Principal Real Estate

SPECIAL BULLETIN #3 | PRIVATE REAL ESTATE DEBT

HIGH YIELD REAL ESTATE DEBT: THE IMPORTANCE OF A FLEXIBLE APPROACH

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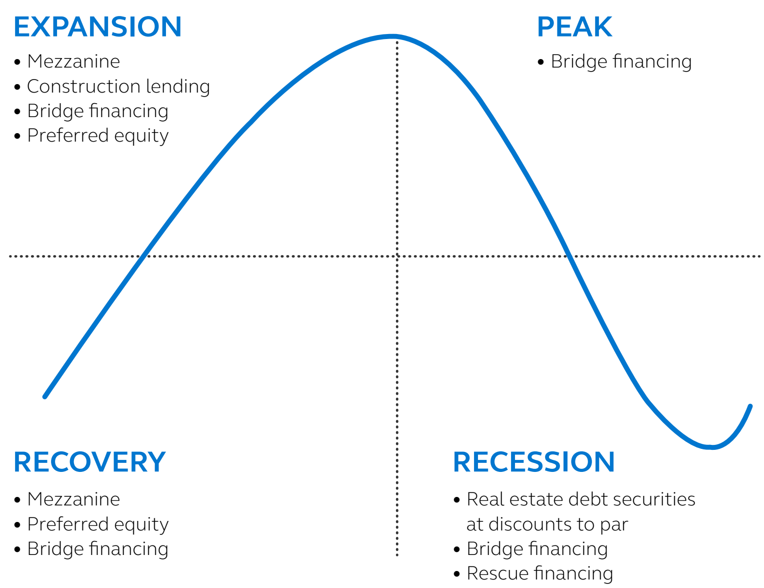
The high yield private real estate debt landscape encapsulates a wide variety of investments, such as mezzanine loans, bridge financing, construction lending, preferred equity, and opportunistically, public securities trading at steep discounts to par.

Through any given investment period, shifts in the market can create complicated scenarios for capital deployment and strategy execution. The most recent market disruptions have highlighted the opportunities and challenges that can arise for debt investors as those shifts take place. Accordingly, we believe managers with the ability to assess the relative attractiveness of various high yield investment strategies and execute across the spectrum of opportunity are better able to help investors achieve attractive risk-adjusted returns in varying market conditions.

Execution through the cycle

Exhibit 1 provides an illustration of potential portfolio construction given a shifting cycle. The actual investment execution could change depending on the specific economic issues impacting the market or a property sector. This further supports the idea that a flexible strategy is preferable—where a bridge investment might be appropriate for a grocery-anchored retail asset, private debt investors may find better opportunity for high yield returns via preferred equity positions when looking at multi-family properties.

EXHIBIT 1: Portfolio focus through the real estate cycle



Source: Principal Real Estate Investors, March 2022

This short paper seeks to highlight the various strategies and how each may be successfully executed in different market environments.

- **Senior mortgage bridge lending:** This type of execution seems to fit across market cycles, whether in the recovery and expansion phases where more assets are being acquired, renovated, or developed, or during peak times when there is a larger focus on downside risk mitigation, or even during a recession in the form of rescue financing. This position in the capital stack helps insulate the investment from valuation declines while providing a coupon, which, when moderately levered, may help achieve targeted portfolio returns.

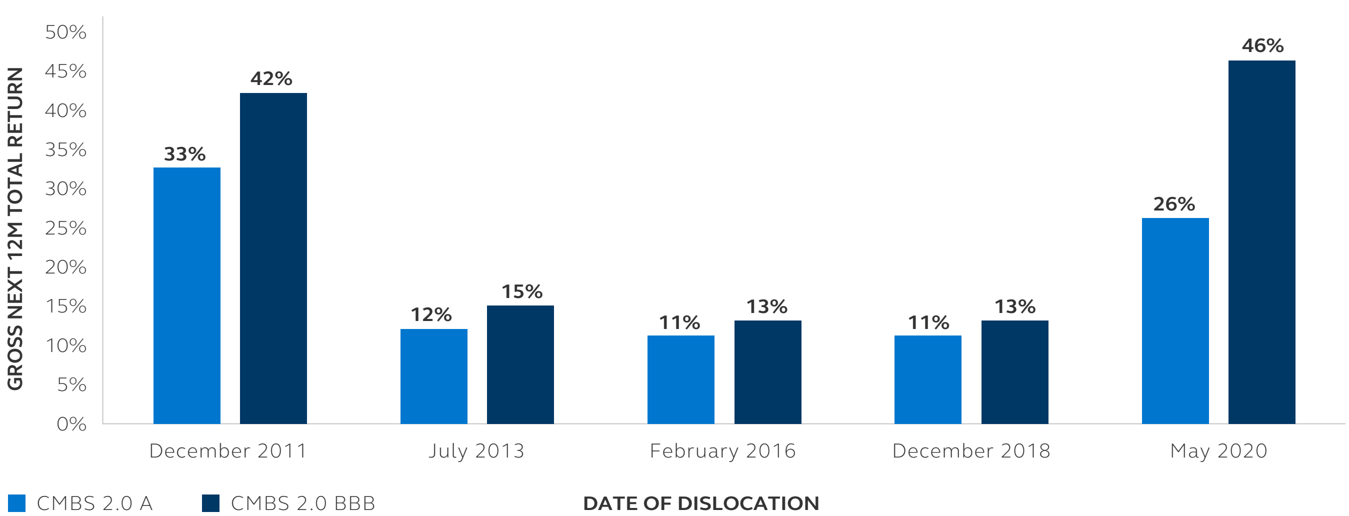
- **Mezzanine:** During times of recovery or expansion, mezzanine debt may provide an attractive risk-adjusted return profile. Mezzanine debt is subordinate to senior debt, but takes priority over equity in the capital structure. Therefore a sufficient borrower's equity buffer may help preserve this investment. In times when asset valuations are increasing, the risk on last dollar exposure at time of origination decreases.

- **Preferred equity:** This strategy is being used more frequently as a debt instrument and, during times of recovery and expansion, can provide more plentiful opportunities for capital deployment as there are more assets in the construction, repositioning, redevelopment, and renovation phases. Preferred equity is used much like mezzanine financing and is subordinate to senior debt. It's structured as a partnership agreement or LLC and is not an intercreditor, like mezzanine. Preferred equity is becoming more common for higher risk profile and construction assets as there is a contractual rate with an accrual component that is favorable for construction lenders or those engaging in more capital intensive projects.

- **Construction lending:** This strategy tends to be more apparent in parts of the cycle where there is a focus on supply delivery. It can be found in the form of preferred equity or mezzanine debt, but can also be traditional construction loans, or participating loan strategies where enhanced returns are needed.

- **Real estate debt securities:** During times of distress or volatility, the real estate debt securities market can be a good source of outsized returns. We can look at the last five instances where market volatility allowed for double digit returns in both investment grade and non-investment grade securities as shown in Exhibit 2.

EXHIBIT 2: CMBS 2.0 index return over subsequent 12 months

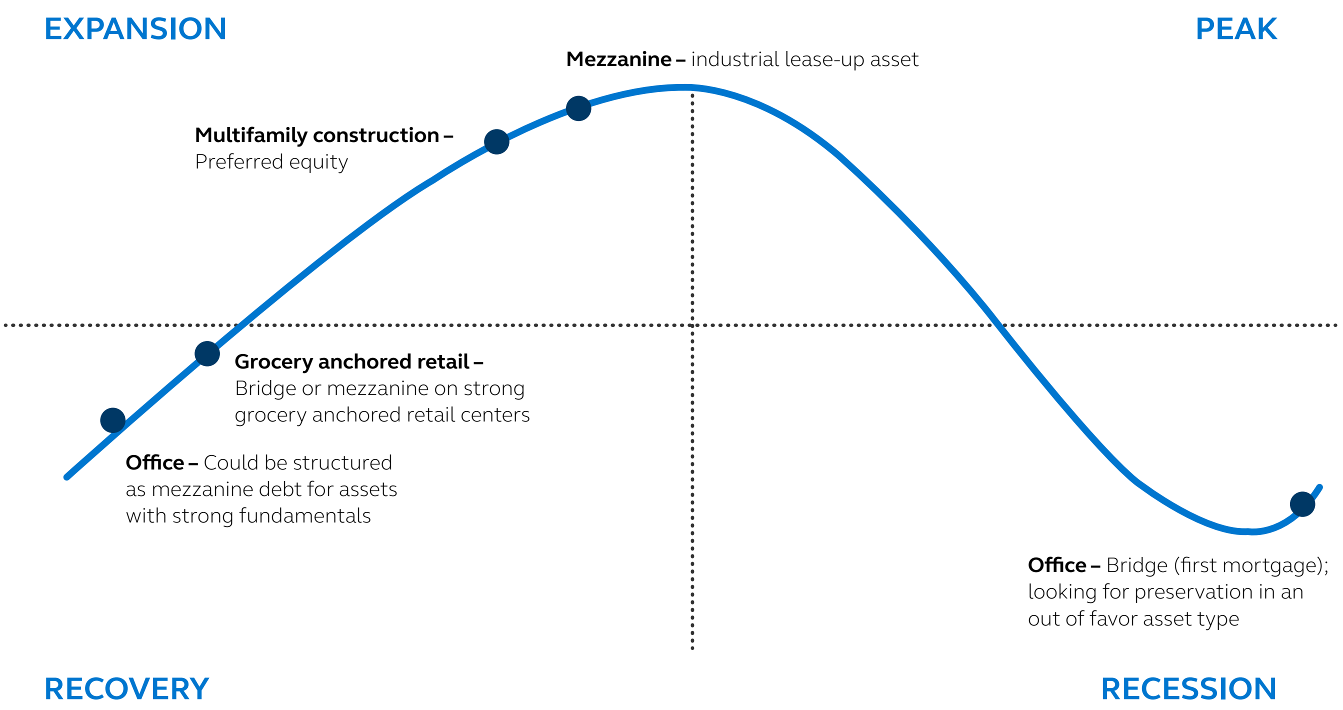


Source: JP Morgan Research, Bloomberg Index Services Limited, Principal Real Estate Investors, December 2021
CMBS 2.0 refers to issuances originated in 2009 and beyond. Past performance is not indicative of future results.

Assets are in different parts of the cycle

Specific assets have their own positions within the cycle. The example shown in Exhibit 3 is meant to be directional as not all assets are created equal. For example, office appears twice across the spectrum indicative of two office assets in different phases of the "office" recovery. As such, one asset may require debt structuring that is more senior while the other's fundamentals may allow for mezzanine investing where the asset level execution is less capital intensive. In the same token, along the same spectrum, preferred equity can be used on a favorable multifamily construction deal or an industrial deal where more capital intensive execution is needed. As these assets continue to make their way through the cycle, the debt execution can change.

EXHIBIT 3: Assets across the cycle



Source: Principal Real Estate Investors, March 2022
For illustrative purposes only

CONCLUSION

A flexible strategy allows for different execution, across different assets, at different times. Regardless of the economic conditions that may arise during a portfolio's investment period, flexibility should allow for consistent capital deployment without sacrificing target returns.

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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