

## PGIM Real Estate

# Investing in the Americas



**Kevin R. Smith** is a managing director at PGIM Real Estate and head of the Americas. Based in Madison, New Jersey, he is responsible for the development and implementation of the strategy and oversight of PGIM Real Estate's businesses in the United States and Latin America.

Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc., spoke with **Kevin R. Smith** of PGIM Real Estate. The following is an excerpt of that conversation.

*Can you give us a short overview of PGIM Real Estate's Americas platform?*

PGIM Real Estate's roots as a real estate investment manager are in the United States, where we pioneered the open-end commingled real estate fund structure for U.S. pension funds in 1970. Since those early beginnings when we focused on core investments, we have expanded our capabilities to span a full range of core, core-plus and value-add strategies, as well as certain niche capabilities, such as senior housing. In addition, we have been investing in Latin America since 2002, where we manage funds specializing in industrial, residential and retail properties in Mexico. We also invest in Brazil — and intend to do more there — and have the capability to invest in Chile. Today, we have nearly \$49 billion in gross assets under management in the Americas, of which nearly \$46 billion is in the U.S.<sup>1</sup>

*How has real estate investment changed since the 1970s?*

When we launched our first open-end fund in 1970, the industry wasn't talking about core, value-add or opportunistic funds. We were just talking about a real estate fund for investors who were looking

beyond stocks and bonds. Eventually, that fund became one of the largest core real estate funds in the U.S.

*Are there other areas where PGIM led the market?*

One of the things we did early in the evolution of real estate investment was expand the sectors in which the industry invested. For example, in 1997, we were investing in self-storage when it was not considered a mainstream institutional asset class. In 1998, we established a senior housing-focused fund in the U.S., which at the time was very much a niche investment but is now much more mainstream. In 2006, we launched a private real estate fund specifically for the U.S. defined-contribution market, and we were also one of the first investors in the for-rent multifamily sector in Mexico as early as 2009. And then in 2013, we combined two closed-end funds into a publicly listed Mexican industrial vehicle — the equivalent of a REIT. So while we're best known for our core real estate expertise, we have a legacy of pioneering investment strategies over these 45-plus years.

*What trends are you seeing in the market today?*

In 2016, investors began to come to grips with the fact that current returns were not going to be as stellar as they had been over the past five years and, going forward, returns were going to be driven by income growth and not predominantly by cap rate compression. That created an uncertainty about appropriate pricing. Add that to the uncertainty with how world events would play out, and the result was a lot of volatility in the markets. Despite that volatility, the underlying demand for real estate by tenants is still growing. It's not dramatic, but it is steadily growing, and that's what we tend to focus on. Not being able to control the capital markets, we focus on what's going on at the property level and which markets are going to have more than their share of rent and income growth.

*Where do you see the greatest risks, and how are you approaching those?*

The two big risks for real estate in the U.S. are the potential for a recession and the impact of quickly rising interest rates. We don't think a recession is likely — the economic factors that would typically lead to a recession simply aren't there. The other risk in the U.S. is what will happen if long-term interest rates rise more quickly than expected. While we can't control interest rates, what we can do is position our portfolios so that they'll do relatively well in all interest-rate environments.

*How important is a global consistency in how you approach risks?*

Given what we went through during the global financial crisis, the importance of demonstrating to clients that we have a handle on risks, and know how to manage those risks, is really important. Our focus on transparency is paramount. Since the crisis, there is much more awareness about what constitutes a robust risk-management process and culture, and we excel in that environment. We still take appropriate levels of risk on behalf of our clients to drive returns. But understanding the risk, quantifying it and managing it effectively — that's what risk management is all about.

*What opportunities do you see?*

This is a market where our size and reputation have been an advantage. Because of the pricing volatility and capital markets uncertainty, some sellers are wary of choosing a buyer who is an unknown commodity when it comes to their ability to close transactions. That has worked in our favor, and I expect it will continue to do so, because we're known as a dependable counterparty and partner in the market. In terms of specific markets, when we look at market fundamentals, there are many more markets that are doing well than there were two or three years ago. The early part of the economic recovery was characterized by huge growth in a few sectors, such as technology. So, some of

the markets were doing very well and some of them were left behind. Now the job and income growth is broadening to many more markets across the United States. That is going to afford more opportunities, especially when many investors are focused only on the largest markets.

*Are there still opportunities in the largest markets, as well?*

We're certainly not abandoning those markets, but we're finding better near-term opportunities in some non-gateway markets. The markets we're looking at are quite large with good fundamentals, impressive job growth and balanced supply. Long-term, investors have good reason to flock to gateway markets, but sometimes in the short term, pricing gets expensive.

*Are you seeing more interest in debt investments?*

We are. Debt can be used as a defensive strategy — the equity in the property is at risk well before the debt — but can also improve returns. The yield on various debt instruments is very attractive on a risk-adjusted basis. So, I think you're going to see more debt investment, whether it's first-mortgage debt, mezzanine debt or preferred equity. We have been active in all of those parts of the market, both in terms of dedicated funds and selective investments in our commingled funds.

*How is PGIM Real Estate catering to the defined contribution market?*

It's reminiscent of how we approached pension funds about investing in real estate in the 1970s. Pension fund CIOs worried about liquidity, pricing and volatility, but eventually learned how it all fit in their defined benefit plans. Similarly, we are now educating the defined contribution marketplace about the benefits and risks of investing in private commercial real estate. Traditionally the exposure to real estate for defined contribution plans has come through ownership of public REIT securities. Today, however, the defined contribution community is more focused on delivering solutions that mirror the risks and returns of defined benefit plans. Defined contribution participants who don't take enough risk and move in and out of funds at the wrong

time can really impact what they have when they reach retirement age. So our approach has been to create investment vehicles that can invest in private real estate and still give some of the liquidity features that participants ask for, while mimicking the outcomes of defined benefit funds. We're very bullish on the growth of the defined contribution world into private real estate, and it's a huge part of our strategy going forward.

*You mentioned earlier that you are growing your Latin America business. What is the appeal of that region?*

Performance and diversification drive almost all investment decisions, and investing in emerging economies is no different. Investors expect emerging market economies to grow faster than mature economies, and therefore the value of the real estate investments to also grow faster. We know we need to be patient in these markets because they will be volatile, but riding out those ups and downs could provide better returns and diversification than we'd get in more mature markets.

*Has the change in U.S. policy toward Mexico affected investor interest?*

There is a lot of uncertainty right now. But we try to stay focused on what's going on in the real estate market in Mexico by looking at our own portfolio — not necessarily what is in the newspapers. From that perspective, so far, leasing and tenant retention look good. We're still very bullish on Mexico's position in terms of manufacturing

and the cross-border benefits of manufacturing, both in the United States and Mexico. It's a very complicated supply chain and not as simple as the political rhetoric may suggest. We're obviously monitoring political developments, but we also think it could result in some interesting investment opportunities.

*What differentiates PGIM Real Estate from some of the other global managers?*

A number of managers invest globally, but that is different than being truly global. We have experienced professionals in 18 offices across the Americas, Europe and Asia Pacific. We have been a consistent player in those markets for a long time. That means we have long-term relationships in each region that we can bring to bear on behalf of our investors. We also have experience managing a variety of funds — open-end and closed-end funds, single-client accounts — in each of those geographies, and investing across the risk spectrum. That type of long-term, local presence is very hard to replicate, and that to me is the differentiator for PGIM Real Estate globally. Cross-border investing numbers are increasing every year, but the favored region tends to change. Because we have an integrated platform with deep local knowledge and expertise in each region leveraging global best practices, we can invest effectively in the markets in which our clients want to invest. So while I acknowledge there are many competitors, there aren't many global firms that have the true footprint that we do.

## CORPORATE OVERVIEW

PGIM Real Estate is the real estate investment business of PGIM, Inc, the global investment management businesses of Prudential Financial, Inc (NYSE: PRU). Redefining the real estate investing landscape since 1970, PGIM Real Estate has professionals in 18 cities in the Americas, Europe and Asia Pacific with deep local knowledge and expertise, and gross assets under management of \$66.0 billion (\$47.6 billion net) as at December 31, 2016. PGIM Real Estate's tenured team offers to its global client base a broad range of real estate investment vehicles that span the risk-return spectrum across core, core-plus, value-add, debt, securities and specialized investment strategies.

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<sup>1</sup>As of December 31, 2016, total net U.S. assets under management equal \$33.3 billion and total net Latin America assets under management equal \$1.8 billion.