Principal Asset Management℠

Principal Real Estate

Resiliency matters in 2023

Listed real assets outlook and opportunities

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Resiliency matters: Overview

There is a high degree of uncertainty for what lies ahead. This is not surprising in a regime of higher inflation and rates not seen in nearly 40 years. Inflation and central bank policies are key signals to the path of growth forward.

Materially weaker global outlook with rolling regional recessions in 2023 are our base case. In eight of the nine times the U.S. Federal Reserve (Fed) has tightened to tame inflation in the past 60 years it has engineered a recession. We expect a moderately worse recession than what is implied in markets today and perceive broad equity markets as susceptible to sell-offs to price in the damage.

The Fed is no longer a friend of the market so don't expect a quick rescue. Investors today are accustomed to short-lived crises, having learned to expect that the Fed will quickly loosen monetary conditions to backstop markets. With inflation likely to remain above average for longer, a Fed pivot is less likely to occur when economic conditions do weaken.

In uncertain times we believe investors should favor listed real assets for the resiliency they offer. Listed REITs and infrastructure companies can provide durable and defensive cash flow streams that are relatively more resilient than other equities.

Peaking real yields and inexpensive relative valuations are tailwinds for REITs. Rising real yields are big negatives for higher duration REITs but this headwind will fade away as growth weakens. REITs trade at wide discounts relative to both equities and private real estate.

Listed infrastructure companies possess multiple sources of resiliency for uncertain times. As regulated monopolies or monopoly-like businesses delivering essential services, most companies have a differentiated ability to preserve margins during periods of rising inflation and deliver stable cash flows. Structural themes of demographics, decarbonization, and digitalization may offer tailwinds for growth to outlast a recession.

The pain of rising real yields is largely in the past

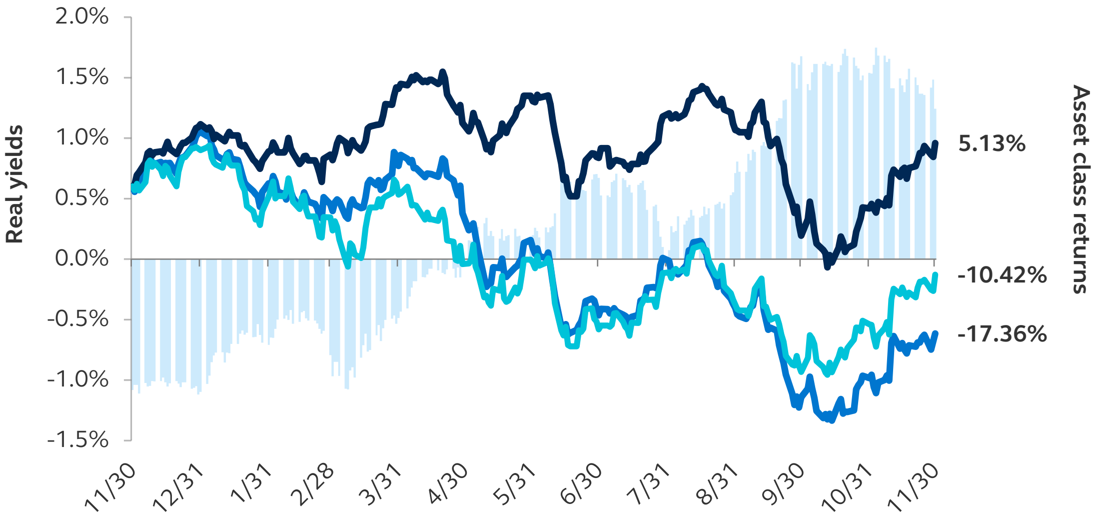
In an environment of rising real yields, the investments that suffer the most are those associated with long duration. In public equity markets, stocks with higher multiples and long-term resilient cash flows are viewed as higher duration, including listed REITs and infrastructure stocks. This explains most of the underperformance of listed REITs in 2022, in our view. Listed infrastructure, however, outperformed. We believe this mostly reflects a catch-up for the asset class after underperforming four of the prior five calendar years and remain constructive on the forward-looking returns potential of listed infrastructure.

Looking ahead, the peaking in real yields should usher in a more favorable environment for REITs and infrastructure as discount rates reach equilibrium and investors focus again on cash flows. The outperformance of listed real assets relative to equities has historically been quite significant after real yields have peaked, and for this top-down reason we are optimistic about listed real assets relative to other equities in 2023.

"We are closer to the peak of interest rates than we are the start of rate hikes, and that itself bodes well for listed REITS and infrastructure stocks."

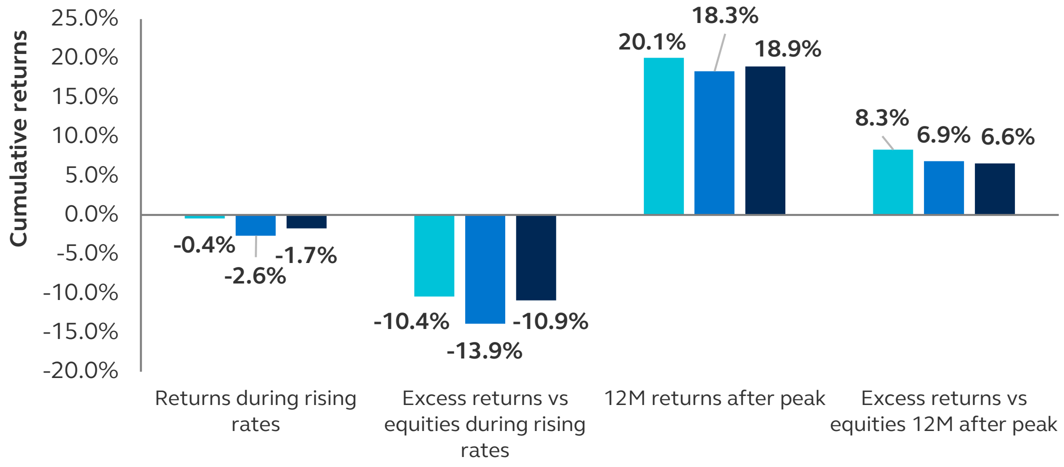
- Kelly Rush

TIPS yields and trailing one year total returns for listed real assets and equities



As of 30 November 2022. Source: FactSet. FTSE Global Core Infrastructure 50/50 Index, FTSE EPRA/NAREIT Developed GTR Index, MSCI World GTR Index, and U.S. 10-year TIPS yields. Returns in USD. Past performance is not a reliable indicator of future return and should not be relied upon to make investment decisions. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

Real assets and real yields



As of 31 October 2022. Source: FactSet. Returns data is showing FTSE EPRA/NAREIT Developed index (global REITs) average cumulative total returns and excess returns over the MSCI World (global equities), FTSE NAREIT Equity REITs (U.S. REITs) over the S&P 500 (U.S. equities), and FTSE Global Core Infrastructure 50/50 (listed infrastructure) over the MSCI ACWI (global equities) during the last 7 periods of rising real yields (an increase of at least 75 bps represented by the US 10-year TIPS) and during the 12 months after the peak of the rising rate period. *Listed infrastructure represents the last 6 periods due to a shorter data history. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

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Earnings resilience should matter in a recession

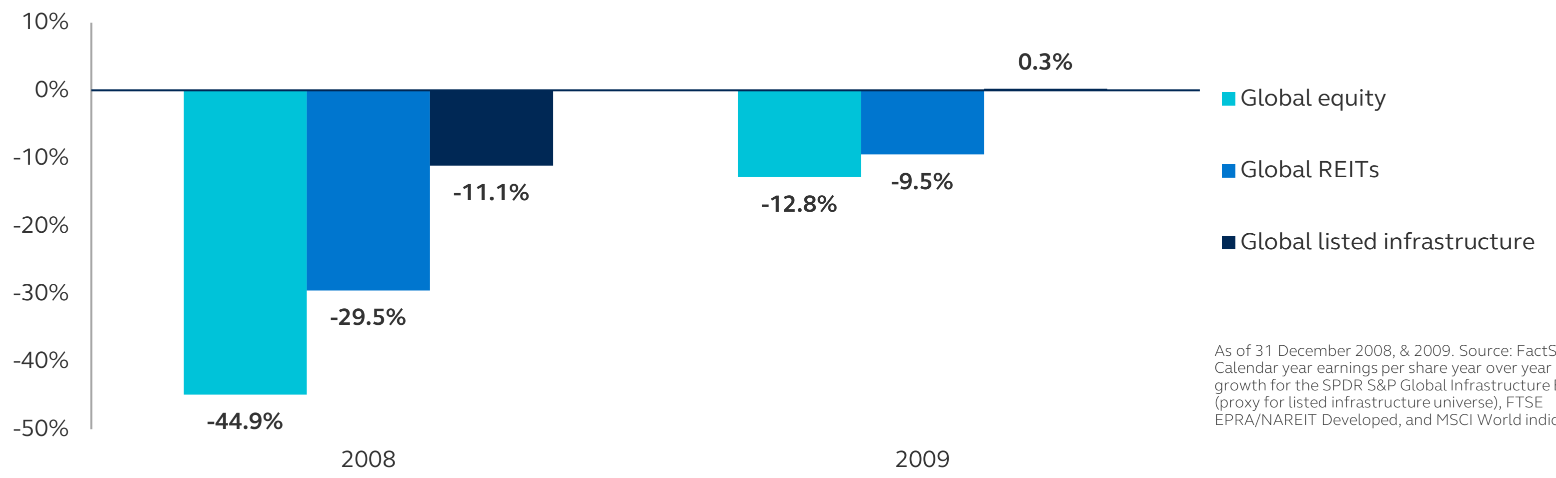
Listed infrastructure and REITs have generally exhibited greater earnings resilience during major downturns, with the best example perhaps how earnings reacted during the global financial crisis (2008-09). The potential for earnings resilience across these asset classes is directly linked to medium- to long-term lease periods in the case of REITs, or in the case of infrastructure, to the robust regulatory or contractual protections the companies enjoy as essential service providers. In many cases, demand for infrastructure services also exhibits relatively low economic sensitivity. The cash flow profile of REITs and listed infrastructure businesses can thus be advantageous when economic times get tough.

We believe investors should be cautious about how much company earnings estimates for the next 12 months need to come down. Comparatively, we expect REIT and infrastructure equities to see more modest declines.

“There are structural themes for listed REITs and infrastructure that are providing tailwinds to growth, themes that we expect will meaningfully outlast central bank tightening and recession concerns.”

- Emily Foshag

Earnings declines during the global financial crisis (2008-09)



As of 31 December 2008, & 2009. Source: FactSet. Calendar year earnings per share year over year growth for the SPDR S&P Global Infrastructure ETF (proxy for listed infrastructure universe), FTSE EPRA/NAREIT Developed, and MSCI World indices.

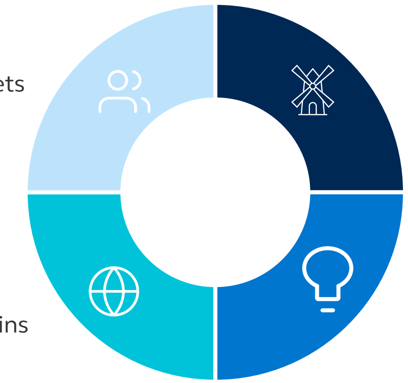
Structural themes are driving change and opportunity in real assets

Demographics

- Aging population
- Shifting migration patterns
- New demand for physical assets
- Housing affordability
- Cost of living

Globalization

- Secular increase in trade & capital flows
- Global technology supply chains
- Mobile/remote workforces



Decarbonization

- Transitioning the electricity generation mix
- Green buildings
- Alternative fuels
- Physical asset resilience

Digitalization

- AI/Big data
- Electric grid modernization
- Flexible working/WFH
- Innovation “hubs”
- Retail disruption
- Intelligent traffic systems

Source: Principal Real Estate

Resilient balance sheets for uncertain times

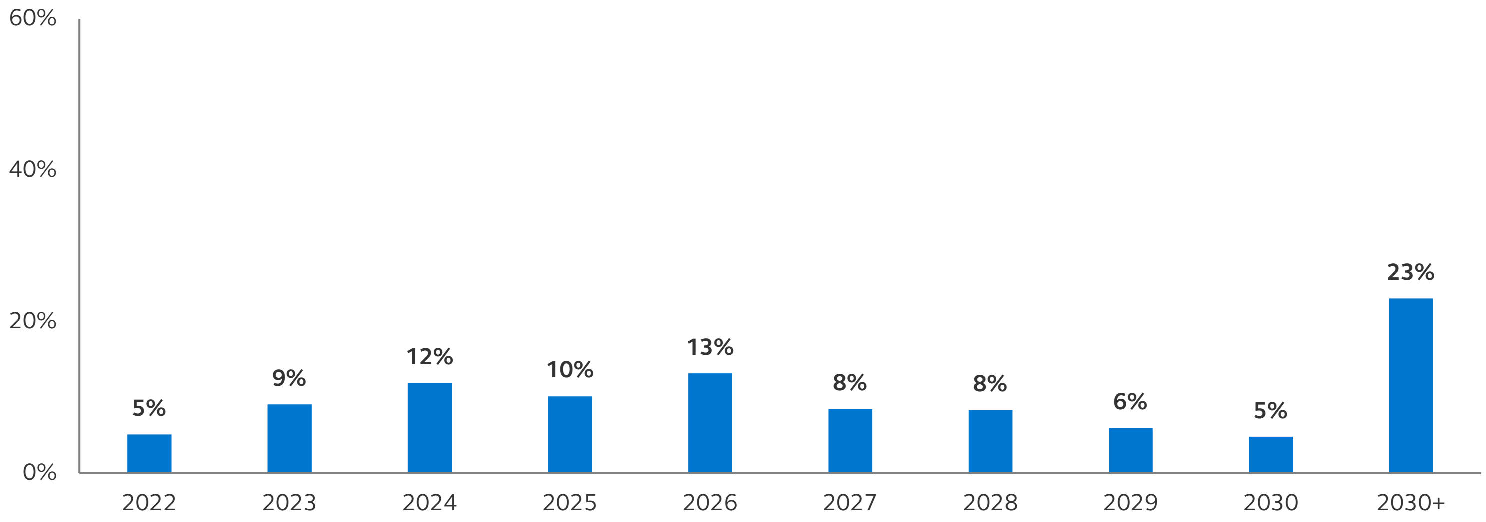
Both REITs and listed infrastructure businesses have resilient balance sheets given the significant amount of long dated and fixed rate debt typically utilized. REITs have demonstrated discipline in the use of leverage and today are in a stronger position than ever before. While leverage ratios for listed infrastructure companies are not materially different than they have been historically, the quality of the businesses has increased notably in the past 15 years and accordingly we remain comfortable with leverage as it stands today. In many cases, leverage ratios are dictated by regulators, and as such companies have formal restrictions on their ability to deviate from reasonable levels of leverage.

Going forward, the cost of capital is indeed higher, and we expect refinancing future debt maturities will represent a drag on earnings. Fortunately, we expect a modest impact as future debt maturities are quite manageable and well staggered over long periods.

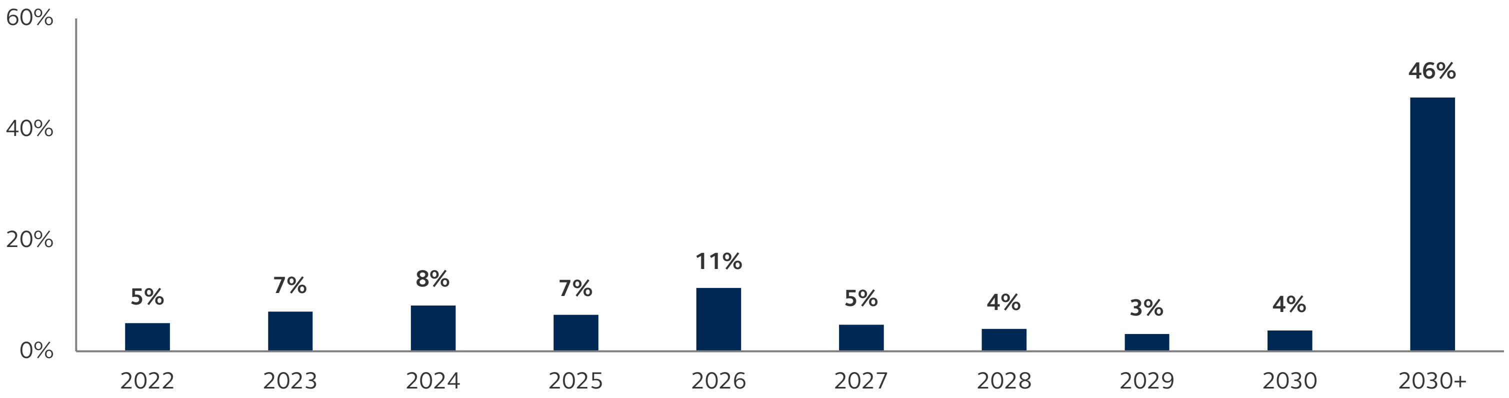
"The balance sheets of public real estate and infrastructure companies are in a good position to weather the storm ahead."

- Kelly Rush

Global REITs: % of debt expiring by year



Global listed infrastructure: % of debt expiring by year



As of 30 November 2022. Source: FactSet. Long term debt maturities for the FTSE EPRA/NAREIT Developed and FTSE Global Core Infrastructure 50/50 indices.

Listed REITs a bargain relative to equities and private real estate

Public REIT markets have priced in much higher real estate capitalization rates due to rising yields and higher cost of capital. This results in REITs looking cheap both relative to equities and the physical real estate they own (i.e., net asset value).

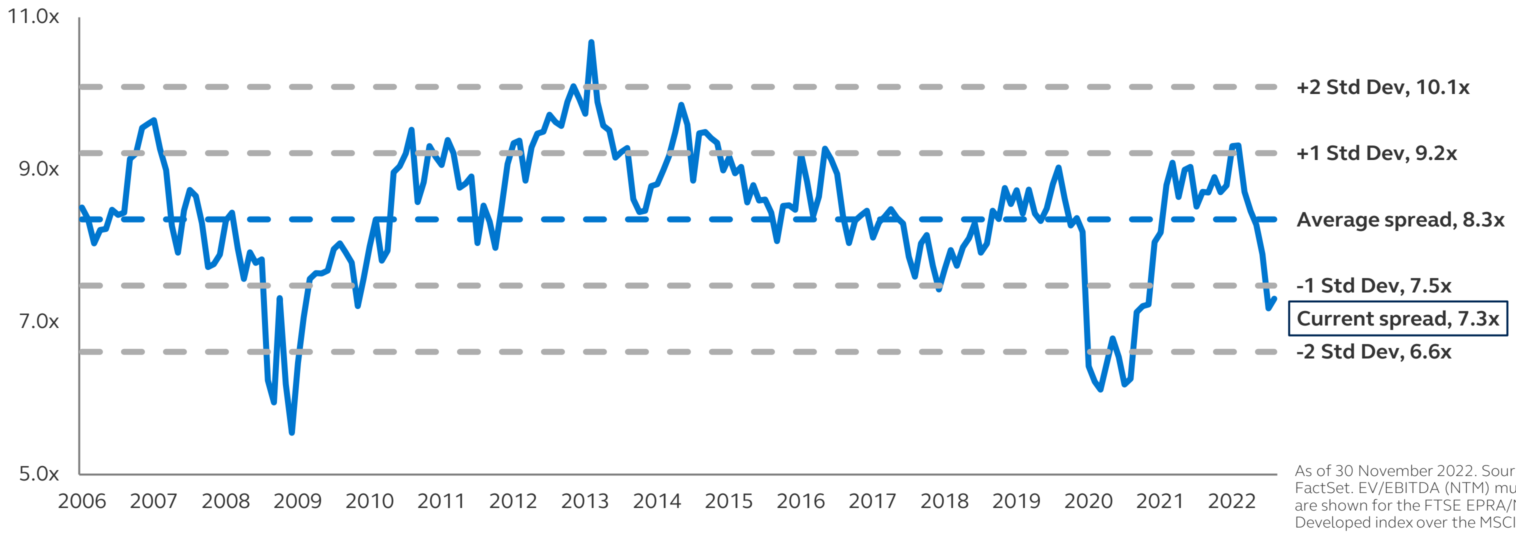
For private real estate funds and non-traded REITs, shares are valued using property appraisals, which tend to lag real-time changes in conditions. With property transactions coming to a standstill this year, participants in the private real estate market don't have the price discovery needed to determine changes in values. We believe this will change as we move into next year, with private real estate values likely seeing downside driven by higher cost of capital and economic headwinds pushing up cap rates.

Historically, we have seen public REITs outperform private real estate the next three years when trading at discounts to NAV greater than 15%.

"The set-up for potential outperformance of REITs next year is positive given cheap relative valuations."

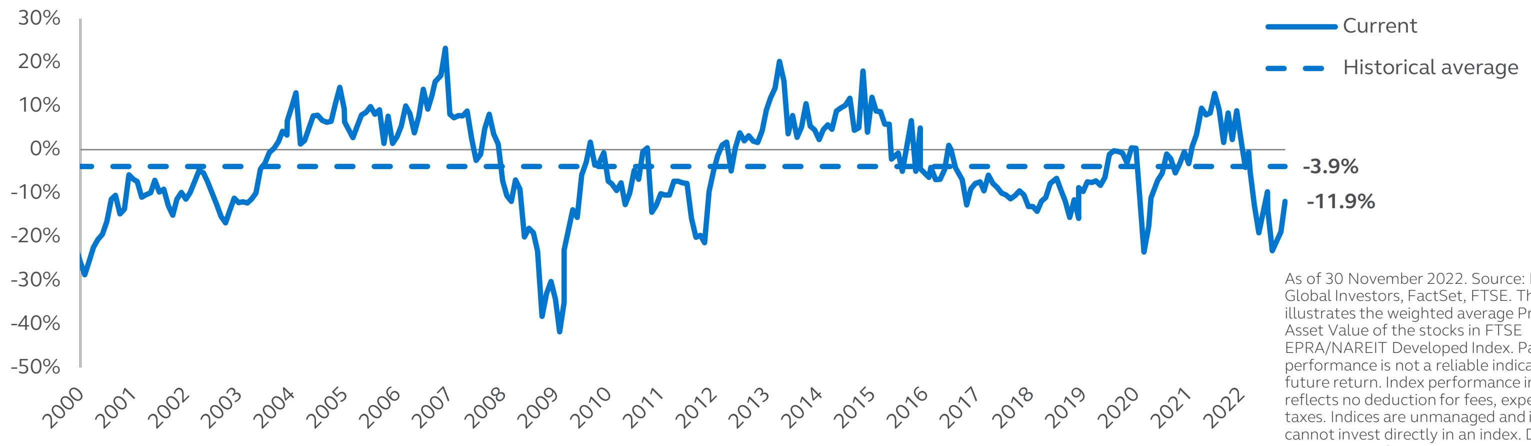
- Kelly Rush

Global REITs vs. equities EV/EBITDA spreads



As of 30 November 2022. Source: FactSet. EV/EBITDA (NTM) multiples are shown for the FTSE EPRA/NAREIT Developed index over the MSCI World.

Global REITs: premium (discount) to NAV



As of 30 November 2022. Source: Principal Global Investors, FactSet, FTSE. This chart illustrates the weighted average Price/Net Asset Value of the stocks in FTSE EPRA/NAREIT Developed Index. Past performance is not a reliable indicator of future return. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

Listed infrastructure valuations remain reasonable

Listed infrastructure currently trades above its long-term average on an EV-to-next 12 months (NTM) EBITDA basis. Valuations for listed infrastructure may therefore seem less compelling on the surface but remain quite reasonable in the context of outsized expected growth, in our view.

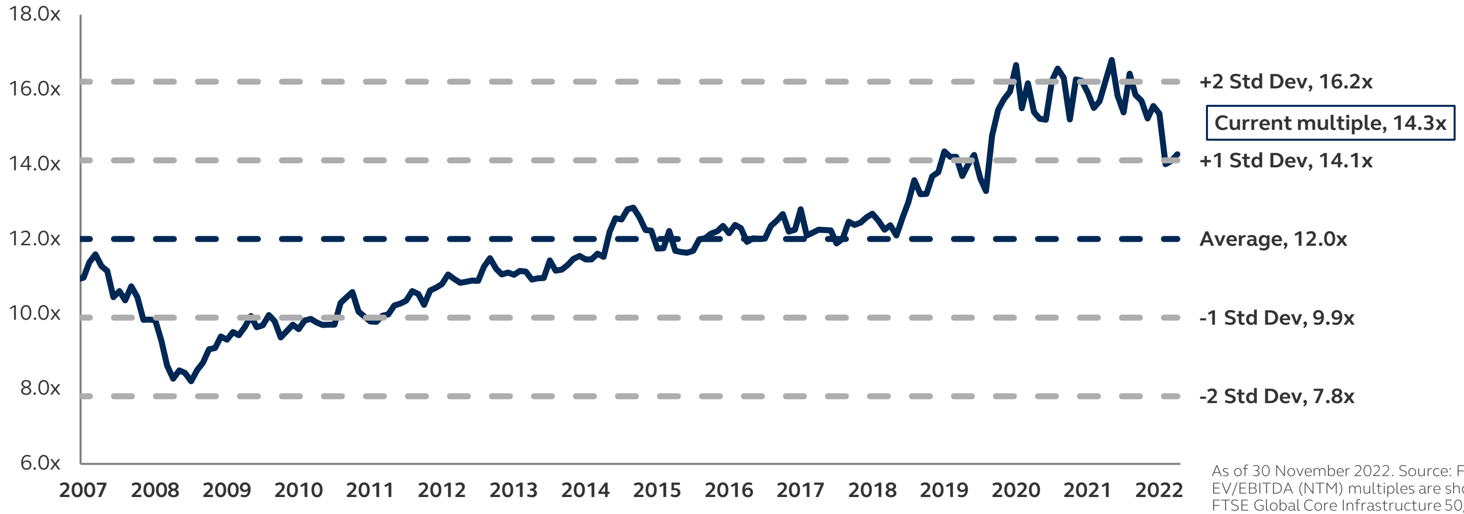
Unlike with other areas of the public equity markets, the higher multiples we are seeing today are not a function of meaningful multiple expansion. Instead, listed infrastructure multiples reflect a still denominator, or EBITDA, compared to pre-pandemic levels. Comparing listed infrastructure to its own long-term history also does not reflect notable improvements in business quality over the last 15 years.

EBITDA growth expectations remain elevated relative to historical levels given tailwinds from a return to normal post- the coronavirus pandemic and an acceleration in structural growth drivers such as decarbonization. Expectations for year-over-year EBITDA growth in the next 12 months are nearly two standard deviations above the long-term average.

“Given the high confidence we have in forward-looking fundamentals, you don’t have to assume further multiple expansion to see positive returns next year for listed infrastructure.”

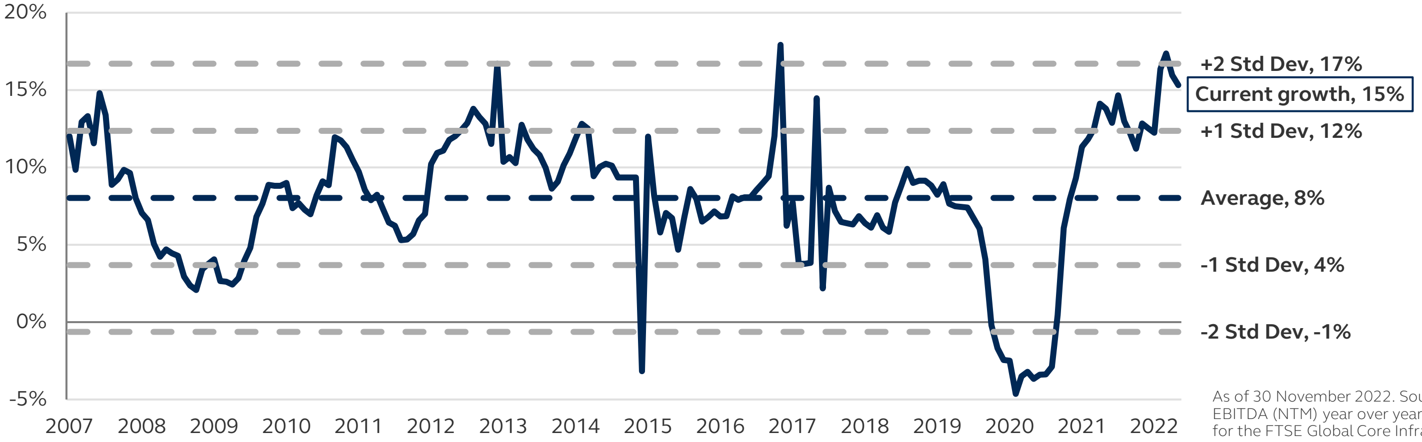
- Emily Foshag

Global listed infrastructure EV/EBITDA next 12 months multiples



As of 30 November 2022. Source: FactSet. EV/EBITDA (NTM) multiples are shown for the FTSE Global Core Infrastructure 50/50 index.

Global listed infrastructure EBITDA NTM year-over-year growth



As of 30 November 2022. Source: FactSet. EBITDA (NTM) year over year growth is shown for the FTSE Global Core Infrastructure 50/50 index.

Sector preferences in 2023

Our investment approach within listed real assets emphasizes resiliency for what we expect to be tougher macroeconomic conditions ahead. We are expressing a preference for businesses with resilient pricing power, lower economic sensitivity, and/or favorable exposure to structural growth drivers. Our emphasis on bottom-up stock-picking does lead to certain sector preferences.

In listed REITs, the non-traditional residential sectors are a favorite given home ownership is expensive, forcing many individuals to rent when they would otherwise buy. In healthcare, senior housing enjoys demographic tailwinds and niche life science office is more immune from work-from-home trends. Long-term growth in mobile data usage is a big structural driver for tower REITs and this subsector is a favorite in our listed infrastructure portfolios, too.

Also, within listed infrastructure, the clean energy transition provides favorable tailwinds for many listed infrastructure subsectors. Water utilities benefit from demand inelasticity for clean water and a need to invest to mitigate the impacts of climate change. Lastly, as the consumer continues to face challenges from the deteriorated macro environment, we see certain subsectors as better positioned given they are less likely to see major regulatory scrutiny over end-user costs. Towers and energy infrastructure companies largely operate using business-to-business (B2B) models, for example, and water bills are typically a much smaller portion of household costs than are energy bills.

	Investment preference				
Sector	**Cautious**	**<**	**Neutral**	**>**	**Positive**
REITs					
Apartments	○	○	●	○	○
Data centers	●	○	○	○	○
Diversified	○	●	○	○	○
Healthcare	○	○	◍ →	●	○
Hotels & resorts	○	●	← ◍	○	○
Industrial	○	○	○	●	○
Malls/outlets	●	○	○	○	○
Manufactured homes	○	○	○	◍ →	●
Net lease	◍	○	○	○	○
Office	○	○	●	○	○
Self-storage	○	○	●	○	○
Shopping centers	●	○	○	○	○
Single family rental	○	○	○	○	●
Towers	○	○	○	○	●
LISTED INFRASTRUCTURE					
Airports	○	◍ →	●	○	○
Electric & Multi-utilities	○	○	◍ →	●	○
Freight Rail	○	●	← ◍	○	○
Gas Utilities	○	○	●	← ◍	○
Marine Ports	●	○	○	○	○
Passenger Rail	○	○	○	●	← ◍
Renewable Energy	○	○	○	●	← ◍
Satellites	●	○	○	○	○
Toll Roads	○	○	●	← ◍	○
Towers	○	○	◍ →	●	○
Traditional Energy Infrastructure	○	○	○	●	← ◍
Water Utilities	○	○	○	●	○

Viewpoints reflect a 12-month horizon. ● ← ◍ indicates a change in preference over the course of 2022

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