Principal Asset Management[SM]

Principal Real Estate

Opportunities in listed REITs today

SEPTEMBER 2023

OVERVIEW

A compelling entry point for REITs

Listed REITs have faced headwinds the past 18 months, with stickier-than-anticipated inflation requiring continued hawkish bank rhetoric, increasing upward pressure on bond yields and negative pressure on real estate values and REIT stock prices. The prospect of a banking crisis driven credit crunch has added to the pressure on the capital-intensive real estate sector.

Amidst the bearish sentiment towards real estate a compelling opportunity to own REITs has emerged. The deeply discounted REIT market has largely priced in the challenges for real estate of higher rates and tighter credit markets.

Peaking or falling yields have historically been the catalyst for strong REIT market outperformance. REITs are often beneficiaries of investor rotation into long duration, defensive assets when yield increases subside.

Areas of concern for real estate – office properties or too much leverage – are well contained in public REIT markets. REITs generally possess high quality balance sheets and have minimal exposure to traditional office space.

Property sectors with resilient, structurally-driven demand dominate REIT markets. These sectors are meeting the demands of a changing economy and society and offer attractive long-term growth.

Principal Asset Management℠

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CEO, Public Real Assets &
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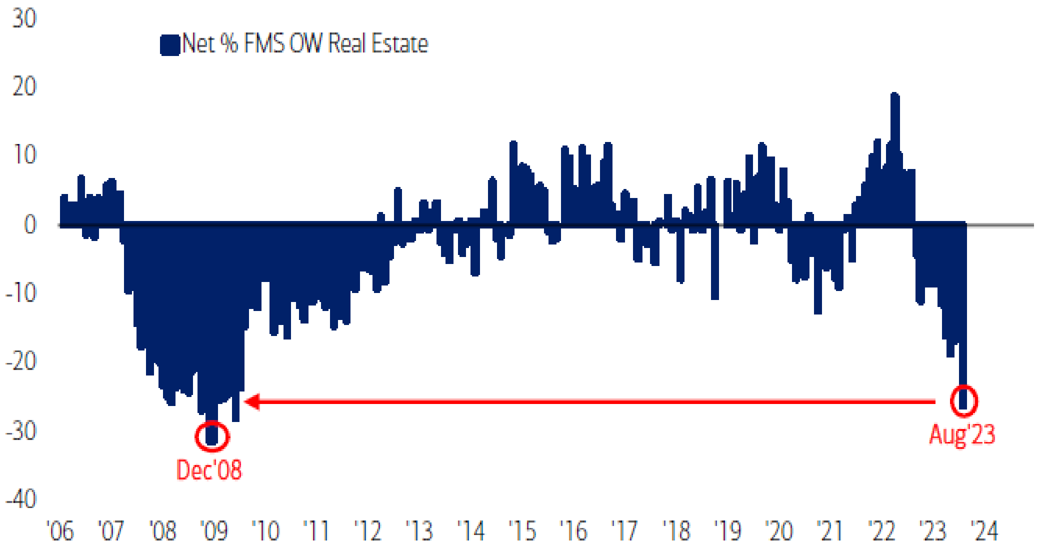
Extreme bearishness towards REITs and a large valuation discount is creating a compelling entry point for investors

As Warren Buffett once famously wrote, *"…be fearful when others are greedy and be greedy only when others are fearful."* In our view, investors should be greedy when it comes to REITs. According to the Bank of America Fund Manger Survey (left chart), the current 26% net underweight by survey respondents is the lowest allocation to real estate since March 2009 and 2.2 standard deviations below its long-term average. The relative valuation of REITs versus equities (right chart) tells a very similar story.

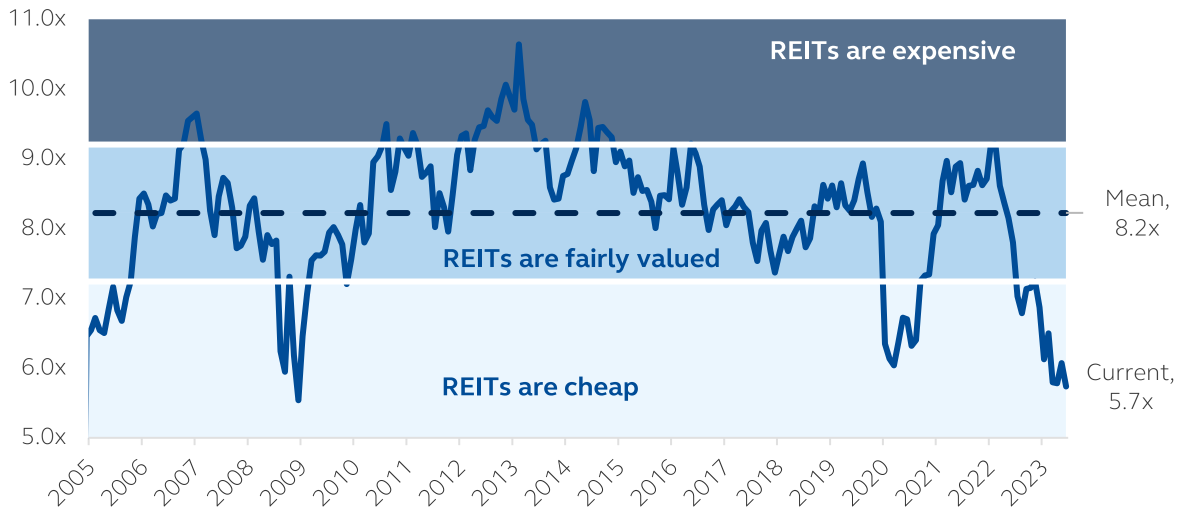
It appears contrarian to favor REITs today compared to the negative news headlines about real estate, but these challenges are well understood in REIT markets. When sentiment does shift back in favor and relative valuations are too cheap to ignore, REITs are poised for potentially strong fund inflows. After all, the number of potential buyers is outnumbering the remaining sellers by a bigger margin every day.

Bank of America Fund Manager Survey (FMS) – August 15, 2023



As of 15 August 2023, Source: Bank of America Global Fund Manager Survey

Relative EV/EBITDA spreads: Global REITs minus equities



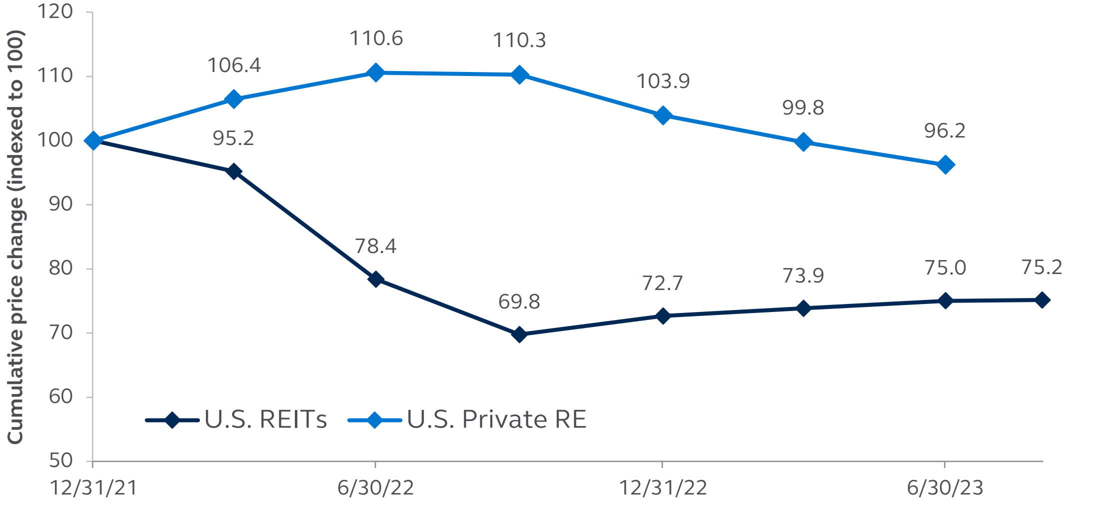
As of 31 August 2023. Source: FactSet. Enterprise Value (EV) to EBITDA price multiples are used to measure valuations. The spread plotted is the EV/EBITDA of the FTSE EPRA/NAREIT Developed index minus the EV/EBITDA of the MSCI World index. Expensive and cheap valuations are represented by spreads higher or lower than one standard deviation from the mean, respectively. Fair value is represented by valuations between one standard deviation from the mean.

Public REITs present an opportunity to buy discounted real estate now

The challenges for real estate have been visible for a while now and markets have priced it in for REITs given their liquid, public nature. Change in valuations for private real estate have been slower given appraisal-based methodologies and limited price discovery in today's transaction markets. The declines REITs have experienced since the Fed started hiking rates are significant compared to private real estate and current REIT implied cap rates suggest REITs offer an attractive return premium over private real estate.

Looking to the future, the valuation gap between public and private markets means the convergence trade that favors public REITs is very attractive in our opinion. While the absolute direction of REITs and private real estate is less certain given the variety of macro scenarios that could unfold, there is conviction in our belief that, on a relative basis, public REITs have a strong headstart at these valuation levels.

Value change since rate hikes began in 2022



As of 31 August 2023. Source: Principal Real Estate, FactSet, NCREIF. Indices: MSCI US REIT index, NCREIF ODCE. MSCI returns through 8/31/2023. ODCE returns through 6/30/2023 due to quarterly frequency of returns. Returns in USD. Past performance is not a reliable indicator of future performance 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.

The large divergence in private and public real estate cap rates favors REITs

	U.S. private real estate NCREIF NPI appraisal cap rates	U.S. REITs Implied cap rates	*Differential* REITs minus NPI
Apartment	4.0%	5.9%	***+1.9%***
Industrial	3.9%	4.5%	***+0.6%***
Office	5.5%	9.8%	***+4.3%***
Retail	5.2%	7.5%	***+2.2%***

Source: Principal Real Estate, NCREIF, GreenStreet. U.S. REIT implied cap rates sourced from GreenStreet Advisors as of 8/25/23. NPI cap rates as of 6/30/2023 Retail implied cap rate is an average of shopping center and mall companies.

The end of central bank tightening and rising yields is historically a strong catalyst for REIT outperformance

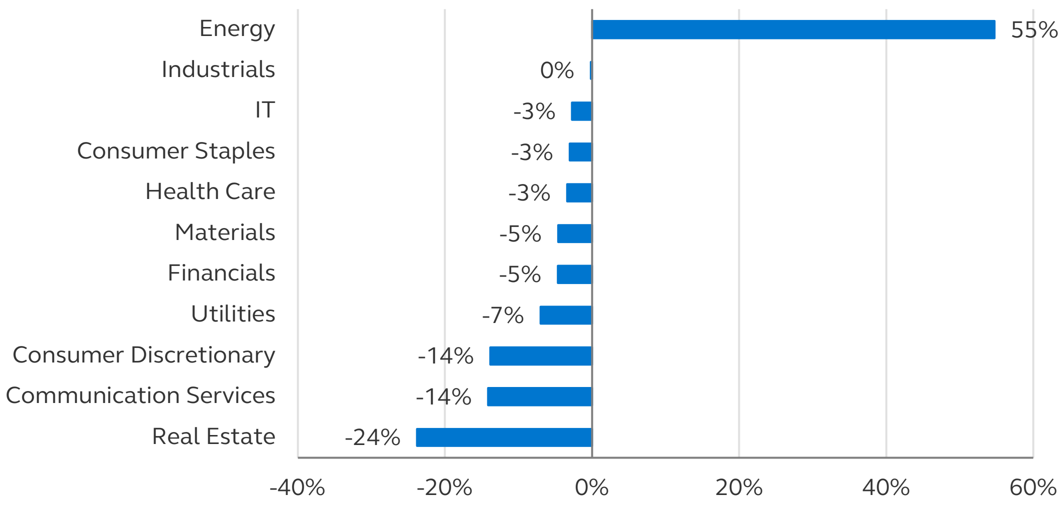
A strong economy and global central bank war on inflation has increased upward pressure on bond yields and negative pressure on REIT stocks.

The good news for REITs is markets are starting to believe the end of rising rates is soon coming to an end. The arrival of peak rates has been deferred but recent soft data (survey based leading indicators) suggest a slowing economy ahead as the lagged impact of monetary tightening works its way through.

This event, a peaking or falling long term yields, is just the catalyst a deeply discounted REIT market needs to potentially start a new return cycle upwards. Historically, REITs have delivered strong positive returns and against equities in the 12 months after real yields have peaked.

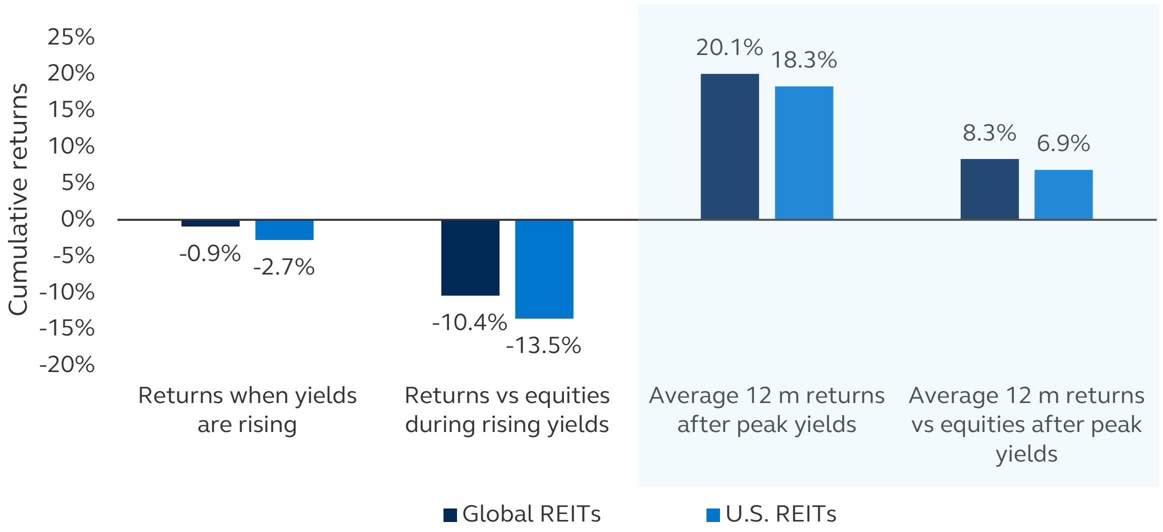
Cumulative returns since rate hikes began in 2022

MSCI World Index, GIC sectors. Returns 12/31/21- 8/31/23



As of 31 August 2023. Source: FactSet, MSCI World Index. Returns in USD. Past performance is not a reliable indicator of future performance 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.

Public REIT performance and changes in long-term real yields



As of 30 June 2023. 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) and 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.

Real estate debt markets are challenging, but we believe REITs can weather the lending slowdown

"The balance sheets of public real estate companies are in better positions today than going into the GFC."*

KELLY RUSH

The prospect of a banking crisis driven credit crunch has added to the pressure on the capital-intensive real estate sector this year. Looking forward, we expect tight lending conditions and less available capital could persist until bank balance sheet issues are resolved. Until then, we expect sluggish real estate transaction markets, pressure on capital values in the private market, and higher loan default risk for over leveraged properties.

REITs should be well insulated from these issues and current share prices already reflect many of the concerns. Most public REITs are low leveraged with manageable debt maturities and diversified sources of capital. We believe this will provide support to weather today's tighter credit conditions and potentially allow REITs to capitalize on opportunities. Looking ahead, we believe any emerging signals of improving real estate capital markets to be a positive upside catalyst for REITs.

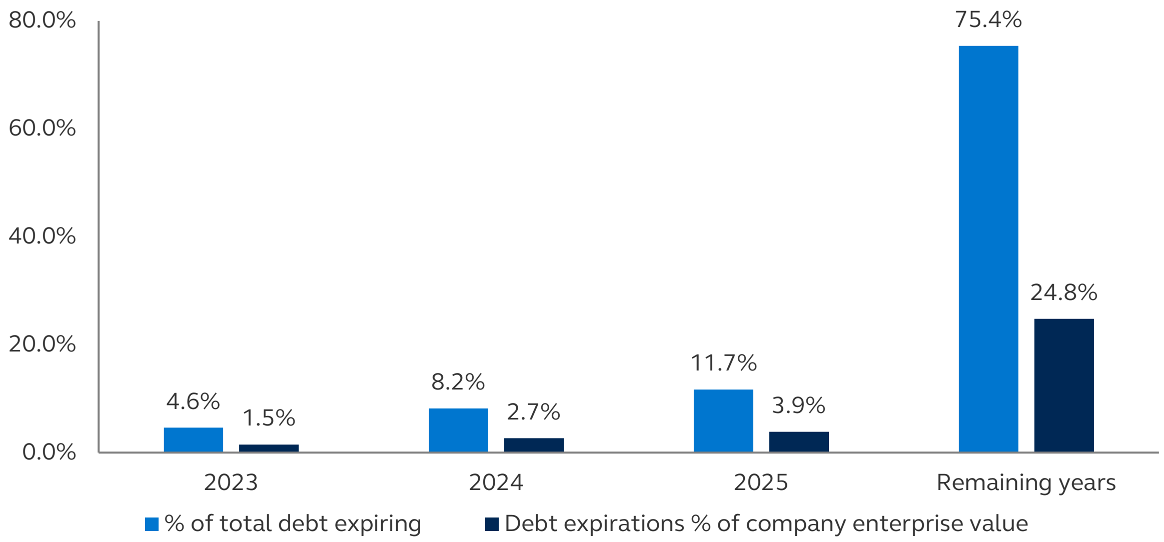
REIT balance sheets are stronger today than pre-GFC

	12.31.2007	Current
Company leverage (%)	38.3	29.4
% of total debt unsecured	48.4	75.4
Weighted avg. term to maturity	5.3 years	6.5 years
Interest expense as % of NOI	38.0	21.2
Interest coverage ratio (%)	2.7	4.5
Dividend payout ratio (%)	79.1	64.1

As of 30 June 2023. Source: FactSet, NAREIT. Data provided for the FTSE NAREIT All Equity REITs Index.

*GFC – Global Financial Crisis

U.S. REIT debt maturities the next three years are manageable

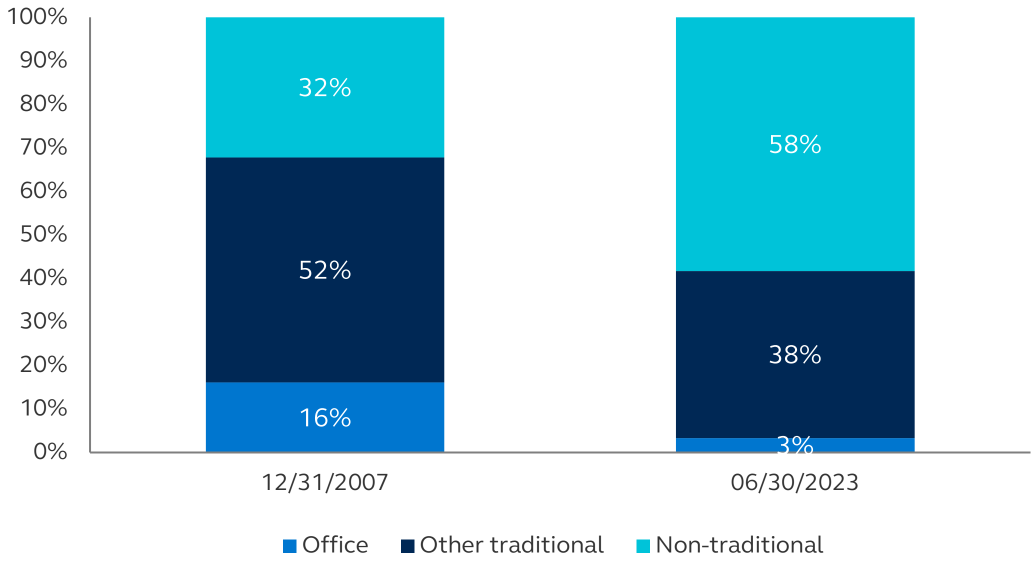


As of 31 December 2022. Source: FactSet. Long term debt maturities for the FTSE NAREIT Equity REITs index.

Office exposure doesn’t move the needle for public REITs

Office REITs have experienced significant declines in market values in a new environment of work from home and hybrid arrangements. The public market values of these companies reflect a future of significantly lower values for office assets and higher cost of capital. The traditional office sector is now only approximately 3% of the U.S. market and 6% of the global market, while many non-traditional property types with structural drivers (e.g. single-family rental, healthcare, data centers) represent the majority of REIT exposures.

U.S. REIT sector exposure (2007 vs 2023)



As of 30 June 2023. Source: FactSet. Change in sector weights are from the FTSE NAREIT Equity REITs index – Other traditional includes industrial, retail, and multi-family residential | non-traditional includes healthcare, hotels, self-storage, net lease, data centers, specialized residential, diversified, other, and land/timber.

Property sectors with resilient, structurally-driven demand drive REIT markets

"Not only are REITs cheap today, but they also stand to benefit from a flight to quality in real estate and strong capital flows into property types with structural drivers."

TODD KELLENBERGER

The public REIT market has experienced significant transformation over the last 10 to 15 years. The market is no longer dominated by traditional sectors such as office and retail, but instead a proliferation of non-traditional sectors has taken over. This can often be explained by structural changes in our economy, demographics, technology, and other factors that have created new and growing demands for different types of real estate space.

These structural changes are creating resilient and predictable demand trends that are expected to drive above average long-term cash flow growth for these properties. This profile has attracted significant interest from investors, and we expect many of these property types to be beneficiaries of strong capital inflows. Better cash flow prospects and large capital inflows should be tailwinds to support property prices.

A few examples of property types experiencing favorable structural demand drivers

	% of U.S. REIT market	2023E earnings growth	2024E earnings growth	2025E earnings growth	Structural tailwind outlook
Industrial	14.18%	8.35	3.35	13.22	E-commerce sales growth which generally requires 3x the warehouse footprint versus brick & mortar sales
Towers	13.12%	1.43	4.29	4.81	Exponential long-term growth expected in mobile data usage and bandwidth demands
Data Centers	9.60%	4.77	6.99	7.39	Rapid growth in technology infrastructure to support Artificial Intelligence, cloud storage demand, network densification, e-commerce, etc.
Healthcare	8.85%	-1.03	8.05	8.10	Long term needs-based demand with an aging U.S. population (especially +80yr old cohort). Muted supply trends.
Single-family rental	2.83%	7.17	6.23	6.48	Large and widening home affordability gap between owning and renting. Aging millennial demographic supports demand for single-family rental.

As of August 31, 2023. Source: FactSet, Principal Real Estate. Expected earnings growth represents year-over-year growth in FFO per share.

Opportunities we're seeing within the REIT market

Preference for demand resiliency and structural growth drivers

	Investment preference					Geographic preference
Sector	**Cautious**	**<**	**Neutral**	**>**	**Positive**	Red (cautious view) | Green (positive view)
Apartments	○	●	○	○	○	U.S. sunbelt, Germany | U.S. west coast
Data centers	○	●	○	○	○	U.S. | Australia
Diversified	○	●	← ◉	○	○	Asia office | HK/Aus residential, Japan/Aus retail
Healthcare	○	○	○	◉ →	●	U.S. senior housing and life science office
Hotels & resorts	○	●	○	○	○	U.S. business-oriented
Industrial	○	○	○	●	○	Global
Malls/outlets	○	●	○	○	○	U.S. | Europe
Manufactured homes	○	○	○	○	●	U.S.
Net lease	●	○	○	○	○	U.S. retail-oriented | U.S. gaming
Office	○	●	← ◉	○	○	U.S. | Canada
Self-storage	○	○	●	○	○	U.S. | Europe
Shopping centers	●	○	○	○	○	U.S.
Single family rental	○	○	○	○	●	U.S.
Towers	○	○	○	○	●	U.S.

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

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