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Real Estate

THE BUILT ENVIRONMENT:
Creating new assets to meet shifting market, capital, and tenant demand

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Executive summary:

- Some of the long-term structural changes that have been shaping real estate markets for several years became dominant drivers of demand during the pandemic challenging the status quo for real estate investors.
- These structural demand drivers are closely entwined with our "DIGITAL" framework[1] which helps to identify high conviction property sectors and markets.
- Structural changes catalyzed by the pandemic have been most impactful in the residential and industrial property types where sustained tailwinds of demand are forecast. Some non-traditional property types such as Life Sciences have also benefited from post-pandemic demand.
- Focusing on the residential and industrial property sectors with an emphasis on development strategies may help fill the void being created by capital and inventory imbalances and generate compelling relative value compared to core pricing.
- Development strategies are particularly compelling given the ability to tailor new build assets to evolving and growing ESG demands and standards from occupiers and buyers that have been catalyzed by COVID-19, climate change, and expanding regulatory requirements.

COVID-19 has served as an accelerant to certain demand drivers that were in place pre-pandemic impacting occupier usage. Uncertainty exists among real estate investors regarding future space utilization resuming pre-pandemic "normal" conditions. How and what can investors do to ensure they are capturing future occupier and investor trends that will shape real estate from ESG to e-commerce?

> In this short paper we will touch on the key trends we believe will impact occupier demand and identify opportunities at the intersection of structural and COVID-19 driven change.

[1] Demographic, Infrastructure, Globalization, and Innovation & Technology-driven trends over the long-term

KEY TREND: "DIGITAL" themes driving real estate demand

Principal Real Estate has developed a proprietary tool to track real estate demand drivers via its DIGITAL framework of Demographic, Infrastructure, Globalization, and Innovation & Technology-driven trends to help determine resilient investment strategies. This framework has been important for understanding the dynamic changes affecting real estate demand and has been critical in assessing growth in traditional and non-traditional property types. Using our framework, we believe the following trends are important considerations for investors:

- Supply chain disruptions and higher costs notwithstanding, tenant and investor demand for industrial/logistics has been turbocharged by the pandemic. We see little end in sight for industrial's expansion, though values for core assets signal some caution. Onshoring of the supply chain and last-mile industrial in major gateway cities will continue to provide opportunities.
- Changes to living and working patterns linger. This has led to many structural themes—including widespread adoption of technology, shifting migration patterns and a robust increase in demand for housing across the continuum. The pandemic provided a perfect catalyst in accelerating migration patterns, particularly since younger generations are comfortable leveraging technology and working from home. We suggest a focus on smaller, growth markets with an attractive cost of living.
- Indeed, housing is one of our highest conviction strategies in a shifting milieu of migration, demographics, and income. At the heart of the shifting patterns of household movement are quality of life concerns, which are often linked to affordability. A lack of supply, combined with elevated prices, has put home ownership out of reach for a vast majority of middle-income households. Renting has also become a challenge in some global cities where household incomes have slipped after decades of constrained wage growth.

Exhibit 1: Digital themes will continue to drive sector performance

Demographics	Infrastructure	Globalization	Innovation & tech
• Ageing population • Shifting migration patterns • Housing affordability • Inequality and cost of living	• Communication • Physical assets • Transportation • Energy and utilities • Social infrastructure	• Secular increase in trade & capital flows • Global technology supply chains • Mobile human capital and remote workforces • Satellite towers	• Artificial Intelligence/ big data and a circular economy • Flexible working/WFH • Innovation "hubs" • Retail disruption • ESG prioritization
– Suburban housing – Single-family rental – Manufactured housing – Self-storage – Senior living/care homes – Grocers, discounters, DIYs	– Data centers – Warehouses – Affordable housing – Care homes, medical offices – ESG focus	– Data centers – Warehouse/Logistics – Last mile facilities	– Life sciences – Lab space/medical offices – Data centers – Cold storage – Self-storage – New format retailers

Source: Principal Real Estate Investors, January 2022

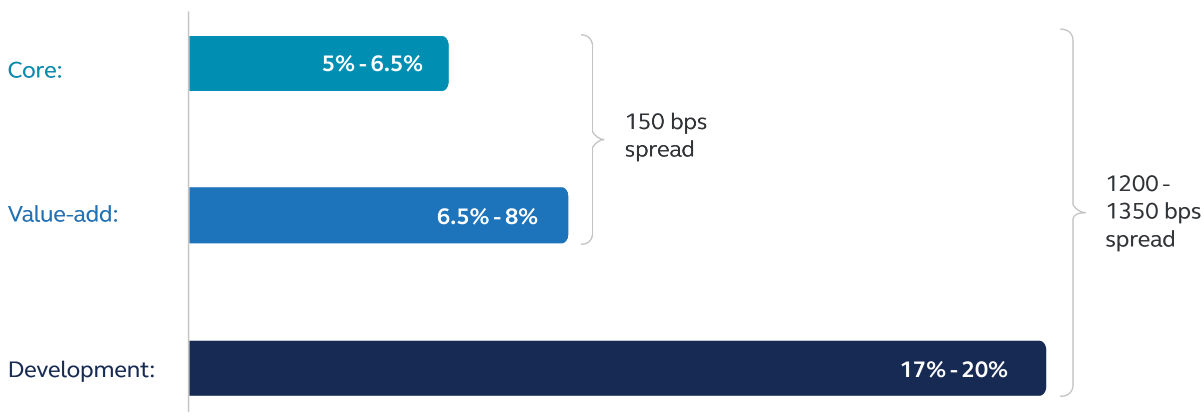
KEY TREND: Capital and inventory imbalances create development opportunities

The weight of capital and low borrowing costs combined with a shortage of inventory have pushed cap rates and core unlevered internal rates of return (IRR) lower in recent years. Total rates of return in the 5%-6.5% range are commonplace for stabilized core assets, a decline of 50 to 100 basis points (bps) over the last 12 to 24 months.

As investors search for higher yielding investment solutions, many are turning to opportunities in the development space given that value-add returns have also seen significant erosion. The premium for investing in value-add has declined materially thereby rendering the risk and return relationship less attractive. Development strategies continue to offer strong absolute and relative returns: relatively robust IRRs in the range of 15%-20% provide the highest spread over core and value-add levels in more than three decades. With core industrial and multifamily assets trading in the 3%-3.5% cap rate range, we believe development of these property types offers a highly compelling relative value opportunity.

While supply and labor shortages have extended development timelines and increased appropriate underwriting contingencies, stronger capital market demand has more than compensated experienced developers for these incremental risks. Low cap rates and powerful rental growth continue to offset cost and timing considerations. Principal Real Estate's multi-decade history of evaluating and mitigating development risk combined with astute partner selection provides the experience to navigate these and any future challenges.

Exhibit 2: Development offers compelling relative value



Source: Principal Real Estate Investors, September 2021. These are the current views and opinions of Principal Real Estate Investors and are not intended to be, nor should they be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.

> We believe a selective development strategy in the current environment can provide opportunistic equity return potential at risk levels traditionally associated with value-add strategies.

KEY TREND: ESG considerations accelerate in the wake of the pandemic, climate change, and expanding regulations—affecting every property type and investor

Environmental, social, and governance (ESG) factors were a strong structural theme unfolding for the commercial real estate industry prior to the pandemic. COVID-19 has accelerated several ESG trends which have manifested across all property types. These include the changing expectations of tenants and residents regarding health and wellness, the massive wealth transfer between baby boomers and more ESG-sensitive millennials, and the fast-paced disruption of technologies that are impacting every facet of our lives. Investors too are demanding increased transparency and performance on ESG criteria such as greenhouse gas (GHG) emissions, energy and water consumption, diversity and inclusion, stakeholder engagement, and supply chain sustainability.

Climate change highlights the intersection of ESG and the real estate industry. The financial impacts of climate change are clearly seen in the property and casualty losses of the insurance industry. In 2021, in the U.S. there were 20 weather and climate disasters with losses exceeding a billion dollars each, totaling approximately $145 billion in property losses and damages. The annual average number of events for the past five years (2017-2021) is 17.2 events (CPI-adjusted).[2] Globally, natural disasters caused overall losses of $280 billion and cost insurers $120 billion in 2021.[3] We're seeing data and analytics firms, credit agencies, startups, and insurers invest significantly in building state-of-the-art climate models to better understand climate change impacts and provide site specific insight on emerging climate risks. One near-term effect is the rise of global commercial insurance prices by 15% in the second quarter of 2021, the 15th consecutive quarter of rate increases.[4] Further, greater data availability and market awareness of climate risks lead to a need to better evaluate both markets and individual assets from a risk mitigation standpoint—and incorporate risk mitigation into underwriting and asset allocation strategies.

[2] Source: National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2022), January 2022. https://www.ncdc.noaa.gov/billions/

[3] Source: Munich Re, January 2022

[4] Source: Marsh *Global Insurance Market Index*, July 2021

Pre-COVID, ESG considerations were rapidly evolving. COVID-19 has accelerated this trend with tenants now acutely focused on health and wellness, particularly related to time spent indoors. New standards surrounding ventilation, sanitation, and distancing, drive a more holistic view of what healthy buildings really mean. As an example, Fitwel—an emerging building certification standard related to health and wellness in the built environment—is reporting a 248% increase for 2021 over the previous year.[5] Given the increased focus on ESG goals and accomplishments, we are now seeing more regulatory focus to ensure consistency, comparability, and third-party assurance around how property and portfolio managers promote ESG-related characteristics and activities associated with their properties. For example, in the United States, both federal and local regulators are taking action to protect investors from misleading ESG claims while pushing for greater ESG results, particularly regarding energy use and emissions.

The pandemic has also rewarded owners in cities that are flexible and adaptive with space, including the outdoors. The incorporation of community amenities such as open green space, pet-friendly walking areas, fitness centers, high-speed internet access, and EV chargers can translate into improved occupant experience but also higher premiums for multifamily developments that have appropriate amenities. Development is particularly well-suited to handle the diversity of ESG issues given the new build nature of the strategy. For example, industrial space with environmental considerations including minimized energy and water consumption, reduced GHG emissions, sustainable design innovation, and efficient use of materials and resources are most easily brought together in a new build. With some of these characteristics, assets command premium rents that are coveted by tenants and investors.

KEY TREND: Industrial and multifamily property types benefit from strong demand tailwinds

Increasing demand across the industrial spectrum

The industrial property sector remains in the sweet spot of both changing and increasing tenant demand accelerated by COVID-19 and its impact on consumer behavior. The disruption in global supply chains has certainly created some headwinds but the push towards onshoring and greater inventory stocking has created strong countervailing demand. Perhaps the most immediate and impactful change of the pandemic has been the shift in consumer and tenant behavior which have embraced e-commerce in a broader swathe. With COVID impacting daily life, common activities such as grocery shopping became an online experience. Consumers pivoted towards fulfilling a greater proportion of their everyday activities via the internet thereby creating demand but also with raised expectations on delivery timelines. Along with the growth of e-commerce has been the increasing expectation of same-day or next-day delivery. This race to reach consumers has led to explosive demand for last-mile infill distribution facilities closer to large U.S. metro areas, leading companies to establish distribution nodes near significant population hubs. This includes large metropolitan areas such as Boston, New York City, Washington D.C., Chicago, and Los Angeles, as the "just-in-time" mantra of past generations has evolved to the "last mile" or the final leg of delivery.

The stress in supply chains has created the need for greater stocked inventories and pushed more onshoring of some manufacturing activities to offset some of the negative impacts of de-globalization. As businesses re-structure supply chains and focus on maximizing delivery efficiencies amidst a labor shortage, there has been a surge in demand for additional industrial and warehousing space in locations close to vital population nodes and major highways. As demand for space outpaces new supply, we believe smaller bay products

[5] https://assets.ctfassets.net/fuo6knzstk5a/6ezTE7n7vhJbiw0EELRkm0/9e7f2749a5402a168cb3b350f28df178/EOY_Letter_2021_and_Beyond_Joanna_Frank__1_.pdf

close to areas with strong population growth, including Atlanta, Austin, Dallas, Denver, Orlando, Phoenix, Portland, and Salt Lake City are likely to outperform.

The stress in supply chains and shortage of labor is also forcing logistics operators to increase exposure to larger bulk distribution facilities in populated coastal gateway cities with ports of entry, such as Boston, Houston, Los Angeles, Miami, New Jersey, and New York where efficient distribution to smaller markets is more feasible. Leery of distribution holdups, operators are taking more bulk space to warehouse products rather than rely on leaner, just-in-time strategies.

A paradigm shift within the residential sector

In the past two years, the residential sector has re-emerged as a deep and broad opportunity set engendered by changes in migration and work patterns. In the U.S., a steady shift out of gateway markets with a high cost of living has led to a focus on cities with a different set of characteristics. COVID-19 forced millions of workers into remote positions on a full-time basis, a first for many. The "new normal" of increased flexibility, for both workers and employers, has generated both uncertainty and opportunity by changing the calculus of where individuals can choose to live and work. During 2020 and 2021, cities representing greater affordability and/or more attractive climates benefitted greatly from remote-worker relocations.

And while demographic shifts continue unabated, with older Baby Boomers retiring and Millennials coming of age to form households, demand has surged for suburban units that offer more space, better schools, and a higher quality of life. The pandemic provided a perfect catalyst in accelerating this demand, particularly since younger generations are comfortable leveraging technology and working from home.

The markets benefitting most from these trends include Atlanta, Austin, Dallas, Denver, Orlando, Phoenix, Portland, Nashville, and Salt Lake City, which combined affordable living options with several sought-after amenities. Interesting opportunities are also possible in markets that are attracting skilled workers, particularly with a strong technology employment base. First-ring communities with transportation access to cities such as Seattle, the Bay Area, Los Angeles, and Boston are experiencing increased tenant interest in newer, high quality properties and investors favor these markets as well for higher-end product.

CONCLUSION: We believe structural themes make development strategies a top choice

The evolving pandemic "normal" provides investors a new era of opportunities and challenges. For investors, understanding the intersection of the structural shifts and COVID-19 induced changes can provide a wide array of investment opportunities across of markets, property sectors, and investment strategies. In our view, targeted development strategies in the markets and property sectors discussed in this paper present some of the most attractive opportunities within the commercial real estate investment opportunity set. We believe that development in these markets and property types can generate potentially strong returns and offer historically high spreads to core and value -add strategies. Additionally, development will allow us to meet evolving tenant needs, centered around ESG and other key characteristics that have become a critical part of the investment dialog in an evolving COVID-19 environment. While the world will continue to evolve in response to changes to the pandemic, we believe our ability to identify and harness long-term shifts with short-term COVID-driven changes in a development -oriented strategy can provide investors with compelling investment opportunities to help navigate a volatile environment in the coming years.

Risk Considerations

Past performance does not guarantee future results. Investing involves risk, including possible loss of principal. 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.

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