Principal Asset Management[SM]

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Core-plus: Cautiously optimistic

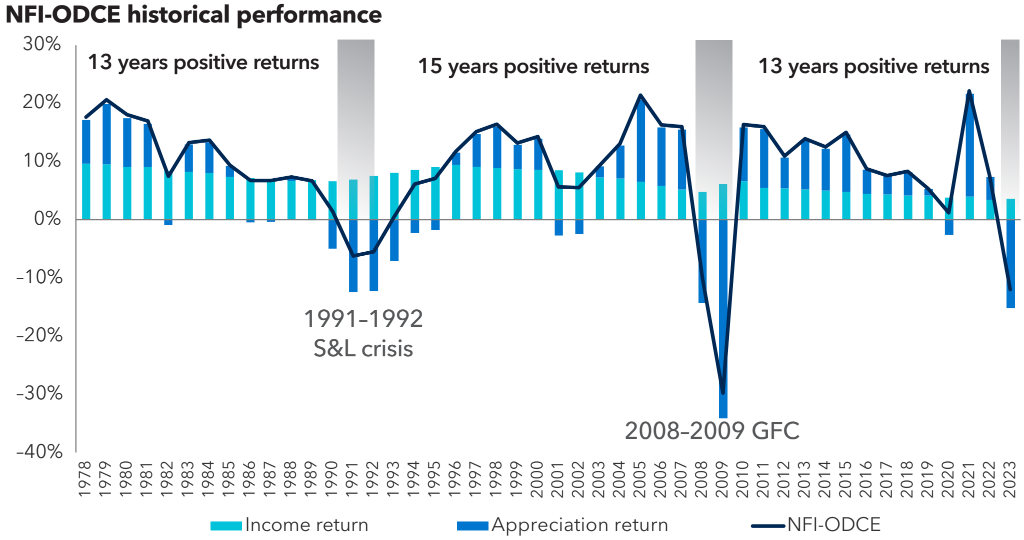
Chase McWhorter, Institutional Real Estate, Inc's managing director, Americas, recently spoke with **Todd White,** managing director, portfolio management, and **Art Jones,** senior director, real estate research, both with Principal Asset Management. Following is an excerpt of that conversation.

Core and core-plus funds have been in a period of value correction for some time now. When do you expect to see a bottom in values, and what should investors expect following that time?

Todd White: Principal Real Estate has been investing in core real estate for more than 40 years and core-plus real estate for 20 years. We have seen values declining for seven consecutive quarters in the NFI-ODCE index, essentially since the Fed began hiking interest rates back in 2022. Based on some recent transactions we have participated in during the second quarter, we believe transaction cap rates for newer assets in strong locations may have already peaked – meaning the values have bottomed – with the exception of the office sector. We expect to see this recent transaction activity reflected in the appraisal-based indices by the end of 2024. There is some softness in residential and industrial fundamentals from heavy supply deliveries, which could have a further impact on values. But we have seen a sharp pullback in new starts for those two property types, and I don't expect this to have a material valuation impact beyond 2024.

Looking at the 45-year history of that NFI-ODCE benchmark, there have only been five calendar years that have seen a negative total return, including 1990 and 1991, 2008 and 2009, and 2023. But following those first two corrections, the benchmark went on to post a 15-year and 13-year period, respectively, where every single calendar year had a positive total return, and the average annual total return in those periods was over 11 percent. We know history doesn't always repeat itself, but if interest rates are stabilising now or even moving lower, it seems reasonable to expect another long period of positive returns from the asset class, which we believe will begin in 2025.

NFI-ODCE historical performance



Sources: NFI-ODCE, NCREIF, Principal Real Estate, 31 December 2023

Do you think price discovery has improved across the various real estate sectors?

Art Jones: Yes, to some degree, we believe it has. The notable exception within real estate is the office sector. There is some work to be done there. We think that is going to take some time, likely the rest of this year and through 2025. The two property sectors that appear to have landed nearest pricing equilibrium in today's market are industrial and retail. The valuations for both sectors appear to have found stabilisation during the past several months, as investors seem to have taken values down to or near their cyclical bottoms. Though demand may appear nuanced, particularly for retail, the right properties today are providing solid operating fundamentals in terms of both occupancy and income performance.

We have also seen multiple multifamily transactions in the past 90 days that are pricing at initial yields in the high 4 percent to low 5 percent cap rate range based on our underwriting – well below what it would cost to borrow on these assets. Most of these transactions offer an attractive basis compared with reproduction costs today, and many of the buyers are not placing debt at closing. Among niche sectors, data centres remain among the most sought-after property type, but transaction activity remains limited. Single-family rentals, including built-to-rent, also have healthy profiles due to lack of affordability in the single-family for-purchase market, and they are also attracting renters by choice who are opting for a lower cost and higher amenity space than traditional multifamily rentals are offering today.

If inflation is sticky and borrowing costs remain high, how will that impact the industry?

Jones: In commercial real estate, the repricing cycle has been driven largely by capital markets and inflation, which has been facilitated by the Federal Reserve Bank's normalisation policy during the past two years. Elevated inflation has been a big part of that, and it has forced central bankers to keep rates higher for longer, which increases the risk of extending an already mature cycle of valuation declines across most property sectors. We had initially viewed 2024 as a transitional year for private equity and real estate valuations, with multiple interest rate cuts coming this year. At best now, we are looking at one cut this year, as opposed to the three we anticipated entering 2024. We believe this means debt-oriented strategies will remain favourable in 2024 and into early 2025, given higher interest rates and elevated maturities within the next 12 months. In private equity, we believe favourable valuations for well-capitalised investors, particularly where distressed investors overextended themselves during periods of low interest rates and are now looking for an exit strategy, will continue to create unique opportunities in some property sectors. The multifamily sector is one of the most prominent examples of this, where we see elevated maturities in 2024 and 2025. There was elevated borrowing in 2020 and 2021 at low interest rates.

White: This environment you're describing, where inflation is sticky and rates are higher for longer, favours equity portfolios that can generate higher levels of income and keep growing that income at a healthy pace, as well as those who have managed their leverage well and may have a lower-than-average borrowing cost locked in with fixed-rate debt.

In your experience, why do some investors prefer a diversified fund, whereas others prefer a sector-specific fund, such as a logistics fund or a data centre fund?

White: Nearly all the investors we speak with want a diversified real estate portfolio. The question comes down to whether they leave the entire sector allocation decision to the managers of the diversified funds or whether the investor has more influence on that sector allocation by picking a group of sector-specific funds, maybe in addition to some diversified funds. The answer to that often comes down to the size of the investor and their staff. Large investors with a dedicated real estate team will often have a base of diversified funds, while adding sector-specific funds with some of the marginal dollars to have more influence on those sector allocations. Whereas investors that may have fewer assets or a smaller staff often leave those decisions to the diversified fund managers.

Which investment themes are most appealing as you construct your diversified portfolios today? Which real estate sectors in the United States should benefit most when interest rates "normalise"?

White: Our favourite sectors today remain those that are focused on long-term structural drivers, such as technology, demographics and supply-chain reconfiguration. We believe data centres, residential and industrial continue to exhibit strong value over the long term. We see a generational opportunity to participate in the buildout of the data centre infrastructure needed to advance efforts such as cloud computing and artificial intelligence — and whatever technology comes next. Within residential, single-family rental appears best positioned based on the demographics and housing affordability challenges due to high mortgage rates and home prices. We believe industrial should continue to benefit from increasing ecommerce and supply-chain reconfiguration, which would include the onshoring and nearshoring of manufacturing facilities, such as the semiconductor factories we see popping up in Phoenix and Austin and the electric-vehicle factories in several markets around the country. If we look at demographics, senior housing and medical office are two other sectors that should have nice tailwinds from those demographics and benefit from the strong growth in the 70-plus age demographic for the next decade.

Jones: In terms of which sectors benefit from an interest-rate normalisation, this is going to be a different cycle. We do not see a return to the ultra-low interest rates we witnessed during or following the global financial crisis or the COVID-19 pandemic. What we are more likely to see is a return to a higher normalised rate environment, where the 10-year yield remains bound around that 4 percent range, which is its long-term equilibrium and where we would expect to see it. The sectors that require higher leverage ratios, such as residential, which Todd mentioned, and retail, will benefit most from that interest rate normalisation, along with sectors where development costs are elevated, such as data centres. Office has one of the highest leverage ratios of any sector and would normally benefit most from that normalisation. The sector, however, will continue to face secular challenges from hybrid work arrangements and weak occupancy for a prolonged period, which will keep valuations subdued. There will be structural challenges, going forward, and higher costs associated with that sector, as well. We don't see a significant rebound in office.

It's 2024, so we have to ask a question about artificial intelligence (AI). How are you using it, and what impacts do you see it having for your strategy?

White: Every conference has a session on AI, and it is coming up in a lot of our internal and external conversations this year. Principal Real Estate, specifically, has had a dedicated team to leverage data analytics and AI since 2020. That team includes seven dedicated professionals now, and they have helped us put five models into production, so far. Right now, our AI roadmap is designed to enhance capabilities in three key areas: risk management, investment strategy support and underwriting. In the longer run, we would expect it to have an impact on nearly everything we are doing — underwriting, valuation, research, lease management, architectural design, predictive maintenance, climate risk and mitigation. In terms of the impact on strategy, we are using a tool now to help with market selection and property-type allocations as we construct the portfolios. But perhaps the most exciting impact, so far, is the incredible demand AI is creating for data centre space and power. And as I mentioned previously, we really see this as a generational opportunity to participate in the buildout of that data centre infrastructure that is needed to advance the AI technology.

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ABOUT PRINCIPAL REAL ESTATE

Principal Real Estate is the dedicated real estate investment team of Principal Asset Management℠. Our knowledge and expertise span the spectrum of public and private equity and debt. Our specialised market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximise opportunities and find the best relative value on behalf of our clients. Visit our website at **www.PrincipalAM.com/realestate**

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