Principal
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Principal Real Estate

2024 Listed REITs Outlook

Expect outperformance this year

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Principal Asset Management℠

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OVERVIEW

REITs – nearing an inflection point

After lagging equities the past two years, REITs offer an attractive investment opportunity in 2024. The headwind of higher bond yields and central bank rate hikes is likely to abate and may turn into a tailwind if our view about an impending economic slowdown and decelerating inflation trends is correct.

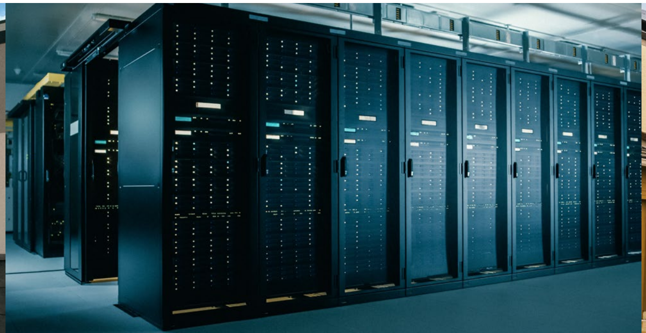
Peaking or falling yields have historically been a catalyst for strong REIT market outperformance. With durable and visible cashflows from staggered lease renewals phased over multiple years, REITs provide defensiveness against sharp earnings declines as the economy slows. The prospect of lower interest rates is an additional tailwind for this capital intensive, longer duration market.

Clear evidence of a growth slowdown and moderating inflation has increased our conviction that global central banks are nearing the point of peak rates and will need to start cutting by mid 2024. Wage growth and the American consumer showed more meaningful signs of deceleration in Q4 ‘23. In Europe, economic surprise indices have been in negative territory since May 2023, while China appears to be flirting with deflation.

REITs screen cheap relative to public equities, trading at EV/EBITDA multiple spreads over one standard deviation away from long-term averages. The discount against public equities compares to levels seen during the global financial crisis (GFC).

Public REITs also look like good value against private real estate. U.S. REIT share prices are implying meaningful cap rate expansion versus private real estate across major sectors.

Property sectors with resilient, structurally-driven demand dominate REIT markets and should hold up better during a recession. These sectors address the demands of a changing economy and society and offer attractive long-term growth. We prefer sectors with such defensive growth attributes.

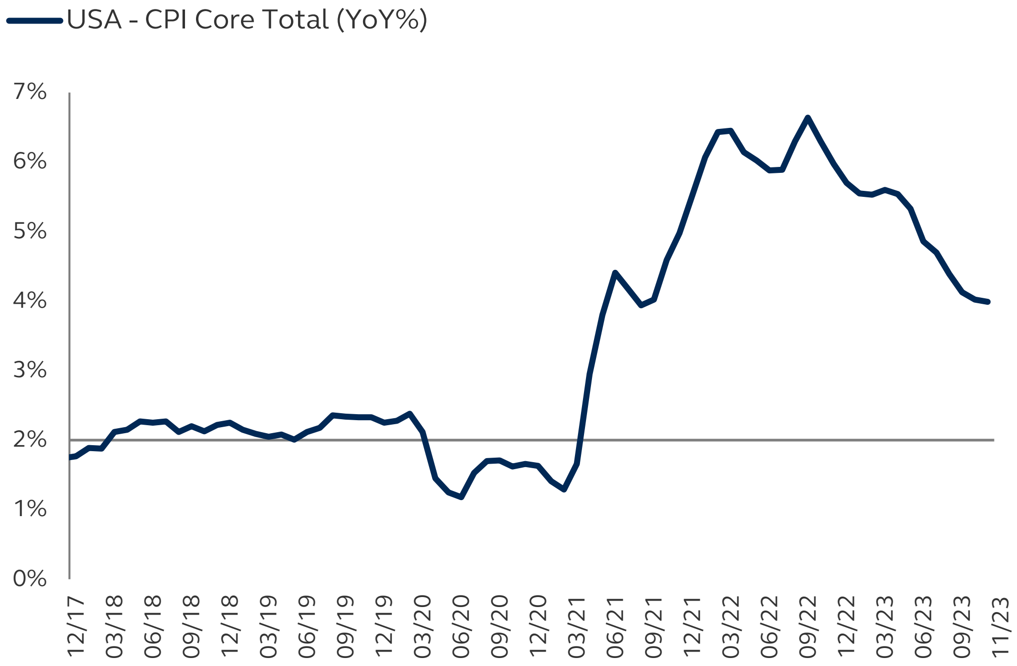


Inflation is waning and U.S. leading economic indicators strongly suggest a recession is approaching. The rate hike cycle is at or near its end.

There are encouraging signs that the steep central bank rate hikes are starting to bear fruit. The U.S. economy has started to show more marked signs of deceleration in the fourth quarter of 2023. Leading economic indicators are now in recessionary territory and the labor market is cooling more visibly.

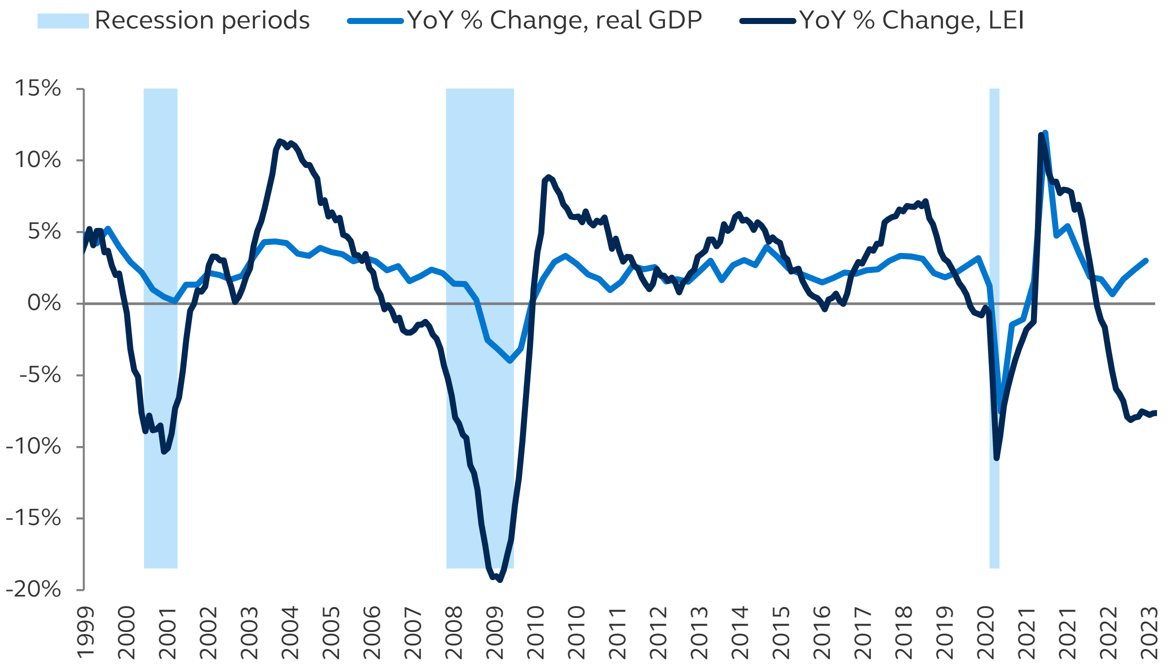
Meanwhile, the downward trend in core CPI inflation ex food and energy looks very encouraging. All these suggest that interest rates have likely peaked or that we are much closer to the tail end of rate hikes than ever before. We are expecting a sharper slowdown, if not recession, in the U.S. in 2024 as the delayed impact of higher interest rates and bond yields takes effect.

U.S. core CPI (less food and energy) has moderated meaningfully



As of 30 November 2023. Source: FactSet.

The Conference Board's lead economic indicators are in recessionary territory



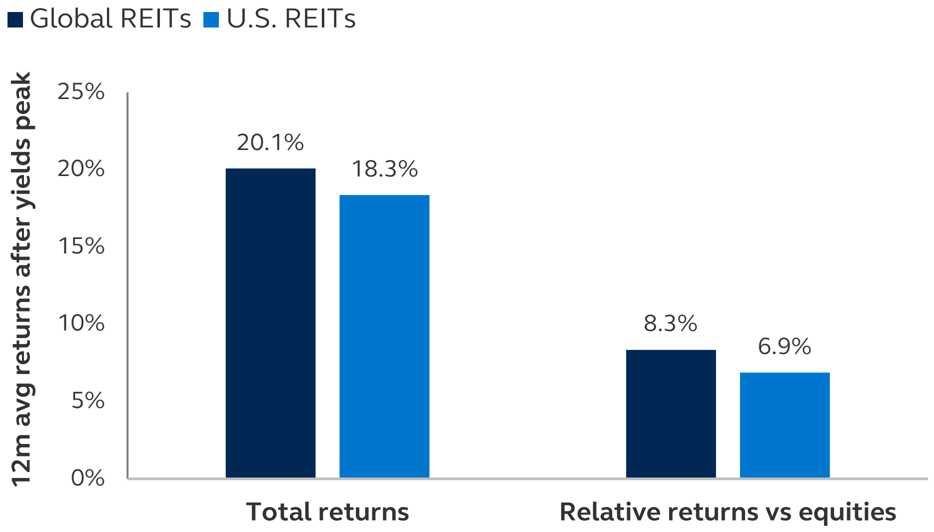
As of 30 November 2023. Source: The Conference Board Leading Economic Indicators, National Bureau of Economic Research (NBER), FactSet

The peak or fall in interest rates is historically a significant catalyst for REITs.

As real yields peak, the prospect of falling interest costs and lower discount rates provide meaningful tailwinds for the capital intensive, long duration REIT market. Historically, REITs have delivered strong positive returns and against equities in the 12 months after real yields have peaked.

We believe the 1999-2003 Fed Fund cycle, accompanied by a mild recession, provides a possible road map for REIT market behavior for the current cycle. REIT stocks started their rally during the Fed pause in 2000 and continued to outperform materially as the Federal Reserve cut rates.

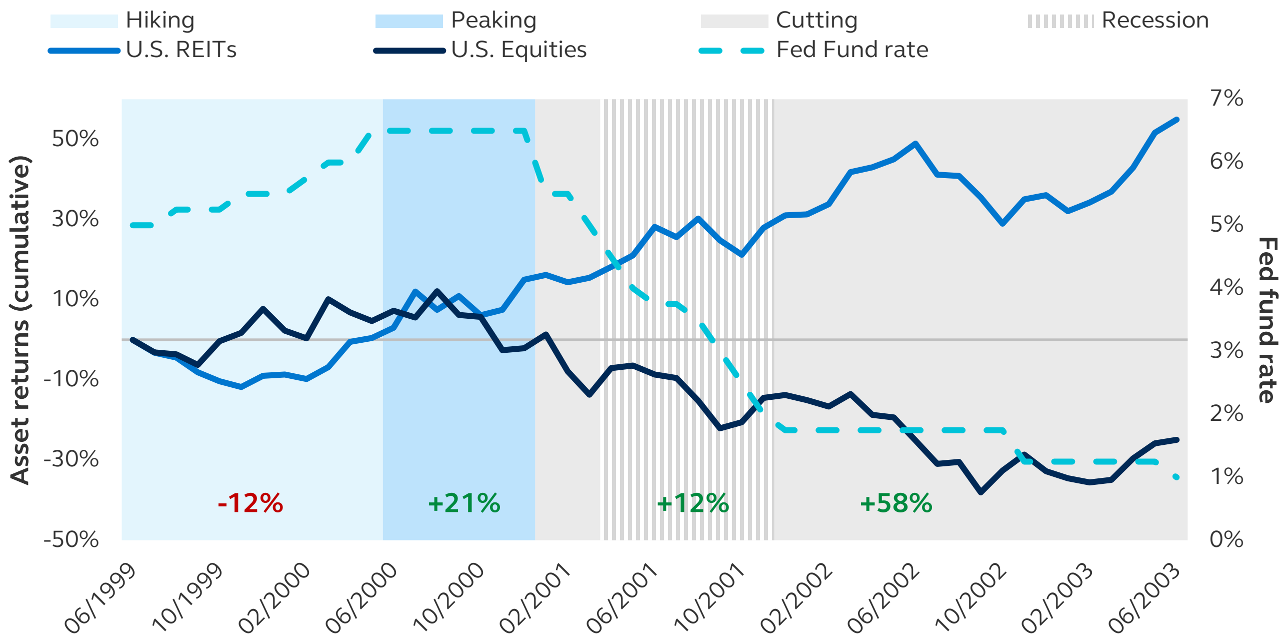
REITs outperform after real yields peak



As of 31 December 2023. Source: FactSet. Returns data is showing FTSE EPRA/NAREIT Developed index (global REITs) average cumulative total returns and excess returns over the MSCI World (global equities) and FTSE NAREIT Equity REITs (U.S. REITs) over the S&P 500 (U.S. equities) during the last 8 periods of rising real yields (an increase of at least 75 bps represented by the US 10-year TIPS) and during the 12 months after the peak of the rising rate period. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

Returns during the 1999-2003 Fed Fund rate cycle

(Red/green data labels show REIT returns relative to equities at each phase)



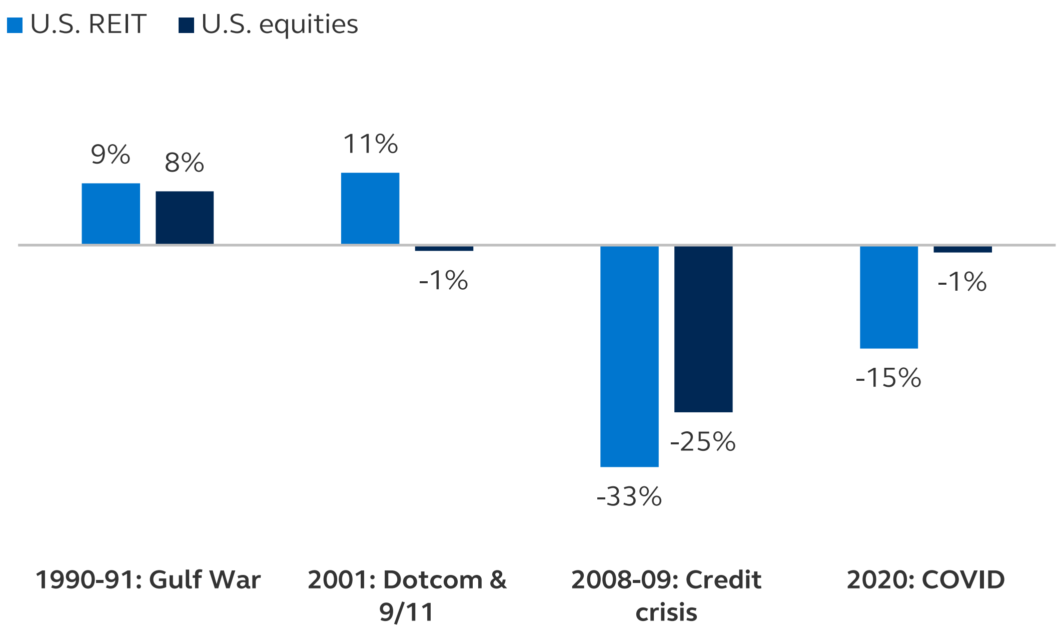
Source: National Bureau of Economic Research (NBER), FactSet. NBER was utilized to identify past recessions. Returns represented by FTSE NAREIT Equity REITS (U.S. REITs) and S&P 500 (U.S. equities) indices. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

REITs have outperformed during conventional recessions, with recent crises more the exception than the norm.

REITs provide defensiveness with durable and visible cashflows from staggered lease renewals phased over multiple years. This should buffer against sharp revenue declines, drawing investors to these long duration stocks as interest rates peak on more visible signs of an economic slowdown. Conversely, more economically sensitive companies in the broader equity market could lose pricing power in a downturn.

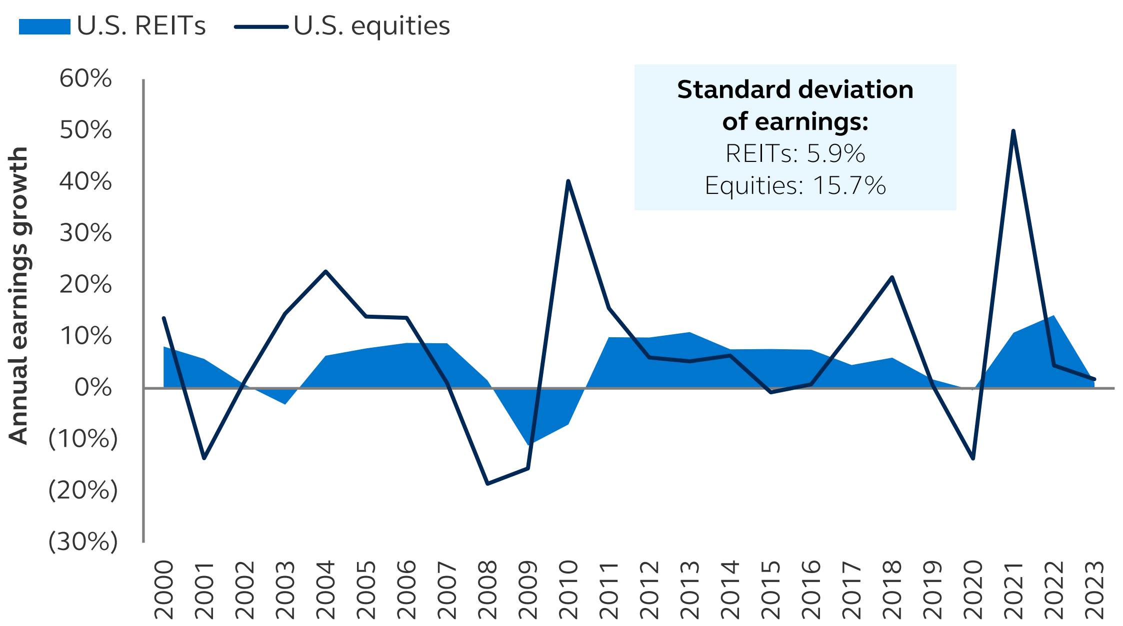
The COVID and GFC crises were more the exception than the norm. REITs have proven to be defensive during the more “normal” recessions experienced over the past 35 years.

Average annualized returns during U.S. recessionary periods since 1990



Source: National Bureau of Economic Research (NBER), FactSet. NBER was utilized to identify past recessions since 1990. Returns data is showing average annualized returns realized during these recession periods from the FTSE NAREIT Equity REITS (U.S. REITs) and S&P 500 (U.S. equities) indices. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

REITs have had lower earnings volatility than equities with better cashflow visibility



As of 21 November 2023. Source: Raymond James

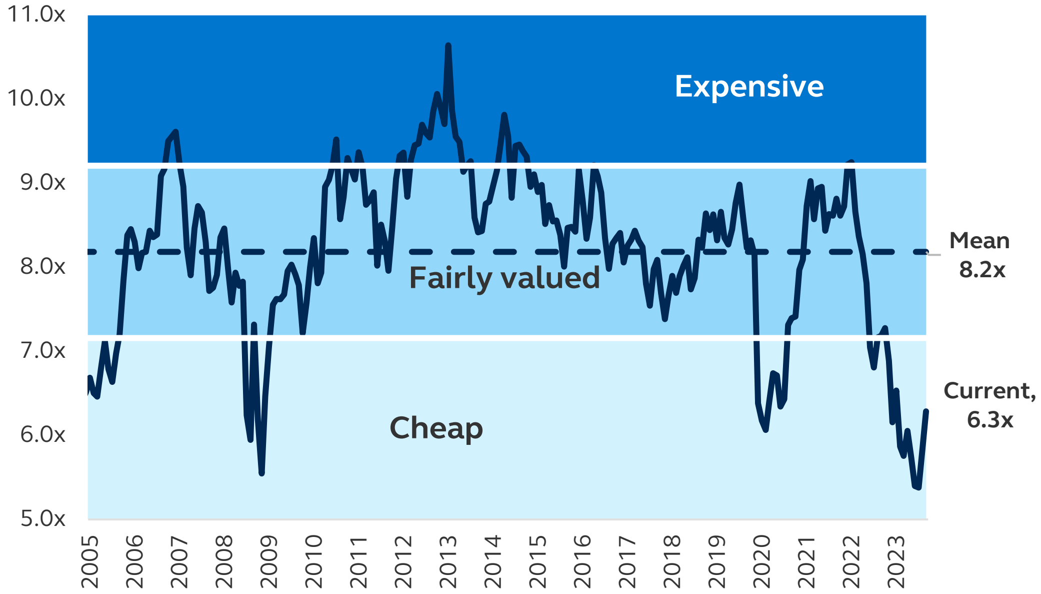
Valuation in favor: REITs are now looking cheap against equities and private real estate.

Against public equities, the earnings multiple discount is near historical lows. Such large discounts have historically been a harbinger of an extended period of strong relative performance against equities going forward.

Current REIT implied cap rates offer an attractive yield pickup over private real estate, which has been much slower to correct given appraisal-based valuations and limited price discovery in today's transaction markets.

While the absolute direction of REITs is less certain, we have conviction that on a relative basis, public REITs should outperform both public equities and private real estate at these valuation levels.

REITs now trade at EV/EBITDA multiple spreads relative to equities in excess of one standard deviation from long term averages



As of 31 December 2023. Source: FactSet. Enterprise Value (EV) to EBITDA price multiples are used to measure valuations. The spread plotted is the EV/EBITDA of the FTSE EPRA/NAREIT Developed index minus the EV/EBITDA of the MSCI World index. Expensive and cheap valuations are represented by spreads higher or lower than one standard deviation from the mean, respectively. Fair value is represented by valuations between one standard deviation from the mean.

The large divergence in private and public real estate cap rates favors REITs

	U.S. private real estate *NCREIF NPI appraisal cap rates*	U.S. REITs *Implied cap rates*	*Differential* *REITs minus NPI*
Apartment	4.1%	6.1%	***+2.0%***
Industrial	3.9%	4.4%	***+0.5%***
Office	5.6%	8.7%	***+3.1%***
Retail	5.4%	7.1%	***+1.7%***

As of 31 December 2023. Source: Principal Real Estate, NCREIF, GreenStreet. U.S. REIT implied cap rates sourced from GreenStreet Advisors as of 12/31/23. NPI cap rates as of 09/30/2023. Retail implied cap rate is an average of shopping center and mall companies.

Property sectors with lower economic sensitivity and resilient, structurally-driven demand should outperform amidst the prospect of an economic slowdown in 2024.

The public REIT market experienced significant transformation over the last 10 to 15 years and is no longer dominated by traditional sectors such as office and retail. Instead, a proliferation of non-traditional sectors has taken over. The structural tailwinds experienced by these non-traditional sectors will drive above average long-term cash flow growth enhancing the resilience of the REIT asset class during a downturn.

Our bottom-up approach favors a number of these alternative sectors given the favorable growth characteristics and attractive relative valuations.

A few examples of property types experiencing favorable structural demand drivers

	2024E earnings growth	2025E earnings growth	Structural tailwind outlook
Industrial	0.9%	12.3%	E-commerce sales growth which generally requires 3x the warehouse footprint versus brick & mortar sales.
Towers	2.0%	4.0%	Exponential long-term growth expected in mobile data usage and bandwidth demands.
Data centers	5.9%	7.4%	Rapid growth in technology infrastructure to support Artificial Intelligence, cloud storage demand, network densification, e-commerce, etc.
Healthcare	6.8%	7.8%	Long term needs-based demand with an aging U.S. population (especially +80yr old cohort). Muted supply trends.
Single-family rental	6.4%	4.8%	Large and widening home affordability gap between owning and renting. Aging millennial demographic supports demand for single-family rental.

As of 31 December 2023. Source: FactSet, Principal Real Estate. Expected earnings growth represents year-over-year growth in FFO per share. There is no guarantee that any forecasts made will come to pass. It should not be relied upon solely to make investment decisions.

Caveats to our expectation of REIT outperformance in 2024

1 A strong economy and sticky inflation scenario could cause REITs to lag equities.

If growth continues to hold up with inflation sticky, interest rates will stay elevated or go higher and REITs could underperform relative to general equities.

2 A recession triggered financial crisis is especially bad for REITs.

The worst-case scenario is that of more banking troubles akin to those from early 2023 metastasizing into a full-blown banking crisis. In this tail-risk event, the capital intensive real estate industry, including REITs, will come under pressure.

3 Should a harder economic landing materialize, equity market pullbacks are likely and investor patience might be necessary, but investor rotation into defensive equities would benefit REITs.

With equity markets today anticipating either no recession or a very shallow one, all forms of equities including REITs may suffer short-term selling pressure if expectations shift toward a moderate or deep recession. We believe it's likely REITs still outperform equities as yields are likely to go lower.

Source: Principal Real Estate, December 2023. These are the current views and opinions of Principal Real Estate and is not intended to be, nor should it be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.

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