

Principal Real Estate

THE ADVANTAGES OF ALLOCATING CAPITAL TO PRIVATE REAL ESTATE CREDIT



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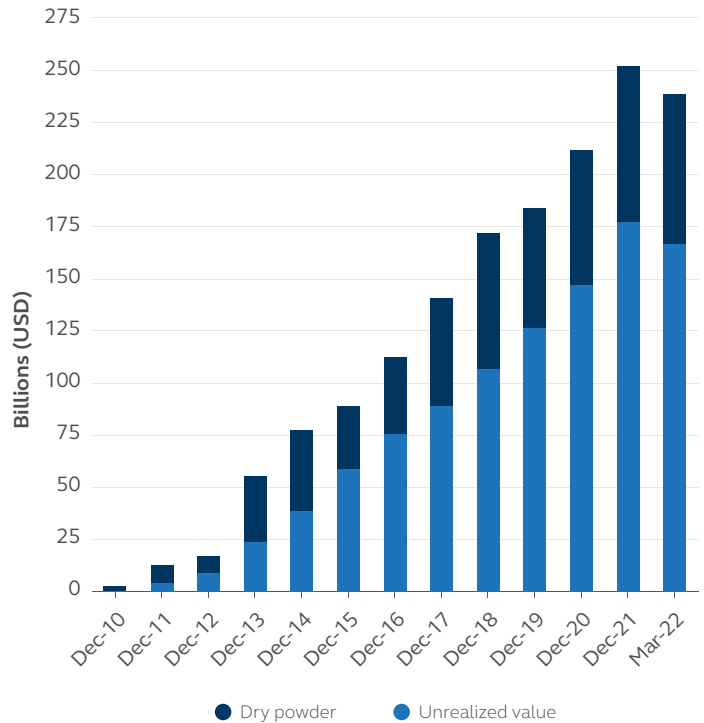
AT-A-GLANCE: Reasons to invest in Private Real Estate Credit

- Capital gap opportunity has re-emerged
- Lower post inflation valuations provide better entry points
- Attractive relative value with high level of current income
- Hedge against inflation: Real assets serve as collateral and short duration of investments
- Complements core equity exposure

Through the years, the advantages of investing in Private Real Estate Credit (high-yield debt) have essentially remained the same: Attractive relative value, equity cushion to absorb asset stress due to unexpected events, real asset collateral to help hedge against inflation, floating rate/short duration to avoid major interest rate driven mark downs, and returns comprised primarily of income.

Exhibit 1 shows private real estate debt funds have for the most part experienced steady growth, as these advantages have spurred increased allocations. Looking forward, new debt investments made in the next couple of years should potentially benefit from underwriting post inflation valuations, higher yields, and better visibility on the post-COVID real estate landscape. In our opinion, the 2023 and 2024 vintage years could be two of the most positive over the next decade. The equity buffer/cushion and high current return are both gaining a renewed focus by investors during this period of uncertainty and market volatility. The opportunities presented by today’s market will be outlined in this paper, and we’ll revisit some of the time-tested benefits of the private real estate credit space.

EXHIBIT 1: Private real estate debt funds have seen steady AUM growth



Source: Prequin, March 2022.

The capital gap has returned

The banking sector is under pressure on several fronts including bank management teams being concerned about how their books will perform going into the Federal Reserve (Fed) induced economic slowdown. Bank balance sheets are heavy from a flurry of activity in 2021. Banks are also under close scrutiny from regulators and face capital adequacy pressure from stress testing and other factors. In addition, existing loans are repaying at a slower speed as borrowers exercise loan extensions that have below-market spreads and above-market proceeds (capital infusion/pay down would likely be required if refinanced in many cases). Banks are still lending but are being very selective and offering lower amounts of leverage. Our expectation is these circumstances will persist until Banks gain confidence that the slowdown has been successfully navigated, allowing for a renewed focus on earnings. There are several steps, including the Fed reaching its terminal point and better visibility on the contour of the slowdown, before this conservative mindset begins to change.

When the banks tighten lending and offer lower loan-to-value (LTV) loans (i.e. 50% - 55% LTV loans instead of 60% - 65% LTV), borrowers will turn to subordinate debt

capital sources to fill the capital gap. Loans that would have been all senior debt in late 2021 will now feature a conservative senior portion combined with subordinate debt. Alternatively, a borrower may take a stretch senior mortgage from a non-bank lender and pay a higher spread to gain the additional proceeds. The securitization markets will also look to use traditional subordinate debt to improve the certainty of the execution around the financing.

This conservative senior debt dynamic will improve the leverage levels of the debt investments made and help offset the reduced flow of slower acquisition activity. There will be existing loans coming due that need to be paid off and the borrowers will be required to refinance/recapitalize these assets. As observed during prior periods of stress, we believe the capital gap has once again emerged as an opportunity.

Reset values lead to better entry points and lower exposure levels

As interest rates—short and long end of the curve—have increased in 2022, the higher debt costs have put pressure on property valuations. This adjustment to a new rate environment will take some time to settle and the ultimate range of the 10-year Treasury will be a significant driver (as opposed to the projected next 12 months of SOFR [Secured Overnight Financing Rate]—temporary in nature). The classic bid ask, quasi stalemate will most likely exist for non-forced sales until investors feel valuations have reset to a reasonable level.

One way to gauge the magnitude of the in-process valuation adjustment is to analyze several capitalization rate (value = income/cap rate) scenarios relative to pre-inflation (Fall 2021). In Exhibit 2, you can see how the values of a hypothetical multifamily asset could change depending upon where cap rates settle. The table also provides insight into how a newly underwritten loan, made on an asset whose value has been reset, will result in a lower exposure level. All else being equal, the lower exposure is a credit positive. In reality, the underwritten LTV for new loans will also be lower until the market stabilizes, helping to further drive exposure levels down.

EXHIBIT 2: Higher cap rates provide for lower exposure levels

Cap rate change scenarios (bps)	Pre-inflation loan	50	75	100
Units (Multifamily)	175	175	175	175
NOI	2,000,000	2,000,000	2,000,000	2,000,000
Cap rate	4.25%	4.75%	5.00%	5.25%
Value	47,058,824	42,105,263	40,000,000	38,095,238
Hypothetical value change	NA	-11%	-15%	-19%
LTV	70%	70%	70%	70%
Loan	32,941,176	29,473,684	28,000,000	26,666,667
Loan per unit	188,235	168,421	160,000	152,381

Source: Principal Real Estate, December 2022.
For illustrative purposes only

Whether the post inflation valuation decline is 5% or 20%, new debt investment/loans will be sized to reset values generating a fresh equity buffer and lower exposure levels. This is one of the reasons why the 2023 and 2024 vintages should more than likely be in a favorable credit position versus legacy loans.

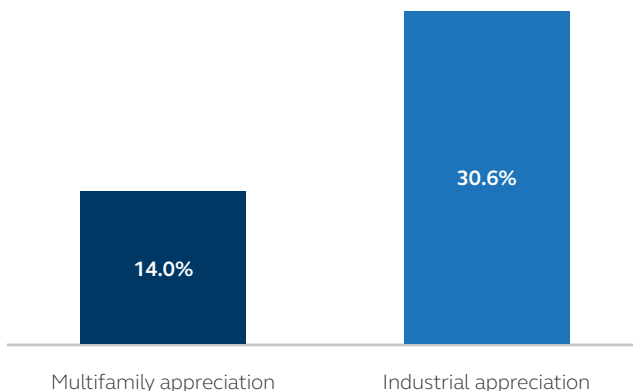
Private real estate credit remains a solid complement and hedge to core equity holdings

As highlighted, property values are in the process of adjusting to higher debt costs. Even the preferred property types are not immune to this dynamic. Although Principal Real Estate is still constructive on industrial and multifamily over the long term, coming off years of very strong appreciation, an allocation to credit with a current income focus is a logical complement to core equity.

Real estate credit investments are typically less sensitive to rental growth. Lease trade-out numbers remain impressive albeit are moderating in late 2022 for many projects, however, rental growth in years 2-5 is harder to predict with the pending economic slowdown. Again, the fundamentals in the preferred property types are healthy but the upside is less clear in comparison to a few years ago. Exhibit 3 shows the trailing four quarter appreciation for multifamily and industrial assets ending second quarter 2022.

EXHIBIT 3: Value appreciation for multifamily and industrial

1-year appreciation only, Q3 2022



Source: NCREIF Property Index, July 2022.

Relative value continues as in years past

For BB to BB+ type of risk in today's market, yields of around 1M Term SOFR + spreads of 450-550 (8.5% to 10% depending upon tenor) are available for subordinate debt investments. Most of this return is in the form of current income, providing cash flow to investors as well as good relative value compared to corporate alternatives. BB corporate spreads as of early December 2022 are in the 280 bps range (ICE BofA BB US High Yield Index).

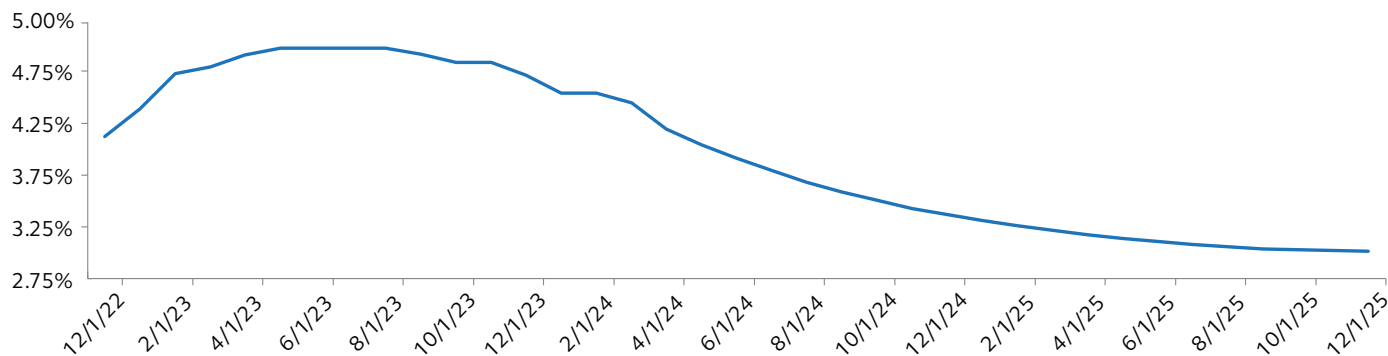
Private real estate credit in the world of elevated inflation

A. Short duration

The majority of loans in the subject space are structured as floating rate debt. The accompanying low duration profile has been a positive for investors as interest rates have risen, resulting in losses of 10% to 20% in some fixed income portfolios in 2022. In our opinion, it is fair to say the Fed will start to cut rates (expected in 2023) lowering the floating rate yields; however, the market anticipates short-term rates to stay above 2.5% in the future, as shown in Exhibit 4. Lenders use the forward curve in modeling yields knowing it isn't an effective predictor of rates beyond 12 months. Notwithstanding, it is hard to envision the Fed cutting rates too aggressively with the inflation fight fresh in their minds. This means short-term yields will likely have a fairly solid floor at or near the Fed's inflation targets and the Fed will be reluctant to cut rates too far.

EXHIBIT 4: Short term rates are expected to stay above 3%

One month term SOFR forward curve



Source: Chatham Financial, November 2022.

B. Real assets

The Fed is taking very aggressive measures to control inflation and will eventually succeed. However, our house view is that inflation, once in the system, takes time to eradicate and 2022 won't be the last year with inflation prints above the Fed's target. The loan collateral for credit investments consists of real assets comprised of land and improvements. Historically, commercial real estate has had a positive correlation with inflation as shown in Exhibit 5. When inflation occurs, such as in the current environment, the resulting higher construction costs (labor and materials) should slow the new supply benefiting existing properties. Interestingly, inflation is indirectly slowing supply by increasing debt costs and making it difficult to project returns on new developments.

EXHIBIT 5: Commercial real estate has historically had a positive correlation with inflation

Q4 1977 through Q3 2022

	CPI	Commercial real estate (total return)	Commercial real estate (income return)	Commercial real estate (appreciation return)	U.S. investment grade bonds (total return)	U.S. equities (total return)
CPI	1.0000	0.4048	0.2143	0.3703	-0.1122	-0.0150
Commercial real estate (total return)	0.4048	1.0000	0.1541	0.9835	-0.1316	0.0608
Commercial real estate (income return)	0.2143	0.1541	1.0000	-0.0270	0.2004	0.0723
Commercial real estate (appreciation return)	0.3703	0.9835	-0.0270	1.0000	-0.1697	0.0484
U.S. investment grade bonds (total return)	-0.1122	-0.1316	0.2004	-0.1697	1.0000	0.1490
U.S. equities (total return)	-0.0150	0.0608	0.0723	0.0484	0.1490	1.0000

Source: NCREIF, Bloomberg, Principal Real Estate, December 2022. Private real estate returns reflect the NCREIF National Property Index. Investment grade bonds reflect the Bloomberg US Aggregate Index, and U.S. equities reflect the S&P index. Indices are unmanaged and individuals cannot invest directly in an index. Please see important information for more details.

Summary

With the tailwinds of reset valuations, higher yields, and improved property type information, we believe 2023 and 2024 are well-positioned to outperform most years. New investments should be underwritten to reset valuations and there is also improved property type information for sectors such as office. In addition, the conservative posture of the banks should allow for opportunities to enter the capitalization stack that did not exist previously and at LTV levels (first and last \$) that weren't available pre-inflation. We believe private real estate credit investments have a margin of safety via the equity buffer which is worth more during periods of volatility. Finally, the high current income typically generated by credit investments should help to stabilize portfolio returns in a period where there is uncertainty around the economy and future rental growth.

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. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk.

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Index descriptions: The NCREIF Property Index (NPI) is the primary index used in the United States to analyze the performance of commercial real estate and use as a benchmark for actively managed real estate portfolios. The Bloomberg US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market. The S&P 500 is a stock market index tracking the stock performance of 500 large companies listed on stock exchanges in the United States.

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