Real Estate

Principal[™]

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



Author: Indraneel Karlekar, Ph.D.

Senior Managing Director, Global Head, Research & Strategy

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.

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

- 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 nontraditional 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.

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

REIT index composition 2020

REIT index composition **2010**

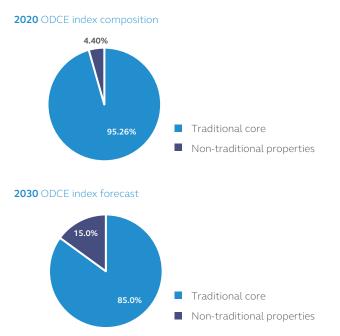


As of 31 December 2020. Source: FactSet, NCREIF, MSCI. NCREIF ODCE Index and MSCI US REIT Index. Traditional core consists of apartment, retail, office, industrial, and diversified (public market only). Non-traditional consists of specialized residential (public market only), self-storage, hotels & resorts, 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



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 nontraditional 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.

	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		

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

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.

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

Exhibit 4: Non-traditional property types are portfolio diversifiers

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 nontraditional 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. For Public Distribution in the U.S. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in Permitted Jurisdictions as defined by local laws and regulations.

Risk Considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. 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.

Important information

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.

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 intent for use 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. United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA"). 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 niFID). 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.

- In Dubai 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 organization. This document is intended for sophisticated institutional and professional investors only.
- Singapore by Principal Global Investors (Singapore)Limited (ACRAReg. 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 License No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- Switzerland by Principal Global Investors (Switzerland) GmbH.
- 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.

Principal Funds are distributed by Principal Funds Distributor, Inc.

© 2021 Principal Financial Services, Inc. Principal, Principal and the symbol design and Principal Financial Group are trademarks and service marks of Principal Financial Services, Inc., a member of the Principal Financial Group. Principal Global Investors is the asset management arm of the Principal Financial Group. Principal Real Estate Investors is a dedicated real estate investment management group within Principal Global Investors.

MM12199 | 052021 | 1654939-123122