Principal Asset Management℠

PRINCIPAL REAL ESTATE

Credit crisis? Why this time may be different for REITs

"Credit crisis" and "banking stress" are dominating headlines and creating uncertainty for capital markets. Real estate is a capital-intensive industry and depends on well-functioning capital markets to thrive.

We believe recent events will likely result in tighter lending standards and translate into lower credit availability and wider credit spreads for real estate broadly. While this is an unwelcomed event and investors likely recall memories of a tough credit crisis for REITs in 2008, we believe this time may be different and the large underperformance of REIT stocks due to credit market concerns is likely overdone.

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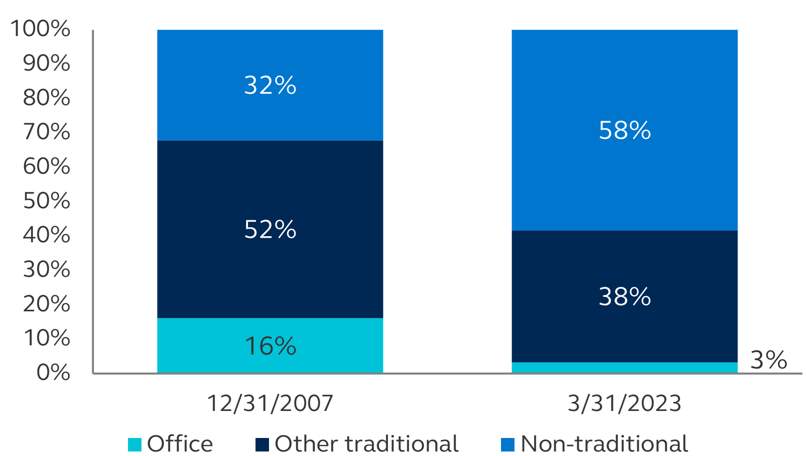
Exposure to traditional office space is only 3% of the overall U.S. REIT market

The office sector, and its struggles, are receiving large and warranted attention with the lasting impact from work from home and sluggish return to office trends. While office grabs the headlines and much of the negative sentiment towards real estate, it's a sector that barely moves the needle for the U.S. REIT market.

The drawdown of office stocks has been so great that it's only about 3% of the overall REIT market today. The public REIT market has changed drastically since the 2008 credit crisis. We believe the increase in non-traditional sectors (single family rental, self-storage, wireless towers, etc.) is a positive as many of these sectors have structural demand drivers to provide earnings resiliency in a more challenging macro environment. Non-traditional sectors continue to be targets of debt and equity capital allocators as well.

EXHIBIT 1: U.S. REIT sector exposure 2007 vs. 2023



As of 31 March 2023. Source: FactSet, NAREIT. 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. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. Percentages may not add up to 100% due to rounding.

REITs are less reliant on banking financing than commercial real estate broadly

REITs have well-diversified sources of capital given their listed status and generally strong balance sheets. In fact, REITs source over 85% of overall capital from listed unsecured bond and equity markets[1]. We estimate only 20-25% of total debt capital comes from banks versus approximately 35-40% for commercial real estate more broadly. When REITs are sourcing debt capital from banks, it's primarily in the form of term loans or revolvers using very large, well-capitalized banks. REITs typically do not source bank loans from regional or community banks.

REIT balance sheets are in a far stronger position than entering the 2008 crisis

The 2008 credit crisis taught some painful lessons for real estate investors, and it resulted in major balance sheet improvement by REITs in the last 15 years. The emphasis on deleveraging by REIT management teams gives them greater financial resiliency to weather a pullback in real estate capital markets and could potentially give them the flexibility to capitalize on any distressed opportunities.

EXHIBIT 2: U.S. REIT financial metrics: 2007 vs. 2023

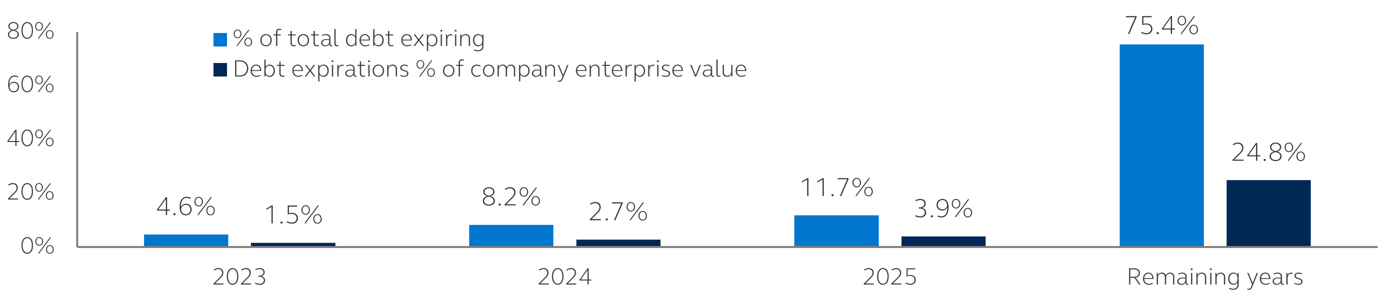
	12/31/07	03/31/23
Price to NAV	84.1	93.8
Company leverage (%)	38.3	28.1
% of total debt unsecured	48.4	76.0
Weighted avg. term to maturity	5.3 years	6.8 years
Interest expense as % of NOI	38.0	20.6
Interest coverage ratio (%)	2.7	4.6
Dividend payout ratio (%)	79.1	74.1

As of 31 March 2023. Source: FactSet, NAREIT.

A large refinancing wave is coming for U.S. real estate, but not for REITs

It's estimated $1.4 trillion of the $5 trillion (i.e., 28%) of U.S. commercial real estate debt outstanding expires in 2023 and 2024[2]. The percentage of debt expiring for U.S. REITs over this same time period is only 12.8% and remains modest in 2025 as well. Debt markets have remained open this year, with several companies issuing bonds, private placements, or securing mortgages. Property cash flow disruption and the inability to refinance is a concern for office, a sector with limited exposure in REIT markets.

EXHIBIT 3: U.S. REIT debt maturities over the next three years are manageable



As of 31 December 2022. Source: Principal Real Estate, Morgan Stanley, FactSet.

In summary, in an environment of increased risk, the stronger financial health of the REIT market and relatively modest exposure to office are important reasons why REITs may better weather any credit crisis storm that comes their way. This is perhaps misunderstood in the market as REIT stocks have lagged other equities by a large margin this year and trade at wide discounts to private real estate. The market's recognition of this dislocation could be the catalyst for REITs to be back in favor once again.

[1]Factset, NAREIT, 31 December 2022.
[2]Moody's . "What's the Real Situation with CRE and Banks: Doom Loop or Headline Hype", April 2023.

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. economic conditions. Investing in REITs involves special risks, including interest rate fluctuation, credit risks, and liquidity risks, including interest conditions on real estate values and occupancy rates. Asset allocation and diversification do not ensure a profit or protect against a loss.

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