Quarterly Insights - United States

Second Quarter 2018

Key Themes

- Growing Concerns Over Rising Construction Costs
- Plug and Play: The Rise of Flexible Office Space

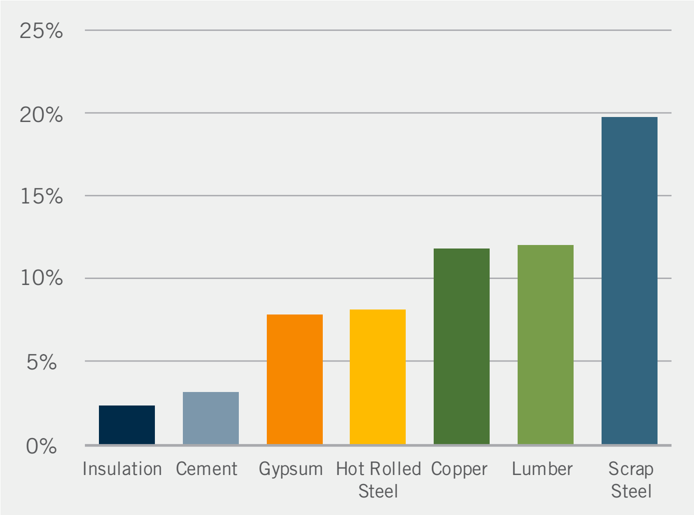
This briefing note highlights key insights arising from our most recent internal strategy meeting, at which the Investment Research team and senior investment professionals from across our platform gather to discuss the investment implications of various topics relating to the economy and real estate markets.

We hope you find the insights informative. Please do get in touch if you'd like to discuss them in more detail with a member of the team, using the contact details below. If you haven't already, we also encourage you to check out our more in-depth annual Global Outlook paper, published in May.

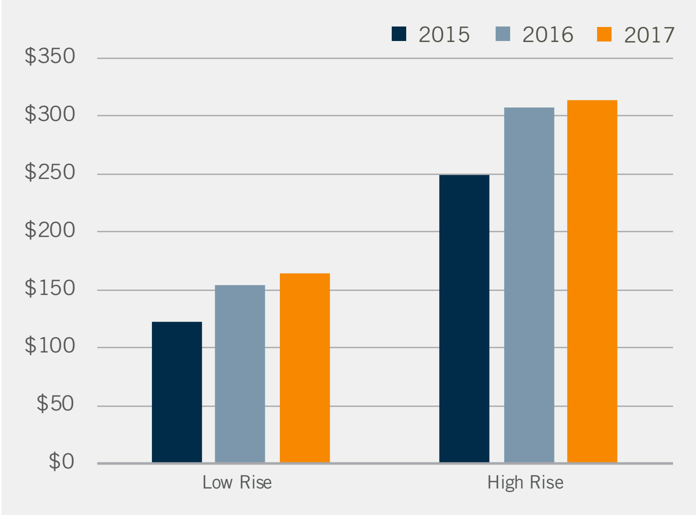
Growing Concerns Over Rising Construction Costs

With real estate returns decelerating and development spreads narrowing, we can now add the rising cost of construction to our list of concerns. Construction costs are expected to rise 4% to 5% this year, according to the Associated General Contractors of America. That's more than twice the growth rate of CPI inflation.

MATERIAL COSTS MOVING HIGHER (YEAR-OVER-YEAR % CHANGE, MARCH 2018)



CONSTRUCTION COSTS BY APARTMENT TYPE, $/SF

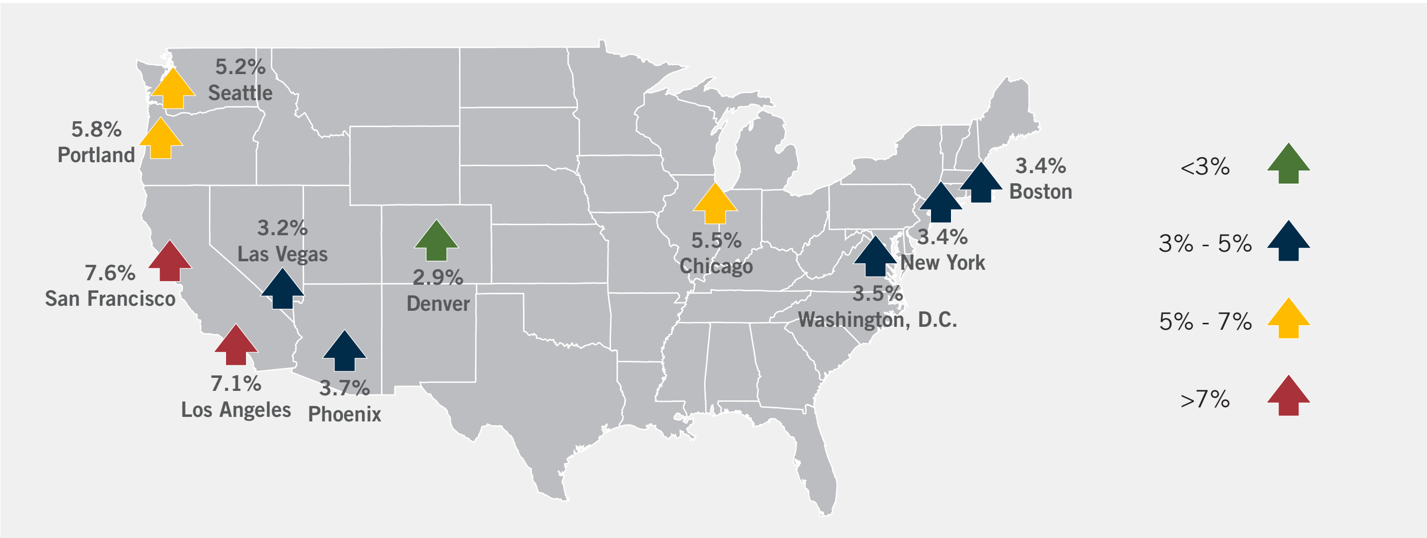


Source: U.S. Bureau of Labor Statistics, Moody's Analytics, Rider Levett Bucknall, PGIM Real Estate. As of April 2018.

At the same time, our asset managers indicate that some contractors are luring crews from nearby projects, reflecting labor shortages within the industry. There are massive regional labor disparities, with common labor costs across some West Coast markets rising nearly 10% over the last 12 months. Moreover, the difficulty in finding workers has resulted in delays, with the average number of months from start to completion for a typical apartment building increasing to 15.7 months in 2017 from 11.9 months in 2013, according to the U.S. Census Bureau.

The good news is that delays will help spread apartment completions over a longer time horizon, limiting the negative impact on rents. For sectors like office, where the supply cycle did not strengthen like it did in previous cycles, developers and investors may think twice about starting a project, thereby lengthening the cycle and providing potential upside for current owners.

REGIONAL CONSTRUCTION COST INCREASES (YEAR-OVER-YEAR INCREASE, 4Q17)

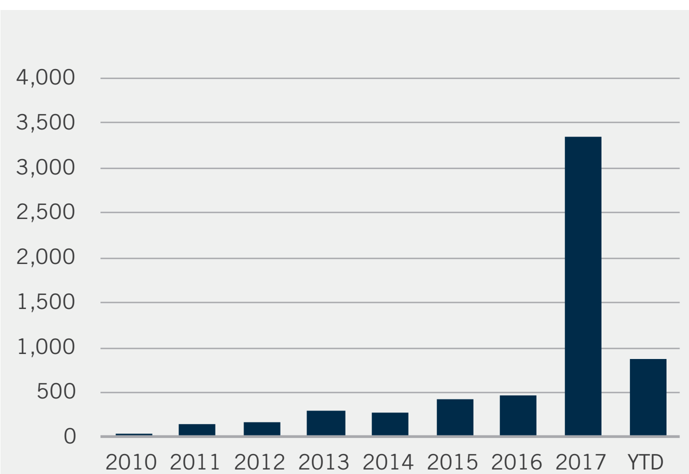


Source: Rider Levett Bucknall, Moody's Analytics, PGIM Real Estate

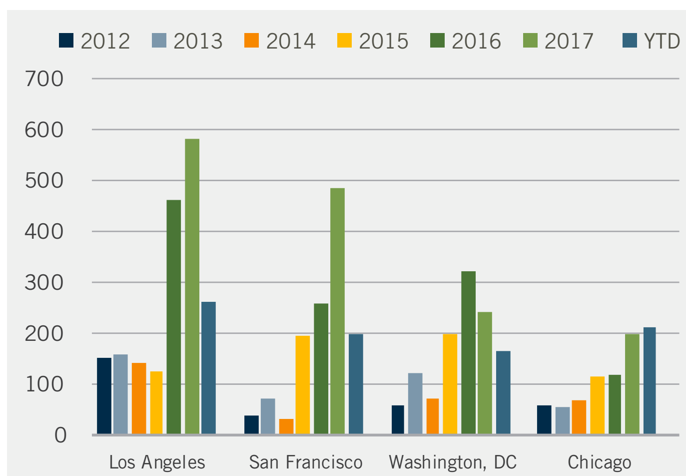
Plug and Play: The Rise of Flexible Office Space

We have a new tenant in town, which may be a threat or an opportunity for existing business models. It's too early to tell, but impossible to ignore. Co-working and flexible office companies continue to capture big headlines, leasing significant amounts of office space both in the United States and globally. Leasing activity by flexible office space providers has surged in New York City over the last two years, as well as in creative urban markets such as Los Angeles and San Francisco. Miami has seen a marked pick-up in activity, as this small-office tenant market provides a perfect platform for flexible offices. Yet, there is a huge amount of uncertainty in leasing to co-working tenants.

FLEXIBLE OFFICE SPACE MOVE-INS - NEW YORK (000 SQF)



FLEXIBLE OFFICE SPACE MOVE-INS (000 SQF)



Source: CoStar, PGIM Real Estate. As of April 2018.

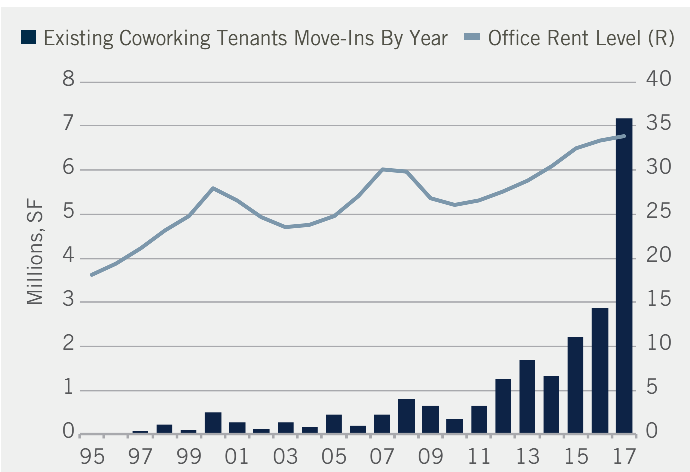
We should think holistically about what co-working tenants mean for property owners and managers. The recent growth of co-working tenants reflects the intersection of broad technological and social changes, including the sharing economy and behavioral shifts, the rapid expansion of technology-related jobs, the need for leasing flexibility, and growth of the millennial population in the labor force. The expansion of the tech sector has coincided with an increased focus on cost efficiencies and flexibility. Start-ups are attracted to shorter lease terms in top buildings that are fully built out and inclusive of administrative and other occupancy expenses. Larger firms are also testing the waters by exploring enterprise solutions that offer higher levels of service and flexibility than they receive from building owners.

Is co-working space an amenity for other tenants? Or is it just a credit risk that is fundamentally unprofitable in the long term? It may be both. Flexible office companies have locked in long-term leases over the last two years at cyclically high rents, driving absorption in certain markets, but also demanding large tenant improvement packages. What remains to be seen in the next downturn is how flexible office space companies manage cash flow and space give-backs to landlords. The historical evidence from Regus – its U.S. business went bankrupt in 2003 following a period of low occupancy, and its UK business pressured building owners to lower rents in 2010 – is certainly not compelling.

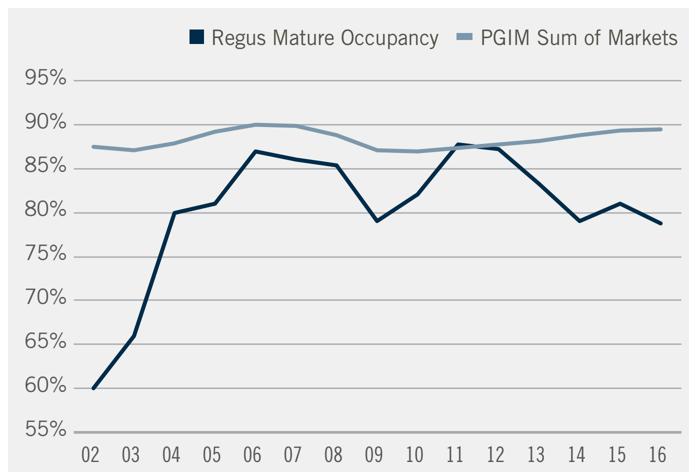
Regardless of whether the business models of office suppliers such as WeWork are ultimately sustainable, these companies and other co-working tenants may be fundamentally changing tenant expectations. Traditional office landlords may need to change how amenities and services are delivered in an office environment. This may cost them upfront, but it may be essential to keeping properties competitive in the market.

Moreover, the ability to be creative service providers extends to other property types as well. For example, the apartment amenity base has exploded, with many new Class A apartments comparable to staying in a four-star hotel, complete with concierges, Amazon Lockers, and frequent social events. In retail, it's about providing experiences as well, from dine-in movie theaters to children's play areas, dog parks, and community event programming.

COWORKING MOVE-INS BY YEAR VS OFFICE RENTS



REGUS VS PGIM REAL ESTATE'S TOP 25 OFFICE MARKET OCCUPANCIES



Source: Regus company filings, CoStar, PGIM Real Estate; Move-in data Include: WeWork, Space, Regus, ServCorp, Premier Business Centers, Knotel, Industrious National Management Company, Convene, Carr Workplaces, and MakeOffices.

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