Principal Real Estate

SPECIAL BULLETIN #2 | PRIVATE REAL ESTATE DEBT

THE ADVANTAGES OF ALLOCATING CAPITAL TO PRIVATE REAL ESTATE DEBT

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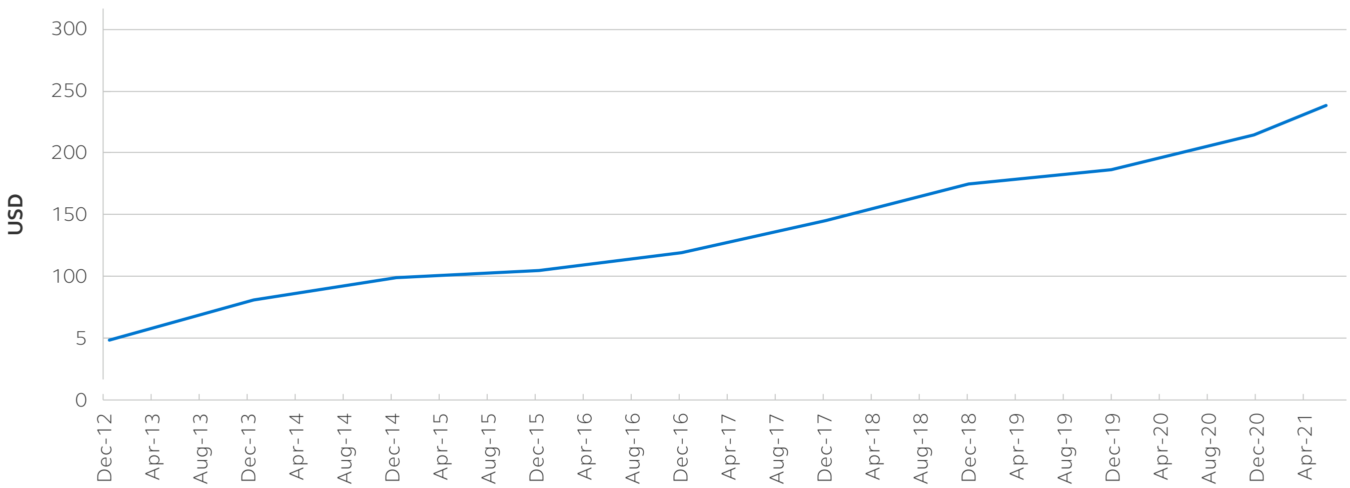
AT-A-GLANCE: Potential benefits of Private Real Estate Debt in a portfolio

- Significant relative value and attractive current income
- Hedge against inflation - Real assets serve as collateral and short duration of investments
- Complements core equity exposure
- Increased portfolio diversification

Over the last decade, the main advantages of investing in Private Real Estate Debt stayed essentially the same. Of course, as the financial markets change, a different subset of beneficial features come to the forefront and gain the attention of investors. Today, the case for Private Real Estate Debt is as strong as ever, which is why capital continues to flow into this space as shown in Exhibit 1. This special bulletin will revisit the investment profile of Private Real Estate Debt and how an allocation to this space can augment an investor's portfolio over the next five to ten years.

EXHIBIT 1: Allocation to private debt funds steadily increased over the past decade

Private debt funds AUM | USD billion

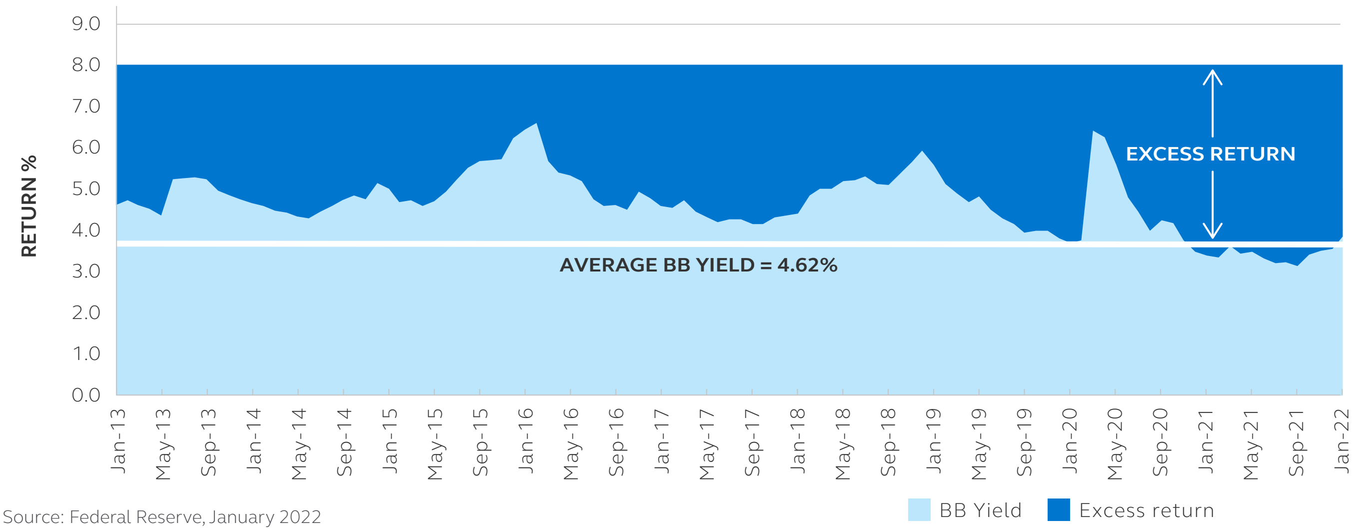


Source: Preqin, June 2021

Relative value and high current income

Principal Real Estate Investors managed a series of commingled debt portfolios along with various separately managed accounts focused on the private real estate debt space. Since 2013, all three of Principal debt portfolios produced attractive returns. The portfolios achieved this by investing in a combination of subordinate debt and levered senior mortgages which generally fell in the BB, BB+, and BBB- area of the risk spectrum per Principal Real Estate Investors' proprietary internal risk rating model. Most of this return was in the form of current income, providing cashflow to investors as well as compelling relative value compared to corporate alternatives. Exhibit 2 compares these returns to BB corporates.

EXHIBIT 2: Private real estate debt: relative value vs. BB Corporates



Source: Federal Reserve, January 2022
ICE BofA, BB US High Yield, Percent, Monthly, Not Seasonally Adjusted

Private Real Estate Debt in a world of elevated inflation

Short duration

Most loans flowing through private real estate debt are structured as floating rate debt. The associated low duration profile was a positive for investors as longer-term rates came off their lows as the COVID-19 pandemic winds down. The Fed began increasing short-term rates which will translate into higher short-term rates, the index now used for most floating rate loans. With each rate increase, the value of the instruments held in private real estate debt portfolios will not decline unless market spreads widen, or the underlying assets experience a credit event. With the uncertainty around mid-to- long-term interest rates over the next couple of years, we believe a predominantly floating rate profile is attractive.

Real assets

The collateral for private real estate loans is either a single asset or pool of assets secured by a mortgage, assignment of ownership interest, or other instrument allowing the lender to step into the ownership. Commercial real estate had a positive correlation with inflation as shown in Exhibit 3. When inflation flared up, the resulting higher construction costs (labor and materials) slows the construction of new competing properties, benefitting existing properties. Between the reworking of supply chains post-COVID, which could take years to effectuate, and unexpected events such as the invasion of Ukraine, being long real assets may provide additional hedge against inflation.

EXHIBIT 3: Commercial real estate has had a positive correlation with inflation

Correlations (1978 Q4 – 2021 Q4)	CPI
CPI	1.00000
NPI Total Return	0.36536
NPI Income Return	0.24431
NPI Appreciation Return	0.32747
Barclays U.S. Aggregate (TR)	-0.04420
S&P Total Return Index	0.01562

Source: NCREIF, BLS, Barclays/Bloomberg, and Principal Global Investors, December 2021

Private Real Estate Debt investments complement core equity exposure to preferred property types

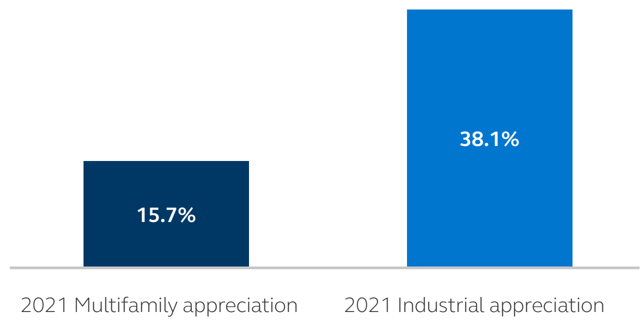
(including now not so niche, niche property types)

Real estate investors are currently seeking exposure to multifamily and industrial, as well as niche property types, because of the strong fundamentals in place as well as concerns over retail and office. Investor interest has driven prices up substantially for assets in these sectors. Exhibit 4 highlights the appreciation of industrial and multifamily properties in 2021 (excluding income). Some would argue, industrial properties are now fully priced with the optimism for future rental growth already being baked into capitalization rates.

Should future value increases fail to meet expectations, due to rental growth rates falling short of projections or market capitalization rates (cap rates) increasing, the borrower's equity cushion inherent in debt investments may incentivize owners to continue performing on their private real estate debt investments obligations. However, as Exhibit 5 shows, equity returns are negatively impacted when NOI growth falls below expectations and/or cap rates increase. In this way, real estate debt may be a defensive complement to core equity.

EXHIBIT 4: Value appreciation for multifamily and industrial

Preferred property type 2021 appreciation



Source: NCREIF Property Index, December 2021

EXHIBIT 5: Impact of increasing cap rates on a loan's borrower equity cushion

		LTV (Year 5)	Five Year Asset Value Change	LTV (Year 5)	Five Year Asset Value Change	LTV (Year 5)	Five Year Asset Value Change
NOI CAGR		3%	3%	5%	5%	7%	7%
Cap Rates	4.00%	65%	16%	59%	28%	53%	40%
	4.25%	69%	9%	62%	20%	57%	32%
	4.50%	73%	3%	66%	13%	60%	25%
	4.75%	77%	-2%	70%	7%	64%	18%
	5.00%	81%	-7%	73%	2%	67%	12%
	5.25%	85%	-12%	77%	-3%	70%	7%
	5.50%	89%	-16%	81%	-7%	74%	2%

Note: LTV (Year 5) = Loan Amount/Year 5 Value — (ex. 80% LTV implies a 20% equity cushion)
Assumptions: Initial Cap Rate = 4%, Initial LTV = 75%, CAGR = Constant Annual Growth Rate
Source: Principal Real Estate Investors, March 2022

The equity cushion combined with solid property fundamentals is the reason the loan returns for these in-favor property types are on the low end of the yield range for private real estate loans. However, these loans can serve as foundational pieces in a diversified debt portfolio and also hedge core equity positions with respect to underperformance.

Broader portfolio diversification benefits

Private debt is not heavily correlated to other segments of the private, and some of the public, investment landscape. In Exhibit 6, we can see that private debt is less correlated to private equity real estate, public REITs, and broader equities (S&P).

EXHIBIT 6: Private debt is less correlated to private equity real estate, public REITs, and broader equities

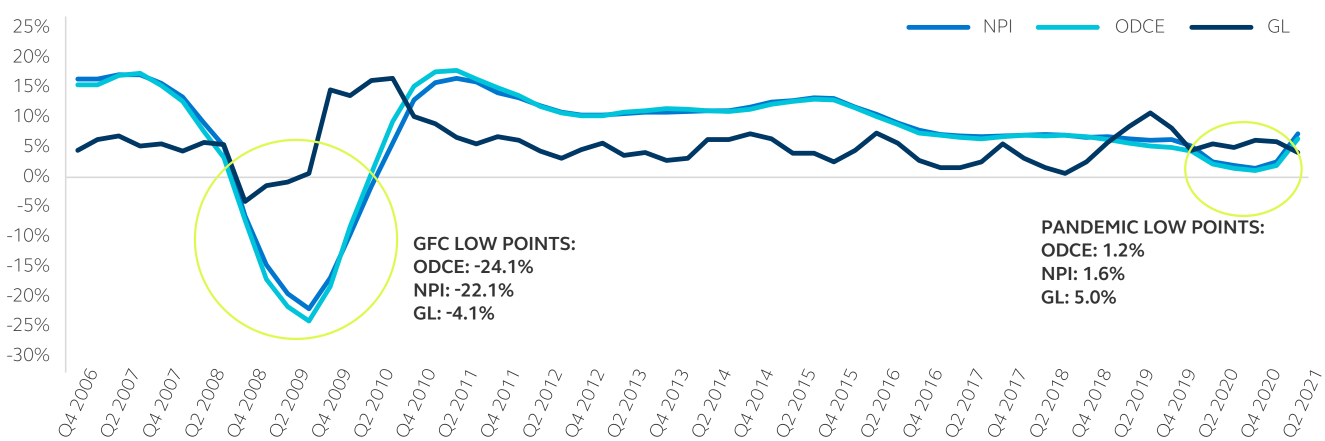
CORRELATIONS	Giliberto-Levy Total Return	NFI-ODCE Total Return (Gross, USD)	NPI Total Return	NAREIT (All REITS Total Return)	S&P 500 Index	Barclays U.S. Aggregate (Total Return)
Giliberto-Levy Total Return	1.0000	-0.0230	0.0265	0.3800	0.2114	0.8126
NFI-ODCE Total Return (Gross, USD)	-0.0230	1.0000	0.9464	0.0957	0.0634	-0.1319
NPI Total Return	0.0265	0.9464	1.000	0.1074	0.0633	-0.1160
NAREIT (All REITS Total Return)	0.3800	0.0957	0.1074	1.000	0.6370	0.2754
S&P 500 Index	0.2114	0.0634	0.0633	0.6370	1.000	0.1062
Barclays U.S. Aggregate (Total Return)	0.8126	-0.1319	-0.1160	0.2754	0.1062	1.000

Source: NCREIF, NAREIT, Giliberto-Levy, Barclays/Bloomberg and Principal Real Estate Investors, September 2021

This diversification helps insulate a portfolio from periods of severe market disruption. In Exhibit 7, we included the rolling one-year returns for various indexes: Giliberto-Levy index, NFI-ODCE index, and the NPI. During the Global Financial Crisis (GFC) and the COVID-19 pandemic, the inclusion of private debt would have acted as a "shock absorber" and helped to preserve a real estate portfolio from suffering more severe losses.

EXHIBIT 7: Private debt can help to preserve a portfolio in periods of severe market disruption

Rolling one-year returns



Source: Giliberto-Levy, NCREIF, December 2021

Potential challenges

With all these benefits, we also want to look at potential challenges facing investors in private real estate debt. Global events or changes in the financial markets (e.g., higher short-term interest rates) could cause the volume of property trades to decline. This would lower the need for acquisition financings albeit from record levels. The overall market activity would be supported by refinancing demand which is expected to remain strong. The other primary risk is if the long-term portion of the yield curve increases to the point where cap rates rise, and property values decline. It is debatable as to what range the 10-year treasury yield needs to enter for this to happen, but there is an argument that yields above 3% would dampen asset valuations (and not just in commercial real estate). Importantly, new investments are underwritten relative to the values in place at origination.

What drives returns

There are multiple factors to successfully executing a private real estate debt strategy. Managers with well-established and diversified market relationships—intermediaries, banks, and sponsors—avoid the need to buy business via lower loan coupons or aggressive credit structuring. Instead, such managers are frequently the first (and occasionally the only) call on behalf of a borrower or senior lender makes, especially in situations where certainty and/or expediency are critical. Having internal servicing and asset management capabilities allows for surveillance and an improved borrower experience which creates quality repeat investment flow (loans). As well, lenders that are able to offer a range of loan options such as core debt and construction mortgages, see a broader set of opportunities and often have a sourcing advantage. Firms with robust private real estate equity capabilities may provide better access to information for decision-making and may also be able to better preserve investments during stress events. In-house research, ESG, and other professionals (valuation, engineering, legal, etc.) also lead to better investment decision making. Such considerations are important in today's competitive environment, and are likely to be especially appreciated in times of market stress.

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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MM12809 | 03/2022 | 2076766-122024