Real Estate

Exploring public REIT markets

Public REIT markets surged this year in response to the global economy reopening. As governments rolled out vaccination efforts and deployed unprecedented levels of stimulus, fundamentals improved dramatically. Markets rallied. With the public's pandemic-related fears somewhat subsiding, a shift toward risk assets led to significant returns in the equity markets, including real estate stocks.

Recently, Principal's global REIT team discussed the performance of real estate markets around the world, including changes in fundamental trends. Our experts presented their views on the current REIT market to help investors determine what will drive global returns going forward.

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North America leading the way

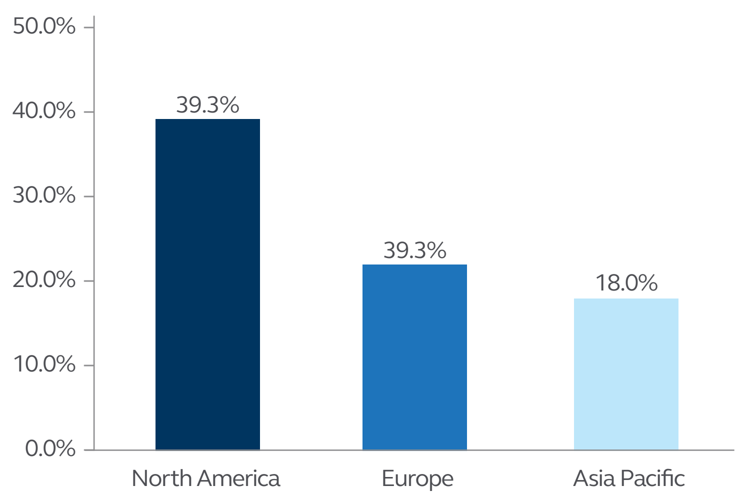
Kelly Rush, Chief Investment Officer, Real Estate Securities, spoke about regional REIT performance, noting that North America led the world in relative outperformance. Greater stimulus measures, particularly in the United States, helped boost sentiment in the equity markets more broadly, which helped lift real estate stocks.

Additionally, the U.S. economy opening earlier than other nations led to its improved fundamentals.

Leadership trends have reversed since the early days of the pandemic. Some companies with steadier earnings and long-term growth prospects underperformed in the most recent 12-month period, while more cyclical and value-oriented stocks

Exhibit 1: Global real estate securities regional performance

TRAILING 12 MONTHS



As of 30 September 2021.
Source: FactSet. Returns represent the FTSE EPRA/NAREIT Developed NTR Index, by region. Returns in USD. Past performance is not a reliable indicator of future return. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

outperformed (e.g., the retail sector). This leadership flip was true for both real estate stocks and the broader equity markets.

In North America, two property types were strong on both sides of this equation. Both the self-storage sector and the single-family residential sector experienced strong structural tailwinds and performed well from the fearful start of the pandemic to the recent environment of embracing risk.

At the same time, the office sector has consistently lagged. It has been weak from the pandemic's early days through the past year, driven by concerns over the long-term utilization of office space and what the new work-from-home (WFH) environment may mean for the sector.

Europe lagged the Americas and the broader global REIT universe, returning about 22% in the past twelve months versus the 30% global REIT average. The cause centers on sluggish vaccine rollout and less stimulus, which made for a slower reopening.

From a leadership standpoint, Germany—almost a quarter of the European universe—heavily impacted performance. Dominated by apartment owners and residential properties, the country had very weak returns. These steady and reliable earnings growers favored during the early days of the pandemic lagged significantly during the past 12 months, weighing heavily on European averages.

Asia saw a similar pattern of performance to North America and Europe. A strong performer in the pandemic's early days, Asia locked down quickly to get COVID-19 under control. Then, as the worst fears about the pandemic passed, the country faced challenges with vaccine rollout and regional outbreaks, leading to further lockdowns. Additionally, concerns about China's intervention in Hong Kong and what that meant for property companies traded in Hong Kong weighed on performance. These factors contributed to Asia being the poorest performer of the three major world regions over the past 12 months.

Evergrande and property market challenges in China

Headlines about real estate developer Evergrande put major pressure on China property stocks and this market remains a key issue for its government. China wants to reduce financial system risks and move the economy away from reliance on levered investment-driven growth. It is concerned that soaring property prices have pushed homeownership out of reach for many. With the property sector accounting for nearly 30% of China's GDP, a plunge in property prices can be extremely destabilizing. resulting in huge negative wealth effects for the middle class and a strain on the financial system. For these reasons, government will likely try to avoid a hard landing for the property sector.

The uncertainty around Chinese developers impacts other APAC areas. There are concerns around contagion from a potential Evergrande default event and the implications to the residential businesses of Hong Kong developers. However, we believe these concerns are misplaced given the strong underlying fundamentals of Hong Kong developers and limited China residential exposure. Hong Kong developers have minimal reliance on onshore financing and therefore are not impacted by higher credit spreads in China. Similarly, in Singapore, developers have actively divested Chinese residential assets as part of recent restructuring, so they are not impacted by higher credit spreads in China.

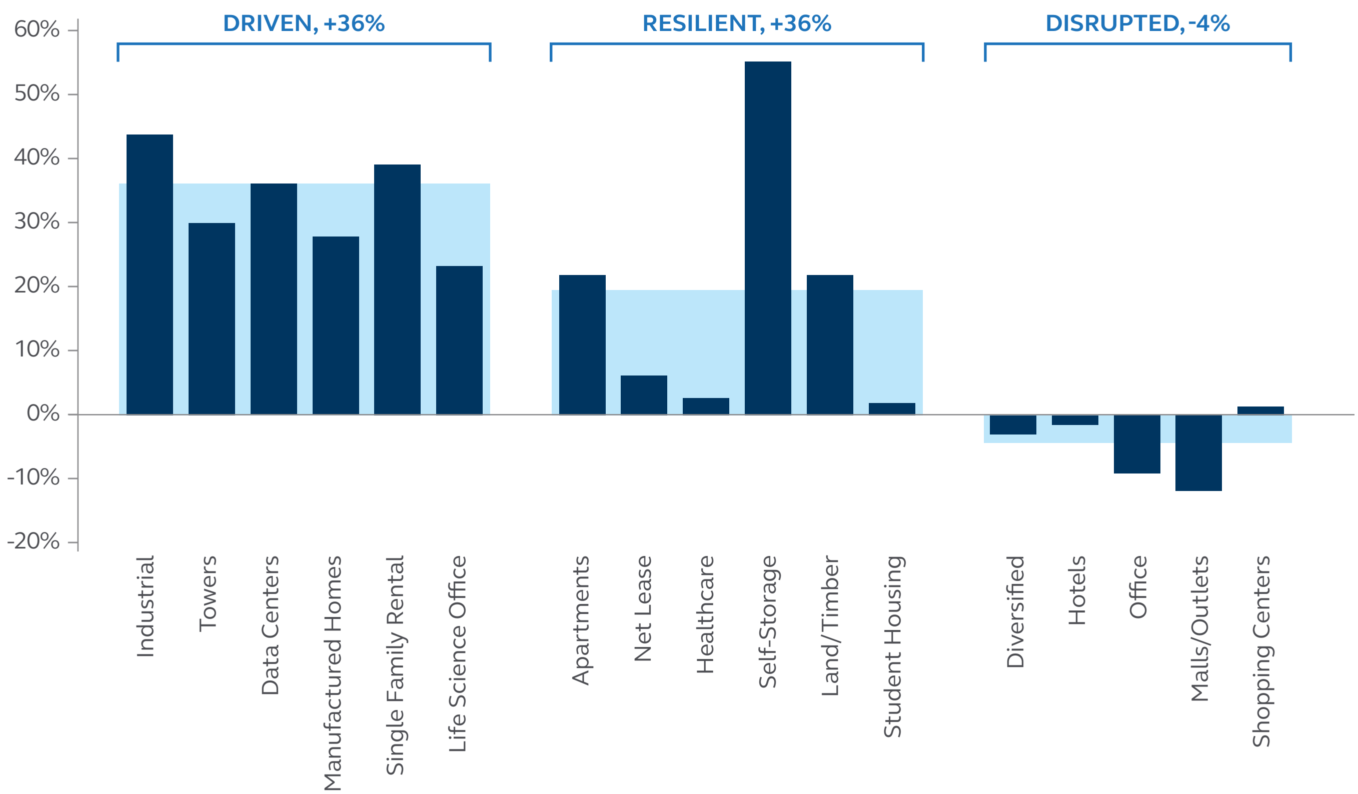
Sector perspective: The driven, resilient, and disrupted

Anthony Kenkel spoke about sector performance, including which areas have been driven by structural changes, which are resilient, and which are being disrupted by these changes. Those property sectors being driven by secular growth drivers include industrial, which is benefiting from rapid e-commerce growth, and data centers, which are benefiting from data consumption growth.

Resilient sectors include areas such as apartments, health care, and self-storage. Those being disrupted include brick-and-mortar retail businesses losing market share to online shopping.

Exhibit 2: Global real estate securities sector performance

TOTAL RETURNS SINCE PRE-COVID (JANUARY 2020 – SEPTEMBER 2021)



As of 30 September 2021.
Source: FactSet, Principal Real Estate. Weighted average cumulative returns are presented by structural change categories from our Principal global real estate securities investment universe. The performance shown is gross of fees, presented for illustrative purposes and is provided solely for conceptual discussion only. Please see important information section for the universe description. Past performance is not a reliable indicator of future return.

Sectors benefiting from structural change have outperformed those being disrupted by it since January 2020. Since then, the universe of global real estate securities has returned a cumulative 16%, with the **driven** category having returned around 36%, **resilient** 20%, and the **disrupted** category returning only 4%.

But the pattern of outperformance hasn't been a straight line. Driven sectors strongly outperformed disrupted areas in the first half of 2020. But then disrupted strongly outperformed in the second half of 2020 following the vaccine announcement.

The future of the office

The expectation is that more companies will mandate the return to office and attendance in the coming months will rise. However, the broader trend is very concerning as employees are primarily returning to the office because they are forced to rather than because they want to.

On the near- and long-term trends regarding traditional office demand, we believe companies will fully embrace a hybrid model. This will likely translate into a moderate but permanent reduction in office demand. While a centralized employee base offers collaboration and cultural benefits, we believe employees greatly value hybrid and full-time WFH. Employers will accommodate this desire, especially in an era of increasing employee turnover.

We do, however, believe there will be very meaningful differences by industry and geography. We expect tech companies will perhaps lead the way in embracing WFH and hybrid work. Geographically, we expect differences due to cultural norms. In Japan, for example, the culture is very office centric, and employees equivocate in-person work with greater career advancement potential. From a practical standpoint, in Asian markets such as Hong Kong or Singapore, living spaces tend to be small, which means that too much time in the home can be difficult for many people.

External growth trends around the world

As companies reshape their portfolios to drive external growth, regional trends have emerged. In APAC, the competition for real estate assets is increasing as the world is awash with capital. This results in strong rate compression for assets offering steady and growing cash flows, meaning that direct real estate pricing remains relatively firm. In some sectors, it's increasing.

There has been dislocation in the pricing of some REITs, making organic growth challenging. As a result of this more challenging growth environment, there have been three approaches in the APAC region:

- Pivot to a property funds management model to pursue incremental earnings growth in a capital light manner. Australia is the most mature market for this model, though its catching interest in Singapore and Hong Kong.
- Step up investment into development pipelines to capture the yield spread. The challenge in the near term with this approach is the uncertain demand environment in a post-COVID world.
- Move offshore. This approach is for groups more constrained in their range of activities—such as externally managed Singapore or Hong Kong REITs—and presents both execution risk and currency risk.

In the Americas, significant external growth activity is reflecting strong capital access as well as well-priced debt and equity. Many REITs within the region are trading at premiums to estimated net asset value. It signifies investors are giving these companies the green light to grow that capital. There has been quite a bit of activity from the single-family rental REITs, despite an increased amount of institutional competition. REITs have been successfully acquiring individual homes portfolios, forming programmatic joint ventures, and engaging in ground-up development. In another notable segment, the traditional apartment space, historically coastal and urban-focused portfolios have started to diversify into suburban and sunbelt-oriented assets, areas experiencing increased migration during the pandemic.

For Europe, strategies differ by sector, but common themes have emerged. For example, public real estate companies in Europe are recycling capital by selling fully leased assets at or above book value then putting these proceeds into a blend of opportunistic assets that require proactive asset management. The average leverage for European companies has continued to decline with the exception of retail. With the benefit of lower leverage going forward and an improving economy, European companies are now positioned with balance sheet flexibility enabling opportunistic acquisitions of individual assets or portfolios.

Where we see opportunities going forward

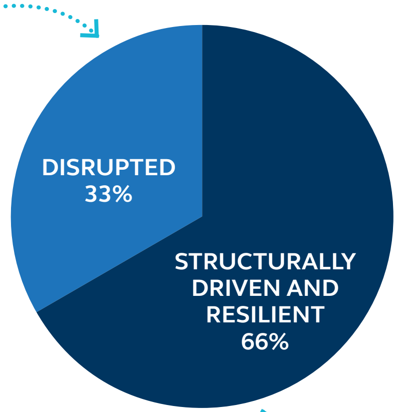
Our favorite theme in the Americas is U.S. residential, with compelling valuations and, in some cases, accelerating fundamentals. While we do like traditional apartments, we favor segments such as single-family rental, manufactured housing, and home builders because we believe they have longer runways for growth. Additionally, single-family rental and manufactured housing provide residential exposure primarily concentrated in the sunbelt, where we see very positive long-term trends. Within technology, we favor cell towers over data centers based on current relative valuations, although both have very strong fundamentals. We also believe fundamentals for industrial remain exceptionally strong.

In Europe, we see sector consolidation underway as telecom companies increase network efficiency through accretive acquisitions. The self-storage sector continues to demonstrate that it is far less cyclical than many investors fear, while its relative immaturity in Europe presents a long pathway for growth. Industrial properties became an investor favorite in recent years, and we believe the opportunity for supernormal profits remains intact, despite superficially high prices. We believe fears of rising bond yields and the potential of further restrictions on rent increases are holding back the German housing sector. In many ways, the German health care sector resembles its housing sector, with a few rapidly growing companies consolidating a very fragmented sector, offering high yielding noncyclical defensive assets.

Lastly, the APAC sectors benefiting from structural tailwinds are generally those experiencing strong cap rate compression and above-average growth. This includes industrial and data centers, which are benefiting from post-COVID demand conditions. We also think conditions remain positive for property fund managers, given the low interest rate environment and strong investor demand. Investors are seeking yield and are generally under-allocated to real estate. We favor fund managers that have operational scale and a strong track record of execution. This exposure is coming largely through Australia and Singapore. Japan generally lagged on the reopening fronts due to a delayed vaccine rollout, but it is largely caught up now and Japanese developers are attractively priced. Lastly, we see opportunity within the China property management sector as these companies have been impacted by concerns around potential policy tightening and developer solvency. We believe a large amount of this risk has been priced in and the market is not valuing the strong earnings growth profiles of these companies.

Exhibit 3: Portfolio tilted towards structural growth tailwinds with selective disrupted opportunities

Diversified	18.2%
Traditional office	7.6%
Retail	4.7%
Hotels & resorts	2.4%



Industrial	15.1%
Apartments	12.2%
Healthcare	7.5%
Single family rental	5.6%
Self-storage	5.3%
Net lease	5.2%
Data centers	4.3%
Manufactured homes	3.5%
Lab science office	2.3%
Towers	2.1%
Other	1.2%
Student housing	0.9%
Homebuilder	0.6%
Land/timber	0.5%

As of 30 September 2021.
Source: Principal Real Estate . For illustrative/example purposes only.

Going forward: The outlook for 2022

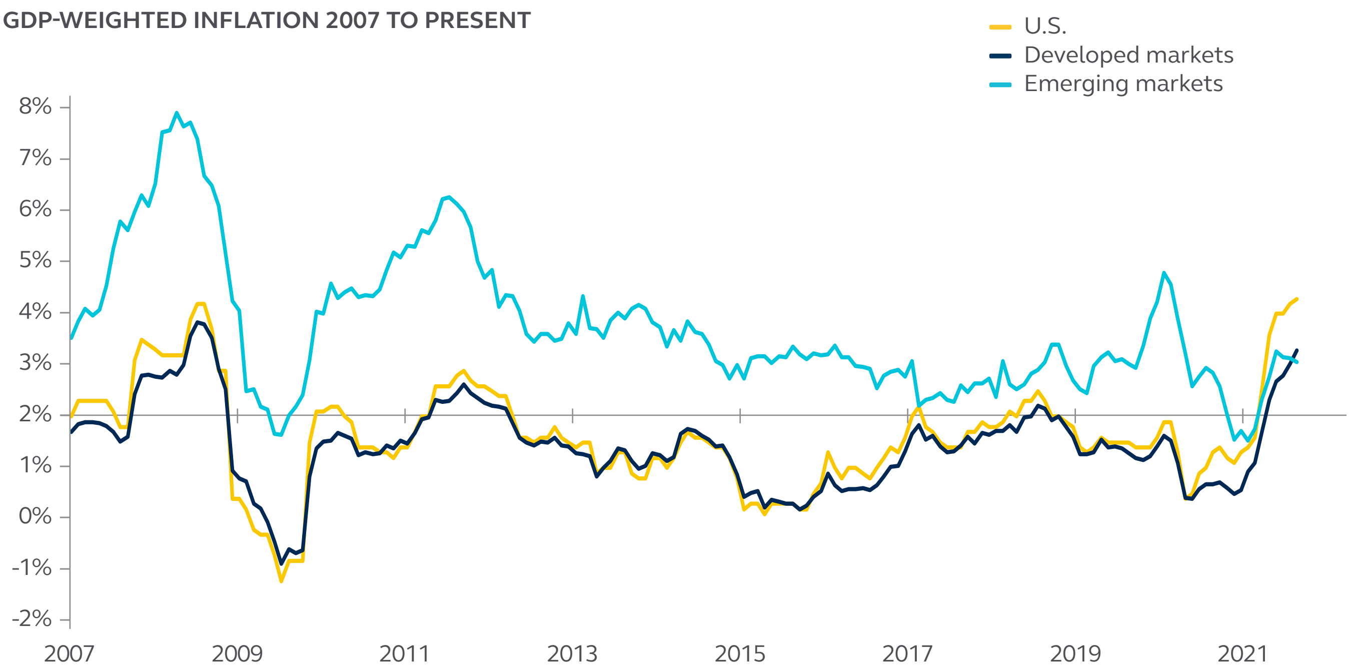
Kelly Rush closed out the discussion by sharing his views on what to expect in the new year.

Rising inflation remains top of mind. Investors have good reasons to be concerned that it could persist and exceed the U.S. Federal Reserve's target over a meaningful period. Monetary and fiscal stimulus measures have created a flood of liquidity. Other factors, such as deglobalization and the onshoring of manufacturing activity, can impact inflation, as can the reduced labor force participation and supply-chain bottlenecks. All factors have raised investor questions about the impact to real estate stocks.

It's possible these inflationary concerns may persist deep into 2022. In this uncertain environment, we are focused on creating a balanced and diversified portfolio with meaningful exposure to companies with pricing power and those with shorter leases, so they can reprice more quickly to adjust to inflationary pressure. We do believe real estate as a sector should fare reasonably well in an inflationary environment because as the costs of materials and construction rise, so do the costs to replace properties, providing support for the underlying real estate assets.

Exhibit 4: Global inflation history

GDP-WEIGHTED INFLATION 2007 TO PRESENT



As of 30 September 2021.
Source: Bloomberg, Principal Global Asset Allocation

It's also possible, however, that concerns about inflation are somewhat misguided. For example, there are leading indicators currently suggesting that some supply bottleneck pressures may be softening. Additionally, the bond markets are reacting calmly with regard to inflation, with interest rates on the longer end of the curve remaining at relatively low levels.

Regarding the outlook for valuations, it's important to highlight that real estate stock valuations share some current trends with the general equity markets. Multiples for equities today are very elevated, far above the past 15-year average, and this is true for global real estate stocks as well. However, while global REITs are trading at below-average dividend yields, valuations are less concerning when considering current interest rate levels. The spread between dividend yields and Treasury rates are at a fairly normalized level for both general equities and global REITs. This may present outperformance opportunities for real estate stocks even in a rising rate environment.

Risk Considerations

Investing involves risk, including possible loss of principal. Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. Past performance is not a guide to future returns.

Important information

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All figures shown in this document are in U.S. dollars unless otherwise noted. The Principal global real estate securities investment universe for the growth and valuations dashboard includes an investment universe of approximately 450 common equity securities, which is what is used in this analysis. It includes the constituents in the FTSE EPRA/NAREIT Developed NTR Index plus some out of benchmark opportunities that we consider real estate and include in our normal investment universe. The universe historical return does not represent an actual strategy managed by Principal Real Estate Investors and no representation is being made that any account will or is likely to achieve profits or losses like those shown.

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