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Real Estate

Principal℠

Structural drivers reshaping real estate investing

COVID-19 has reshaped real estate investing, helping accelerate the thematic demand drivers that were in place pre-pandemic. The current environment is raising many questions for real estate investors, including the role of real estate in portfolios during an inflationary period and when, or if, living and working patterns will return to pre-pandemic norms.

Members of the Principal Real Estate senior investment team recently provided some insight into these questions and presented an update on the key macro and capital market considerations underpinning real estate investments today. Following is a summary of their discussion.

INDRANEEL KARLEKAR, PH.D.
Sr. Managing Director,
Global Head of Research & Strategy

ROD VOGEL
Sr. Managing Director,
Head of Private Equity Production

TODD WHITE
Managing Director,
Portfolio Management

The macroeconomic perspective

Indraneel Karlekar, Global Head of Research & Strategy, provided a high-level perspective of the macroeconomic factors and themes that will be most relevant going into 2022. In the next 12 to 18 months the United States is still likely to lead global economic performance. Retail sales have been very strong, a positive sign for the U.S. economy in 2022. However, U.S. leadership will likely fade a little as Europe and the emerging markets strengthen, particularly as vaccination rates rise.

For the rate outlook, this shift should be quite good. The impact of strong growth on inflation is front-of-mind for many investors, especially in light of U.S. inflation rising to 6.3% in October. If growth remains very strong in 2022, the likelihood of inflation remaining elevated is also quite high. This scenario would probably put the U.S. Federal Reserve under even greater pressure to act sooner to raise rates. Because inflation numbers are running much higher than the Fed expects, the central bank has ceased terming inflation “transitory” in nature. This could impact the timing of the Fed’s plans to raise rates bringing forward the first interest rate increase to 2022.

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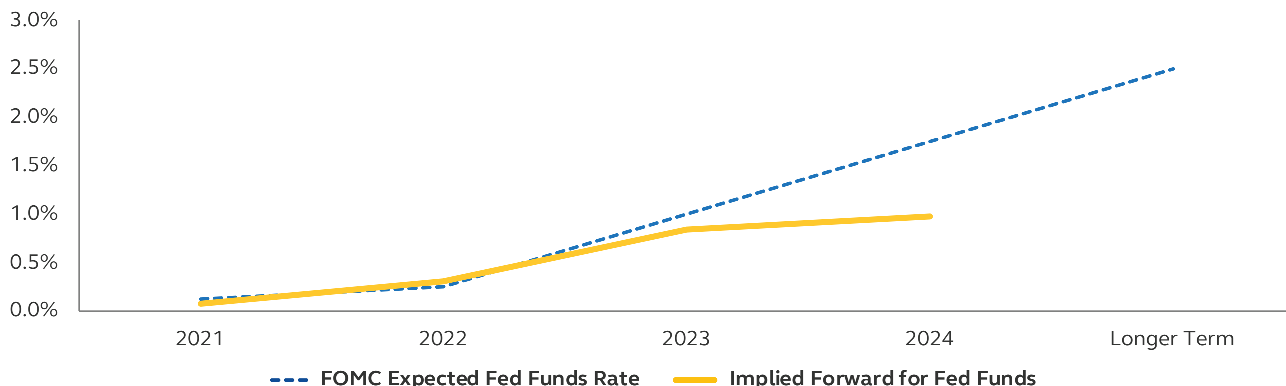
Exhibit 1: Fed signals change is coming

FOMC Expected Fed Funds vs. Forward Fed Funds

FOMC as of September 22nd, 2021 with Forward as of December 3rd, 2021



Source: Bloomberg, Principal Real Estate, December 2021

"DIGITAL" themes are driving demand

Demand drivers for the real estate markets, which Principal Real Estate Investors refers to as DIGITAL themes (Demographics, Infrastructure, Globalization, and Innovation & Technology), have become very important in driving the growth of formerly niche, or non-traditional, property types. As the pandemic transformed the outlook for occupiers, the capital markets are propelling these property types into the mainstream. This key theme will unfold over the next year, and likely far beyond.

Another theme is that core asset values in some markets and property types have risen significantly over the last year, and some moderation is likely going forward. When core assets are pricing above replacement costs, it is a good sign to start considering alternative strategies. As the appetite for real estate remains very strong, there are new opportunities in non-traditional property types with long-term structural tails that fall within Principal Real Estate Investors DIGITAL themes. As a result, our outlook for 2022 is optimistic, even as we remain very aware of some of the swelling crosscurrents that lie ahead.

Our DIGITAL themes manifest themselves in both the traditional and non-traditional real estate property types, (see Exhibit 2). Increasingly, non-traditional properties have become the beneficiaries of these demand drivers. While these factors can impact every aspect of investing, they are particularly relevant to the real estate markets. To put this in perspective, it's helpful to consider one area of the DIGITAL themes: infrastructure.

Exhibit 2: "DIGITAL"–driven property types prove very resilient

DEMOGRAPHICS	INNOVATION & TECH	GLOBALIZATION	INFRASTRUCTURE
• Ageing population • Shifting migration patterns • Housing affordability • Inequality and cost of living	• AI/Big data and a circular economy • Flexible working/WFH • Innovation "hubs" • Retail disruption • ESG prioritization	• Secular increase in trade & capital flows • Global technology supply chains • Mobile human capital and remote workforces • Satellite towers	• Communication • Physical assets • Transportation • Energy and utilities • Social infrastructure
• Suburban housing • Single-family rentals • Manufactured housing • Self-storage • Senior living/care homes • Grocers, discounters, DIYs	• Life sciences • Lab space/Medical office • Data centers • Cold storage • Self-storage • New format retailers	• Data centers • Warehouse/Logistics • Last mile facilities	• Data centers • Warehouses • Affordable housing • Care homes, medical office • ESG focus

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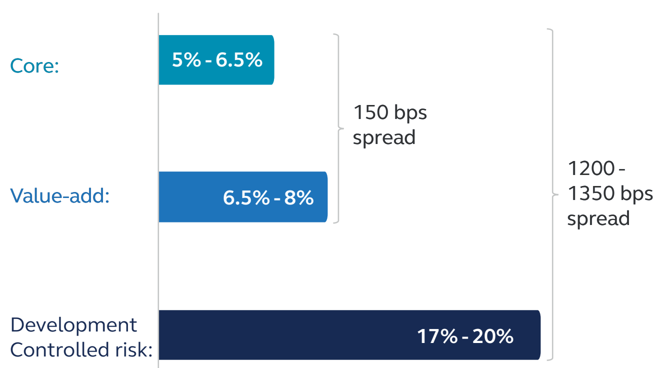
The trillion-dollar infrastructure bill recently signed into law by President Biden will have significant repercussions for all investors, but for real estate investors in particular. Many physical assets will benefit, as will fiber optic communications and energy and utilities. Clean energy is going to big beneficiary, and a huge component of investing going forward. By considering the impact of the DIGITAL themes on real estate, we have identified specific property types that will benefit in this environment including data centers, warehouses, and affordable housing with an ESG orientation. Understanding the structural demand drivers through the DIGITAL lens has helped deconstruct a much larger set of demand drivers, ultimately allowing for more informed decision making when choosing where to invest.

Opportunities beyond core assets

Rod Vogel, Head of Private Equity Production, spoke about the high level of capital pursuing the U.S. commercial real estate market. The impact of this has been reflected in the pricing of core assets. Core unlevered internal rates of return (IRR) are in the 5%–6.5% range, which is down 50 to 100 basis points (bps) over the last 12 to 24 months. This is the result of both the amount of capital coming to the marketplace and the low interest rate environment within the U.S. As investors search for higher-yielding investment opportunities, there are opportunities in the value-add space. The market for these types of investments is 6.5%–8%, or 150 bps over core.

Exhibit 3: Why opportunistic real estate now?



As of September 2021. These are gross unlevered internal rates of return. For informational purposes only. Source: Principal Real Estate

The above return observations are not intended to predict or guarantee the return of any fund or strategy managed by Principal Real Estate. The Internal Rates of Return ranges reflect unlevered property level returns before fees and expenses over an assumed ten year holding period and reflect estimates of returns that Principal Real Estate Investors has observed on the U.S. commercial real estate market generally, both through its analysis of real estate sales offer packages from third party sellers and their representatives as well as deals underwritten by the Firm's Acquisition Area when considering potential investment opportunities for clients. These ranges do not reflect any deductions for investment management fees or expenses that would reduce the actual returns realized by investors. Investors should keep in mind that the real estate markets are volatile and unpredictable. Commercial real estate investing is subject to significant risks and there is no guarantee that the above property return ranges will be realized or achieved or that any investment strategy will be successful. The ranges shown are for investments of institutional investment quality that Principal Real Estate would consider for client portfolios and are not inclusive of all real estate sales offer packages from third party sellers received by the Firm. This is shown for Illustrative, informational purposes only and subject to change without notice. This information is not intended to forecast or predict future events.

In the development of commercial real estate, unlevered IRRs during the construction development and lease-up timeframe is almost 20% today, the highest levels in more than three decades. One factor driving this is low interest rates, which is helping support low cap rates for core assets. Industrial and multifamily core assets are trading in the 3%–3.5% range and given the strong space market fundamentals for multifamily assets, this property type is experiencing rent growth of up to 7%, depending upon the market. When the asset is stabilized, the property value is 25–30% higher than the cost basis, which makes the development of multifamily an extremely attractive investment opportunity.

The impact of rising prices

Todd White, Managing Director, Portfolio Management, discussed real estate property valuations and the continued strong price appreciation in certain sectors. For core multifamily and industrial, many assets are trading at nearly two times what it cost to build that product. This pricing has led the firm to allocate more new capital to developing multifamily and industrial assets instead of buying core.

Leverage or the use of debt has also factored into how these properties fit into portfolios. The current interest rate environment makes it a great time to be a borrower. Principal Real Estate has been increasing borrowing across funds to take advantage of the low interest rate environment, with a preference for longer-term, fixed rate debt.

Short-term versus long-term shifts

Among the four major property types—office, retail, industrial, and multifamily—office and retail clearly suffered—and are still struggling—from the pandemic. While grocery-anchored retail has started to come back, there are also signs the hybrid work-from-home (WFH) model is going to have a dampening effect on demand for the foreseeable future. Office is clearly in a transition period right now. For older buildings, their obsolescence has been accelerated due to the pandemic, but this may help new and modern buildings (e.g., those with LEED certifications).

On the other hand, industrial and multifamily have benefited greatly from the pandemic. There has been almost insatiable demand from occupiers of industrial buildings despite supply chain challenges. In the U.S., 2021 may be a record year for industrial as groups are trying to get merchandise out to consumers via Amazon, UPS, or similar services. Industrial will likely continue to exhibit strength as market fundamentals remain positive.

In multifamily, there has been a bit of a "haves and have nots" environment. Urban markets have struggled with the migration out of big cities like New York, Washington, D.C., and Chicago. It's unclear if these population losses, mostly to the suburbs or to the south, are part of a longer-term paradigm shift. It's very possible these are just short-term changes and over the longer-term people will return to these cities, which could bode well for urban apartments in the future. Regardless, multifamily has performed exceedingly well as a core asset or a development.

Inflationary pressures are going to impact different sectors in different ways. Property types with longer-term triple net leases may underperform inflation quite significantly. Shorter-duration apartments are attractive because they renew annually, and rents can reset. Hotels could be a good place in a rising inflationary environment, especially if there is a return to normal levels of business travel. Many of the non-traditional property types have ingrained demand drivers that will help them power through inflation. Life sciences, self-storage, and manufactured housing have experienced very strong rent growth. This is a structural shift that's pushing occupiers towards these property types. In the coming 12 to 24 months, many non-traditional property types are poised to perform well.

Data centers and life sciences, as well as anything housing related, are growing in importance in real estate portfolios. These property types offer very compelling returns, particularly on the development side. For example, compared to multifamily, manufactured housing is experiencing similar rates of return with more potential growth opportunity and strong fundamentals. This effectively is creating higher total returns and double-digit IRRs with the conservative use of leverage.

CONCLUSION: Structural themes will drive performance in 2022

Going into 2022, investors should expect continued economic rebound, led by the U.S. Monetary policy accommodation will likely throttle back, but rates will remain low and debt capital will continue to be widely available.

For real estate investors, the economic landscape is creating new opportunities. While core assets in the largest property types are priced at or above replacement costs in many markets, suggesting a moderation in core performance going forward, many non-traditional, niche sectors like data centers, life sciences, and manufactured housing are presenting attractive opportunities.

COVID-19 accelerated many of the structural trends already taking shape in the real estate markets, and we believe these DIGITAL themes will continue to drive sector performance, with non-traditional property types enhancing the core investment universe and providing the opportunity for additional sources of alpha.

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 does not guarantee future results.

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