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PRINCIPAL REAL ESTATE

An entry point for Private Equity Real Estate in 2024

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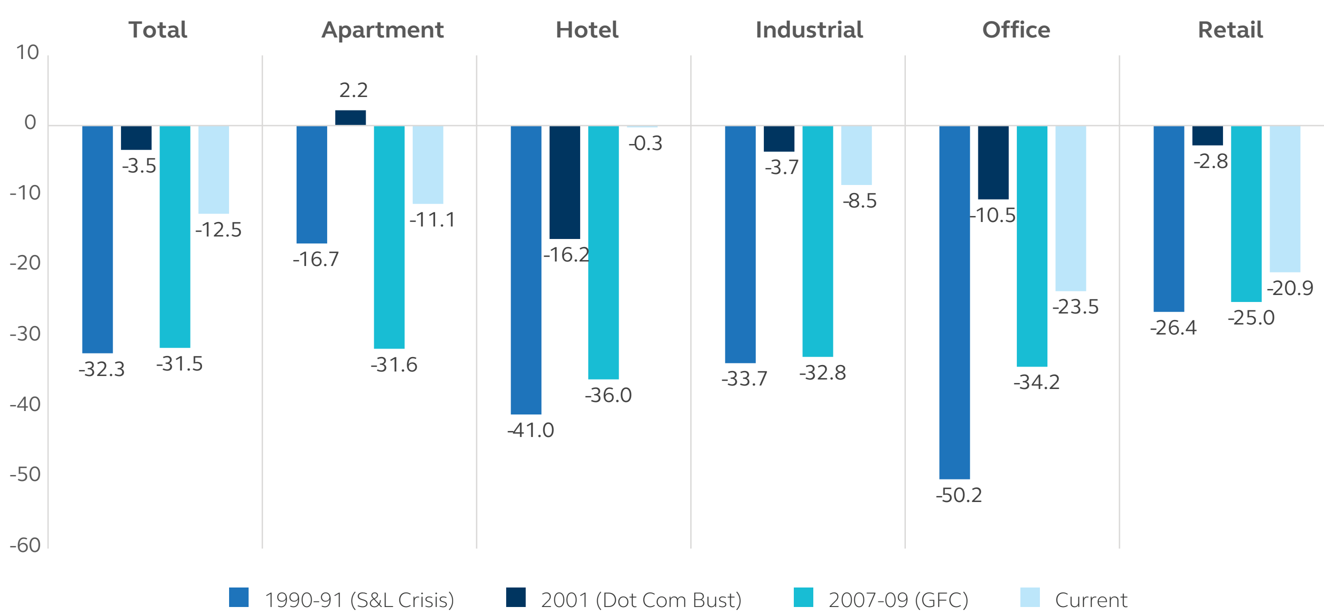
The past 12 months have been challenging for commercial real estate. Despite economic growth that is firmly above trend and a robust labor market expansion—both of which tend to predict healthy fundamentals and investment performance—commercial real estate values are down 12.5% from their peak during the current correction that began at the end of 2022. As difficult a year as 2023 was, however, there is a flicker of light at the end of the tunnel for private equity markets in 2024. Despite numerous headwinds, the U.S. economy enters the New Year on solid footing and there are signs that inflation is slowly trending toward the Federal Reserve's (Fed) inflation target. Absent any significant shocks to the economy or capital markets, we believe that private equity capital values are nearing their trough for the cycle, with another quarter or two of write-downs in the offing, which we estimate at approximately between 5 to 7% by the middle of 2024.

EXHIBIT 1: NPI appreciation – peak to trough declines, percent



Source: NCREIF NPI, Principal Real Estate, Q3 2023. S&L Crisis = Savings & Loan Crisis; GFC = Global Financial Crisis

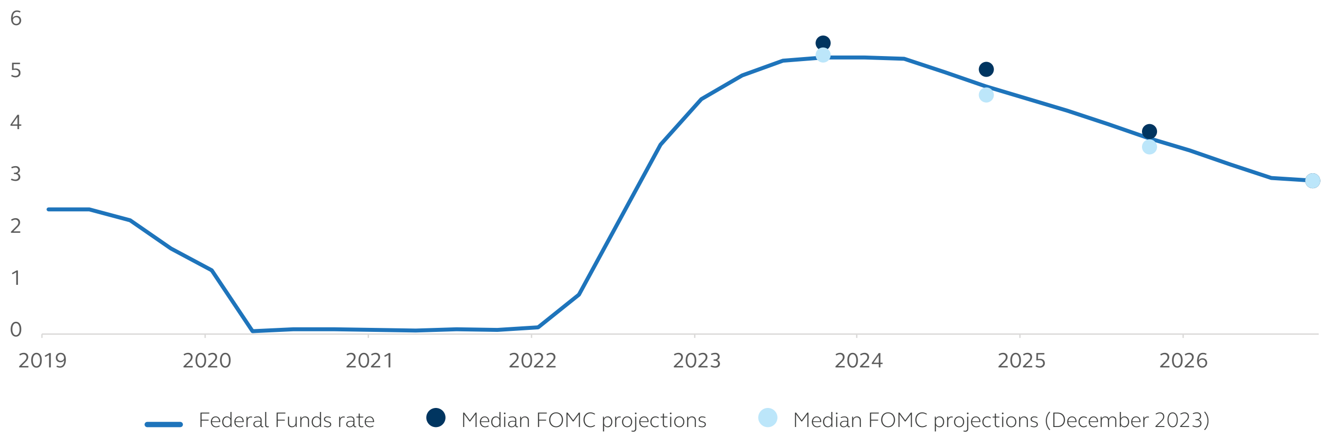
The correction in real estate values has been pervasive across property sectors, including two of the most favored among investors: apartment and industrial, down 11.1% and 8.5% respectively according to the NCREIF NPI. While space market fundamentals within these sectors have shown signs of weakening in 2023, which is due more to excess supply than a lack of physical demand, the primary cause of declining capital values has been capital market headwinds, which have conspired to depress both investor sentiment and capital values.

Blame it on the Fed?

High interest rates themselves do not tend to predict the trajectory of capital values— under normal circumstances it is economic growth and the balance of supply and demand fundamentals. This cycle, however, is different. When the Fed began increasing interest rates in March of 2022, it effectively ended a period of negative real interest rates dating back to the Global Financial Crisis (GFC). Over that period, real estate was increasingly priced for that environment and not one where nominal interest rates were on par with longer-term equilibrium.

As a result, the ensuing rate normalization designed to wring out excess inflation from markets that followed the pandemic, waylaid the growth in capital values as spreads on property yields compressed rapidly. Uncertainty on pricing among investors abruptly disrupted the flow of debt and equity capital to the market. As rates increased, investor appetite for risk assets—particularly for private equity real estate—declined due to a lack of clarity on the direction of pricing.

EXHIBIT 2: Fed Funds rate and median projections, percent



Source: Federal Reserve (FOMC), Bloomberg, Principal Real Estate, Q4 2023. 2024-2026 are forecasts.

As we enter 2024, the good news is that we appear poised for a turning point for private equity markets. High inflation has given way to disinflationary trends, and the Fed is signaling that it anticipates three interest rate cuts in 2024, while public markets are telegraphing five to six rate cuts. We believe this has the potential to reduce borrowing costs and, at least modestly, increase the flow of capital toward commercial real estate relative to what was experienced in 2023.

Industrial and apartment sectors

While 2024 is anticipated to be a year of slower—and perhaps below trend—economic growth, we believe that market fundamentals across most property sectors are entering the year from a position of strength. For their part, both the industrial and apartment sectors remain fundamentally healthy. Vacancy rates across both property types, while increasing, remain well below their equilibrium ranges, which suggests that rental growth, though more moderate, will remain positive over the next 12 months.

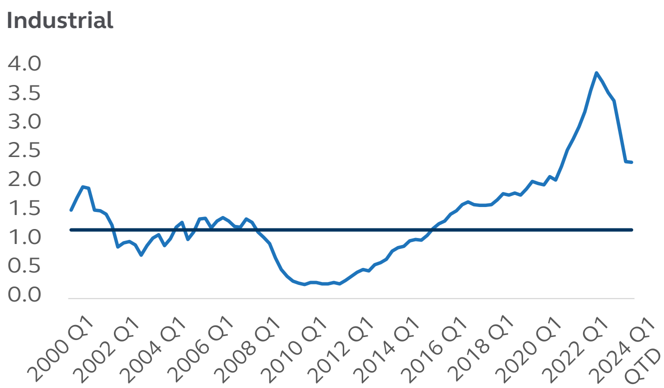
EXHIBIT 3: Vacancy rates

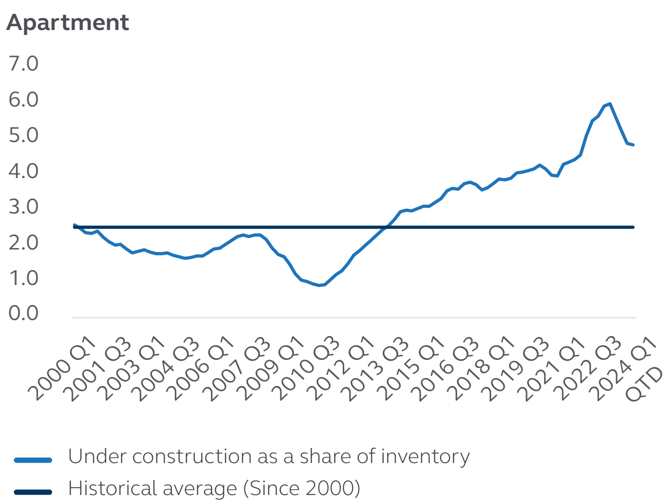
Property type	Measure	Q4 2023	Equilibrium rate
Office	Vacancy rate	18.6% **(+20 bps)**	13 to 14%
Industrial	Availability rate	7.1% **(+60 bps)**	9 to 10%
Retail	Availability rate	6.5% **(-10 bps)**	8 to 9%
Apartment	Vacancy rate	5.4% **(+30 bps)**	6 to 7%

Source: CBRE EA, Principal Real Estate, Q4 2023

While we remain constructive on both the apartment and industrial sectors, we realize that headline risks remain in place throughout 2024. For starters, both sectors continue to face excess levels of new development which is already in the supply pipeline and likely to deliver in the next 12 months. High levels of new deliveries will certainly put upward pressure on vacancy rates in most markets, which will place a limit on rent inflation as market pricing power shirts toward neutral.

EXHIBIT 4: Industrial and apartment under construction, percent of inventory





Source: CoStar, Principal Real Estate, Q1 2024

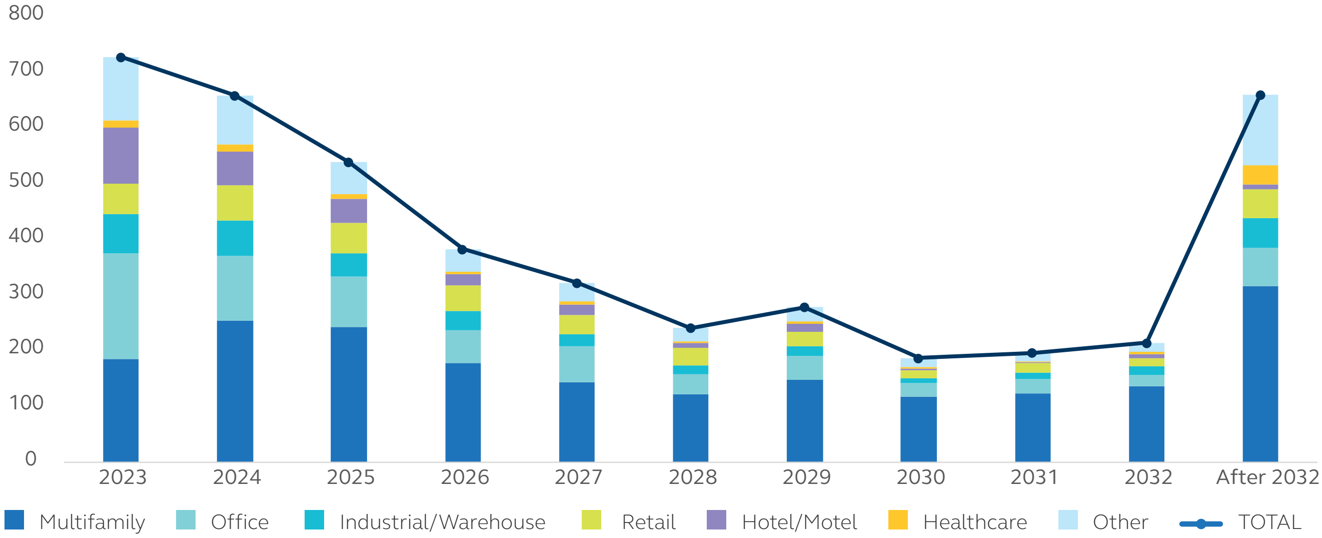
That said, we still anticipate that both sectors will continue to see modest rental growth this year with potentially more distress among apartment landlords, where asking rents on new leases have declined as of late 2023 and have the potential to carry over into 2024. The good news for both sectors is that structural demand drivers remain firmly in place. Additionally, three years of strong rental inflation since the start of the pandemic has the benefit of providing healthy mark-to-market increases on new leases, which will help preserve NOI growth for property owners through the first half of the year.

Capital markets: Lemonade out of lemons

Lenders have been highly selective over the past 12 months when underwriting commercial real estate assets. While apartment and industrial have been among the more liquid sectors, lending spreads have remained elevated and underwriting standards are now far more stringent than they were in the pre-COVID environment. The regional banking failures in early 2023 have also reinforced that banks are now far more concerned with their real estate exposure, although much of that stems directly from an overweight to office assets.

In 2024, the lack of a fully functioning debt market will be compounded by commercial maturities totaling $659 billion coming due within the next 12 months. The impact of the potential refinancing gap will be different across property sectors. The industrial sector tends to be less sensitive to the availability of debt capital due to lower leverage requirements on both transactions and development projects when compared with more capital intensive sectors, such as office and apartment.

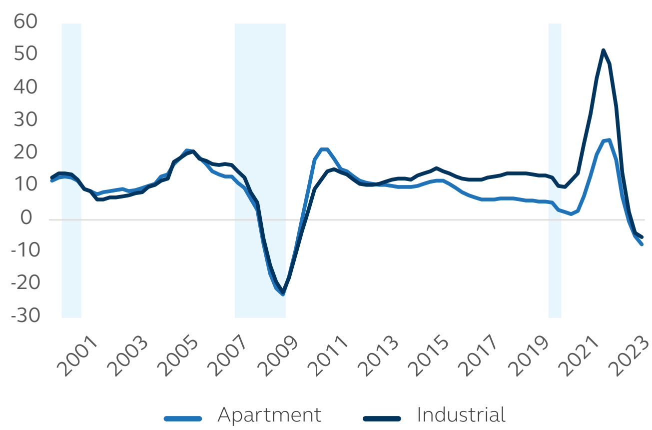
EXHIBIT 5: Total maturities by property sector, $ billion



Source: Mortgage Bankers Association, 2023

For its part, the apartment sector accounts for $255 billion in maturities alone in 2024, which has the potential to create pockets of distress in certain markets, particularly among less well-capitalized developers and operators. It should be noted that we do not see the potential for the broad-based distress selling that occurred during the GFC, but the lack of capital could still present interesting entry points over the next 12 months as values near their bottom. Moreover, the lack of financing available for developers and higher carry costs will also act as a restraint on development over the next 12 to 18 months, which will benefit both the apartment and industrial sectors.

EXHIBIT 6: Apartment and industrial total return, 12-month trailing %



Source: NCREIF NPI, Principal Real Estate, Q3 2023

Outlook and conclusion

Corrective phases in capital values tend to be followed by outsized returns in private real estate markets. Following the GFC, for example, the apartment sector posted an 18.2% total return for 2010 on a four-quarter trailing basis; the industrial sector posted 9.4% in 2010 and a 14.6% return in 2011. These returns were preceded by a significant corrective phase in asset values in both sectors. Our timing for the bottom of the current cycle is early to mid-2024 with a modest recovery beginning in H2. We feel this is an excellent entry point for private equity investors to take advantage of pricing dislocations, particularly on modestly distressed properties.

While it is difficult to predict the exact magnitude of returns and capital appreciation, early indications of investor sentiment suggests that 2024 will be a better year for most sectors than 2023. We believe this will be the case for both the apartment and industrial sectors; it will also set the stage for stronger appreciation over the intermediate term as the lack of debt capital will constrain new development heading into 2025. As the economy transitions onto a healthier growth path aided by lower borrowing costs, inflation, and stabilized household balance sheets, property values will continue to improve. This is particularly the case for newer apartment and industrial assets delivered over the 2025 to 2027 time frame.

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MM13862 | 1/2024 | 3330218-122024