Real Estate

Non-traditional property types are no longer niche - they are the future of commercial real estate

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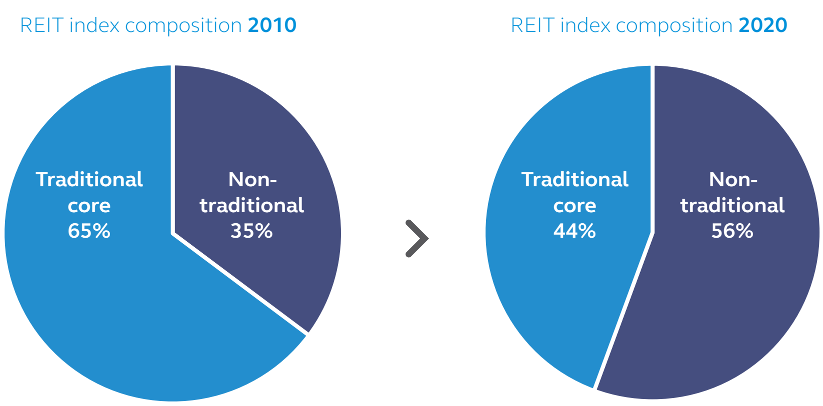
Executive summary

- REITs have spearheaded the growth of real estate investors into non-traditional property types. The U.S. institutional private real estate market is also rapidly expanding into these property types and we anticipate a material allocation to non-traditional properties in the future.
- We believe the rapid and significant adoption of non-traditional property types reflects a structural shift within the economy enabled by "DIGITAL" drivers of growth and demand, fueled further by the COVID-19 pandemic.
- The expansion of the universe should also allow investors to generate additional alpha by making conscious investment decisions on their strategies pertaining to non-traditional property types.
- Ultimately, the growth and assimilation of non-traditional property types will be a material benefit to the asset class, attracting additional capital, enhancing investment opportunities, and ensuring that investors will emerge as winners.

Historically, real estate institutional investors have allocated capital to five property types in the U.S.—office, retail, multifamily, industrial, and decreasingly, hotel. In recent years niche and emerging property types (herein referred to as non-traditional) have seen a significant increase in investor interest and capital allocated in both the public and private real estate quadrants. According to Real Capital Analytics, as of year- end 2020, alternative property types accounted for approximately 24% of all transaction volume in the U.S. and approximately 56% of total REIT market capitalization. Rapid growth and investment into these fast-growing property types that sit outside the traditional sectors of institutional real estate are clearly worthy of a deeper dive.

The listed REIT market has spearheaded the push into non-traditional property types (exhibit 1) greatly expanding the investment universe and improving the diversification outcome for investors. Many of the largest REIT companies by market capitalization belong to the non-traditional property type category, begging the question on whether the nomenclature makes much sense given how significant these companies have become within the index. Their stable and steady cash flows augment the growing case for inclusion in a real estate portfolio.

Exhibit 1: REITs sprearhead growth of non-traditional property types



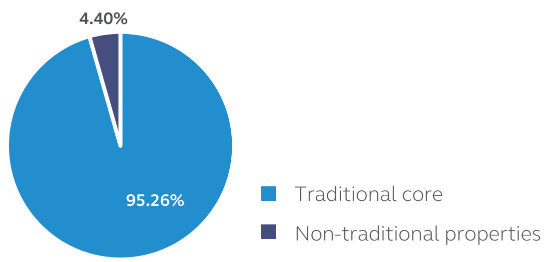
As of 31 December 2020. Source: FactSet, NCREIF, MSCI. NCREIF ODCE Index and MSCI US REIT Index. Traditional core consists of apartment, retail, office, industrial, and diversified (public market only). Non-traditional consists of specialized residential (public market only), self-storage, hotels & resorts, healthcare, net lease (public market only), data centers (reported within industrial in private market), and other. Due to rounding, figures and percentages shown may not add to the totals or equal 100%. May not reflect current allocations.

The private real estate universe is rapidly embracing non-traditional property types

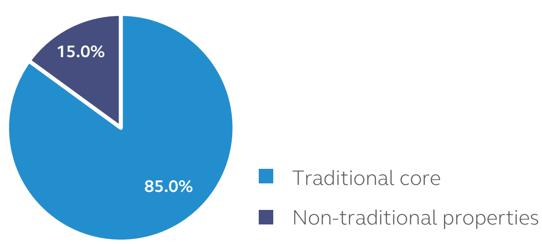
Although well behind the REIT market, the U.S. institutional private real estate market is rapidly expanding into non-traditional property types; the past couple of years has seen a significant uptick in investment into these property types. Currently non-traditional property types sit at 5%-6% within the widely followed National Council of Real Estate Investment Fiduciaries (NCREIF) ODCE index. Much of the index is concentrated in self-storage while data measurement for data centers, life sciences, etc. are still evolving. Other property types such as manufactured housing and single-family rentals are yet on the margins within private real estate but investor appetite for them is growing quickly. Our expectation is that on a conservative basis, non-traditional property types could comprise 15% of the ODCE index by 2030, a near tripling from current levels. This increase would still trail the experience of listed real estate and be quite comparable, for example, to the growth in the industrial sector in the ODCE index, which increased from approximately 14% in 2010 to around 20% in 2020.

Exhibit 2: Forecasted increase in non-traditional property types in the NCREIF ODCE index

2020 ODCE index composition



2030 ODCE index forecast



Source: NCREIF, Principal Real Estate, April 2021

The growth of non-traditional properties represents a secular shift in demand drivers

The rapid and significant adoption of non-traditional property types in both the listed and private real estate universe is not just a cyclical rotation: in our view, it reflects a structural shift within the economy wherein "DIGITAL" drivers have become the dominant drivers of growth and demand. The COVID-19 pandemic has further accelerated these structural changes, in some cases rapidly upturning how consumers and businesses behave and occupy space.

Our key DIGITAL drivers of demand—demographics, infrastructure, globalization, innovation, and technology—have a clear impact on the growth of non-traditional (and traditional) property types directly and indirectly given their sheer scale. But diving a little deeper, there are specific sub-themes within our broader DIGITAL framework that tie in directly to the rise of non-traditional property types and their increasing importance which we briefly spotlight below.

- **Demographics**: senior living, medical offices/labs space, single family rentals, manufactured housing, self-storage, affordable housing
- **Infrastructure:** data centers, logistics, warehouses
- **Globalization:** logistics, warehouses, last mile distribution, cold storage
- **Innovation and technology:** life sciences, lab space, medical office buildings

Listed REITs demonstrate that non-traditional property types benefit a traditional real estate portfolio

A critical issue for investors is to understand the benefits to portfolio diversification that non-traditional property types may bring to an existing real estate allocation. The early and rapid adoption of non-traditional property types in listed REITs provides a robust data set of performance metrics; this cannot yet be said for private real estate where data collection is evolving and does not yet offer the depth necessary to generate a high level of confidence in performance analysis. That said, major industry data providers such as NCREIF are rapidly expanding their collection of performance metrics for non-traditional property types and we anticipate near-term availability of robust data sets to examine their performance metrics.

Data from listed REITs indicates that non-traditional property types have delivered some of the strongest absolute returns over a 20 -year history (exhibit 3). Self-storage, health care and manufactured homes property types stand out for their strong absolute performance over nearly all time periods. The industrial sector is the only traditional property type to exhibit somewhat comparative performance over a similar duration.

Exhibit 3: Non-traditional property types have delivered some of the strongest absolute returns

	Traditional Properties					Non-Traditional Properties				
	Apartment	Office	Retail	Industrial	Hotel	Self-Storage	Health Care	Manufactured Homes	Data Centers	Infrastructure
Total Returns										
3-Year	4.6%	-2.0%	-2.9%	18.8%	-4.6%	9.5%	4.3%	18.6%	16.1%	22.1%
5-Year	5.7%	2.7%	-3.8%	20.7%	2.7%	4.6%	5.3%	16.8%	15.8%	19.8%
10-Year	9.1%	4.9%	5.1%	15.1%	4.1%	15.2%	7.0%	19.3%	N.A	N.A
15-Year	8.1%	3.4%	2.6%	5.6%	1.5%	12.7%	9.1%	14.3%	N.A	N.A
20-Year	10.9%	6.9%	8.9%	10.1%	4.5%	16.5%	12.3%	13.2%	N.A	N.A
Standard Deviation										
3-Year	20.9%	16.8%	31.7%	12.7%	36.3%	13.7%	26.8%	16.8%	16.0%	12.2%
5-Year	16.6%	15.0%	27.1%	12.8%	30.2%	17.6%	21.8%	14.5%	14.3%	11.2%
10-Year	16.3%	13.4%	22.9%	14.8%	25.7%	16.5%	18.5%	13.4%	N.A	N.A
15-Year	26.7%	25.9%	30.8%	28.6%	42.6%	21.4%	21.8%	19.1%	N.A	N.A
20-Year	24.2%	23.7%	29.1%	25.6%	39.3%	21.1%	24.4%	18.2%	N.A	N.A

Source: NAREIT, Principal Real Estate, May 2021

Correlation analysis further demonstrates the diversification benefit of adding non-traditional property types to a portfolio. While intuitively it would seem that return correlations between traditional and alternative property types would vary, the data does indeed confirm it (exhibit 4). Despite the growth and maturation of non-traditional property types, correlations have stayed low indicating the variability of business and operating models that are brought into a portfolio with purely traditional property types. In fact, it is the operating model of many of these underlying companies that helps bring in added diversification to a more traditional portfolio comprising of income-oriented real estate.

Exhibit 4: Non-traditional property types are portfolio diversifiers

15-Year Correlations	Apartment	Office	Retail	Industrial	Hotel	Self-Storage	Health Care	Manufactured Homes	Data Centers	Infrastructure
Apartment	1.0000	0.9093	0.8828	0.7158	0.7963	0.8108	0.8028	0.7762	-0.0586	0.2263
Office	0.9093	1.0000	0.8953	0.8283	0.9049	0.7092	0.8126	0.7088	0.1972	0.2902
Retail	0.8828	0.8953	1.0000	0.7524	0.8533	0.8028	0.8693	0.7020	-0.2919	0.0875
Industrial	0.7158	0.8283	0.7524	1.0000	0.6914	0.5870	0.6339	0.6525	0.5915	0.6334
Hotel	0.7963	0.9049	0.8533	0.6914	1.0000	0.5762	0.7256	0.5834	-0.2359	-0.0660
Self-Storage	0.8108	0.7092	0.8028	0.5870	0.5762	1.0000	0.6760	0.6219	-0.1652	-0.1540
Health Care	0.8028	0.8126	0.8693	0.6339	0.7256	0.6760	1.0000	0.5997	-0.1058	0.3320
Manufactured Homes	0.7762	0.7088	0.7020	0.6525	0.5834	0.6219	0.5997	1.0000	0.2216	0.4395
Data Centers	-0.0586	0.1972	-0.2919	0.5915	-0.2359	-0.1652	-0.1058	0.2216	1.0000	0.5532
Infrastructure	0.2263	0.2902	0.0875	0.6334	-0.0660	-0.1540	0.3320	0.4395	0.5532	1.0000

Source: NAREIT, Principal Real Estate, May 2021

Mirroring a similar analysis in the private real estate quadrant is hampered by lack of data but we can infer a certain degree of similarity between the performance of listed and unlisted real estate given the underlying operating and business models are the same. Data centers, self-storage facilities or single-family rentals for example, operate under similar models whether held in listed or private ownership. Most importantly, REIT historical data demonstrates that allocation towards non-traditional property types addresses two key investor requirements: performance and diversification which ultimately benefit portfolio construction.

Investors will be winners as non-traditional properties go mainstream

In our view, the mainstreaming of non-traditional property types is well on its way within institutional investing with several positive implications. Non-traditional property types will materially broaden the real estate investment universe and in turn attract a wider array of investors (fixed income and equities saw a surge of investor capital flows when they expanded their universes). Since the listed REIT market has blazed the path forward in expanding the horizon for real estate investors, we are likely to see greater cross-proliferation of investor appetite for the private and public formats particularly within the non-traditional property types. The public market already provides a great implementation option to access this market now and we believe a wave of private market options will exist in the future.

We also believe that the increasing investment into property types such as data centers, cold storage and last mile warehouses will further blur the lines between real estate and infrastructure thereby offering additional flexibility to investors. The shift and expansion of the universe should also allow investors to generate additional alpha by making conscious investment decisions on their strategies pertaining to alternative property types. Ultimately, we believe the growth and assimilation of non-traditional property types will be a material benefit to the asset class, attracting additional capital, enhancing investment opportunities, and ensuring that investors will emerge as winners.

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