Principal Asset Management℠

ANNUAL

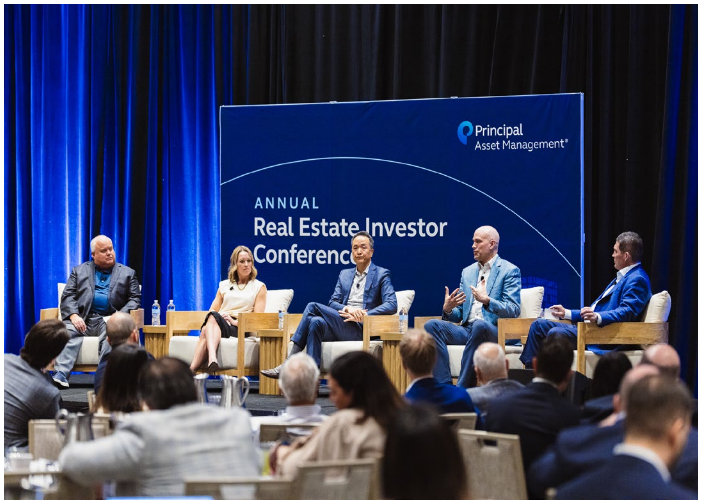
Principal Real Estate Investor Conference

Key takeaways

The bottom-line

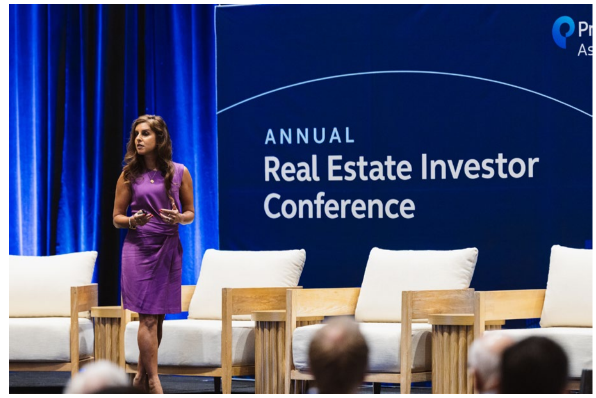
Principal Asset Management recently hosted our annual Real Estate Investor Conference and Advisory Committee in Scottsdale, AZ from May 7 – 9, 2025. The conference provided Principal with a valuable opportunity to (re)connect with clients and share insights regarding how we are positioning the business in the current market.

The overall tone was pragmatic with participants acknowledging an uncertain macro backdrop, however, most agree that commercial real estate (CRE) total returns in 2025 should continue to rise as income returns help offset potential headwinds to capital returns and history shows that 7% to 8% annual returns over the longer term are reasonable.



Listed REITs are a leading indicator that CRE is relatively well positioned while the debt markets remain open for business supporting valuations. While European investors are allocating away from the U.S. (albeit not selling), Middle Eastern and wealth advisory clients see opportunity given the recent drawdown in valuations and less competition. Investors across the board are taking a back-to-basics approach—selecting good properties in the right global markets to drive attractive fundamental growth and solid returns. Development to core, value-add and opportunistic are emerging as bigger components of portfolios.

The macro backdrop



Seema Shah, Chief Global Strategist for Principal Asset Management, presented the state of the economy and outlined the key themes to watch in 2025. Her view is that the global economy confronts upheaval as the U.S. looks to restructure international trade. Tariffs threaten a sharp deterioration in U.S. economic growth, but the U.S. is likely to avoid a recession. Of all the trade deals, China's is the only one that would truly move the needle for U.S. growth. The recent announcement that the U.S. and China will temporarily lower tariffs on each other's products to give the two countries three months to work toward a broader agreement is therefore an important development to monitor. While the Federal Reserve is biased to ease policy, they are in a "wait and see" mode that likely pushes out the timing of cuts and constrains the number of cuts. Global economies are also bracing for tariff impact, but offsetting policy stimulus is coming into play especially in Germany given a combination of defense and infrastructure spending. A global dollar backlash is threatening U.S. assets over the near term, but there aren't viable alternatives to the greenback and the U.S. will remain a haven over the medium-to-long term.

No pushback on our "muddle along" narrative for private equity commercial real estate

The U.S. real estate market entered 2025 from a position of strength bolstered by lower interest rates, durable cash flows, and well-capitalized balance sheets. However, the announcement of the Trump administration's tariff hikes on April 2 roiled global asset markets and created a sense of agita among investors, including and especially those focused on real estate. While tariff-driven uncertainty has the potential to slow broader economic growth, real estate valuations—already down around 20% from 2022 levels despite a lack of macroeconomic distress – reflect much more of this risk than other asset classes. We expect unlevered total returns to "muddle" along in 2025 in our base case as stable income returns help offset a potential decline in capital returns, but medium to long term returns will likely be higher (as discussed further below). Indeed, valuations rose for the 3rd consecutive quarter in 1Q25 at approximately 1.3% and, while many expected valuations to accelerate in the coming quarters prior to "Liberation Day," 2025 returns in the high single digits likely reflects a bull case in our opinion. We think the credit markets remain on healthy footing unlike the drawdowns that occurred post the Global Financial Crisis (GFC) and the Savings & Loans (S&L) crisis. This is helping to support asset valuations.

Using history as a guide for medium-to-long term returns

Rolling annual 10-year unlevered "core" total returns have averaged 8.8% since 1Q 1991 compared to 5.5% over the prior 10-years. We argued that the next 10-years will likely be meaningfully higher than last 10-years given the recent draw down in valuations – 7% to 8% annual returns seem reasonable. This is similar to 1991 to 1992, late 1999 to 2022, and 2013. It's worth noting that 5-year annual total returns have never turned negative unlike the S&P 500 where returns have dipped to the -5% to -7% range on several occasions. In fact, even if you bought at the peak of the market in 1Q 2008 before the GFC, your 5-year total returns were still 3.5% and the 10-year annual return rose to +6%. Investors that cited higher return targets are increasingly focused on build-to-core, value-add, and opportunistic where returns of +10% can be achieved.

Listed REITs are a leading indicator

Listed REITs have generated year-to-date returns of +1.5% as of May 9, outperforming the S&P by +479bp and the NASDAQ by +841bp. Importantly, real estate is the 5th best of the eleven S&P sectors and was as high as 3rd best earlier in the month. Principal panelists cited four primary reasons for the recent outperformance: 1) Earnings are relatively insulated from the direct impacts of tariffs and other Trump policies while they have strong balance sheets with LTVs of approximately 30%, 2) They are favored by investors in a defensive market rotation given their durable income profile, 3) Valuations relative to equities have grown historically cheap as interest rates rose in recent years and the market favored the growth of the so called Mag 7 and 4) REITs are an important diversifier in portfolios and serve as a hedge against a potential de-risking of America by foreign investors and a U.S. economic recession.

Are investors buying, selling, or holding U.S. CRE?

We heard different perspectives on the attractiveness of the U.S. as an investment destination post tariffs. Most European investors stated that they were not likely to sell U.S. commercial real estate assets, but they were unlikely to allocate more capital to the U.S. over the near term. However, this perspective was not shared by every investor, as Middle Eastern and wealth advisory clients saw the drawdown and reduced competition as a longer-term opportunity to invest in the U.S. at prices perceived to be on sale. The biggest beneficiary of a potential allocation away from the U.S. was European logistics where increasing trade on the continent drives demand for developing modern facilities and well-located older facilities in under supplied markets could offer redevelopment opportunities to value-add investors. Germany was of particular focus partially because of the above-mentioned economic growth potential.

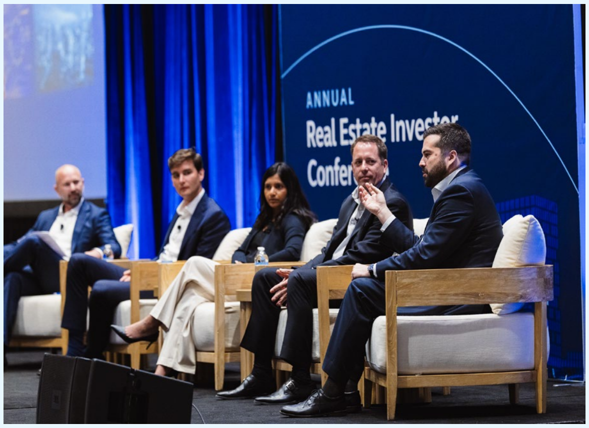
Debt's time to shine

The attractiveness of debt, both absolute and risk-adjusted, was a topic of discussion over the course of the two-day conference. Conservative loan-to-values on property prices, that have already reset approximately 20%, protect against further declines in unlevered property valuations. And, in the event of foreclosure, the property is owned at a basis that provides options on leasing / redevelopment. Yields are attractive given higher risk-free rates and widening credit spreads. Lender appetite is solid for low-risk, high-quality core commercial mortgage loans, as investors continue to seek safe-haven assets. While apartments and industrial have been favored property types over the past several years, there was discussion about expanding the box to other sectors, including office. Participants argued that $2.5tn of maturing loans by the end of 2028 would provide ample opportunity and rising distress may create opportunities to acquire loan portfolios. For investors that are focused on liquidity, we suggest Single Asset/Single Borrower (SASB) CMBS deals that are effectively liquid private credit. These deals are typically backed by high-quality assets with lower loan-to-values.

Focus on fundamentals vs. financial engineering

The 10-year treasury rates were in a secular decline from 1980 until 2022. In fact, there were only three months (out of a total of 507 months) during this period when the 10-year Treasury wasn't lower a decade into the future. For instance, the 10-year Treasury rate was lower in January 1990 than it was in January 1980 and the 10-year Treasury rate was lower in January 2000 than in January 1990. Why is this important? Investors were able to constantly refinance into lower and lower interest rates, which was a significant tailwind to cap rate compression and rising valuations. This all changed in 2022 as the Fed embarked on raising interest rates to combat inflation leading the cap rate spread to the risk-free rate to meaningfully tighten. Against this backdrop, many conference participants argued that identifying the right properties in the right markets to drive fundamental growth would be the driver of returns rather than financial engineering.

Property type rundown



Data centers remain a favored segment within commercial real estate, with demand continuing to outpace supply. Development costs are higher than most other property types, requiring longer construction timelines and substantial electrical power capacity. The volume of data being created and consumed is growing faster than digital storage capacity, supporting a strong fundamental outlook for the sector. However, emerging technologies, such as AI innovations like DeepSeek, introduce some uncertainty about whether data growth will sustain its previously projected pace. Hyperscalers have provided stability, though recent signals from major players like Microsoft suggest tempering of enthusiasm. Additionally, there is increasing scrutiny of the significant capital inflows into the sector over the past several years, with questions around whether all investors have acquired the most strategically located and highest-quality assets. As a long-term owner of data centers since 2007, we believe Principal is well positioned to navigate these market cross currents.

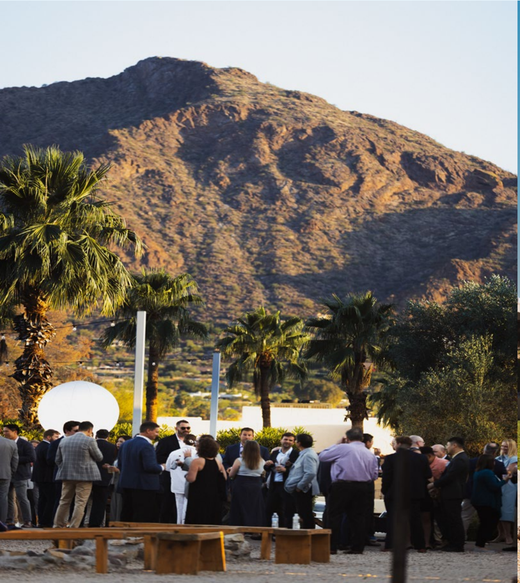
Industrial has also been another favored sector over the past several years. Unlevered total returns have risen a cumulative +82% since the end of 2019 (+12% annual return), pushing cap rates lower. While net operating income growth is expected to remain robust over the next couple of years as in-place rents are below market rents, market rent growth has decelerated to 2-3% in many markets. This is leading to debate whether a rising tide still lifts all boats in the industrial sector or if greater selectivity is now required to drive compelling returns.

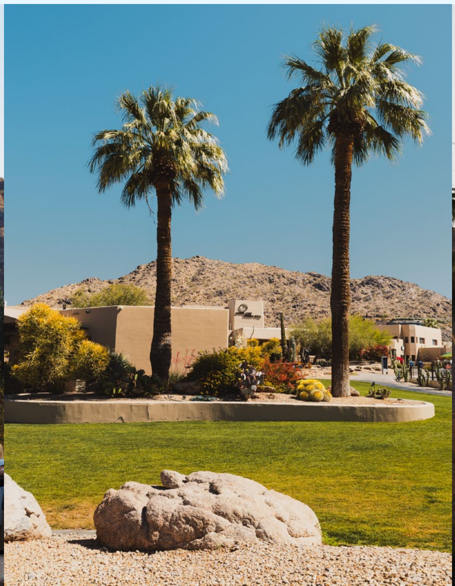
Retail real estate, especially necessity-based open air shopping centers, have become a more favored property type in recent years. In fact, strip centers generated unlevered total returns of +3% in 2024 according to NCREIF, making the sector one of the better performing property types last year. The vacancy rates for neighborhood and power centers stand near a historical low of 4.5% as of 2Q 2025. This is driven by limited new development of properties over the past 15 years while tenant demand is on solid footing. While the knee jerk reaction is that tariffs are a potential headwind, we heard from conference participants that the favorable supply versus demand backdrop would continue to be a sector tailwind.

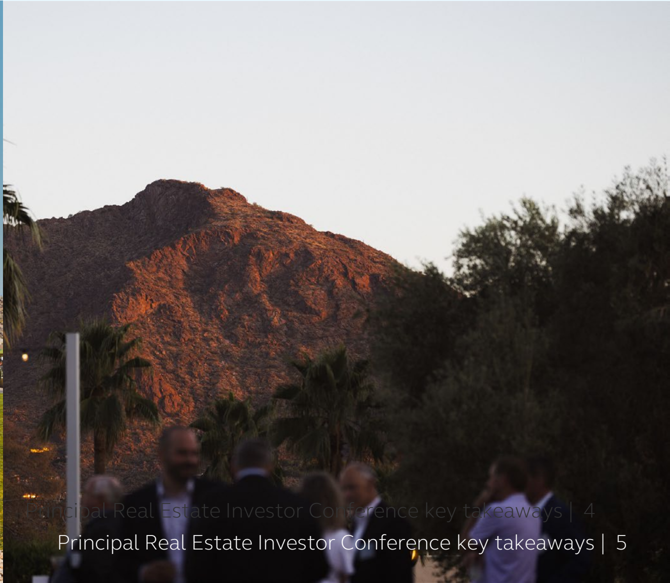
Office – There seems to be increasing confidence in properties where you live. Concern is turning to curiosity, and investors attempt to establish the framework by which to think about office investment. Home territory bias coupled with job growth has positive implications for New York and London. People that live in New York like New York office, people that live in London like London office and people that live in Australia like Australian office, but people that live in New York don't necessarily like London office and vice versa. We believe it's a healthy start to making the sector more investible as it demonstrates that fundamentals on the ground may be starting to stabilize, but it's primarily focused on the highest quality cohort, and it requires a longer-term perspective. Medical office, on the other hand, was cited as a property type that is increasingly of interest.

Holistic housing – It's well understood that the U.S. is underhoused by 1.3 to 1.6 million homes (for sale and for rent) through 2034 in aggregate. This is because there has been chronic underbuilding of housing over the past several decades, coupled with baby boomers living in their houses for longer and adults born in the 1990s / 2000s now entering their prime household formation years. We do not expect this to change over the near term. But two interesting discussions appear to be emerging. First, housing should be viewed holistically across both ownership and the various forms of rentership including apartments, single-family rental, manufactured housing, and student housing. This provides a diverse investment opportunity set. Second, while the U.S. is underhoused in aggregate, there may be a housing mismatch across markets – development has primarily occurred in high population growth markets, but other markets have seen far less development. This theme may grow in importance in the coming years as population migrations begin to shift due to growing pains and diminished affordability in some high growth markets.

Senior housing – The sector has been an area of focus for Principal Real Estate given favorable demand versus supply imbalance driven by an aging U.S. population and unattractive development yields. Occupancy rates now stand at above pre-COVID levels with favorable tailwinds for the foreseeable future. This, coupled with rent growth that is expected to remain in the mid-single digits and decelerating expenses as labor costs continue to improve, drives unlevered IRRs into the +8% range. Investors appear to be taking notice as sector realized +5.7% unlevered total returns over the trailing 4-quarters (2Q24 – 1Q25) according to NCREIF, with independent living rising +8% and assisted living at +3.6%. The performance of listed healthcare REITs is even more impressive, with returns of +28.9% year-over-year compared to +12% for the listed REIT index, +2.5% for the S&P and +1.8% for the NASDAQ. This is important because, as we argued above, public markets are leading indicators.







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