

# THE DIFFERENTIAL

IN CONVERSATION WITH IAS

IAS' Michelle Teng discusses recent trends in the commercial real estate market with PGIM Real Estate Head of Americas Investment Research, Lee Meniffee



## Lee Meniffee

MD, Head of Americas  
Investment Research  
PGIM Real Estate

*Lee Meniffee is a managing director at PGIM Real Estate and head of Americas Investment Research. Based in Los Angeles, Lee leads PGIM Real Estate's research, oversees the research teams supporting PGIM Real Estate's US and Latin America investment activities, and is a member of both Investment Committees. Prior to PGIM, Lee led American Realty Advisors' research capability, supporting portfolio, asset management, acquisitions, and marketing. Earlier, Lee was managing editor of Global Real Estate Strategy for BCA Research, a leading provider of global macro research, where he was responsible for product development, and spent 14y at CBRE Investors, holding various research roles, lastly as senior director of Global Strategy. Lee has a BS in Environmental Studies and Planning from UC Santa Barbara and a master's in Urban Planning from USC.*



## Michelle Teng, PhD, CFA

VP, Co-Head of Private  
Assets Research  
PGIM IAS

*Michelle is Vice President and Co-Head of the Private Assets Research Program in PGIM's Institutional Advisory & Solutions (IAS) group. She joined IAS from the Prudential Retirement's Investment & Pension Solutions team. Michelle is also author of the IAS "business-school" case study series tracking the transformation of the (hypothetical) Cenland Corporation's traditional DB plan to a DC plan from the perspective of the plan's CIO and portfolio managers. These case studies are available at [www.PGIM.com/IAS](http://www.PGIM.com/IAS). Michelle received a PhD in Electronic and Electrical Engineering from University College London (UCL) and an MBA from Tuck School of Business at Dartmouth. She holds the Chartered Financial Analyst® designation.*

**MT: In the current economic environment, real estate transaction volumes have dropped. Can you tell us what is going on with commercial real estate (CRE)?**

LM: Transaction activities did briefly shut down in 2020. But, by early 2021 things were really coming back, and we saw a surge of transaction activities for more than a year. Going back to last year, Q1 2022, real estate was still cheap relative to other asset classes, such as corporate and high yield bonds even though prices had earlier enjoyed good appreciation. But then the Fed started raising interest rates and the transactions market started to slow down immediately. Nevertheless, through June 2022, there was still a fair amount of activity. When it became clear that the Fed was going to continue to hike rates, suddenly real estate did not look so attractive relative to other asset classes, especially fixed income, so transaction activities virtually stopped.

As a highly leveraged asset class, real estate is quickly impacted by declines in debt availability. At the same time interest rates started

rising, the large banks came under regulatory encouragement to lighten up on their real estate exposures. They started pulling back from the lending market. Even though the sources of real estate credit are fairly diversified – banks account for a little less than half of the lending market – the pullback in lending was felt quickly. The other major source of real estate financing is the securitized CMBS market, which was hugely important before the GFC but more-or-less shut down for 5 years afterwards. More recently, the CMBS market was coming back but is still not close to where it was during the GFC, and has now once again essentially shut down.

So even though the United States has diversified sources of real estate credit, at this point almost all the sources seem to either be pulling back or tightening their loan criteria. This is further reinforcing the freeze in transactions markets.

The situation in Europe is even more pronounced, since banks account for up to 90% of real estate lending. In some ways

that's been helpful because it has caused buyers and sellers to understand that pricing between the two regions isn't the same, with Europe experiencing faster re-pricing, which should help to re-open those transactions markets more quickly.

**MT: There is a big valuation gap between public and private real estate. Even though public markets are not necessarily a good predictor, do you think private valuations will catch up to the public market? How long will it take?**

LM: During periods with very little liquidity, public markets show a decline in values. It is true that private market valuation changes lag changes in public market valuations. But in many cases, private markets don't reflect the volatility in the public markets. There must be some persistence in that valuation gap for the private market to reflect changes in public market valuation. We have had 3 or 4 significant REIT downturns since 2012 (for instance, U.S. REITs were down in 2020 by approximately 50%), but those downturns did not persist long enough for private valuations to adjust. Another thing that typically happens at the beginning of a recession is that equity values increase, which will also be true for REITs. It will take private markets a long time to catch up with REITs. There is a lag both on the way up and on the way down – not totally symmetric but fairly symmetric. The lag is typically 6 months to 1 year for a baseline. But right now, we still have a disconnect between public and private pricing that's not likely to resolve one way or the other for at least a few quarters.

**MT: Thinking a bit about sectors, what is the nationwide condition of the office market? How likely will office be re-purposed to residential? Besides office, what other CRE sector should we be paying attention to?**

LM: We need to think about office in the context of the entire private real estate universe. Office values have been falling since the pandemic. Even before the pandemic, there were concerns about office as a poor performing property type. In fact, the long-term performance of office is by far the worst of the major property types. One of the reasons is that they are very capital intensive. Owners need to put a lot of money into those buildings to maintain their rents.

When the markets are tight, owners don't have to invest as much money in the office buildings, but when the markets are weak, they have to put in more capital to attract tenants. Importantly, since the GFC, the additional capital needs for office buildings never stopped. Owners have had to continually put in capital even when the vacancy rates were coming down as supply and demand never became balanced.

There are two forces driving this supply-demand imbalance in the sector. First, the market is overbuilt and, second, the traditional relationship between office-based jobs and office demand has broken down, as companies began to use space more efficiently, e.g., remote working, which had already started before the pandemic. The office sector entered the pandemic in poor shape. Then the world shut down, and no one went to the office for 9 months. Now, even though people are coming back to the office, companies are looking at ways to save, including on occupancy costs, which is why we do not see any net demand for office in

the near-term. There may be net negative demand, and this is outside of a recession scenario.

At the same time, we need to separate office from other real estate sectors due to the likelihood of foreclosures and the pressure on banks. Let's say banks own a lot of real estate loans and some percentage of those are fixed rate loans. Any loans originated in the past 2 years are now worth less because the loan coupons are very low. They have those loans on their books and they are worth less today than they were a year ago on mark-to-market basis. But banks do not have a credit issue with most of those loans because borrowers will be able to pay as scheduled and the loans will mature at par. There also should not be a lot of issues with loans originated years ago because there has been so much property appreciation since the loan origination. Office, unfortunately, in many cases will be an exception.

One big difference between the GFC and now is that loan-to-value ratios (LTVs) have remained low throughout this entire cycle. Prior to GFC, the average LTV was about 60%. Then it came down to about 50%. Since 2013, real estate values have doubled, on average, so loans originated at 50% or 65% LTV in 2013 should be about 35% LTV on maturity, suggesting no systematic refinancing risk.

But the problems will be around office. Office values are down by 20% since the beginning of the pandemic, with more to come. What is potentially alarming is the dispersion around that average drop. There will be many office assets with values less than the loan amount. That is the foreclosure situation where banks will sell the loans and take a loss. What is interesting is that the capital charges for banks for owning a real estate asset are much higher than holding the loan on that asset. So, if a bank has a \$50m loan exposure, and the office is now worth only \$50m, you would think the bank would be indifferent to taking over the property. Not so! What changes is that the capital charge for the bank to own the office is higher than to own the loan. So, the first thing we will start to see is banks selling loans at a discount. This has already started and there will be a lot more of it. In many other cases, banks have no reason to go the foreclosure route because the assets have leases in place with enough income to service the loan.

Overall, regarding discounted loan sales and foreclosures, we expect to see most of this activity in the office sector. For the other property types, property values are much higher than when the loans were originated. For example, since most banks loan 50-60% of the value for apartment properties, it is going to be very rare for an apartment building to fall in value that much. So that is a much more manageable risk for banks than office.

When we talk about office converting to residential, in many cases office buildings are not built to suit that need. Office buildings are too big and there are not enough windows. This presents a physical challenge.

The second challenge is the cost to rebuild the systems, complete plumbing work, etc. Also, you have zoning and political issues that will prevent the conversion. In many cases, it is cheaper to build a new apartment building than to convert an office building into one. Therefore, I do not expect to see a lot of office

conversions.

**MT: Over the decades, institutional investors have been through cycles and have seen several CRE downturns. Can you put the current downturn in perspective? What's different about today's market? Where do you see opportunities for institutional investors?**

LM: The challenge for investors is that most of them are now overallocated to real estate versus what they intended. Modern institutional investment in real estate, which in the United States started around 1980, has followed a pattern during every single recession where interest rates were high in the beginning of the recession and then started to come down quickly during the recession. And structurally, interest rates fell from 1980 to 2022. Real estate values, like many other asset classes, benefitted from that structural drop of interest rates.

In a typical recession, when your loans mature you can refinance at a lower rate because interest rates drop. That is where our current downturn could be very different. Interest rates are still high and it is unclear whether they will continue to go higher. Regardless, rates are still much higher than where they were and they probably will not go back down to where they were during the mid-2010s to 2022. So, the key difference is that owners will not be able to refinance their loans at a lower rate and, in fact, they might have to refinance their loans at a higher rate which means they need to come up with additional equity to pay down the loan.

Additionally, real estate investors will experience pressure on values, but they can typically quickly find a valuation bottom. However, what has changed is how investors will value real estate relative to other asset classes. Real estate was relatively cheap versus most asset classes for most of the past couple of decades. But not any longer. This relative value loss must work itself through. Real estate values will continue to decline, but it will take some time to reach the bottom. Our expectation is that it will happen this year. Once we get to the valuation bottom, investors will no longer be overallocated to real estate and a risk premium will be re-established. Right now, there is no risk premium in real estate sufficient to compensate investors. At lower valuations, the risk premium will likely return, and, in turn, capital will likely come back into real estate.

For investors seeking real estate exposure right now, there are a few things I can recommend. We think the public equity side is priced appropriately for where we see valuations eventually going. Another potential area would be on the lending side, where the returns from debt are quite attractive on a risk-adjusted basis. In fact, debt returns are now higher than the equity returns we experienced a couple of years ago. This is the case across the board, from core to high yield. So, if investors want to get into real estate right now, I would recommend a focus on public securities and on debt. And, further out the risk spectrum, there will potentially be owners that need "rescue capital" to either refinance loans or deal with liquidity or solvency concerns.

# THE PURSUIT OF OUTPERFORMANCE

**Past performance is no guarantee or reliable indicator of future results. All investments involve risk, including the possible loss of capital. Equities may decline in value** due to both real and perceived general market, economic and industry conditions. Alternative investments are speculative, typically highly illiquid and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for long-term investors willing to forego liquidity and put capital at risk for an indefinite period of time. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk and liquidity risk. Commodities contain heightened risk, including market, political, regulatory and natural conditions and may not be suitable for all investors. The use of models to evaluate securities or securities markets based on certain assumptions concerning the interplay of market factors, may not adequately take into account certain factors and may result in a decline in the value of an investment, which could be substantial.

The analysis in the paper is based on hypothetical modeling. There is no guarantee, and no representation is being made, that an investor will or is likely to achieve profits, losses or results similar to those shown. Hypothetical or simulated performance results are provided for illustrative purposes only and have several inherent limitations. Unlike an actual performance record, simulated results do not represent actual performance and are generally prepared through the retroactive application of a model designed with the benefit of hindsight. There are frequently sharp differences between simulated results and actual results. In addition, since trades have not actually been executed, simulated results cannot account for the impact of certain market risks such as lack of liquidity. There are several other factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of simulated results and all of which can adversely affect actual results.

All charts contained herein were created as of the date of this presentation, unless otherwise noted. Performance results for certain charts and graphs may be limited by date ranges, as stated on the charts and graphs. Different time periods may produce different results. Charts are provided for illustrative purposes and are not an indication of past or future performance of any PGIM product. If any assumptions used herein do not prove to be true, results may vary substantially. These materials may contain hypothetical and simulated examples, which are provided for illustrative purposes only. Simulated examples have certain inherent limitations and are generally prepared through the retroactive application of a model designed with the benefit of hindsight. There are frequently sharp differences between simulated results and actual results. PGIM routinely reviews, modifies, and adds risk factors to its proprietary models. There is no guarantee, and no representation is made, that an investor will achieve results similar to those shown.

These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein, and are subject to change without notice. Certain information contained herein has been obtained from sources that PGIM believes to be reliable; however, PGIM cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. Any forecasts, estimates and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM or its affiliates. These materials are for informational or educational purposes only. In providing these materials, PGIM is not acting as your fiduciary. The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

The information contained herein is provided by PGIM, Inc., the principal asset management business of Prudential Financial, Inc. (PFI), and an investment adviser registered with the US Securities and Exchange Commission. PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients or eligible counterparties for the purposes of the Financial Conduct Authority's Conduct of Business Sourcebook. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd. ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. Pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you of that: (1) PGIM, Inc. is not registered in Canada and relies upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

IAS AS 0731-400