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Privcap/ Report

The Evolving Core Plus Investment Opportunity

Real estate investment experts comment on asset-level strategies and portfolio construction

Featuring commentary by:
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About the Experts

Darin Bright
Senior Portfolio Manager, U.S. Core Plus
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Darin Bright is a managing director at PGIM Real Estate and senior portfolio manager for PGIM Real Estate's flagship U.S. core plus equity fund. Based in Madison, New Jersey, Darin directs all aspects of the account's portfolio strategy, including investment allocation and selection, asset management, and portfolio reporting. Darin is a member of PGIM Real Estate's U.S. Executive Council, U.S. Investment Committee and the Americas Executive Council.

Todd Goldberg
Head of U.S. Transactions
PGIM Real Estate

Todd Goldberg is a managing director and head of U.S. Transactions. Based in Madison, New Jersey, he is responsible for leading the U.S. Transactions function, which focuses on acquisitions, sales, and financing nationally on behalf of PGIM Real Estate's managed accounts. In this capacity, he has sourced, underwritten, and closed several billion dollars of transactions. He is currently the chair of the U.S. Equity Investment Committee and a member of the U.S. Executive Committee.

Privcap: Let's start in the pre-COVID market. Todd, please walk us through the historic importance of asset management and leasing strategies to the core plus asset class.

Todd Goldberg, PGIM Real Estate: There are two main strategies for core plus. The first is upgrading the quality of the property, which is really an undertaking of an analysis to expend capital where you think there's value to be created. So, things like upgrading common areas of residential, office, retail or hotel properties, which will give the tenant a better experience and potentially create more rent for the asset. Some of those could be amenities like fitness centers, enhanced outdoor space, meeting areas or even food and beverage options.

There could be upgrades to residential units like flooring, appliances or bathrooms, or building fully-specified suites in an office building so a tenant can come in and plug and play, as opposed to waiting for the space to be built.

From a leasing standpoint—really, a property strategic plan—you might push occupancy rates versus trying to hold out for higher rent. All property types should enhance the overall quality of the cashflow stream relative to where you bought it. You might take leasing risk on any property type, meaning that an asset either is not fully leased at the time you purchase it, or tenants that are in the building might be expected to move out shortly after the purchase.

Investors are generally looking for an outsized core plus level of return relative to a core stabilized asset. This could mean taking on an under-occupied asset if it was 75 percent leased, but could be up to 95 percent over time. Or properties that might have some lower initial return where lease rates are less than market. As an investor, you're taking the risk that those lease rates grow over time so you can achieve some overall returns.

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Privcap: How have the various core plus real estate "food groups" fared during COVID-19?

Darin Bright, PGIM Real Estate: The COVID crisis was really an economic shock to real estate. The reaction to the real estate sector diverged across different property types, depending on the demand and the support for that demand. We saw an improvement in the industrial sector in order to handle those goods and the delivery of those goods. And now, we're seeing a much more significant penetration in terms of home purchases and delivery. We're seeing industrial sector demand and rent growth actually get stronger post-COVID than pre-COVID.

The opposite happened in the retail sector, with the issues of social distancing, masks, infection rate and a lot of the shutdowns. However, we had already had seen the retail sector slowing for different reasons. Prior to COVID, you certainly saw a significant change in terms of demand and operations. Now, we're unfortunately seeing some bankruptcies across the retail sector. The support for renters from the government in terms of PPP was very helpful, as were unemployment checks.

In the apartment sector, the major markets are very urban and dense, and they have the issues of social distancing and infection rates. But, outside the major markets, we actually saw the rental market stay about the same as it was pre-COVID because of government checks to help to pay for rent.

The office sector is really what's been most uncertain. Levels of physical activity are quite low today versus pre-COVID. Corporations have a lot of stay-at-home initiatives in place, adhering to government standards and also actually being very sensitive to making the right decisions from a corporate perspective. There is a lot of uncertainty about the use of office space and footprints, and whether or not you'll see office demand increase or decrease over time as a result of COVID. We've had good news of late, but whether or not the format of that space may change because of densification and interaction at the employee level. So, there is uncertainty around use of space within that footprint.

Privcap: What are you hearing about leasing visibility within the office space?

Bright: It's hard for corporations to make decisions today. But we are seeing some level of activity in suburban and Sunbelt markets—those markets with less restrictions. In gateway markets like San Francisco or New York City, some tenants entered the COVID pandemic with excess space; they are now putting that excess space onto the market, creating vacancy through subleases. So, that is going to create some headwinds

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for the office sector. Anecdotally, we do have some tenants in smaller, mid-tier and Sunbelt markets that are actually looking to either renew or take new space. But, in general, we're seeing a significant pause until there's more certainty in the economy.

Privcap: Talk about the difference between core plus at the asset level and building a core plus diversified portfolio.

Bright: There's a misperception that core plus portfolio construction is made up of all core plus risk levels. A core plus portfolio is not really an accumulation of core plus properties—that would be really difficult to do in terms of targeting that type of risk every time in new acquisitions. In our view, it's a combination of different strategies across that risk spectrum that are at different stages of their investment life cycles. Maybe some are stabilized core assets, some may have moderate risks with a core plus profile, and some may be what we would call value-added or opportunistic type investments where we're taking on development risk or a very significant vacancy investment change.

So, when we compare a core plus strategy versus a blue-chip, Odyssey-level core fund, there are two major differences on the margin that produce additional risk for the additional return: the level of leverage and the level of non-stabilized assets in a portfolio. For a core plus strategy, we'd say those are moderately higher than what you'd find in a core fund. But there are several other minor factors that I would include. You have a higher transaction rate—your hold period for an investment is shorter. You have a higher tolerance for less liquid investments, whether that be because of the property type or because of the market. You would have a higher investment weighting towards smaller, niche property types that have less depth than you see in the traditional investment property types like office and retail.

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>
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Goldberg: From a transactions perspective, when we're out looking for the various types of returns, whether it be core, core plus or value-add, it's our job to know and understand internally what the core plus portfolio manager wants to accomplish. So, at any given time, if the portfolio is overweighted to core, then I think we need to be out in the market looking for more value-added investments that ultimately would provide an outsized return.

If the opposite was true, where there was a heavy concentration of value-added or development assets, we might look for things that have more of a core profile. We're out looking for every type of asset—core, core plus, value-add—and we need to work closely with the portfolio manager to add those types of investments that would make the combination right for a core plus portfolio.

Privcap: Can you give examples of asset types that you and your team are looking at now as you seek to build a core plus portfolio?

Goldberg: We are looking at self-storage, which has performed well through the pandemic and in past recessions. It's a sector that is based on life changes—there is lots of that happening, and it outperforms under those circumstances.

Manufactured housing is another sector where we've spent time—it is also performing very well, and there's a few reasons for that. In mobile home parks, there are smaller homes that provide affordable housing for people. It's a retirement home for people 55 and older. For some people, they are vacation homes. Manufactured housing is performing well now because it's an affordable option for many.

Data centers are becoming more important. Demand continues to grow and will probably accelerate with more online activity and working from home.

Finally, student and senior housing are both a bit more operational in nature, and both have some inherent risks relative to multi-family. Given the situation we're in with the pandemic, they both have really different risks: when will students go back to class and, in senior housing, obviously making sure that the residents are safe.

Those are sectors that are not part of the four main food groups, so therefore they're a little less liquid and maybe a bit more risky than typically underwritten assets in the major food groups. Because of that, those can provide some spread to core returns that we might look at from a core plus perspective.

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Bright: All those property types and strategies that Todd mentions are good for a couple of reasons that shape our strategy: demographic changes in the U.S., and technological advances. When it comes to demographics, there is also life science in the office sector, because of the longevity of life expectancy in the U.S. When you look at what's happening in the U.S. today in terms of the growth of the Baby Boomer segment, as well as aging Millennials, the resounding theme is affordable housing. So, for a core plus strategy, it's not just having investments in apartments, it's where do you invest across that apartment spectrum? And how do you add to that through a residential portfolio play? You can invest in residential apartments because that's one of the biggest property types in the country. But can you diversify not just by location, but also by income bracket? Can you invest in very high-end, high-rise properties, but also in more income-sensitive workforce housing segments? All of this plays into the question of how to get income growth, which is very important for a core plus strategy. Then, how can you create value within the property type?

Privcap: What is the right way to think about liquidity in this market?

Goldberg: Early on, once we saw there was a lockdown, like many others in the industry, we were first and foremost focused on liquidity. So, we hit pause on any transactions that were in the pipeline to see what would happen as things started to unravel. The theme here is bifurcation of sectors. We saw some of the sectors outperforming. From a transactions perspective, you need to look at how much liquidity you need and what can you take advantage of in the market? We concluded over the last six months that we should slowly move some of that liquidity into the sectors in which we had high conviction, like industrial and multi-family. We didn't get those types of assets at a huge discount. But we were able to place dollars where we might not have had access before. As we go through the remainder of this cycle, it's going to continue to change. When I look at which types of transactions to pursue, a portion will go to high-conviction sectors, but we'll leave some liquidity available to take advantage of pain in markets like office and retail, which may be mispriced.

Bright: From a portfolio perspective, the impact of this pandemic really has brought to the forefront the importance of a diversified portfolio in real estate. There's divergence across property types and some are less liquid than others. If you are invested in a fund that is only invested in one property type—let's say, retail today—that is very illiquid and is going to be more difficult in terms of getting money in and getting money out.

The funds that we manage are very diversified across both property types and geographies. That allows us to find opportunities across the real estate sector, even during very difficult times. The most important thing for our investors is to communicate what we're doing and to be as liquid as possible at

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all points of the cycle. But, clearly, when you have an economic shock like this, that's very hard to do. Investors realize that real estate is not as liquid as stocks. You can't sell real estate overnight. That difference theoretically means that you should be getting a return premium for that illiquidity. Historically, that's what we've seen.

Privcap: What kinds of skills do core plus managers need to get the job done? What kinds of questions should investors be asking them?

Bright: A lot of what we do when we're investing in a joint venture is underwriting the development partner or operating partner. We do that more so than the property itself. I would say the same thing for investors—they're investing in people, they're investing in a platform. So, they have to have confidence in those. There isn't a unique set of skills just for core plus. Across the asset classes, you should be looking for the same types of skill sets: having sound judgment and the ability to communicate effectively. Specifically in real estate, the skills of leadership, collaboration and relationship-building are extremely important in terms of executing, certainly in a corporate strategy where you take on extra risk and you need to execute a plan cohesively across a team.

Understanding the global economy and what's going to drive demand—and, therefore, the use of real estate—is very important if you're constructing a portfolio. Investment managers have to continually look into the future, to position the fund to take advantage of where the demand growth may be.

Identifying risk, whether it be portfolio-level risk or investment risk, is very important. Then, continuing to make decisions to mitigate that risk is ultimately how you both protect the downside for your performance and also provide an opportunity for additional return. And that's how we drive performance for the investor.

As to the ability to communicate—like every other asset class, investors should always know what your plans are, how you are driving returns and how you're protecting them against the risks in the marketplace. Frequent communication is key because investors don't like surprises.

The other thing I would mention is that it takes a lot of different people in different parts of the platform to deliver a return on an individual investment. And being able to collaborate with all those people is very critical in terms of executing real estate. The people aspect of real estate is crucial.

Goldberg: There's a lot of value in having different experiences. You should have a team with experience in portfolio management, asset management, transactions, buying, selling hedging and financing. You should have all those different experiences, especially in a core plus fund where you are going to be touching so many different things. ■

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