



GLOBAL OUTLOOK

JULY 2014 | “POSITIONING FOR GROWTH”



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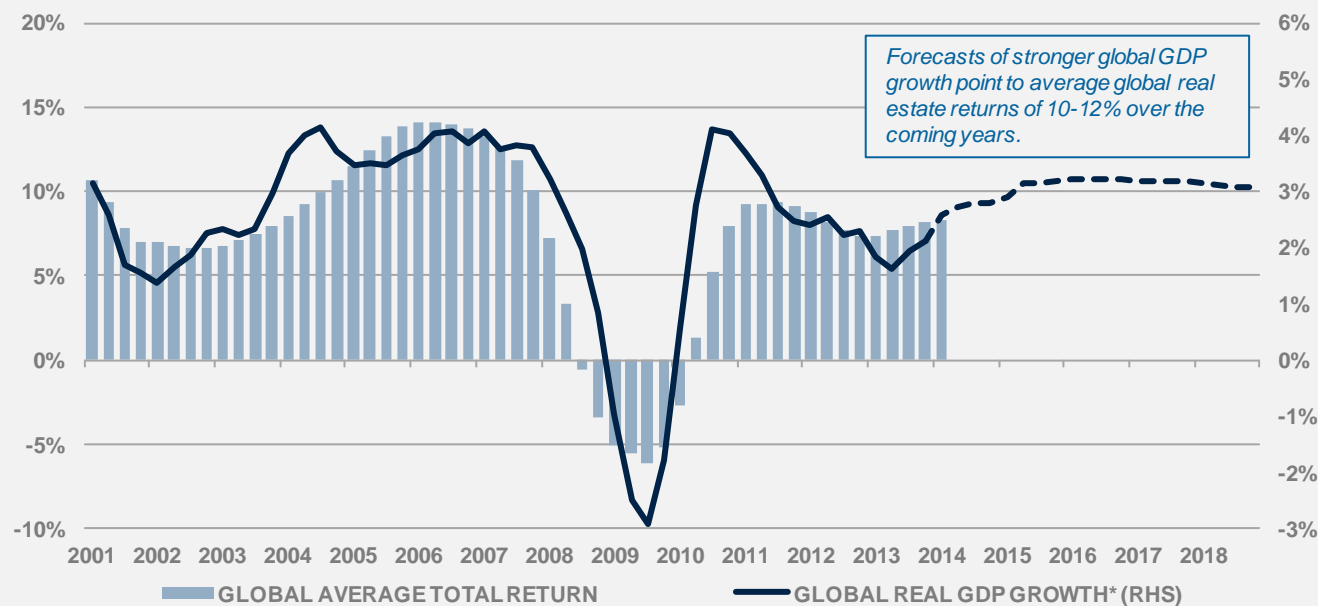
GLOBAL RETURNS EDGING UPWARDS

At the global level, property performance tends to go hand in hand with economic growth. Softer global growth news over the past year is gradually making way for a more optimistic outlook and real estate markets are following suit. Global GDP forecasts point to a pick-up in growth this year, boosting sentiment among real estate investors. Transaction volume is rising and global real estate returns are edging upwards ([Exhibit 1](#)).

Softer global growth news over the past year is gradually making way for a more optimistic outlook and real estate markets are following suit.

Occupier performance across global regions and sectors is showing signs of improvement. However, while soft indicators such as tenant enquiries are now rising, reported rental growth remains sluggish and returns are still largely being driven by sentiment. Positive “yield impact” – the effect of yield movement on values – typically occurs ahead of rental growth, as investors anticipate an improvement in occupier markets. Confidence about the outlook for the economy and occupier markets among investors is growing, and risk appetite is rising. As a result, yields continue to compress steadily in all regions and sectors, boosting capital values.

EXHIBIT 1: GLOBAL ALL PROPERTY AVERAGE TOTAL RETURN AND GDP GROWTH



Note: Average returns are trailing four-quarter, based on IPD's Global Total Return Index

*Global GDP growth weighted by estimated real estate market size

Sources: IPD, Oxford Economics, Prudential Real Estate Investors; As of June 2014

The importance of economic growth to real estate performance begs the question of whether the global economy is on the right track. Stronger global GDP growth expectations for the second half of 2014 are being underpinned by major developed markets, led by a cyclical rebound in the U.S. economy, which is regaining momentum after a weather-related slowdown in the first quarter. Meanwhile, Europe's economy appears to have broken the shackles of recession, recording five straight quarters of growth.



The prospects for an upswing in global growth remain delicately poised – for example, a sharp slowdown in China would be disruptive at this stage of the cycle. Elsewhere, growth in other emerging markets has eased – albeit still at a fast pace – while the European Central Bank (ECB) felt it necessary to ease monetary policy further in June in an effort to stimulate growth and ward off deflation in the sluggish eurozone. Central banks eventually will need to unwind their large policy stimulus packages, implying a period of uncertainty as they navigate their way through previously uncharted territory.

While there are downside risks ([Appendix 1](#)), we remain broadly confident about the outlook. Rising employment and house prices in the United States bode well for demand in the world's largest economy, while fears that an apocalyptic event, such as a eurozone collapse, might trigger another financial meltdown have receded. Despite concerns about China, emerging markets should benefit from increased demand from developed markets. With little inflation on the horizon, we are confident that policymakers will be able to maintain policy stimulus for the time being. The threat of deflation hasn't disappeared entirely, but, if growth disappoints on the downside, recent actions by the ECB demonstrate that there is still scope to loosen policy further if necessary.

Overall, as the second half of the year progresses, we expect stronger growth news to underpin a further increase in sentiment among real estate lenders and investors and, ultimately, drive further improvements in investment performance.

OCCUPIER MARKETS TURNING A CORNER

Sentiment is driving investment performance in prime markets and property yields are now closing in on pre-crisis lows in many core markets. This leaves investors wondering whether pricing is being driven by fundamentals, or whether it simply reflects a “bubble” caused by exceptionally loose monetary policy. Notwithstanding low bond yields, low real estate yields imply that investors are factoring in a substantial rental growth recovery, and, with this in mind, it is clear that occupier market performance holds the key to the next phase of the recovery in global property markets.

EXHIBIT 2: GLOBAL OFFICE ABSORPTION INDEX AND SERVICES HIRING INTENTIONS

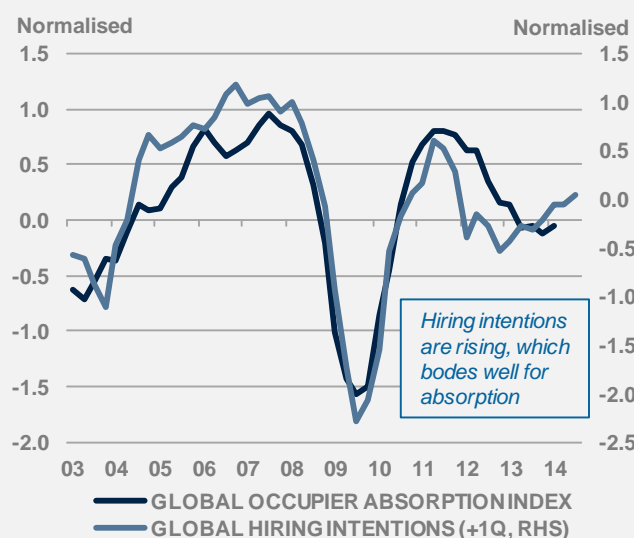
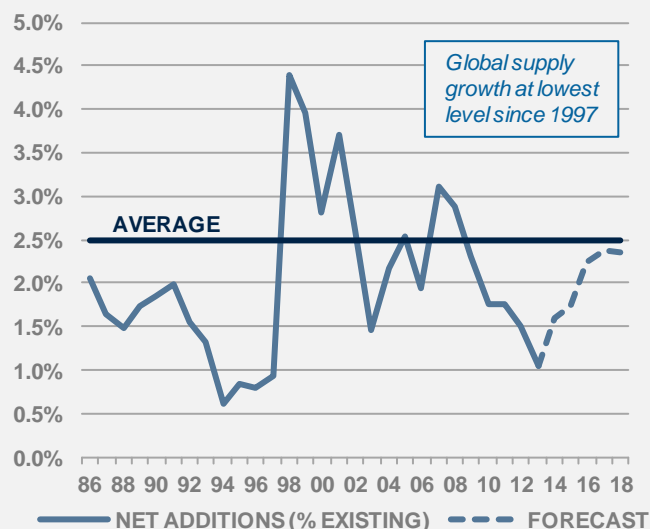


EXHIBIT 3: GLOBAL NET ADDITIONS TO OFFICE STOCK



Sources: PPR, Cushman & Wakefield, JLL, PMA, Eurostat, Moodys, Hudson Report, Prudential Real Estate Investors; As of June 2014



The potential for a stronger occupier market recovery to boost returns and give credibility to pricing levels in core markets motivates the question as to whether a pick-up in rental growth is on the horizon. On the whole, occupiers remain slightly cautious, reflecting scars left by the last recession and, in a number of markets, a legacy of overcapacity. Corporate occupiers remain cost-conscious, focusing on efficient space use, although sentiment is starting to shift and space enquires are rising. Our composite measure of global hiring intentions surveys has improved, pointing to stronger absorption of office space in the second half of 2014 ([Exhibit 2](#)).

In many developed countries, output and employment levels have barely recovered to pre-crisis levels, most notably in Europe where unemployment remains very high. In the faster-growing U.S. market, employment has only recently risen above its pre-crisis peak, six years after the initial phase of crisis began. In developed markets, job creation is currently skewed towards lower value added back-office services, rather than higher value added positions in banking and financial services. As a result, absorption in major global office markets is lagging the economic upswing, while the resulting lower wage growth is weighing on retail spending.

On the supply side, lenders and developers have reined in construction projects in most major markets in response to sluggish demand growth.

On the supply side, lenders and developers have reined in construction projects in most major markets in response to sluggish demand growth. In office markets, global supply growth has dropped to its lowest level since 1997 and the pipeline is only gradually re-starting ([Exhibit 3](#)). Low consumer spending growth and a lack of available financing for large capital projects means that the retail development pipeline is also low in most major developed markets, while, in the industrial sector, development of logistics space is generally restricted to “build-to-suit” projects.

Banks are slowly rediscovering their appetite for lending against developments but remain constrained by regulations, including incoming Basel III risk weightings, which may make risky lending prohibitively expensive. As a result, they remain highly selective and still want strong evidence of pre-lets. With rents still below pre-crisis levels, a widespread pick-up in building activity in the near future remains unlikely. Low completion rates are weighing on the availability of class A office, logistics and retail space, supporting the outlook for rental growth as occupier demand grows.

INDUSTRIAL GAINING MOMENTUM

Our estimate of annual global all property prime rental growth remains stable at about 2.5% – slightly below its 10-year average of 3.3% per year – although occupier markets around the world are at different stages of the cycle. At the broad sector level, rental growth in the trade-oriented **industrial sector** is leading the way ([Exhibit 4](#)), reflecting an upswing in global export activity as well as ongoing changes to the characteristics of retail markets.

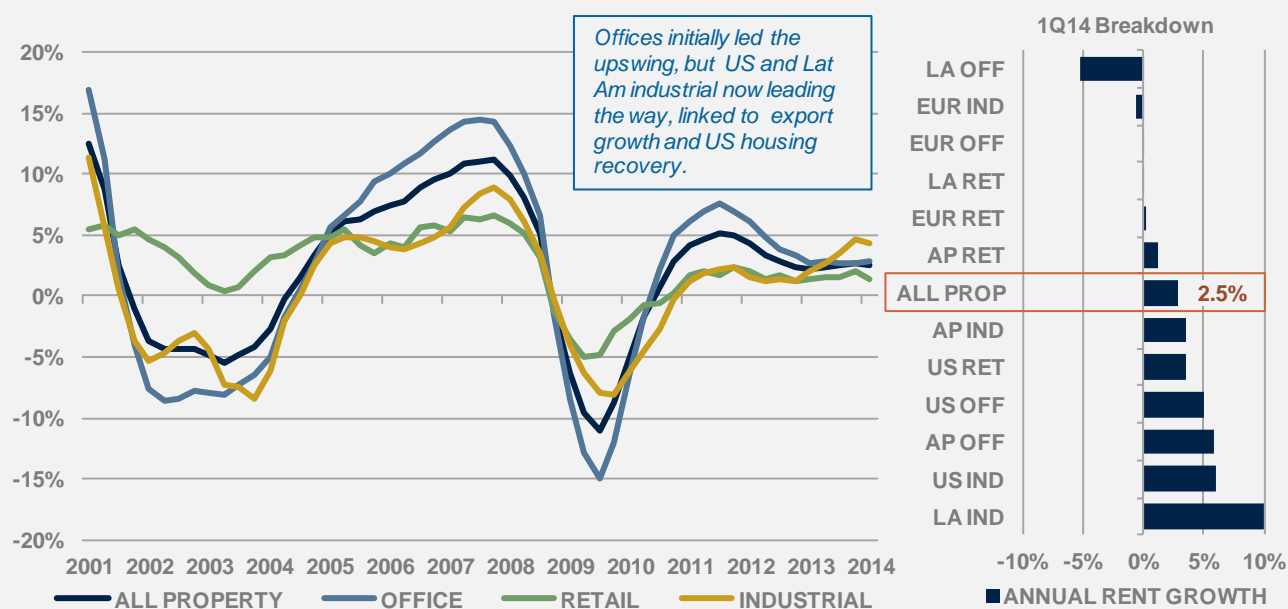
Mexico and the United States are at the forefront of industrial rental growth, linked mainly to improved demand for housing and consumer goods in the United States, while industrial occupiers in Mexico are also benefiting from pro-market reforms to their important domestic energy oil sector. Elsewhere, industrial markets are more circumspect: Europe is only just exiting recession and still has an overhang of spare industrial capacity, while concerns about China’s growth outlook are weighing on demand in Asia.



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In many countries, rising online retail penetration is shifting the point of sales away from physical stores, leading to an increased emphasis on distribution networks, which is boosting demand for logistics facilities. The corollary is a growing threat to “bricks and mortar” retailing that is casting a shadow over the **retail sector**, which is lagging the recovery. Retail markets are facing a number of challenges from other sources, too: a legacy of high unemployment and household indebtedness in consumer-driven markets in the United States and Europe; and a squeeze on retailer profitability as a result of weak sales growth and rising transport costs.

EXHIBIT 4: GLOBAL ANNUAL PRIME RENTAL GROWTH BY SECTOR



Sources: PPR, Cushman & Wakefield, JLL, Colliers, Prudential Real Estate Investors

Retail absorption is rising in the United States as retailers respond to a stronger consumer spending outlook, pushing rents up as a result of low supply growth. In developed markets across Asia and Europe, rents are broadly stable, although prime shopping streets and “destination” retail schemes are performing well, as international retail chains compete for flagship stores. In Asia, slower luxury goods spending as a result of a government action in China and a looming supply pipeline in developing Asian markets are weighing on rental growth, despite strong consumer spending.

The **office sector** initially led the upswing in rental growth after the global financial crisis, as occupiers in fast-growing Asian central business districts (CBDs), tight supply CBDs in Northern Europe and tech- and energy-driven markets in the United States took advantage of low rents to secure prime space in attractive locations. Office absorption and rents are steadily rising in the United States, linked to the employment recovery that is gathering pace. In Europe and Asia, the sector is in a mid-cycle transition phase as rental growth has slowed in strong markets that have now recovered to previous peaks, while occupiers remain cautious elsewhere, especially in developing Asian markets and the eurozone periphery, where occupiers remain nervous about the economic growth outlook.



MARKETS AT DIFFERENT STAGES OF THE CYCLE

When considering the outlook, we need to look beyond a simple overlay of macro-economic trends that explain broad movements in aggregate sector and regional occupier markets. Opportunities for investors stem from the fact that individual markets and sub-markets around the world have varying characteristics and are at different stages of the cycle. Identifying and understanding the differences – and similarities – between various locations holds the key to outperforming in the next phase of the global real estate cycle. There are a number of key themes that we expect to shape the outlook.

Opportunities for investors stem from the fact that individual markets and sub-markets around the world have varying characteristics and are at different stages of the cycle.

THEME 1: STRONG GROWTH, HIGH DEVELOPMENT

Office and Retail in Fast-Growing Asian and Latin American Markets

Buoyed by strong rates of economic growth in recent years, developing markets in Asia and Latin America are at the forefront of the global occupier demand cycle, despite a recent slowdown. Office absorption continues to accelerate in a number of Asia's fast-growing non-financial markets, including Jakarta and Kuala Lumpur, and remains strong in Beijing and Shanghai, albeit down from a previously ferocious pace, reflecting occupier concerns about China's growth outlook. In these markets, rents have recovered from the damage inflicted by the global financial crisis and are now above previous peak levels ([Exhibit 5](#)).

As a result of an ongoing need to cater for a growing institutional occupier base, the supply pipeline in Asia's developing markets is rising. Over the next three years, office CBDs in developing Asian markets will have to absorb more than 3 million square metres of new space – equivalent to an increase of about 8% per year. The recent experience of Latin America's office markets acts as a warning. An early-cycle rental growth recovery stimulated building activity in Brazil, Chile and Mexico in the aftermath of the global financial crisis. Fast forward to the present day and vast swathes of office schemes are being delivered into slowing leasing markets, pushing vacancy rates well above average and choking off rental growth. Our long-term view on these markets remains positive, but the extent of supply growth is hampering the near-term outlook.

Similarly, in retail markets, there is a bright outlook for retail spending in developing Asia, Mexico, and Central and Eastern European markets, where the retail offering is in need of modernisation to cater for a growing middle class. As with office markets, the supply pipeline is elevated, especially in Kuala Lumpur and China's tier-1 cities. In both sectors, rather than an outright threat to the future of the markets, the level of supply implies winners and losers as older buildings are increasingly exposed to stiff competition from new schemes.

THEME 2: EARLY RECOVERY

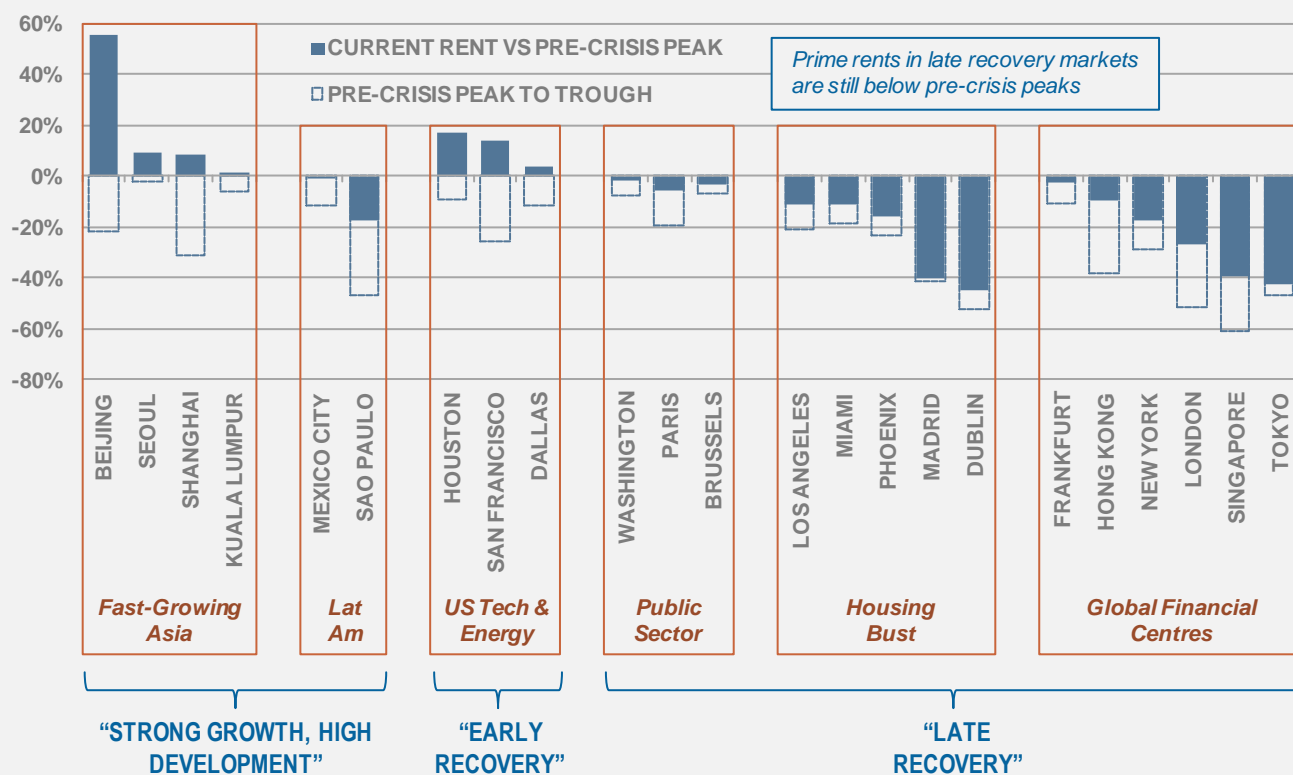
U.S. Tech & Energy Markets, North Europe CBDs, U.S. Industrial Markets, U.S. Apartment Markets

Employment levels have risen well above pre-crisis peaks, and the growth in demand for office space has been strong in U.S. technology and energy corridor markets including Seattle, San Francisco, Houston, Austin, Dallas, Portland and Raleigh. Tight supply CBDs in relatively fast-growing Northern European markets such as Munich, Stockholm and London West End also continue to attract occupiers keen to secure addresses in prestigious locations. In both groups of early recovery markets, CBD rents are rising. Development activity is picking up in some U.S. markets that have high enough rents, but supply in European cities continues to be restricted by a lack of finance. Occupiers are now taking space in secondary buildings and non-CBD submarkets to meet requirements for modern space and large, efficient floorplates.



In the United States, apartment markets initially led the cycle, but the outlook points to a moderation in performance due to a supply response. Demand for apartments received a counter-cyclical boost from favourable demographics and housing market woes that, for a while, turned would-be buyers into renters. Lower unemployment boosts rental demand among young adults, but the housing ownership market is improving, while low vacancies and high rents are attracting developers to apartments. More recently, industrial markets have recorded strong demand and they too are facing the prospect of supply responding to rising rents, although the outlook remains strong in tight supply, high population areas including New York, Miami, Southern California and the San Francisco Bay Area.

EXHIBIT 5: PRIME OFFICE RENTS VS PRE-CRISIS PEAKS – SELECTED MARKETS



Sources: PPR, Cushman & Wakefield, JLL, Colliers, Prudential Real Estate Investors

THEME 3: LATE RECOVERY

Financial- and Government-Led Office Markets, Housing-Led Markets, Eurozone Periphery

Despite the increase in global office-using employment, take-up of CBD office space outside of early recovery markets remains downbeat. In major developed markets, job creation is currently skewed towards lower value added services, rather than higher value added positions in banking and financial services. Among normally fast-growing global financial centres, the pattern of demand is inconsistent: employment and take-up are rising quickly in London City and New York, while leasing activity is more subdued in Frankfurt, Hong Kong and Tokyo. Competition for scarce CBD space in financial-led markets means that rents have risen from trough levels, but in most cases, prime rents are still some way below their pre-crisis peaks.



The group of late recovery markets also includes those with exposure to structural challenges in the global economy. Persistent weakness in a number of housing markets in the United States and peripheral Europe has weighed on occupier activity in cities such as Los Angeles, Miami, Phoenix, Madrid and Dublin. Sentiment is turning quickly in these cyclical markets, particularly in the United States, where the housing market outlook is improving. High public debt-to-GDP ratios in many countries have also impacted activity among increasingly frugal public sector occupiers, which is holding back space demand in markets such as Brussels, Paris and Washington DC. Rents in the much maligned eurozone periphery – where sentiment and growth are now slowly returning – also remain a long way below pre-crisis levels.

Our view is that the next phase of the cycle will increasingly favour late recovery markets, which generally have a limited supply of grade A space, low development pipelines and greater scope for rental growth from depressed levels. We continue to favour “high barrier” markets – those markets with a strong demand base in which natural constraints or planning restrictions limit supply – which typically outperform through the cycle. Second tier cities in the United States are expected to perform well, but in Europe the focus remains on core markets. Employment growth in Europe’s periphery is simply not strong enough to bear down on still elevated vacancy rates, although leading indicators show that occupier sentiment is noticeably improving. Over time, the emphasis for rental growth is likely to shift to non-CBD and suburban areas, where demand is rising due to a lack of availability in CBDs and there is rental “catch-up” potential.

THEME 4: CHALLENGES IN THE RETAIL SECTOR

Developed Retail Markets

Unusually, the retail sector – which normally leads a cyclical recovery – is lagging the broader upswing, held back by weak consumer activity in indebted western markets. Meanwhile the growing impact of e-commerce is contributing to increased caution among retailers, which is affecting physical space demand, although some formats have been resilient. Lower-end, grocery-anchored schemes remain well-let, while demand among luxury retailers for flagship stores on major shopping streets has pushed prime rents up rapidly in low vacancy markets such as Manhattan, London and Paris.

Despite a number of headwinds, we anticipate a broader cyclical pick-up in retailer activity in the second half of the year as rising employment, stronger earnings growth and growing consumer confidence give retail sales a welcome boost. Retailers are targeting expansion in major markets with scale and growth potential, most notably Germany and the United States. In addition, an ongoing lack of new supply in developed markets points to rental growth in well-located retail schemes. However, structural changes to retail markets mean that secondary and poorly-located schemes are at risk of being left behind, and the stark contrast between winners and losers is expected to continue.

CAPITAL MARKET RECOVERY UNBALANCED

Market pricing reveals an inconsistency between occupier performance and the way investors are pricing real estate. Rental growth is varied across markets, regions and sectors, but yields are moving in a uniform way: cap rates continue to compress slowly but steadily in all regions ([Exhibit 6](#)). Office and retail cap rates have both compressed by about 20 basis points over the past year, despite the fact that retail rental growth has lagged offices significantly over the last couple of years. Ongoing compression of retail yields in Asia’s developing markets and Latin America suggests that markets are pricing in an outlook that could prove too optimistic given the challenges posed by a large supply pipeline.

We are concerned that pricing is becoming detached from fundamentals, reflecting the sheer scale of policy support.



More broadly, pricing is looking expensive in prime markets as yields approach and, in the case of the office sector, move below pre-crisis lows. Even if occupier markets stage a broad-based pick-up in the coming years, we are concerned that pricing is becoming detached from fundamentals, reflecting the sheer scale of policy support from exceptionally low central bank interest rates and Quantitative Easing (QE). The vast injection of liquidity by central banks in the United States, United Kingdom and Japan has to find a home in risk assets. Investors remain keen to acquire relatively high yielding core real estate product, which offers a secure source of income and attractive spreads compared to risk-free rates.

EXHIBIT 6: GLOBAL PRIME NET INITIAL YIELDS

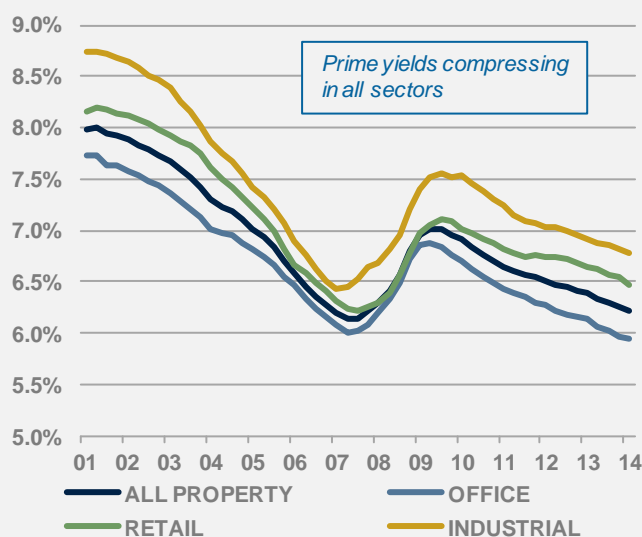
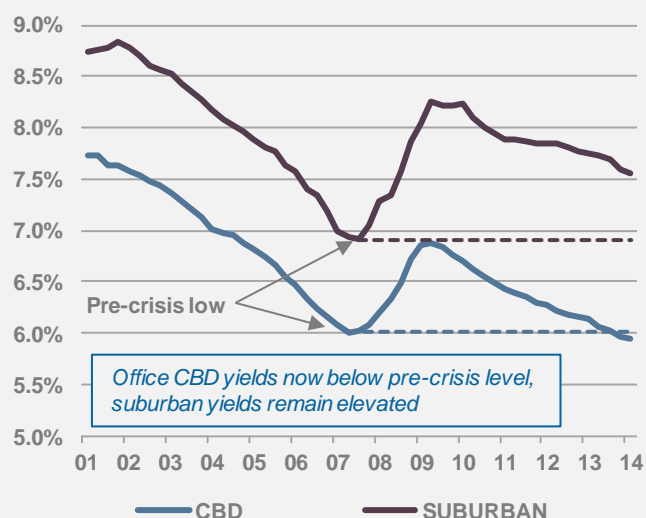


EXHIBIT 7: GLOBAL PRIME OFFICE YIELD – CBD VS SUBURBAN



Sources: PPR, Cushman & Wakefield, JLL, Colliers, Prudential Real Estate Investors

There are signs that the capital market recovery is unbalanced. With occupier markets showing signs of improvement, our view is that investors are factoring in too much risk in non-core assets as the gap between yields for the best assets in gateway cities and other assets and locations remains high. While CBD office yields are now below pre-crisis levels, suburban office yields are only slightly below their 10-year average and still some way above their 2007 low point (Exhibit 7). The gap is starting to close in early recovery markets – for example, offices in North Europe's tight supply CBDs or tech- and energy-led markets in the United States – where investors are following occupiers into non-CBD markets and yields are starting to edge downwards.



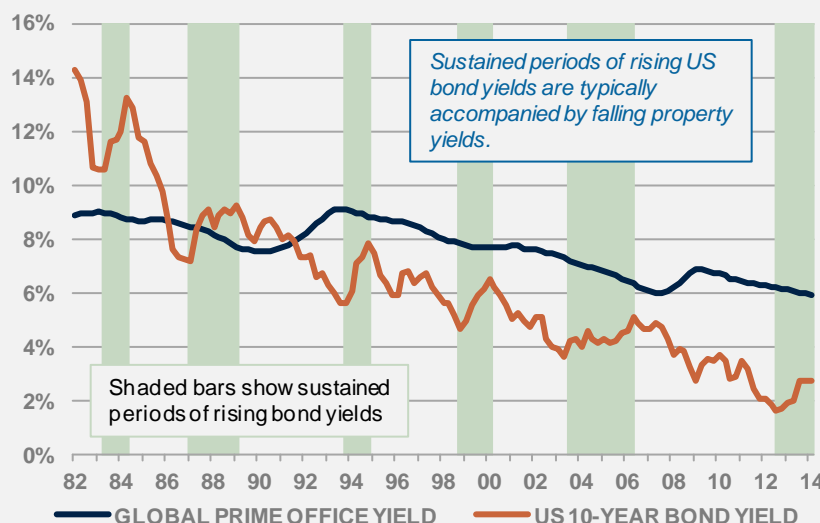
GROWTH EXPECTATIONS MORE IMPORTANT THAN INTEREST RATES

Signs of a broad based improvement in real estate pricing shouldn't divert attention from the bigger picture: policy support remains extensive and some major central banks – the European Central Bank and the Bank of Japan, for example – are still easing. However, markets are already anticipating tighter U.S. monetary policy and, elsewhere, rates are very likely to go up eventually. Looking ahead, the key question is: what will happen to property values when interest rates do start to increase?

The combination of rising interest rates and falling property yields might seem to contradict conventional wisdom, but it is typical during a cyclical upswing.

Recent market movements give a useful indication. US bond yields are about 100 basis points higher than they were a year ago, but real estate yields are falling (Exhibit 8). The combination of rising interest rates and falling property yields might seem to contradict conventional wisdom, but it is typical during a cyclical upswing. During the last sustained period of rising bond yields between the third quarter of 2003 and the second quarter of 2006, a period of robust global economic growth, yields on 10-year U.S. bonds rose by 84 basis points, while global office yields declined by 88 basis points. A similar pattern holds for earlier periods of rising bond yields too. Put simply, during periods of faster economic growth, the positive impact of higher rental growth expectations and a perception of lower risks – which exert downward pressure on real estate yields – outweigh the upward pressure on yields from higher risk-free rates.

EXHIBIT 8: GLOBAL ALL PROPERTY PRIME YIELD AND US 10-YEAR BOND YIELD



ANALYSIS OF SUSTAINED PERIODS OF RISING BOND YIELDS

Date	Duration (Q)	Bond Yield (bps)	Property Yield (bps)
2Q83	4	+266	-24
1Q87	8	+201	-73
4Q93	4	+223	-28
4Q98	5	+181	-13
3Q03	11	+84	-88
Avg.	6	+191	-45

Current Cycle

3Q12	6	+112	-24
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Sources: PPR, Cushman & Wakefield, JLL, Colliers, OECD, Prudential Real Estate Investors

As such, in a situation where central banks are comfortable enough about the outlook for growth and inflation to raise interest rates, we remain confident about the outlook for real estate pricing. In general, then, our concern is



not rising, but *falling* interest rates, which are a signal that growth expectations are deteriorating and that capital is retreating from risky assets such as property. There are perhaps a few exceptions though. Interest rate sensitive sectors such as multi-family housing may suffer in a rising rate environment, while in markets with ultra-low yields, such as the prime retail pitches of London or Paris, higher interest rates would effectively rule out all but cash buyers, which could spark a correction in pricing from elevated levels.

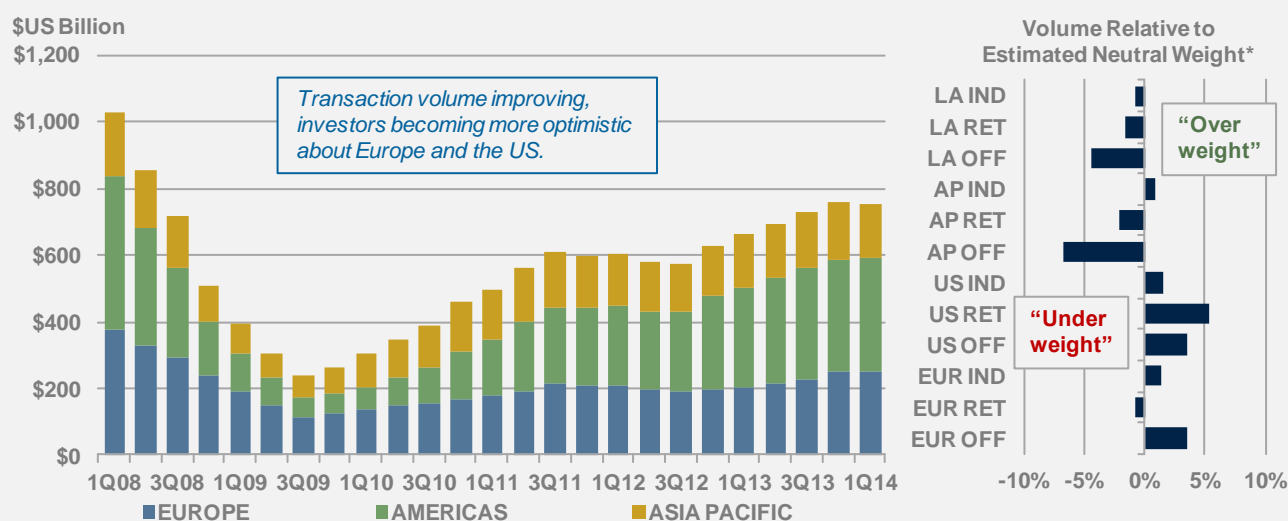
DEBT MARKET RECOVERY SUPPORTING TRANSACTION VOLUME

Market liquidity is high and cross border capital flows are accelerating as investors look further afield for diversification and higher returns. Global capital is becoming less focused on a narrow set of core markets, and there are clear signs that investors and lenders are turning their attention to cheaper-looking non-core markets that offer higher yields, improving occupier activity and rental growth “catch-up” potential. Our view is that a broader rotation of capital away from expensive prime markets will go hand in hand with an occupier recovery in the next phase of the investment cycle.

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Along with rising sentiment as a result of a stronger global economic outlook, an improvement in real estate debt availability is underpinning a steady increase in real estate transactions. Stiffer competition among lenders – including investment banks that are able to syndicate whole loans – and rising credit availability are driving improvements in lending terms, continuing a trend that began in the second half of last year. Loan-to-value ratios remain low as banks adapt to tougher capital requirements, but lending margins are coming down and all-in debt costs are generally stable or falling, despite the uptick in U.S. bond yields.

EXHIBIT 9: ROLLING ANNUAL GLOBAL TRANSACTION VOLUME



Note: Transaction volume excludes land sales in China

*Neutral weight based on estimated real estate market size. The chart compares the share of transaction volume over the past year with the neutral weight for each grouping.

Sources: RCA, Prudential Real Estate Investors



Global transaction volume dipped at the start of 2014, edging down after a seasonal jump in the fourth quarter of 2013. In total, Real Capital Analytics (RCA) recorded about \$750 billion of global real estate transactions over the past twelve months, which is up 14% compared to a year ago, but still short of pre-crisis levels ([Exhibit 9](#)). The pace of activity is increasing most quickly in Europe and the United States, where overall volume has risen by 25% over the past year. The share of transaction volume in both regions is above their estimated neutral weights meaning that investors are effectively “overweight” – implying optimism about the returns outlook. In contrast, concerns about slowing economic growth and large development pipelines in emerging markets have impacted activity in Asia and Latin America, most notably in the office sector, where investors are effectively “underweight” based on transaction volume.

Offices, the largest investment sector, accounted for more than one third of activity over the past year. However, on a global basis, industrial recorded the largest “overweight” relative to estimated neutral weight. Investor intentions surveys suggest this trend is set to continue. According to CBRE’s Global Investment Intentions Survey, nearly 30% of investors are targeting the industrial sector in 2014, attracted by the opportunities arising from e-commerce growth and increased demand for industrial facilities in the United States and Europe, linked to stronger production growth and the return of previously “off-shored” manufacturing jobs. Investor attitudes to the retail sector are cooling as rising online retail penetration dampens sentiment.

Risk appetite among investors continues to grow. Investors in the United States have the clearest preference for higher-returning value-add and opportunistic strategies, but there are signs that investors in Europe are starting to follow suit as conditions in the lending markets improve. Appetite to lend against assets in smaller regional cities and in the eurozone’s periphery – where occupier fundamentals remain hampered by a legacy of high vacancy rates – remains low. However, banks are now easing standards in secondary assets in major cities, in many cases moving ahead of investors. Debt terms are now improving more quickly than yields are compressing, pointing to a compelling opportunity for equity investors to earn surplus income.

OPPORTUNITIES: POSITIONING FOR GROWTH

The low-growth environment that has provided the backdrop for global real estate investment markets over the past few years is shifting. An improving outlook for economic growth points to higher real estate returns and better prospects outside of the narrow core segment that has been dominating investor attention. Core assets in major, gateway cities look expensive as cap rates approach cyclical lows, while the prospect of rising interest rates points to a need to target higher returns and growth potential, rather than safe income. Yield spreads on secondary assets and locations are wide and we expect higher returning, value-add strategies to grow in prominence, aided by a general increase in risk appetite among lenders and investors.

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There are structural opportunities too, also targeting higher growth, but with a focus on the changing nature of real estate markets. Structural change is mainly taking place in developing markets, where, for example, rising incomes and a growing middle class point to a need for an increased provision of retail and residential assets. In developed markets, there are fundamental changes to retail markets via the impact of e-commerce, and to debt markets via the impact of changing regulations, all implying ongoing opportunities for investors.

In summary, we believe that opportunities for investors to earn attractive risk-adjusted returns in today’s global real estate market fall into three broad groupings: “Taking on Risk”, “Buying into a Late Recovery” and “Structural Shifts”. These opportunities are summarised below and in [Exhibit 10](#).



OPPORTUNITY 1: TAKING ON RISK

Nature of Opportunity: *Taking on additional asset risk in early recovery markets to take advantage of a cyclical upswing in real estate fundamentals*

Target: *Developed Office Markets*

Our leading indicators on sentiment point to stronger leasing activity in office markets and low yields on prime assets. This suggests that investors should look beyond the boundaries of a “buy-and-hold” core investment to earn higher returns. Yield spreads remain elevated in non-CBD and suburban markets in the United States and Europe, while lenders are becoming active in these markets again. Investors are able to follow occupiers that have to take sub-market space due to a lack of provision in CBDs, where vacancy rates are now below average.

Taking on leasing risk in North European CBDs and US gateway cities, either through vacancy or short income, is increasingly attractive. We anticipate a further improvement in demand as higher-value added jobs are created, particularly in U.S. office markets. Meanwhile, there is still plenty of potential for rents, which are generally well below previous peaks, to “catch-up” in the cycle. As rents rise, we favour “high barrier” markets, which typically outperform in an upswing and have greater defence against a supply response. Repositioning and refurbishing secondary assets continues to look attractive in high barrier markets, given the lack of grade A space being completed.

OPPORTUNITY 2: BUYING INTO A LATE RECOVERY

Nature of Opportunity: *Identifying underpriced core assets in capital-starved late recovery markets*

Target: *Eurozone Periphery, Second-Tier Cities in Europe and the United States*

Opportunities in late recovery markets stem from differences in the growth outlook across countries and regions, exacerbated by patterns of investor and lender behaviour. Investors are starting to look beyond the narrow set of major cities that have dominated activity, but there is a broad group of late recovery markets that continue to suffer from a shortage of capital. Low pricing and an improving occupier outlook indicate a compelling investment opportunity, particularly in markets that have under-capitalised domestic banking sectors.

Reflecting structural challenges and persistently sluggish economic activity across much of the continent, the bulk of late recovery markets are located in Europe, including core cities in the peripheral nations of Spain and Italy and eurozone laggards such as the Netherlands. The group also includes some second-tier cities in the United States – particularly those not driven by the finance, technology or energy sectors – and in smaller regional markets in faster-growing core European countries, where growth has been skewed towards major cities.

A lack of capital means that yield spreads in late recovery markets are elevated, while, at the same time, occupier demand is improving in line with better economic sentiment. Opportunities remain selective though, as availability in smaller office and secondary retail markets is often high. However, there is very little new space and prime rents are very low, which points to the prospect of a steep pick-up in rents and values, even if not to pre-crisis levels. Buildings have been starved of capital expenditure in recent years meaning the opportunity extends beyond a simple buy-and-hold strategy, especially in the retail sector. However, markets are starting to price in a recovery, and there are already hints that yields are compressing from elevated levels.



OPPORTUNITY 3: STRUCTURAL SHIFTS

Nature of Opportunity: *Capitalising on ongoing structural opportunities that exist as a result of the changing nature of real estate markets*

Target: *Developing Asia, Latin America, Debt Markets*

Initially, developing markets led the global recovery, before recording a drop in performance, linked to concerns about growth in China as well as the negative effects of a reversal in capital flows that accompanied expectations of tighter monetary policy and rising interest rates in the United States. A number of markets in Latin America continue to deal with domestic issues, particularly in Brazil where domestic imbalances are high, limiting the prospect for policy stimulus to boost growth.

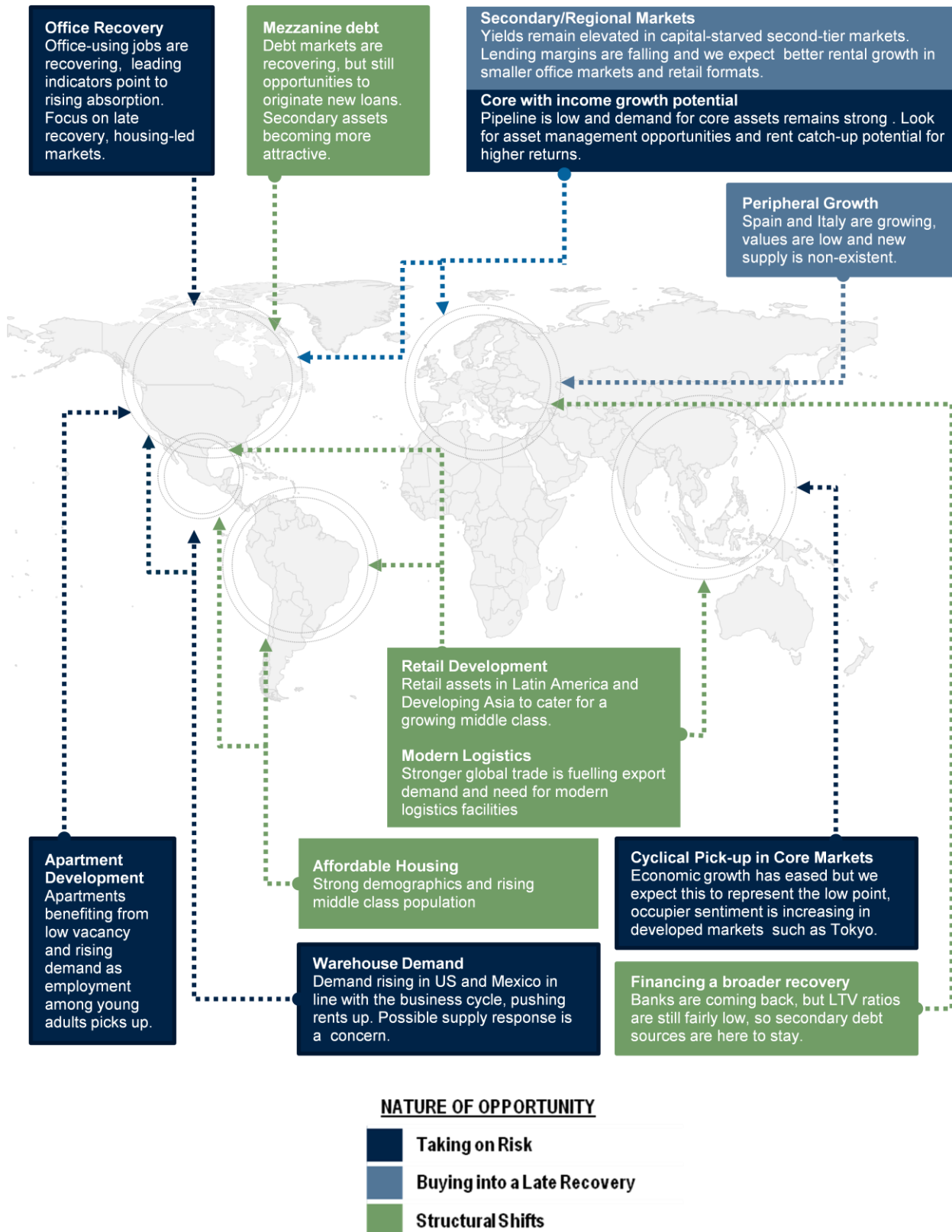
On an absolute basis, compared to the United States and Europe, real estate returns in developing markets are still high, although oversupply in some office and retail markets as a result of the recent slowdown in growth, limits the potential for cyclical investment opportunities. As a result, investors remain more focused on structural growth opportunities in these markets, developing assets in absence of local capital sources, to meet the growing need for modern office and retail real estate assets to cater for a gradual transition to a more services-oriented economy and growing consumer class.

In developed markets, the retail sector is undergoing rapid changes as the way in which consumers and retailers interact is shifting constantly. Demand for traditional industrial facilities, such as plants and factories, is also increasing in the United States and Europe, linked to stronger domestic production activity and the return of previously “off-shored” manufacturing jobs. Changes to the physical environment can also bring about shifts in demand for real estate space: recent earthquakes in Japan highlighted the importance of seismic-proof logistics facilities, which are currently limited.

Meanwhile, debt markets continue to offer an interesting opportunity. While pricing and availability of debt is improving, the regulatory environment for banks, which provide about 50% of real estate debt in the United States and 75% in Europe, is toughening. Under the incoming Basel III framework, banks face a general requirement to hold higher levels of capital against their loan books, and must apply a higher risk weighting to commercial real estate. The impact is to effectively restrict the amount of capital banks have available to lend, and we expect loan-to-value ratios to remain structurally lower than they were before the global financial crisis. An influx of secondary debt providers is closing the so-called “funding gap”, but we expect junior and mezzanine lenders to continue to play an important role in the United States, Europe and developed Asian markets of Australia and Japan.



EXHIBIT 10: SUMMARY OF GLOBAL OPPORTUNITIES





APPENDIX 1: KEY GLOBAL INVESTMENT RISKS

Risk	Key Features	Likelihood: Next 12m	Impact on Economy	Impact on Real Estate
BUMPY EXIT FROM US POLICY STIMULUS	Fed in unknown territory. Pace of tapering dependent on jobs recovery and inflation. A sharp increase in interest rate expectations could choke off growth.	Low	Medium A sharp rate increase would impact interest-rate sensitive sectors of economy such as housing. Financial market volatility rises, hurting confidence.	Medium Occupiers are cautious and absorption slows, but supply remains low. Investors retreat to quality, but values under pressure, even in major gateway markets.
CHINA HARD LANDING	Efforts to curb domestic credit bubble and reduce “shadow banking” sector risk causing a slowdown in the Chinese economy.	Low	High Sentiment worsens. North Asia and Latin America in the firing line due to close trade links. Global output growth eases and central banks loosen policy further.	High Emerging and weaker peripheral markets suffer from falling sentiment and capital outflows. Flight to quality means investors target income returns in major gateway markets.
GEOPOLITICAL TENSIONS	Recent tensions between Russia and Ukraine escalate. Full-scale civil war in Iraq.	Low	Low Economic impact largely contained, but spillovers affect investor sentiment. Concerns about energy supply.	Low Impact on real estate markets contained as Russian capital flows are small. Larger impact in CEE and markets with middle-east links.
EMERGING MARKETS CAPITAL FLIGHT	Rising risk aversion and higher US interest rates means capital flows out of emerging markets.	Medium	Low Impact on major, developed economies low, but emerging markets hit by need to tighten policy.	Low Impact felt in emerging markets as higher interest rates and weaker investment flows put pressure on yields to rise.
RISING INFLATION	Excessively loose monetary policy – designed to avoid deflation – eventually causes a sharp increase in global inflation.	Low	Medium Higher inflation weakens business and consumer spending. Authorities under pressure to tighten monetary policy while growth is slowing.	Medium Slower GDP growth and rising bond yields are bad news for occupier and investment markets. Investors focus on high barrier markets and inflation-protected sectors.
US POLITICAL UNCERTAINTY	Uncertainties surrounding US debt limit resurface.	Low	Low Adds to volatility and uncertainty, but impact on real GDP growth is limited, even in the US. Business planning decisions delayed.	Low Space demand affected by occupier caution. Rental growth weakens and low cap rates under pressure to move out.



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