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Principal Real Estate

Resiliency matters in 2023

Global REIT 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 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.

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The pain of rising real yields is largely in the past

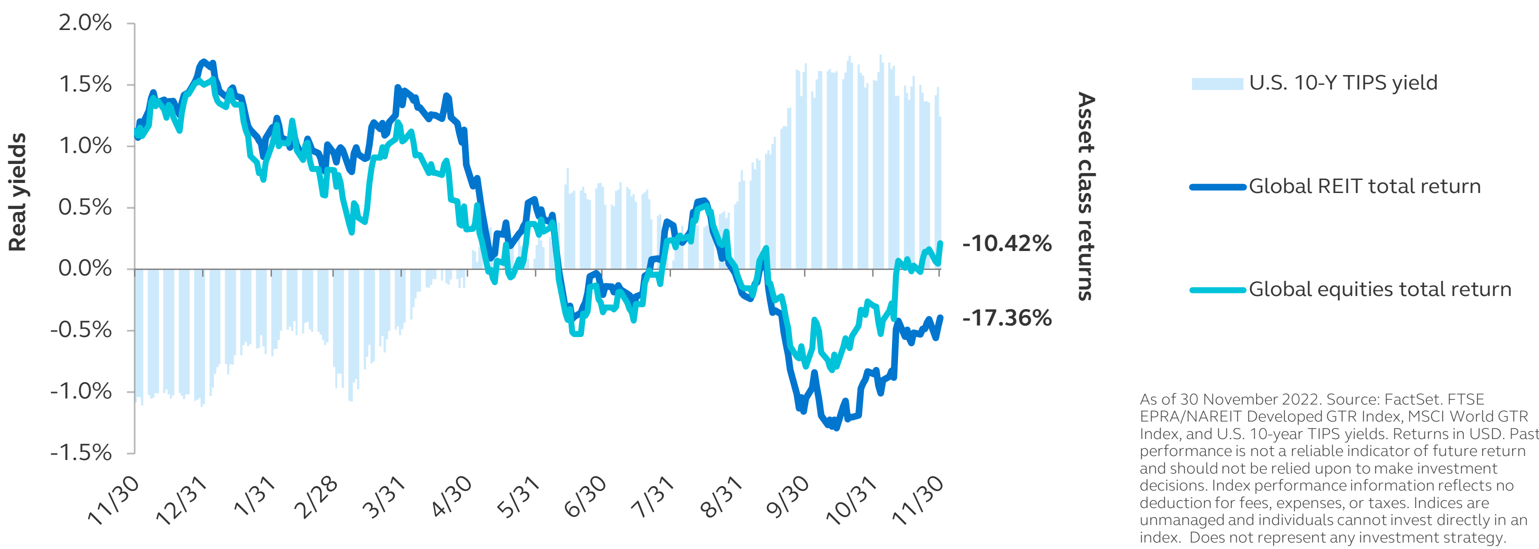
In an environment of rising real yields, the investments that suffer the most are those associated with long duration. In public equity markets, stocks with higher multiples and long-term resilient cash flows are viewed as higher duration, including listed REITs. This explains most of the underperformance of listed REITs in 2022, in our view.

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

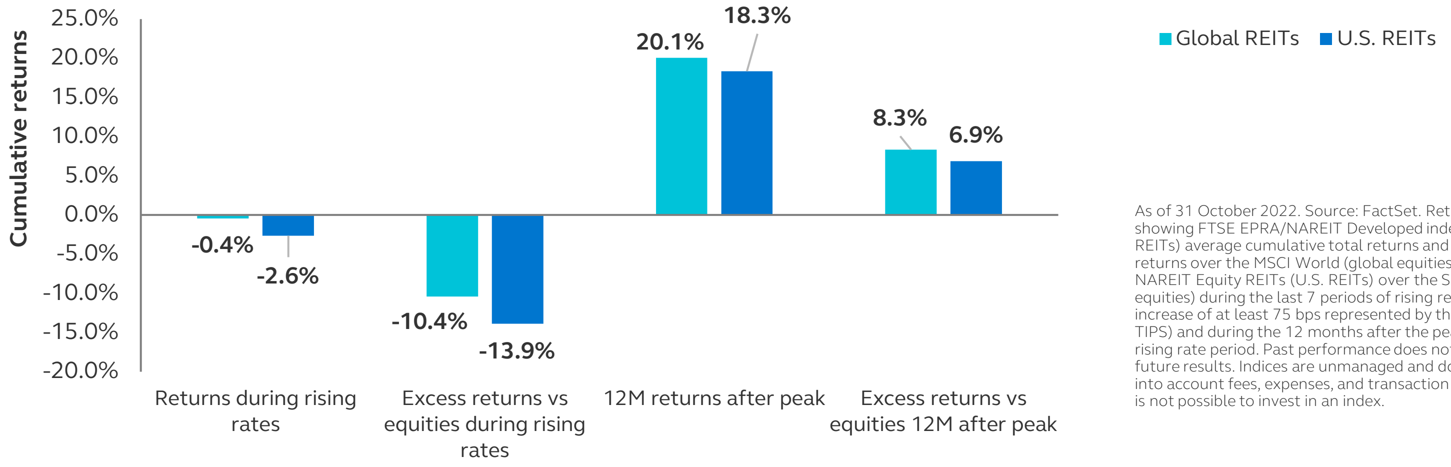
- Kelly Rush

TIPS yields and trailing one year total returns for REITs and equities



As of 30 November 2022. Source: FactSet. 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) 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. 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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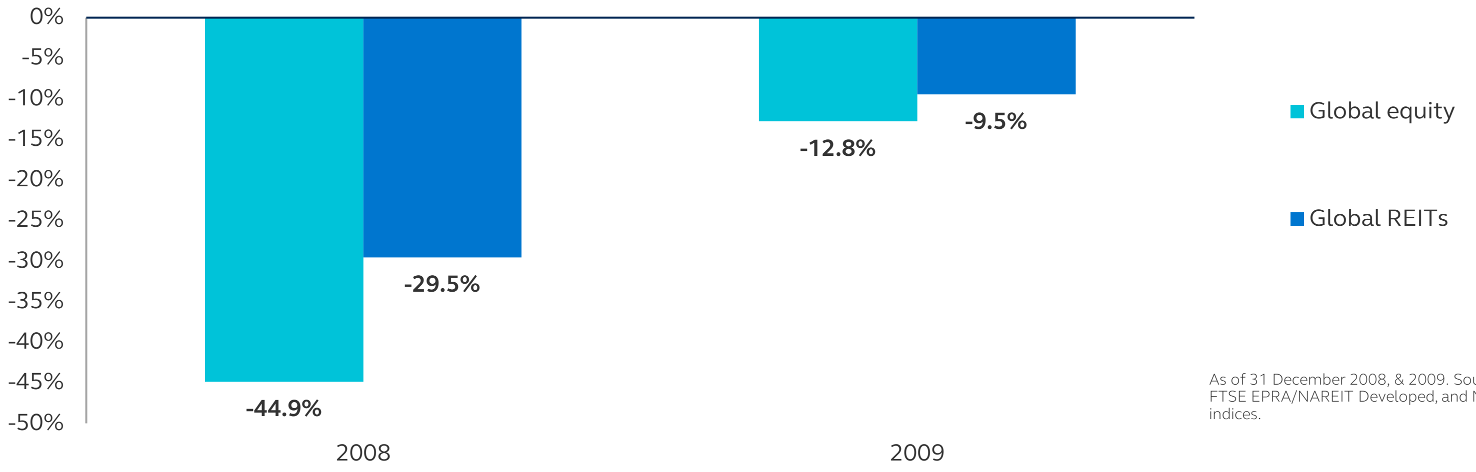
Earnings resilience should matter in a recession

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 REITs is directly linked to medium- to long-term lease periods The cash flow profile of REITs 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 REITs to see more modest declines.

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

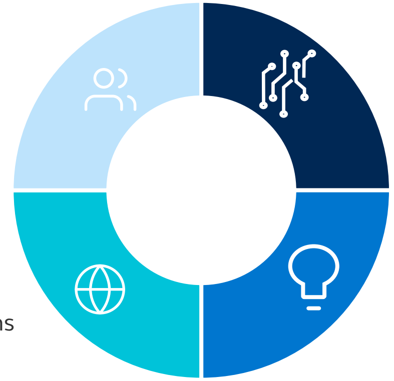


As of 31 December 2008, & 2009. Source: FactSet. FTSE EPRA/NAREIT Developed, and MSCI World indices.

Structural themes are driving change and opportunity in REITs

Demographics
- Aging population
- Shifting migration patterns
- Housing affordability
- Cost of living

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



Infrastructure
- Communication
- Physical assets
- Transportation
- Social infrastructure

Innovation & tech
- Artificial intelligence/Big data
- Mobile data
- Flexible working/Work from home
- Innovation "hubs"
- Retail disruption

Source: Principal Real Estate

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Resilient balance sheets for uncertain times

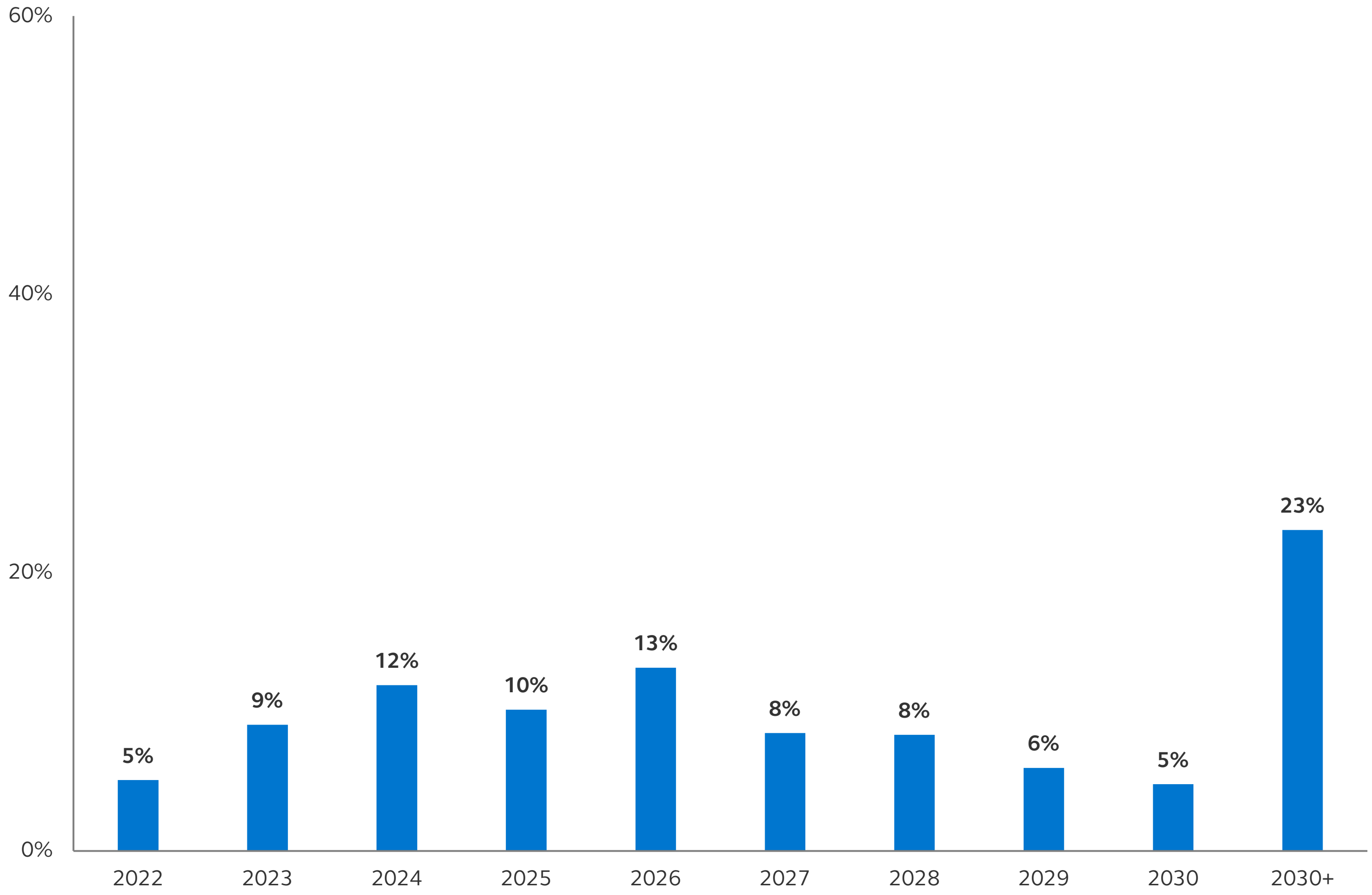
REIT businesses have resilient balance sheets given the significant amount of long dated and fixed rate debt typically utilized. REITs have demonstrated discipline in the use of leverage and today are in a stronger position than ever before.

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 companies are in a good position to weather the storm ahead."

- Kelly Rush

Global REITs: % of debt expiring by year



As of 30 November 2022. Source: FactSet. Long term debt maturities for the FTSE EPRA/NAREIT Developed index.

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).

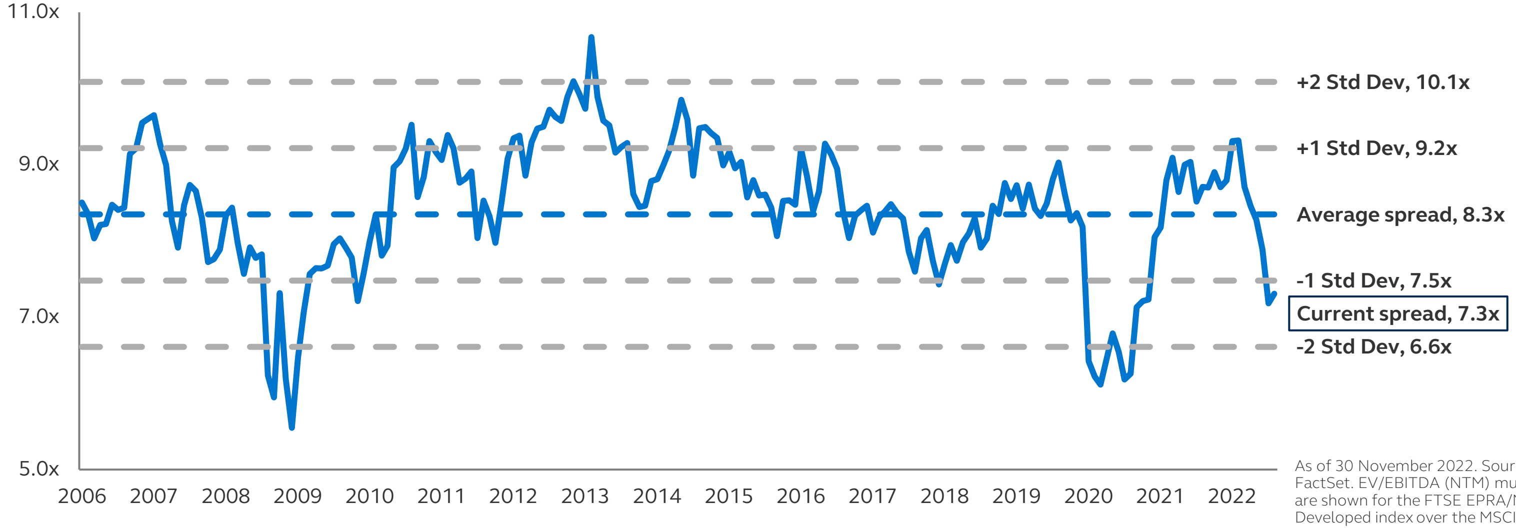
For private real estate funds and non-traded REITs, shares are valued using property appraisals, which tend to lag real-time changes in conditions. With property transactions coming to a standstill this year, participants in the private real estate market don’t have the price discovery needed to determine 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.”

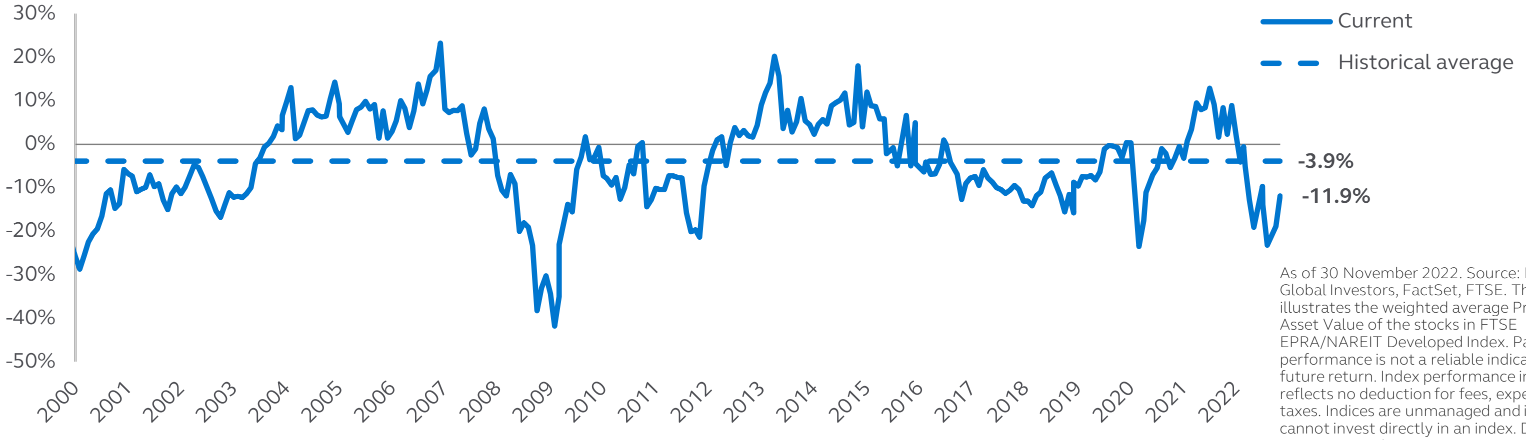
- Kelly Rush

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.

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Sector preferences in 2023

Our investment approach within listed REITs 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.

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.

Sector	Cautious	<	Investment preference 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	○	○	○	○	●

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

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