Opportunities in private debt

Private real estate fixed income investments continue to have many characteristics that investors find attractive. In addition to providing income, private real estate debt can offer relatively low volatility and limited correlation with other asset classes. Scott R. Smith, Managing Director, Portfolio Management, recently moderated a panel of experts from Principal Real Estate to discuss current opportunities in these markets, specifically in core commercial mortgages, construction loans, and higher yielding commercial real estate debt. Following is a summary of their conversation.

SCOTT R. SMITH
Managing Director,
Portfolio Manager

DAN DICKMAN
Portfolio Manager

SARA PEDERSON
Investment Manager

TROY KORT, CFA
Portfolio Manager

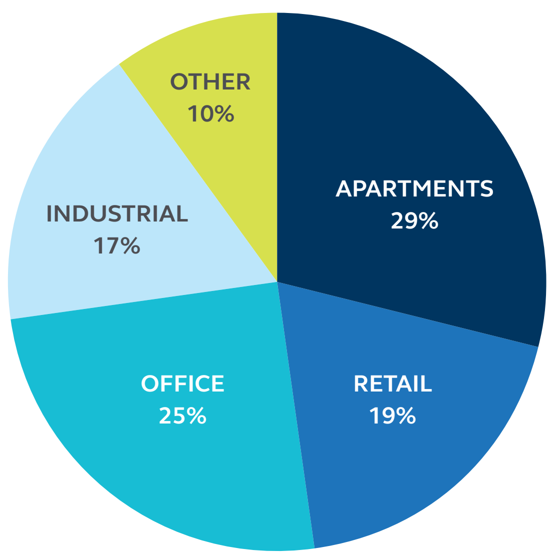
Core mortgages remain an important part of institutional portfolios

Dan Dickman spoke about the importance of core commercial mortgages to investor portfolios. This is particularly true for institutional investors, such as insurance companies, that need fixed income as part of asset/liability matching strategies. For example, life insurance company portfolios currently have about 12% of their investment in mortgages, the vast majority of which are in core senior loans.

A commercial mortgage loan (CML) includes both commercial properties, such as shopping centers, as well as multifamily properties. The property type weightings for insurance company mortgage portfolios are similar to the overall universe of investable properties, but in general insurance companies hold less office exposure and more of everything else. Their portfolios include sectors like hotels but have also more recently focused on non-traditional or specialist areas such as life sciences, data centers, self-storage, and manufactured housing. But most assets remain in the office, industrial, retail, and multifamily sectors.

Loan size within these portfolios is driven by the size of the property, as well as by the property's age and other factors. During the second quarter of 2021 the average loan size was about $22 million, with the vast majority of investments falling between $10 million and $75 million.

Exhibit 1: Property types in insurance company commercial mortgage loan portfolios



Source: American Council of Life Insurers, Q1 2021

The potential benefits of commercial mortgages

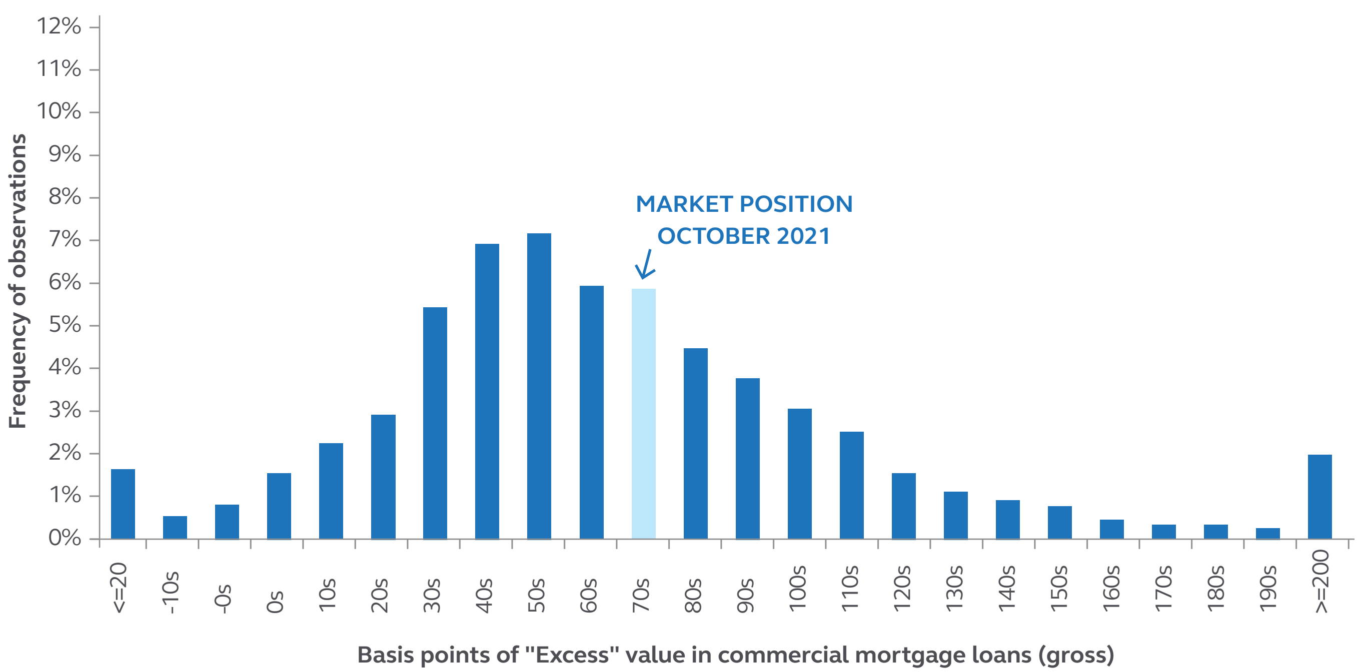
Commercial mortgage loans provide a host of potential benefits for investors. Current income is appealing to many institutional investors, as is the limited correlation of returns to other asset classes. These loans historically have had less return volatility and tend to be strong credit performers, too.

An additional attribute of private commercial mortgage lending is the lack of non-affiliated credit risk ratings. Most of these loans are not rated by third-party ratings agencies, however, investment managers frequently assign ratings to investments based on historical experience.

Arguably the most important attribute of core commercial mortgage loans is their relative value. Earnings on core commercial mortgage loans tend to be between 30 and 80 basis points higher in most market environments than for yields on comparable quality corporate bonds. While the cost to originate and manage commercial mortgage loans might be higher than corporate bonds, this higher yield provides an attractive premium.

Exhibit 2: Relative value at market-clearing: CML spread premiums observed since 2000

5 & 10-YEAR TERMS, BBB+ EQUIVALENT & BETTER, CLASSES & TIMES WEIGHTED EQUALLY, ANNUAL EFFECTIVE YIELD BASIS



Source: Barclay's, Aladdin, and Principal Real Estate, October 2021

Additionally, over the past 20 years real estate debt returns an average of 5.87% with a 5.72% income component.[1] These returns are in line with the income returns from real estate equity and better than income returns from corporate debt or corporate equity.

[1] Source: NCREIF-NPI, S&P, Giliberto-Levy, Bloomberg Barclays, October 2021

Construction lending: Features, opportunities, and risks

Sara Pederson shared her views on obtaining higher yields through construction lending, a space Principal has been investing in for more than 30 years.

Construction loans can be fixed or variable rate, and short- or long-term in duration. Typically, they will have a construction phase as the project launches followed by a permanent phase that can last 20 or more years. Most core construction loans have a loan to cost (LTC) ratio in the 55%–70% range, and lenders can typically expect a spread premium of about 25 to 75 basis points over a comparable core commercial loan.

Construction loans have several standard features. First, the lender most often does not fund the loan until the borrower has its entire equity invested in the project. For example, for a 60% LTC apartment construction loan, the borrower must spend 40% of the cost by the time the lender funds the loan. Loans are typically funded monthly over the construction period and interest is accrued to the loan balance prior to the property breaking even. Requiring the loan to remain “in balance” helps ensure that there are enough funds to complete the project. So if costs go up during construction or the borrower decides to add additional units or features, the lender can require additional equity from the borrower. Finally, the lender for a construction loan typically requires a completion guarantee from the borrower, which will resolve once the lender gets confirmation of project completion.

Construction loan risks include the time it takes to complete a project, as well as the possibility of budget issues arising. Because these are non-stabilized assets, there is a heavy reliance on developers during the construction process but also to lease the property once complete. These loans require highly experienced underwriting, asset management, and construction expertise. However, as noted previously, these loans can create higher returns for investors compared to core loans. These loans can also be easier to access than other loan types and when the project is complete, they are top of the market assets.

In addition to core construction loans, borrowers can access other types of construction lending products. Mezzanine or preferred equity loans are often shorter term than core construction loans, with lower relative returns depending on the property type and the loan provisions. This product can be more difficult for borrowers to secure due to senior lender hesitations to allow mezzanine financing. This type of loan will also increase LTC, sometimes up to 90%. Another financing option is a participating construction loan, which is attractive for developers who wish to avoid an equity partner and work with a separate core lender. This loan structure can take the LTC ratio up to 90%, but it does offer a mechanism for the lender to participate in a minority interest of cash flow and sale proceeds after construction is complete.

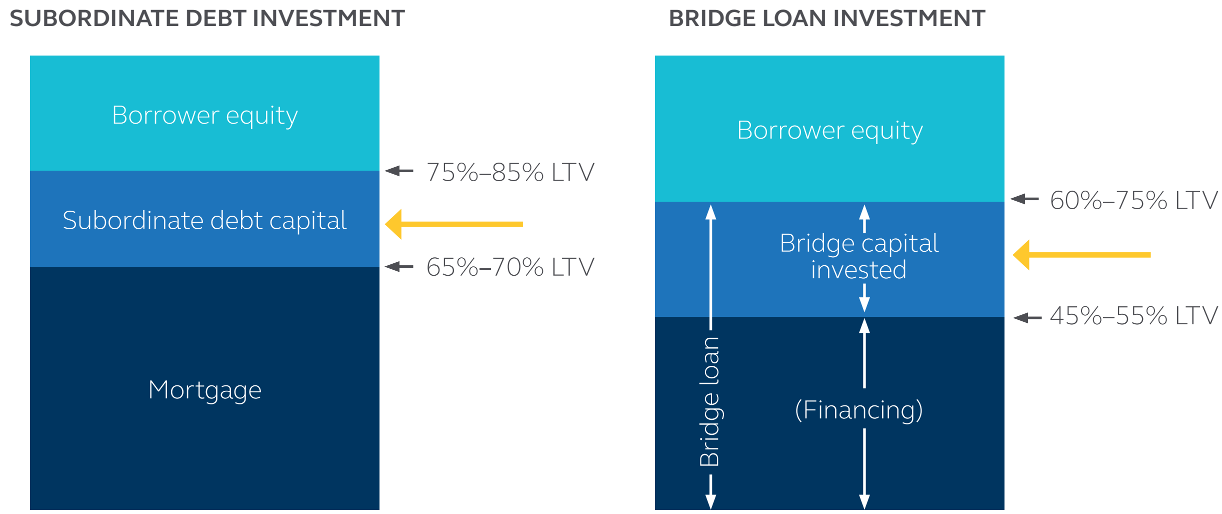
Exhibit 3: Common features of a construction loan

- Equity requirement from borrower
- Loan dollars funded on a monthly basis over the construction period
- Interest is accured to the loan balance prior to property achieving breakeven
- Borrower required to keep loan in balance during construction
- Completion guaranty required, but not repayment guaranty

Bridge lending and subordinate debt

Troy Kort joined the conversation to discuss two additional types of private credit: subordinate debt and bridge lending. A subordinate debt investment sits between a securitized mortgage and direct borrower equity in the capital stack. Yield drivers can vary with subordinated debt, as no two investments hold the same composition and property quality (e.g., location and improvements). Most subordinated debt is done in the form of mezzanine loans.

Exhibit 4: Commercial real estate private credit: Location in the capital stack



Source: Principal Real Estate

Bridge loans are generally floating rate, senior mortgages on assets where the borrower wants to execute a business plan (renovations, lease-up, etc.) and then either sell property or refinance with permanent debt. The fund manager applies leverage to the bridge loans to achieve the targeted yields. The capital invested is the difference in the bridge loan and the financing amount.

The types of financing used includes credit facilities, collateralized loan obligations (CLOs), and the sale of a senior portion of the debt.

Why invest in private real estate debt?

The potential benefits of private credit commercial real estate strategies include:

- A low duration risk, as 80% to 90% are floating rate
- The assets are also secured by real assets and the borrower's credit cushion can help reduce the risk of loss
- These assets can outperform equities in certain scenarios and offer higher relative yield than corporate debt, and
- Downside risk can be mitigated by loan structure and returns are not reliant on the appreciation of property valuations.

Finally, it's important to keep in mind that debt is inherently defensive in nature, and that real estate debt can help provide a reliable source of lease-driven cash flows for investors. In the current environment, where inflationary pressures are rising, floating rate debt can help hedge against rising rates. Selecting a manager with the tools to navigate this evolving environment can help investors protect their portfolios and generate new opportunities for alpha.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is not a guide to future returns. Fixed Income investments are subject to interest rate risk; when interest rates rise, the price of debt typically declines. 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. Commercial mortgages are subject to the basic risk of lending and direct ownership of commercial real estate mortgages - borrower default on the loan and declines in the value of the real estate collateral. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Subordinate Debt may or may not include loans that are not secured by interests in the underlying real estate but share all of the risks similar to senior commercial mortgages and in addition, the subordinate debt lender will not have the primary security interest in the real estate collateral that increases further the risks of subordinate debt lending.

Important information

Unless otherwise noted, the information in this document is accurate as of December 2021. This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This material may contain ‘forward looking’ information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- Europe by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited (“PGIE”) or Principal Global Investors (EU) Limited (“PGI EU”) will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
- United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority (“FCA”).
- This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
- United Arab Emirates by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation.
- Singapore by Principal Global Investors (Singapore)Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act (Chapter 289). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- Hong Kong SAR (China) by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- Other APAC Countries, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

MM12604 | 12/2021 | 1945019-120121