Principal Real Estate

Principal Asset Management[SM]

European Core investing: Seizing the opportunity of non-traditional sectors

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The European economy is currently facing significant headwinds from the ongoing conflict in Ukraine, rising cost of energy and living, and central banks tightening monetary policy to control persistently high inflation. Given this weak outlook, it is important to execute a thoughtful investment strategy that can help navigate the diversity of sectors and markets available.

Our "DIGITAL" investment framework*, which is guided by long-term structural thesis, is particularly well suited for a challenging environment. By monitoring and analysing the long-term structural forces shaping core real estate, our DIGITAL framework identifies property types that have the potential to deliver resilient investment performance on a relative basis.

The long-term thematic drivers that fall within our framework, are presented in Exhibit 1. These factors include demographic considerations, such as the desire from Generation Z for coworking spaces or Baby Boomers' demand for independent senior living facilities. Our thematic also includes innovation developments such as "smart city" initiatives aimed at expanding the digitisation of services, improving energy efficiency, and attracting global talent. Assets underpinned by these long-term thematic drivers should prove to be more resilient during the turbulent period the economy is bracing for.

The modern core portfolio, at a glance:

- Specialist assets are playing a more important role.
- ESG considerations are a necessity.
- Investing outside of home country assets (i.e., geographical diversification) is increasing the set of opportunities and reducing portfolio risk
- Consider fund size and tax implications.

EXHIBIT 1: DIGITAL-driven property types prove resilient

Demographics

- Ageing population
- Shifting migration patterns
- Housing affordability
- Inequality and cost of living

Suburban housing
Single family rentals
Manufactured housing
Self storage
Senior living/care homes
Grocers, discounters, DIYs

Innovation & tech

- AI/Big data and a circular economy
- Flexible working/WFH
- Innovation "hubs"
- Retail disruption
- ESG prioritisation

Life sciences
Lab space/ Medical offices
Data centres
Cold storage
Self storage
New format retailers

Globalisation

- Secular increase in trade & capital flows
- Global technology supply chains
- Mobile human capital and remote workforces
- Satellite towers

Data centres
Warehouse/Logistics
Last mile facilities

Infrastructure

- Communication
- Physical assets
- Transportation
- Energy and utilites
- Social infrastructure
- Seaports
- Tunnels

Data centres
Warehouses
Affordable housing
Care homes, medical office
ESG focus

*DIGITAL – Demographic, Innovation, Globalization, Information & Technology long term drivers

Technology in particular, is changing our relationship with real estate. For instance, work-from-home (WFH) initiatives may be a large part of many workplaces going forward and is highlighting the obsolescence risk to office and retail.

Collectively, these thematic drivers of demand underscore the importance—and necessity—of targeted investment selection in core real estate.

Core investing today

While real estate sectors such as industrial and residential still have some long-term growth potential due to the underlying factors driving demand, the traditional core areas of retail and office properties are set to become less prominent and will likely see significant capital value declines in this period of economic downturn. The shift towards non-traditional sectors continues to expand driven by the aforementioned DIGITAL themes.

A high allocation to sectors like retail and office can present a big risk. Many funds are committed to exposures of 30% or more in these sectors and, as a result, are ill-equipped to adjust to the impact of the fallout of an economic recession or long-term structural changes. Funds that have been able to identify structural themes should be well positioned to take measured, targeted opportunities in non-traditional property types. These include specialised sectors like data centres and health care which have gained significant investor interest since the pandemic but were long part of our investment framework given their favourable longer-term structural outlook. Thus, we believe these property sectors will become increasingly important to generate portfolio returns.

In addition to the potential for enhanced long-term performance, non-traditional sectors can also provide important diversification benefits, an increasingly dominant consideration in the current turbulent backdrop. While traditional offices are likely to follow the wider economic cycles, student housing, another specialist sector, is considered being a better investment option during times of recession since post-secondary enrolments tend to increase when job opportunities are scarce.

Despite the growth and developing maturation of non-traditional property types, correlations have remained low. For an income-oriented core real estate portfolio, the varying operating models of the underlying companies making up non-traditional sectors like data centres or student housing can help bring in important diversification benefits. Our analysis of 15-year correlations between traditional and non-traditional sectors supports this point, showing that many specialist sectors provide material diversification benefits to traditional real estate.

Exhibit 2: Non-traditional property types are portfolio diversifiers

15-Year Correlations	Apartment	Office	Retail	Industrial	Hotel	Self-Storage	Health Care	Manufactured Homes	Data Centres	Infrastructure
Apartment	1.000	0.844	0.812	0.671	0.705	0.711	0.768	0.762	0.396	0.492
Office	0.844	1.000	0.894	0.781	0.809	0.676	0.806	0.693	0.312	0.427
Retail	0.812	0.894	1.000	0.750	0.819	0.671	0.819	0.682	0.153	0.359
Industrial	0.671	0.781	0.750	1.000	0.630	0.681	0.718	0.693	0.651	0.556
Hotel	0.705	0.809	0.819	0.630	1.000	0.530	0.621	0.519	0.038	0.182
Self-Storage	0.711	0.676	0.671	0.681	0.530	1.000	0.707	0.690	0.472	0.490
Health Care	0.768	0.806	0.819	0.718	0.621	0.707	1.000	0.755	0.340	0.538
Manufactured Homes	0.762	0.693	0.682	0.693	0.519	0.690	0.755	1.000	0.530	0.512
Data Centres	0.396	0.312	0.153	0.651	0.038	0.472	0.340	0.530	1.000	0.661
Infrastructure	0.492	0.427	0.359	0.556	0.182	0.490	0.538	0.512	0.661	1.000

Source: NAREIT, Bloomberg, Principal Real Estate, November 2022

Additional considerations for core investors

For investors in core real estate, looking beyond traditional sectors for opportunity is one of several important factors to consider in 2023, in conjunction with geographical diversification, ESG, fund size and tax implications. Geographical diversification has the potential to provide essential benefits given the differences in individual countries, and it should be achieved by pursuing an exposure in line with the size of each market as this helps manage liquidity issues. From a geographical perspective, it's also important to understand how individual regions have been impacted by and are responding to critical challenges such as the heightened geopolitical tension between the NATO alliance and Russia, or the rising impact of extreme weather events. Since buildings are a major contributor to climate change, ESG policies and initiatives, including the implementation of carbon neutrality proposals, will remain a top priority for occupiers, landlords and investors. In real estate investing, ESG considerations can help to improve investment outcomes by aligning stakeholder interests, facilitating operational excellence, and reducing overall risk.

Actual fund size plays a critical role as well: very large funds may be unable to obtain the right exposure to the new industries benefiting from structural changes, a necessary requisite to perform well through the different phases of the economic cycles. Traditional sectors inheritance can be limiting large funds, with potential drag on returns. On the other side, smaller funds are agile enough to pursue alternative strategies, by gaining exposure to those sectors better positioned to benefit from the upcoming demographic and technological changes, including data centres, healthcare and student housing.

Tax considerations, within both countries and sectors, are another factor for investors to keep front-of-mind as policies evolve. The complexities of real estate tax policy can be challenging to comprehend, and as governments seek new areas for revenue generation, we anticipate the tax landscape will continue to evolve within individual countries but also for the EU as a whole.

In conclusion, several factors impact core investing, from non-traditional sectors' exposure, to geographical diversification, ESG, size and tax considerations. All these elements are not immutable, but rather evolve in line with the economic cycle. We believe that partnering with a fund manager who shares the right strategic framework and is nimble enough to implement it in sync with the macro environment can add great value to institutional investors.

Going forward

While COVID-19 and the war in Ukraine had a profound impact on the economy and capital markets, what hasn't changed is what makes a good investment: understanding an asset's covenants and the risks to income from that asset. Heightened economic uncertainty has made flexibility and the ability to react to take advantage of opportunities as they arise increasingly important. Rigid investment strategies will not work today or over the long term. By allocating to non-traditional and specialist assets, and maintaining less exposure to sectors where cash flows have been weak, we believe we are positioned to benefit from the changing thematic drivers in the real estate markets and withstand the ongoing global economic slowdown. In addition, our fund size grants us the ability to take advantage of pricing corrections, helping ensure that portfolio returns are maximised while maintaining the income-producing characteristics of a core real estate portfolio.

For more information on **Principal Real Estate's capabilities** in the European Core space, visit **PrincipalAM.com/real estate**.

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