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Principal Asset Management℠

PRINCIPAL REAL ESTATE

Core and core-plus real estate: Enhancing diversification in institutional portfolios

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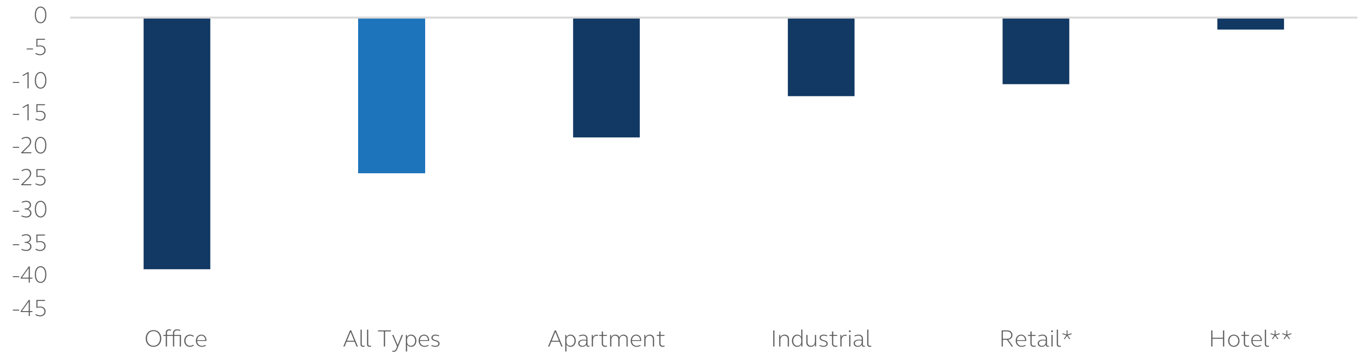
The commercial real estate market has been in recession since central bankers began increasing interest rates in 2022 to combat inflation. Investors, for their part, have been forced to reevaluate their portfolio strategies and are poised to re-enter the market as policy shifts towards a more favorable capital market environment. We believe that commercial real estate investors will have the opportunity to re-engage in the transaction market across a broad risk spectrum and take advantage of more opportunistic pricing as the global real estate recovery takes hold.

Since 2022, both core and core-plus real estate have undergone significant repricing as higher interest rates have slowed investment activity and created pockets of distress within investor portfolios. Property values, according to the NFI-ODCE index, have fallen by 24% across all sectors—led by the struggling office sector—but declines have negatively affected all sectors, including apartment and industrial, which have remained favored by most institutional investors (Exhibit 1). We feel that a sustained growth environment, combined with more accommodating interest rates and significant re-pricing of real estate assets, provides an opportunity to generate attractive returns through a combination of income and growth.

EXHIBIT 1: Commercial real estate assets have been repriced and may offer attractive returns

Property sector capital values, Peak to current %



*Reflects correction beginning in 2022, retail commercial real estate values are 25.4% below their peak established in 2017.
** Reflects correction beginning in 2022, retail commercial real estate values are 28.6% below their peak established in 2015.
Source: NCREIF NFI-ODCE Principal Real Estate Q2 2024

Over the past 45 years, the NFI-ODCE has recorded negative total returns in only five calendar years: 1990, 1991, 2008, 2009, and 2023. Following the first two corrections—both of which were associated with recessions—the benchmark went on to achieve 15-year and 13-year spans of positive total returns. During these recovery periods, annual total returns averaged 11%.

What is different this time, is the lack of underlying economic stress. The correction in real estate values was driven purely by capital market stress created by higher interest rates, which corresponded to a period of strong economic performance. One benefit of higher interest rates is the depressing effect it had on new development, which has already begun to have a positive impact on overdeveloped sectors like apartment and industrial and we believe it will continue to benefit investors well into 2025.

While history does not always repeat itself, we believe that with sustained economic growth and more accommodative interest rates, real estate is poised to enter another period of positive returns, which will benefit both core and core-plus strategies.

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The approach to core and core-plus

Private equity real estate investments tend to be categorized based on the risk-return profile of the underlying investment strategy:

- **Core:** This is the foundation of most institutional real estate portfolios, focusing on high-quality, stabilized assets with occupancy rates in the 90% range. The low-leverage strategy targets assets and markets that generate most of their return from stable income yields over the holding period. Core strategies tend to own property in established infill locations with competitive attributes and modern specifications, and portfolios tend to have exposure to major cities driven by well-educated workers and high-value-added industries, providing investors with structural growth drivers over the life of their investment.

- **Value-add:** Tends to take on more risk, including leasing and capital improvements, which may generate higher returns and capital gains.

- **Opportunistic:** Carries the highest risk-return potential, generated mostly from capital gains. It often includes development and leasing risk.

- **Core-plus:** As the name suggests, core-plus focuses on investments that fall within the lower end of the risk-return spectrum but can also capitalize on value-add and development opportunities to enhance total returns. This strategy typically focuses on maintaining 60% to 80% of gross asset value in stable, income-producing core assets, while pursuing value-add and development opportunities with 20% to 40% of assets. Core-plus strategies also use a moderate amount of leverage (typically 35% to 50%) to achieve higher returns.

Core-plus in the current environment

Given the mature nature of the recent period of price discovery, core-plus offers an attractive entry point for investors:

- **Lower interest rates ahead:** Commercial real estate, among risk assets, has been penalized by elevated interest rates due to a less accommodative central bank policy. As a result, the sector has been in recession over the past two years, despite healthy operating fundamentals. More recently, policy has shifted, which could support more robust and stable economic growth as capital costs for businesses are reduced. For core-plus real estate, stronger demand as well as the ability to reduce cap rates and maintain more favorable spreads could be highly accretive to attractive returns through both appreciation and income returns.

  A well-executed core-plus strategy will result in a steady income stream in our view and lower interest rates in the near term should help provide opportunities to generate greater returns through the prudent use of leverage.

- **Tactical advantage:** Core-plus strategies are less constrained by traditional benchmarks, allowing more tools to generate higher returns. While leverage has been challenging in the current environment, a lower interest rate environment should benefit core-plus investors. Desirable properties are trading below replacement cost, and with elevated debt maturities on over levered capital structures, distress will create unique opportunities as liquidity constrained investors seek exit strategies. Well-capitalized core-plus investors can take advantage of discounted pricing and sell into healthy tenant and investor demand within most property sectors.

- **Benefits of private real estate:** Both core and core-plus strategies benefit from low correlations with other risk assets, historically stable returns, and protection against inflation due to strong income returns. Several core-plus strategies are also available in an open-ended fund format, which is attractive for investors, given the relative ease of redemption compared with individual properties or closed-end funds.

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Why core real estate funds?

- **Income stability and growth:** Private equity real estate has earned a well-deserved reputation as an effective inflation hedge. While the last two years have been an outlier, this is more an anomaly than a rule. The income component of property returns is remarkably stable, outperforming inflation by 328 basis points on an average annual basis since the inception of the NCREIF NPI. High-quality assets in top-tier markets allow core real estate portfolios to maintain healthy income returns that provide stable long-term returns with lower volatility, even during periods of higher market uncertainty.

- **Tactical opportunities:** Although core real estate's appeal has long been its ability to provide durable income returns for investors, in today's environment the strategy also offers the potential for healthy returns on capital. Lower interest rates coupled with attractive valuations today offer investors interested in adding core real estate to their portfolios an attractive entry point.

- **Systematic economic exposure:** Core real estate funds have the unique advantage of exposure to economic drivers within the largest and most vibrant metro areas. This exposure is unavailable to individuals investing in single properties, offering increased diversification, long-term appreciation potential, and lower risk than other risk assets. As part of a diversified portfolio, core real estate may offer some of the highest risk-adjusted returns, aiming to enhance returns through diversity and income stability.

- **Growing diversity:** In addition to regional diversity, core real estate also offers sectoral diversity. The NPI-ODCE has seen dramatic shifts in its asset allocations, most notably away from the office and retail sectors in recent years and toward alternative sectors traditionally associated with publicly listed REITs. Open-ended funds now hold a significant allocation to non-traditional sectors (including data centers, self-storage, life science, medical office, student housing, manufactured housing, age restricted housing, and single-family rentals), and that allocation is expected to grow, providing access to emerging growth areas while maintaining the stability of core assets, such as industrial, apartments, and retail.

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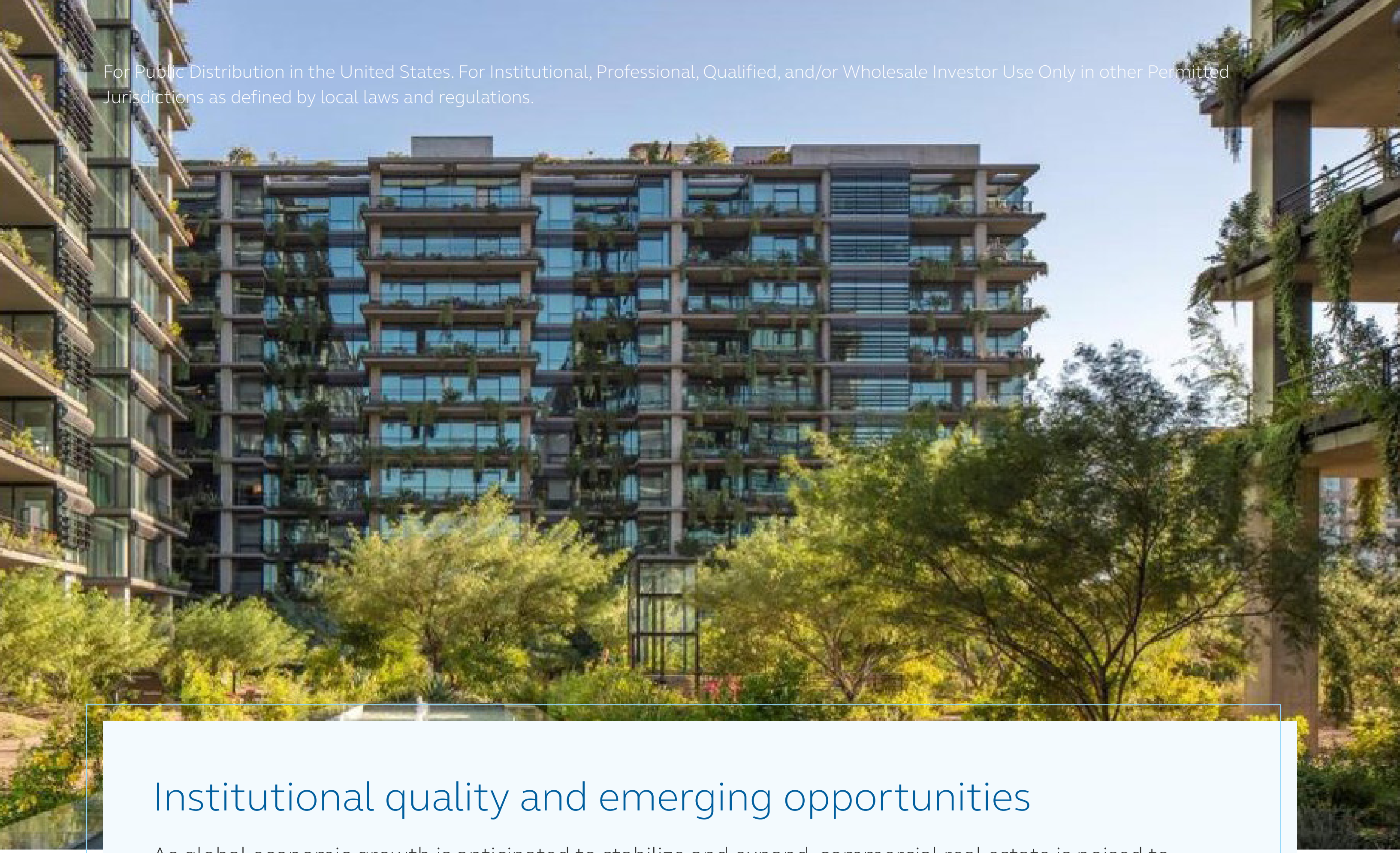

Institutional quality and emerging opportunities

As global economic growth is anticipated to stabilize and expand, commercial real estate is poised to recover following a difficult period of pricing correction. Investors should consider core and core-plus strategies to enhance their real estate portfolios. Under normal circumstances, core real estate could be viewed as a more conservative approach. However, we believe the market is poised for a moderate increase in valuations as central banks ease upward pressure on interest rates, reducing current bid-ask spreads. Core portfolios will continue to offer solid income performance with the potential for increased capital value growth throughout the recovery.

Core-plus investors, meanwhile, will look for emerging opportunities and use debt to enhance portfolio returns through stable income—secured by institutional-grade real estate—while taking advantage of favorable pricing. These strategies also offer increased liquidity through open-ended funds, absent in most opportunistic funds. We believe core-plus strategies will continue to offer favorable risk-adjusted returns for investors seeking to improve their portfolios and increase real estate allocations.

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