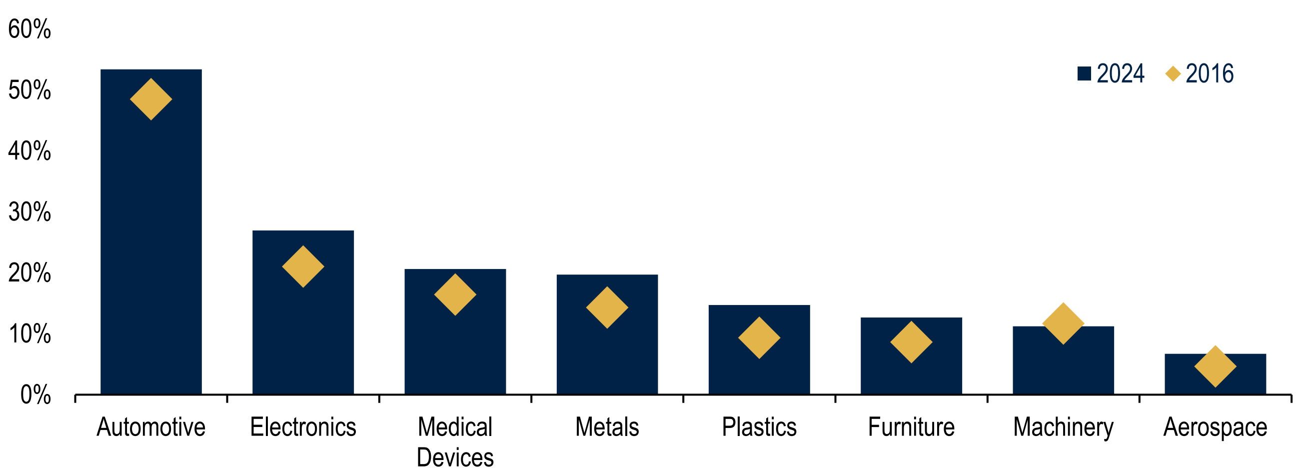
What Does Tariff Uncertainty Mean for Industrial Investment in Mexico?

It is too early to speculate on the specifics of U.S.-Mexico trade policy changes. Nevertheless, initial weeks of the second Trump administration portend a prolonged period of uncertainty. Will that end the recent Mexico industrial market expansion? Given the importance of Mexico's manufacturing base to North America supply chains, and the experience in the first Trump administration, we doubt it.

From 2016 to 2024, Mexico's share of U.S. imports in certain goods rose across a broad range of industries, as shown in **Exhibit 1**. The rises occurred despite uncertainty about trade policy during the first half of that period, when multiple threats of tariffs were lobbed by the first Trump administration in every year until the new U.S.-Mexico-Canada Agreement (USMCA) was finally signed in 2020.

Exhibit 1: U.S.-Mexico Trade Linkages Have Strengthened

Mexico's Share of U.S. Imports by Industry



Sources: U.S. Census Bureau, PGIM Real Estate. As of March 2025.

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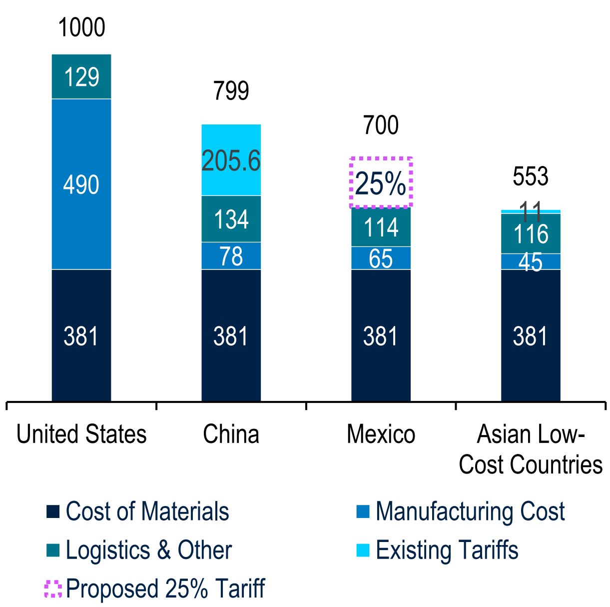
Mexico has become a more important trading partner with the United States in industries including medical devices, electronics, and particularly in the automotive sector, with more than half of the share of U.S. imports. Importantly, this share is not just finished products, but reflects decades-long investments in supply chains that facilitate the movement of intermediate goods back and forth across the U.S.-Mexico border.

Cost is an important motivation for these supply chain investments. As shown in **Exhibit 2**, Mexico is already a lower-cost production location than China.

The dotted bars estimate the potential impact of a 25% tariff on goods imported from Mexico, which would leave Mexico's goods more than 10% less expensive than China's. (And that ignores the likely beneficial impact of a depreciated Mexican peso versus the U.S. dollar.) The main beneficiary of tariffs on Mexican goods would most likely be low-cost countries in Asia, rather than producers in the United States.

Exhibit 2: Mexico Would Still Be Low Cost With Tariffs

Indicative Manufacturing Cost Structure



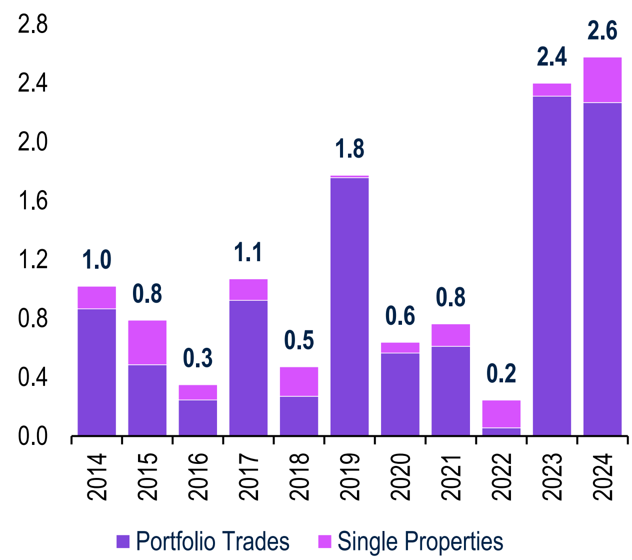
Sources: BCG Global Manufacturing Cost Competitiveness Index 2023, PwC Beyond China: US Manufacturers are Sizing Up New Global Footprints, PGIM Real Estate Research. As of March 2025.

Investment in Mexico industrial properties provides us with additional evidence of durability in periods of uncertainty. As shown in **Exhibit 3**, the last two years were record-setting with US$5 billion invested including multiple large portfolios. Interestingly, the prior two largest investment years were in 2017 and 2019 – during the first Trump administration, before the USMCA was signed.

While the short-term outlook for Mexico industrial investment is clouded by tariff policy uncertainty, we maintain conviction that the long-term outlook is positive.

Exhibit 3: Investment Boomed Prior to the USMCA

Mexico Industrial Investment (US$ Billions)



Sources: Real Capital Analytics, PGIM Real Estate. As of March 2025.

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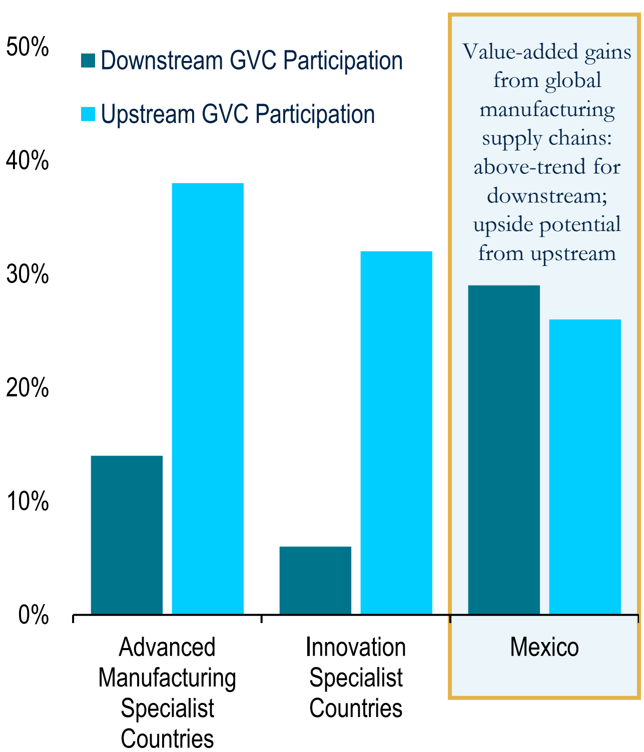
Which Markets Benefit Most From Higher Productivity?

Mexico can present a productivity paradox. Employment growth, annual hours worked and a deepening of the capital stock have driven economic growth – and industrial real estate rent growth – in Mexico. Productivity explains much of the differences in rent growth.

Increasingly, Mexico is a specialist at importing intermediate goods to produce more sophisticated exports. This is known as "backward participation" or "downstream participation" in global value chains (GVCs). As **Exhibit 4** shows, Mexico achieves much higher added value from its downstream GVC participation than international peers.

Exhibit 4: Mexico Excels at Downstream Global Value Chain Participation

Value Added From Downstream and Upstream Manufacturing GVCs



Sources: OECD, World Bank, PGIM Real Estate. As of March 2025.

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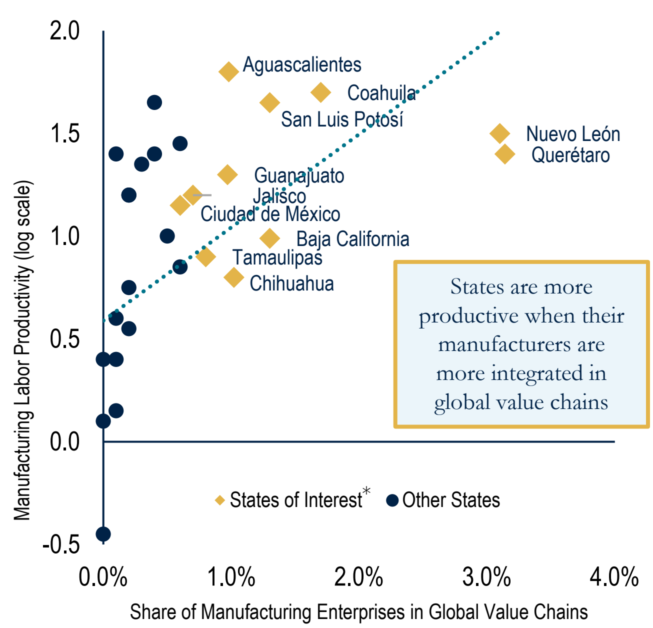
Because Mexico's economy is oriented toward manufacturing and trade, with ~80% of exports flowing to the United States, the country has very high levels of participation in global value chains.

To analyze productivity impacts on industrial rents, we dig into state-level and metro-level differences,. There is significant untapped potential if "total factor productivity" kicks in as a share of growth – but in the interim, there are outperformers.

Some states do offer higher productivity – manufactured output per worker – and **Exhibit 5** shows that these states tend to have a higher share of their manufacturing firms integrated in global value chains. For example, Nuevo León (home to Monterrey), which offers very strong integration in GVCs, has labor productivity of more than 50% above the national average.

Exhibit 5: Higher Labor Productivity in States With More Global Manufacturers

Manufacturing Labor Productivity (log scale)



*Note: States of Interest refers to states with significant institutionally held industrial real estate assets as tracked by CBRE: Aguascalientes, Baja California, Chihuahua, Ciudad de Mexico, Coahuila, Guanajuato, Jalisco, Nuevo Leon, Queretaro, San Luis Potosi and Tamaulipas.

Sources: Oxford Economics, INEGI, World Bank, PGIM Real Estate. As of March 2025.

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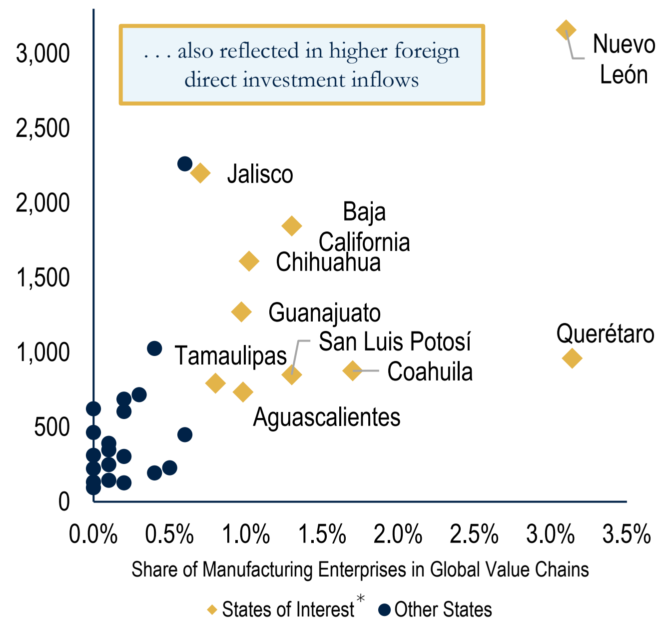
That is not the entire story. **Exhibit 6** shows us that states with the most foreign direct investment (FDI) over the past four years include a few others. Baja California, Chihuahua, Guanajuato, Jalisco and Ciudad de Mexico stand out for their inbound capital investments in plants, property, machinery and equipment. We expect these regions to shift upward on their labor productivity over the coming years.

How does this impact real estate? According to INEGI data, each state's integration into global value chains is correlated with its human capital, i.e., the availability of medium- and high-skilled labor in the workforce (r-squared = 0.46). As manufacturers seek out high-skilled and abundant labor over the coming years, this demographic strength should become more and more relevant.

Exhibit 7 shows us how this supports rising industrial rents. All 11 metros have experienced attractive and outsized rent growth of over 8.5% p.a. over the past three years. Yet, metros like Monterrey and Saltillo, where the share of medium- and high-skilled labor is more than 10 percentage points higher than Guanajuato, benefit most from productivity growth.

Exhibit 6: States Are Highly Differentiated in Global Value Chain Linkages and FDI

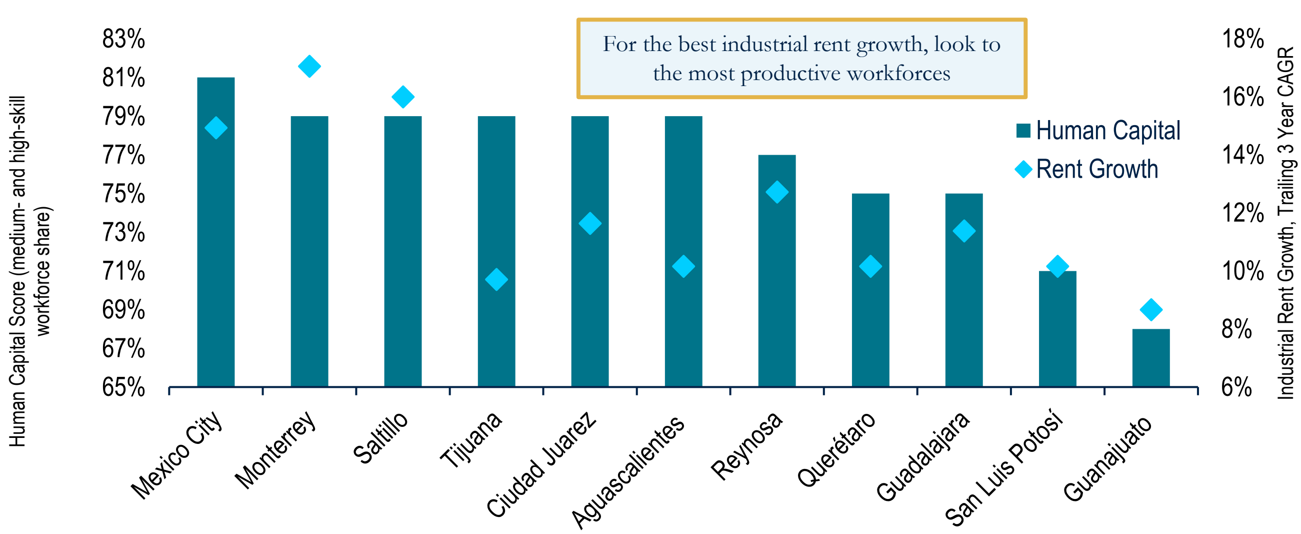
Average Annual FDI, 2020-24 (USD MM)



*Note: States of Interest refers to states with significant institutionally held industrial real estate assets as tracked by CBRE: Aguascalientes, Baja California, Chihuahua, Ciudad de Mexico, Coahuila, Guanajuato, Jalisco, Nuevo Leon, Queretaro, San Luis Potosi and Tamaulipas.
Sources: Oxford Economics, INEGI, PGIM Real Estate. As of March 2025.

Exhibit 7: Where Do Rents Outperform?

Higher Human Capital = Higher Productivity = Rent Growth



Sources: World Bank, CBRE, PGIM Real Estate. As of March 2025.

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INVESTMENT RESEARCH | MARCH 2025

PRIVATE CREDIT INSIGHTS

Key Themes

- How Will a Higher U.S. 10-Year Treasury Yield Affect the Private CRE Credit Landscape?
- How Will Rising Benchmarks Influence the Outlook for Private CRE Credit Returns?
- How Will the Recovery in Real Estate Markets Create New Financing Opportunities?

How Will a Higher U.S. 10-Year Treasury Yield Affect the Private CRE Credit Landscape?

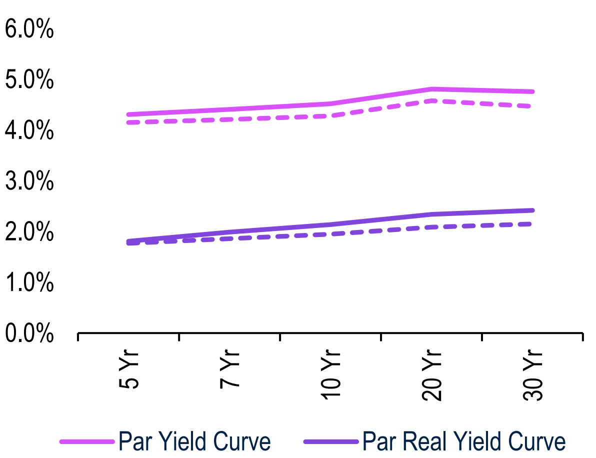
Recent upward revisions to the 10-year Treasury yield forecast, driven by persistent inflation (**Exhibit 1**) and concerns over government debt, indicate a prolonged period of higher borrowing costs. For private credit, this signals an environment of elevated yields and extended opportunities for strong income generation.

Higher borrowing costs translate into higher interest rates on loans and debt instruments, leading to higher potential returns from credit investments. If inflationary pressures persist and push yields up further, private credit investments would benefit from even stronger income generation, offering even more attractive returns.

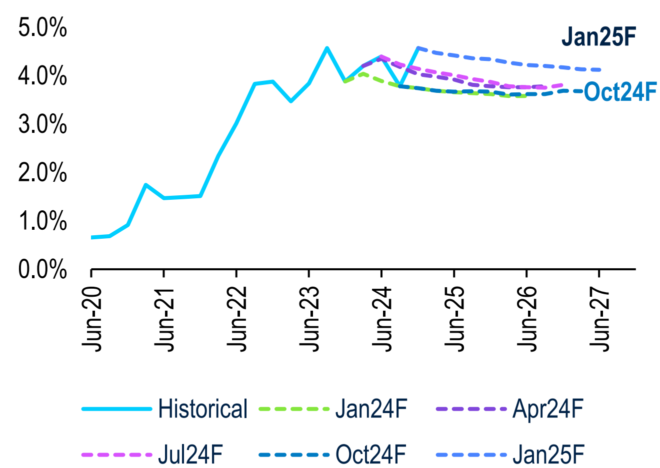
For borrowers navigating this higher rate environment, the impact of rising yields is being offset by tightening

Exhibit 1: 10-Year Treasury Yield Forecast Revised Upwards Fueled by Higher Inflation Expectations

Inflation Expectations: Par Yield Curve vs. Real Par Yield Curve



10-Year Treasury Yields: History and Evolution of Forecasts



Dashed lines refer to previous yield curves as of October 31, 2024. Solid lines refer to current yield curves as of January 30, 2025.
Sources: U.S. Department of the Treasury, Bloomberg, PGIM Real Estate. As of March 2025.
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CRE credit spreads. This is driven by expectations of a real estate market recovery and increased market liquidity, helping to contain debt costs for borrowers.

Private CRE credit markets stand to benefit from this real estate market upswing, as expectations of stronger NOI growth, a rebound in property values and a steady pipeline of transactions and refinancing activity, will improve credit fundamentals and unlock transactions.

In a nutshell, the higher 10-year Treasury yield forecast extends the window of opportunity for stronger income streams from private credit investments, as higher borrowing costs create sustained opportunities for income generation in CRE credit markets.

How Will Rising Benchmarks Influence the Outlook for Private Credit Returns?

The rise in the 10-year Treasury yield is shifting the risk and reward dynamics in credit markets. While higher yields drive borrowing costs up, they also set the stage for more attractive returns in private CRE credit investments (**Exhibit 2**).

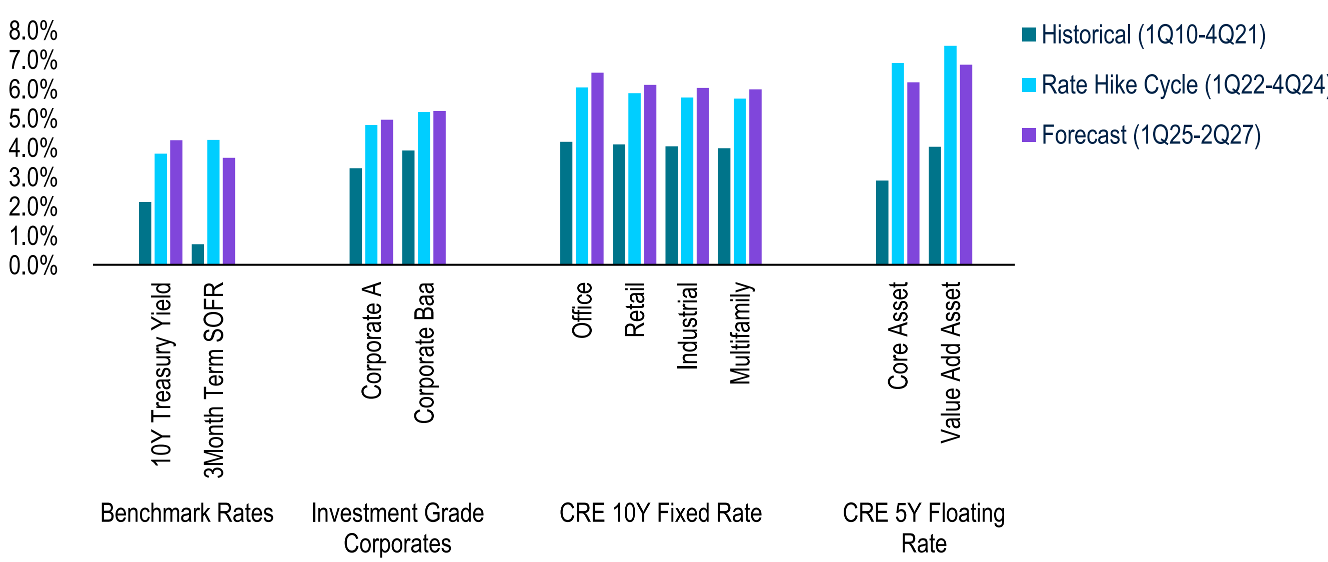
Both public and private credit spreads have been tightening, with private CRE spreads normalizing due to heightened lender competition and expectations of a market rebound. Property values have largely reset, pointing to appreciation in the coming years, while strong economic growth is driving robust NOI projections.

However, lenders are expected to remain cautious in light of ongoing market volatility and uncertainty. Senior lenders, constrained by debt service coverage requirements, will continue to limit leverage levels. This environment benefits alternative debt capital providers, who are well positioned to fill the gap left by traditional lenders.

While higher Treasury yields will keep new loan coupons elevated, conservative underwriting practices will maintain low attachment points, mitigating downside risk. This dynamic enhances the risk-adjusted return potential for private CRE credit investments, particularly as the market moves toward recovery.

Exhibit 2: Higher Treasury Yields Will Keep New Loan Coupons Elevated

New Loan Coupons (%)



Sources: Bloomberg, CREFC, Trepp, Cushman & Wakefield, PGIM Real Estate. As of March 2025.

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Ultimately, the private CRE credit landscape offers attractive opportunities for investors who can balance yield expectations with prudent risk management. As the market stabilizes, those positioned within the alternative credit space stand to benefit from an increasingly favorable risk-return profile.

How Will the Recovery in Real Estate Markets Create New Financing Opportunities?

The recovery in CRE transaction volumes is gaining momentum, supported by improving market fundamentals and increasing debt availability.

Strengthening property cash flows and recovering capital values are setting the stage for renewed investment activity, while rising liquidity is helping to unlock pent-up demand (**Exhibit 3**). As lenders re-engage and pricing expectations stabilize, transaction activity is poised to accelerate.

Credit markets are becoming more accommodative, with NOI growth upgrades supporting stronger debt serviceability, and sustained long-term capital appreciation potential.

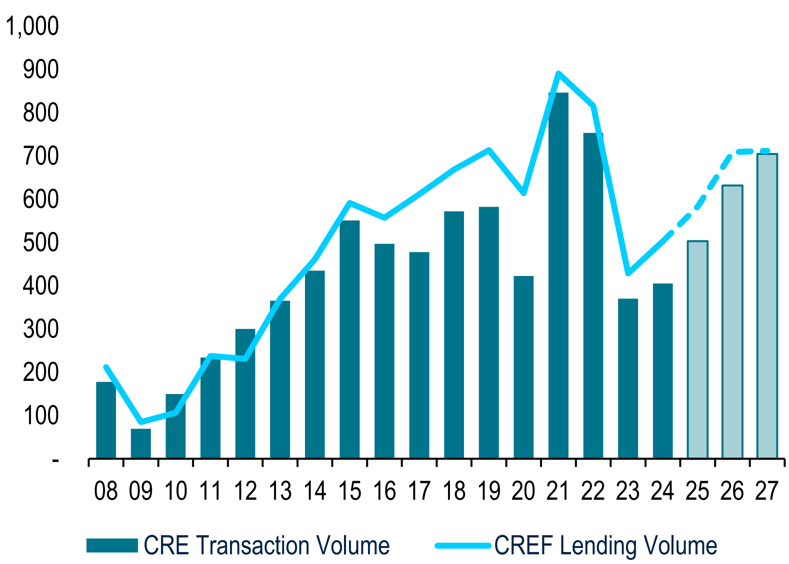
These dynamics are driving lenders to deploy capital more aggressively, particularly in refinancing opportunities as large loan rollovers and delayed maturities come due.

Traditional banks remain selective, but alternative lenders are well positioned to offer flexible capital solutions to meet rising demand. As competition among lenders intensifies, credit spreads will continue to tighten. This increased liquidity will support price discovery and deal execution, further boosting transaction volumes.

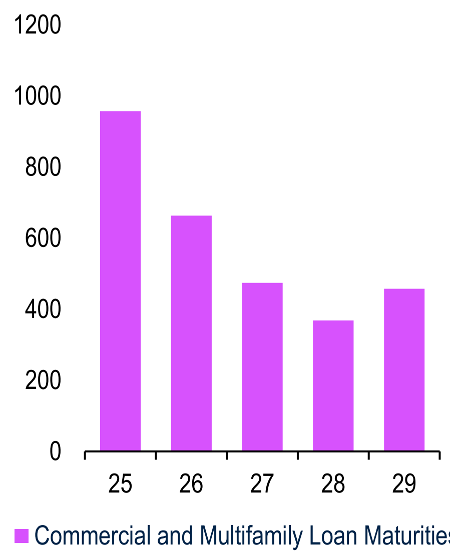
As capital flows improve and market fundamentals strengthen, the CRE financing landscape is set to become more dynamic. Investors who can navigate these evolving market conditions will be well placed to capitalize on the next phase of the recovery.

Exhibit 3: Transaction Volumes and Refinancings to Increase Providing More Financing Opportunities

Transaction and Lending Activity* ($Bn)



Loan Maturities ($Bn)



* CREF lending forecast as of February 2025.
Sources: Mortgage Bankers Association, RCA, PGIM Real Estate. As of March 2025

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