Principal Asset Management℠

Principal Real Estate

Inside Real Estate Mid-Year Outlook Companion

What investors may be missing about this recovery

AUTHOR:

RICH HILL
Senior Managing Director
Global Head of Research & Strategy

We published our mid-year outlook, "Resilient recovery," in late June 2026. We subsequently met with investors in both Europe and the U.S. in a series of Inside Real Estate Roadshows. In this brief report, we summarize the key themes that emerged.

Bottom line, this cycle is playing out in textbook fashion, but consensus is underappreciating both its duration and the degree of dispersion within it. Recoveries and expansions are longer than the market believes, NOI growth - not cap rate compression - will be the primary driver of total returns, and hyper-selectivity across property types, markets, and managers is what will separate alpha from beta this cycle.

Cycle mechanics

- **This cycle is playing out in textbook fashion.** Listed REITs trough first, private real estate valuations trough second, and debt market distress lags, typically peaking 12-to-24 months after private valuations bottom.
- **Distress is the last stage of the grieving process – acceptance.** Lenders don't like resolving distressed loans into a distressed market; they prefer resolving them into a stabilized market like today's.
- **Cycles are longer than consensus believes.** They last ~16 years on average, supported by capital returns but, more importantly, by underappreciated income returns. Recoveries last ~2 years, expansions ~12 years, and downturns ~1.5 years. This pattern holds across three cycles in publicly listed REITs and two cycles in private real estate.

Public REITs are sending constructive signals

- **Public REITs are flashing green for private real estate.** Up +19% YTD and the 4th best-performing sector of the eleven in the S&P 500
- They've recently transitioned from **recovery into expansion.**
- The market is valuing **predictable earnings and income-driven total returns** again.

Return drivers this cycle

- **NOI growth will be the primary driver of total returns.** It drives both income returns and capital returns in a market where cap rate compression will be limited.
- **Rent growth forecasts vary widely across property types and markets,** making the selection of the right properties in the right markets critical — a shift from prior cycles. Pre-Global Financial Crisis (GFC) was all about picking the right markets; post-GFC was all about picking the right property types. Themes still matter, but they require hyper-selectivity.
- **This is driving significant dispersion in returns** across property types, markets, and fund vehicles. This is not a flaw of the cycle — it is the cycle. Headline returns may look modest given the law of averages, but the alpha opportunity is significant.

The dispersion nuance consensus is missing

- **Consensus calls this a K-shaped recovery,** but that misses an important nuance. Dispersion has always existed and always will — the market simply hasn't focused on it in a long time. When even relative underperformers produce positive returns in a broad-based expansion, and relative outperformers produce negative returns in a broad-based downturn, the market pays little attention. The last recovery was V-shaped post-GFC.
- **What sets this cycle apart is that some markets aren't recovering at all** — or are barely recovering. The last time we saw dispersion of this magnitude was nearly 30 years ago, following the S&L crisis. During that recovery (1Q93–2Q95), the bottom quartile generated average quarterly returns of -14.5% to +0.7%, compared to -15.6% to +0.5% in the current recovery from 3Q24–1Q26.
- **Bottom line: this environment feels like a shock to the system** — neither a V-shaped rebound, a broad-based expansion, nor a uniform downturn. Alpha is earned, not given.

Portfolio optimization

- **Overweight private CRE debt.** Attractive risk-adjusted and volatility-adjusted returns - the NCREIF/CREFC aggregate index has not posted a negative quarter of total returns since 2014.
- **Core AUM is consolidating around a smaller group of managers** who deliver attractive total returns. There's a +600bp spread in total returns between the top and bottom quartile of managers. Managers who consistently outperform the benchmark - rather than back into outperformance via a random walk (i.e., attractive information ratios) - will be rewarded.
- **Investors are moving from core to core+ to deliver alpha.** "Real" core-plus focuses on light value-add and carries higher leverage as a byproduct; "fake" core+ owns core assets with higher leverage as the primary driver of higher returns.
- **Early-cycle environments reward moving out of the risk spectrum** into value-add and opportunistic, but manager selection is critical. Some managers outperform in bad vintages and vice versa - the key is doubling down on managers who consistently outperform across vintages.
- **Investors should consider holding a 10–30% allocation to listed REITs within their private portfolios, depending on their objectives.** REITs serve as a liquidity accordion, allowing investors to efficiently scale exposure up or down. More importantly, they reduce portfolio volatility over the medium- to long-term, since REIT valuations zig when private valuations zag.

Property type selection

- We see opportunities and risks across most property types. It's therefore hard to have extreme conviction on any sector, but we also don't redline any.
- Avoiding the losers that blow up track records is just as important as picking the winners.
- Here we outline key themes where investor expectations may be overly simplistic or where the gap between winners and losers could widen over the next cycle.

Commodity Class A apartments

Apartment fundamentals remain healthy, but much of the last development cycle delivered one-bedroom product at a time when demographic growth is increasingly concentrated in older, family-forming households.

The sector may be more dependent on continued strength in white-collar employment than investors appreciate, creating potential downside if AI-driven productivity gains slow hiring or increase labor displacement.

Success may depend less on broad housing demand and more on buying the right product at the right basis while maintaining realistic NOI growth assumptions.

We see opportunities in Class A apartments that can be bought at the correct basis and where rents are underwritten at the correct levels.

Our top recommendation is a diversified living strategy that allows for targeted investments across markets in apartments, Build-to-rent, manufactured housing, student housing, and senior housing.

Senior housing

We see secular tailwinds for senior housing given aging demographics that may push structural occupancy ceilings from 91-92% to closer to 95%.

The sector's operational complexity, labor requirements, and rising acquisition prices may create greater performance dispersion than many investors expect.

The key risk is assuming favorable demographics alone will overcome execution challenges and elevated valuations.

Market selection shows a clear disparity between the properties poised to perform and those that are not.

Self-storage

Storage continues to perform well in select markets where housing stock lacks basements and attics or where household formation supports demand growth. Urban markets are more compelling.

However, many markets have experienced significant development activity, potentially limiting future rent growth.

Demographic shifts and changing consumer preferences may also challenge assumptions that demand will continue to grow uniformly across markets.

Data centers

AI demand remains compelling, but the sector is becoming increasingly differentiated between cloud, AI training, AI inference, and cloud facilities.

Power availability is emerging as a critical determinant of value, yet access to power alone may not be sufficient if assets lack the connectivity, network density, and ecosystem advantages found in major availability zones.

The greatest risk may be excessive capital pursuing a popular theme, resulting in a growing gap between the sector's winners and losers.

We see opportunities to develop the right property type in select markets and have an increasing focus on lease structure that's driving cap rate dispersion.

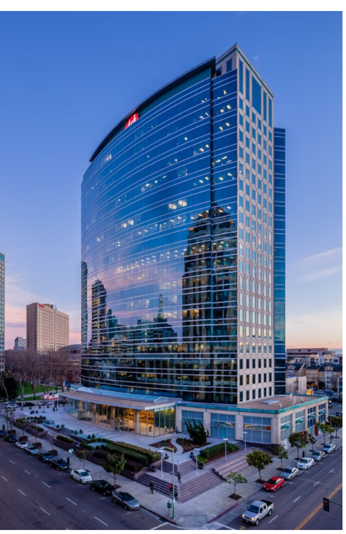
Industrial

Industrial real estate remains supported by e-commerce, logistics, and long-term supply chain needs, but the sector is transitioning from extraordinary growth to a more normalized environment.

Future performance is likely to depend increasingly on location, building quality, and market selection rather than broad sector tailwinds.

The greatest risk may be assuming that future rent growth and appreciation will resemble the exceptional conditions experienced during the post-pandemic cycle.

There's continued demand for modern logistics facilities, and we see select opportunities to develop.



Office

The debate is increasingly less about office versus remote work and more about good office versus bad office.

Demand continues to concentrate in highly amenitized, well-located buildings, while older commodity assets face growing competitive pressures and capital requirements.

A recovery in office fundamentals is unlikely to benefit all buildings equally, creating a wider gap between top-tier assets and the rest of the market.

The top quartile of property types may prove to be outperformers over the next cycle, but capex is an important consideration.

We prefer lending in the US and buying listed office REITs that trade at meaningful discounts to replacement cost. Europe may offer better opportunities than the U.S. in private equity over the near term.

Risk Considerations

Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. 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. Portfolios concentrated in real estate securities may experience price volatility and other risks associated with non-diversification. Commercial real estate (CRE) investing carries several inherent risks, including those related to the economy, interest rates, market fluctuations, high upfront costs, and tenant-related issues like defaults or high turnover. Economic downturns can lead to decreased property values and increased vacancy rates, while financing costs, insurance expenses, and potential environmental or structural problems can also pose significant challenges. All these factors and risks can impact rental income and overall investment returns.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account.

Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. All figures shown in this document are in U.S. dollars unless otherwise noted.
This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- Europe by Principal Global Investors (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGII, PGIE or PGII may delegate management authority to affiliates that are not authorised and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID).
- United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA").
- This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
- United Arab Emirates by Principal Investor Management (DIFC) Limited, an entity registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as an Authorised Firm, in its capacity as distributor / promoter of the products and services of Principal Asset Management. This document is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation.
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001.
- Hong Kong SAR by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission. This document may only be distributed, circulated or issued to persons who are Professional Investors under the Securities and Futures Ordinance and any rules made under that Ordinance or as otherwise permitted by that Ordinance.
- Other APAC Countries/Jurisdictions, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

MM15072 | 07/2026 | 5778337-122027