Pramerica Real Estate Investors

*Recently, **Sheila Hopkins,** managing director – Europe and infrastructure with Institutional Real Estate, Inc, spoke with **Cathy Marcus** of Pramerica Real Estate Investors. The following is an excerpt of that conversation.*

Cathy Marcus is a managing director and senior portfolio manager for Pramerica Real Estate Investors and is involved in all aspects of fund management including portfolio strategy and investment decisions. She joined the Global Management Committee in March of 2013. From 2002 to early 2004, she was the head of investment underwriting and operations for the transactions group of Pramerica. This included the underwriting review of each investment presented for approval to Pramerica's Investment Committee, as well as the coordination of the acquisition activity of the Pramerica acquisition professionals located in four regional offices.

Why is there such a demand for core US product, and what is it investors need that they believe core gives them?

It comes down to the universe of available options, particularly for an investor who is looking at opportunities globally. If you are a CIO in Europe and you look around the globe for possibilities at the lower end of the risk spectrum, Europe lacks visibility and the returns in Asia are low. So when you compare the risk/return dynamic in Europe or Asia to what you can find in the US these days in the core space, it is really very compelling. Look at forecasts for what the ODCE, the US core open-end fund index, is going to produce this year — the original guidance was 8–10 percent total return, but clearly it is going to be higher than that. You can invest at the lower end of the risk spectrum in the institutional real estate space, and it is a very compelling investment option. Of course, not every investor is looking to invest in funds. There are institutional investors all around the globe looking to do direct investment or form joint ventures to invest directly in US core real estate. And the attractive risk-adjusted returns for US core real estate is driving that movement. If you are investing in an existing, stabilised asset and can get a 5 percent income return, that is something you can't really find elsewhere.

Is core pricing going to continue to be a good relative return?

Cap rates have compressed quite a bit over the past couple of years and are already quite low. The worry right now is: If interest rates continue to rise, will there be a corresponding rise in cap rates? Because cap rates are so low, even if they go up just 10, 15 or 25 basis points, that will have a fairly significant effect on value. To be fair, most investors are underwriting some interest rate growth, but if the economy really does take off — and you would like to think that if interest rates are going up, there is some good news in the economy — then income growth could offset quite a bit of the impact of any interest rate driven expansion of cap rates. There are risks in the core space right now, and interest rates are certainly one of them. But is it easy to envision a scenario where a lot of this demand to acquire core properties evaporates overnight? For me it really isn't. While there could be some forces at work on the interest rate and economic front that could lead to an expansion of cap rates, as long as there continues to be capital market demand, the steady stream of capital should keep cap rates down.

Have managers already adjusted for a rise in interest rates in their underwriting?

I can only speak for our underwriting, and it does assume some level of interest rate expansion because clearly there is only one direction that they can go. One way to underwrite for that is to have expansion in the exit cap rates, and I think most people appear to be underwriting that way at this point. What is very difficult to underwrite or to even account for in any way is the impact of a precipitous rise or a spike in rates. That is a bit difficult to anticipate.

Demand in Europe is unbelievably laser-focused on core. Is the focus in the US, which is a couple of years ahead of Europe in recovery, as laser-focused on core as it is in Europe, or do you see investors being a little more willing to go further out the risk curve?

There is definitely a greater willingness in the US to go a little bit further out the risk curve, but I wouldn't say it is at the opportunistic level yet. You definitely see demand for core-plus and value-add. For the past two years, US investors have been talking about moving out of core and into value-add. We have definitely seen some core investors starting to funnel money toward more value-added strategies, but we are also still seeing both investors new to the game and making decent-sized allocations to core because it is their first real estate investment as well as large funds adding to their core allocations.

Do you see a material increase in the amount of risk that investors are willing to take?

There are some investors who, at the margin, are willing to take a little more risk now, but most are still being somewhat cautious. The world has changed, and even investors who now have an appetite to do something value-added or potentially even opportunistic have changed their expectations of what that looks like, how their risks are going to be characterised, and how transparent the managers are going to be regarding what that risk actually is. So even though investors are feeling a bit more comfortable with more risk, the risk management culture that emanated from the global financial crisis isn't going away. Investors are taking that discipline with them if they are moving out along the risk spectrum.

There is huge investor demand for core investment vehicles. How are new entrants into the core open-end fund space affecting the sector?

There are a lot of new entrants relative to other periods of time. It is not an easy business to get into, so I think part of it is the tremendous amount of capital looking for a home. Some of the new funds are typical open-end funds, and some seem to be more targeted, a little bit more niche. A lot of the big established funds have large entry queues, so it has been a competitive advantage for some of these new, smaller entrants to be able to take capital right away. Normally, it is very difficult to raise a fund without a significant track record.

Are these new funds focusing on the same markets as the established funds, or are new entrants trying to invest in other parts of the country?

A lot of these new funds are small and building their portfolio. From a diversification standpoint, you almost can't start by buying a trophy office building in New York City because it might be your only asset, so I would imagine they are having to look in different markets.

So if investors are focused on core and want to stay on the lower end of the risk curve, where do you find good opportunities?

A good strategy is doing as many off-market deals as you can or finding recapitalisation opportunities. If you believe office is going to take off in the next year or so, which is our view, then getting out in front of that rent growth is a good opportunity. So you would invest in markets where there hasn't been much office recovery yet, but you feel the fundamentals are going to improve soon. The market has been really bifurcated for the past couple of years, and people are only buying essentially perfect assets that could be perfectly financed. Now, a good opportunity would be to buy something that doesn't hit that perfect strike zone, but is in a market where you really believe in the supply/demand dynamics and think there is going to be good rent growth.

Are the banks open to financing now? Have they loosened up at all?

To a certain extent, lenders are still very risk-averse. But if you are in the lower leverage arena — if you are looking for 50 percent to 60 percent LTV — then financing is really not difficult to come by, even if you have some vacancy.

In London, sovereign wealth funds have swooped in and basically changed the market valuation because they are buying the top assets. Is there anything like that happening in the US?

Yes. One of the places in the US where you see that dynamic is Washington, DC. There are a lot of non-US investors continuing to invest in DC, particularly in office, even though the fundamentals in the DC office market are not that good right now. So that seems to be one place where there is just a complete disconnect between the capital markets and real estate fundamentals. Long term, Washington, DC, still looks like a good place to invest, but the reality of the supply/demand dynamic is not that pleasant right now, and it's hard to see how that will change anytime soon.

Why would European or Asian investors want to invest in a US core fund? What advantage would that give them?

The real advantage of US core funds is that they give investors instant diversification. It is possible to achieve a level of diversification across the country that would take direct investors a) years and b) billions of dollars to achieve. A direct property investor would have to have a pretty large portfolio in order to achieve the same level of both property type and geographic diversification. With $50 million to $100 million, an investor can invest in one of the core open-end funds and get diversification across the US geographically and by product type, as well as get exposure to gateway markets such as New York City, Boston, San Francisco and Washington, DC. Unless you have several billion dollars, you can't achieve that level of diversification because it is so expensive to get into some of those markets.

It is also easier to exit an open-end fund rather than be stuck in a closed-end fund for the next seven years.

Sure, definitely. I also think some of the attraction is the efficiency of the market and the level of transparency. The open-end fund construct is not as popular in Europe, where the closed-end structure tends to be preferred. But in the US, we have a whole industry and a core open-end index as well as a significant level of transparency on the market. ❖

CORPORATE OVERVIEW

Pramerica Real Estate Investors (Pramerica) is the real estate investment management business of US-based Pramerica Financial. Pramerica has been investing in real estate on behalf of institutional clients since 1970, with gross assets under management of $53.0 billion and net asset value of $37.3 billion, as at 31 March 2013. Investment products are structured primarily as open-end and closed-end commingled funds for institutional investors. Our funds pursue core, value-added, opportunistic and specialised real estate investment strategies. Real estate securities strategies are offered through individually managed separate accounts, mutual funds and subadvisory arrangements.

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