Real Estate

Development offers outsized opportunities in the U.S. housing market

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Executive summary:

- Generational changes to the U.S. population are intersecting with COVID-19 creating sustained demand in the residential sector that will have long tailwinds.
- A substantial shortage of housing, coupled with rising affordability issues, are generating significant demand for rental real estate, which has expanded beyond traditional apartments to include single-family homes, manufactured housing, and built-to-rent units.
- The demand for residential real estate has also shifted into high gear among investors who recognize the acute need for housing and the increasingly broad swathe of options the sector can offer renters.
- Markets that sit at the cross-roads of demographic change and "DIGITAL"[1] growth drivers offer some of the most compelling long-term investment opportunities in the residential sector.
- We believe that development strategies offer the best risk-adjusted opportunities within the residential sector by generating significant return premium over core, stabilized assets. Further, a development-oriented approach offers the ability to:
  a) Tailor assets and formats to meet shifting tenant profile, including more ESG-related amenities and,
  b) Meet and exceed inflationary pressures by covering increasing material and labor costs via increased stabilized asset values.

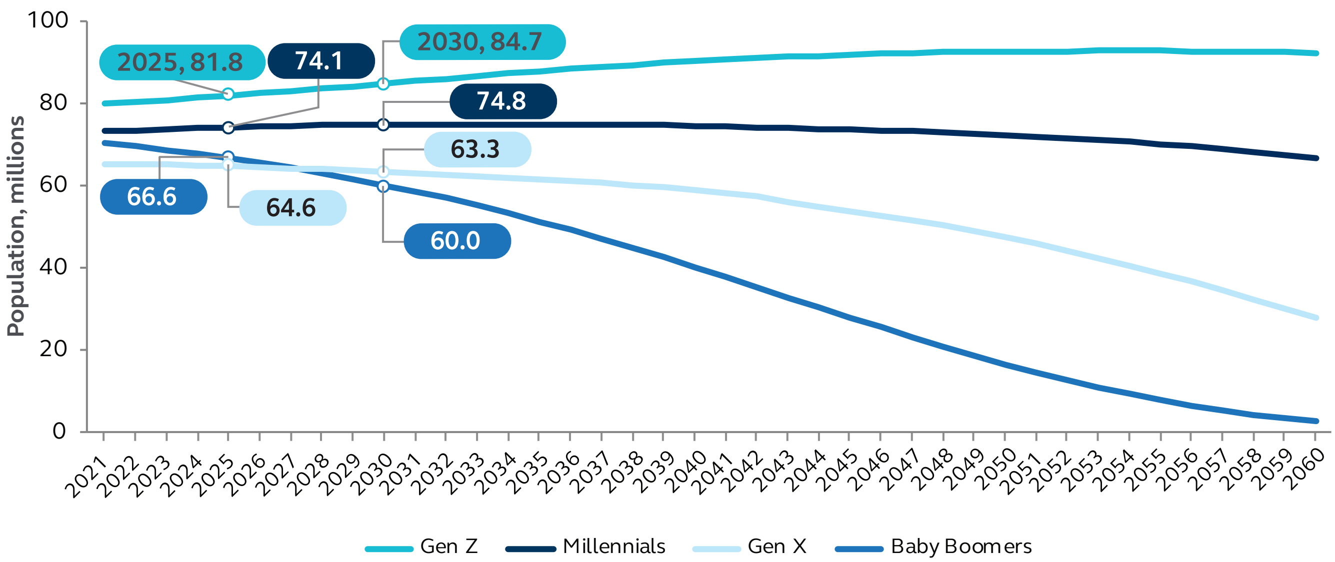
[1] DIGITAL refers to key long -term growth drivers centered around demographics, innovation, globalization, infrastructure, and technology that Principal has identified as metrics of long-term market outperformance.

Shifting demographic patterns intersect with COVID-19 to set up sustained residential demand

The U.S. economy is undergoing a demographic shift as the post-war (baby-boomer) generation exits the workforce. By 2025, population projections from the U.S. Census Bureau indicate there will be 66 million baby boomers and 140 million millennials and members of generation Z, with the latter entering peak rental years and the former requiring more varied housing options (Exhibit 1).[2] While this structural shift has been underway over the past decade, COVID-19 disrupted the labor market substantially, putting millions out of work, particularly millennials and members of generation Z. In fact, 32.8% of young adults, 24.3 million people between the ages of 18 and 34, were living at home in 2021.[3] With the pandemic receding and the labor market rapidly recovering, the structural shifts are resuming and, along with some changes brought about by COVID-19, triggering a material increase in residential demand across much of the U.S.

Exhibit 1: Millennials and Gen Z's are now the dominant demographic groups

Projected population by generation



Source: U.S. Census Bureau, Principal Real Estate Investors, 2021
Projections for the United States: 2017 to 2060.

As a result of the generational demographic shift, the renter pool has expanded along with the income composition of the groups looking to enter various segments of the rental market. A key feature of the U.S. economy has been wage stagnation over the past two decades, which has increased household income inequality. Over 65% of U.S. households have an annual income of under $100,000[4]—a segment where housing supply is stretched but demand remains very strong (see Exhibit 2). This "middle-income" segment of the U.S. offers a large, growing, and important target set for residential investment.

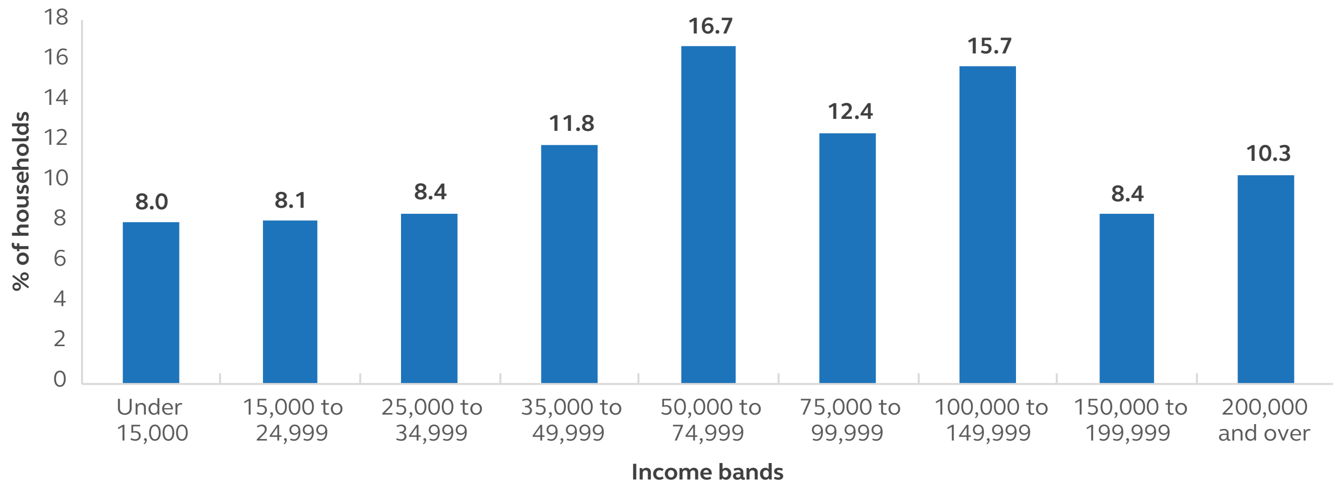
[2] https://www.census.gov/data/datasets/2017/demo/popproj/2017-popproj.html

[3] U.S. Census Bureau, Historical Living Arrangements of Adults, https://www.census.gov/data/tables/time-series/demo/families/adults.html, November 2021.

[4] According to calculations by Principal Real Estate Investors from the Current Population Survey's Annual Social and Economic Supplement (ASEC), as of March 2021. Data obtained from IPUMS-CPS, University of Minnesota, www.ipums.org.

Exhibit 2: U.S. household distribution by income ranges

Annual household income in U.S. dollars



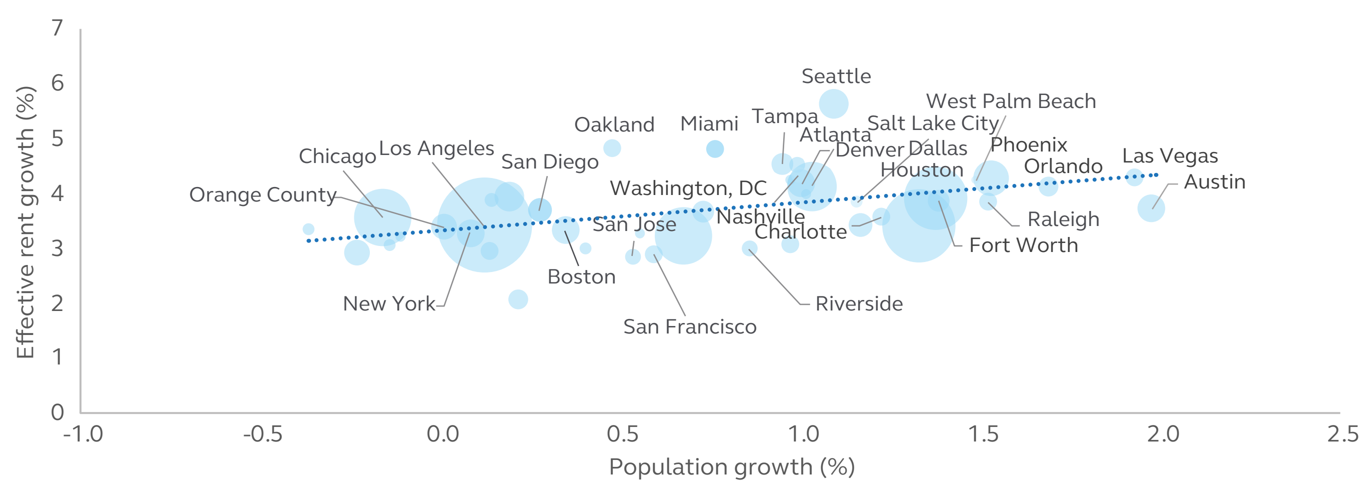
Source: U.S. Census Bureau (Current Population Survey, ASEC), Principal Real Estate Investors Calculations, 2021

The housing shortage is exacerbated by low affordability metrics particularly in coastal and gateway markets where many baby boomers transitioning from single-family homes are looking to unlock decades of equity. At the same time, many potential first-time homebuyers are facing lofty home prices and the prospect of rising interest rates, forcing them to move to lower cost of living cities or to become renters by necessity. Many of these lower cost markets are in the sunbelt regions where high population and economic growth prospects are driving outsized rent growth. A lack of residential supply, along with highly skilled workforces and the prevalence of DIGITAL industries, is also creating housing opportunities in many larger gateway markets despite slower population growth (Exhibit 3). The U.S. residential market has become a broader and more vibrant universe catering to an equally diverse and growing universe of renters.

Exhibit 3: Population increases and skilled workforce drive rental growth

Population and rent growth

5-year annualized % change



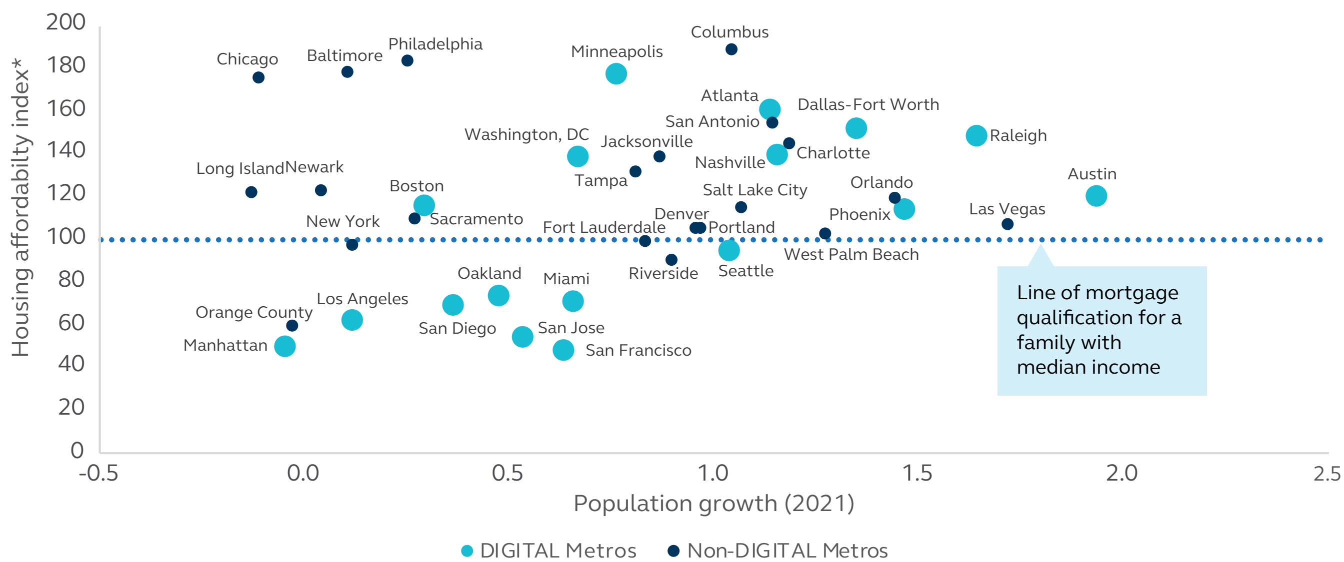
Source: U.S. Census Bureau, REIS, Moody's Analytics, Principal Real Estate Investors, Q4 2021

This intersection of demographic shifts with pandemic-related catalysts are creating some discernible trends that will impact investment opportunities, which we identify as:

1. Most of the metropolitan population in the U.S. is in suburban locations (61.9%) compared with central city locations (38.1%). Between 2016 and 2021 the suburban population growth averaged 0.7% compared with 0.4% for center cities on an annualized basis[5]
2. A material shortage of housing options in gateway and coastal markets that have strong exposure to DIGITAL drivers
3. An increasing shift towards emerging growth markets that offer material advantages in cost and greater flexibility in housing options
4. A substantial shortage of affordable housing catering to middle-income and workforce households
5. A broadening of housing needs away from traditional multifamily into more bespoke or individualized solutions including single-family rentals, manufactured housing, and senior living communities

In analyzing these trends, we believe that the investment opportunity set will be diverse but particularly attractive in (a) high growth demographic markets and (b) markets with strong DIGITAL drivers coupled with challenged affordability metrics. As such, we identify an initial list of target markets that meet some of the investment criteria identified (Exhibit 4).

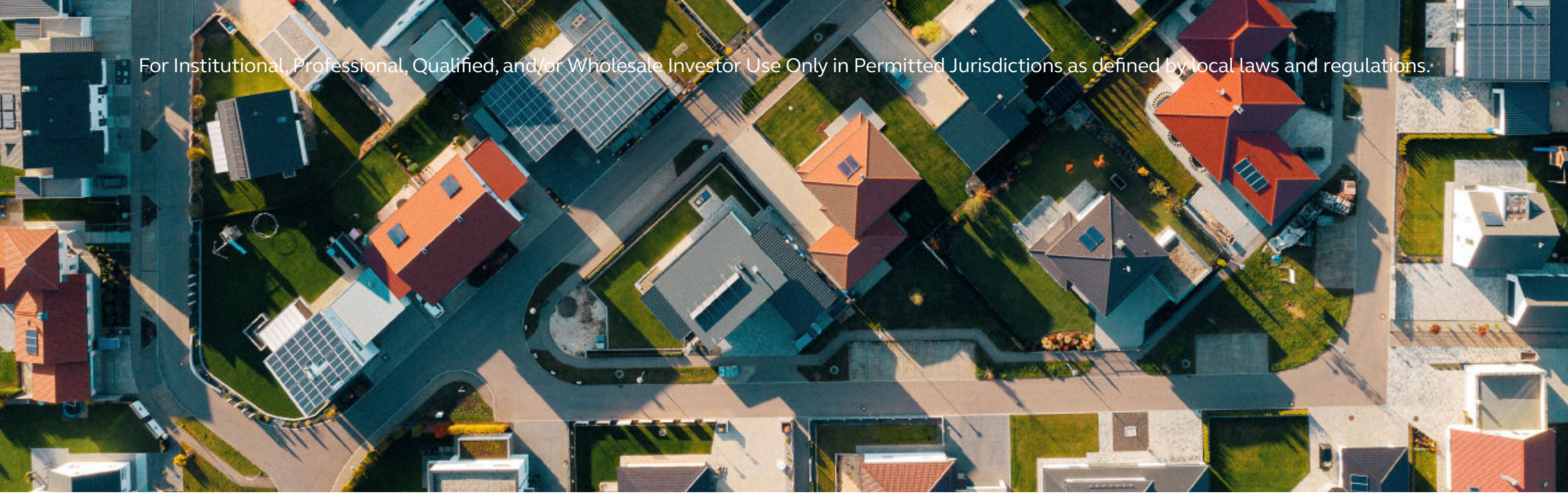
Exhibit 4: Population growth and housing affordability



Source: U.S. Census Bureau, Moody's Analytics, Principal Real Estate Investors, Q4 2021

*A value of 100 means that a family with the median income has exactly enough income to qualify for a typical mortgage on a median-priced single-family home. An index above 100 signifies that the family has surplus income.

[5] Based on Principal Real Estate Investors' analysis of U.S. Census data from the March Annual Social and Economic Supplement for metropolitan areas with populations above 1 million persons. Data are from IPUMS-CPS, University of Minnesota, www.ipums.org



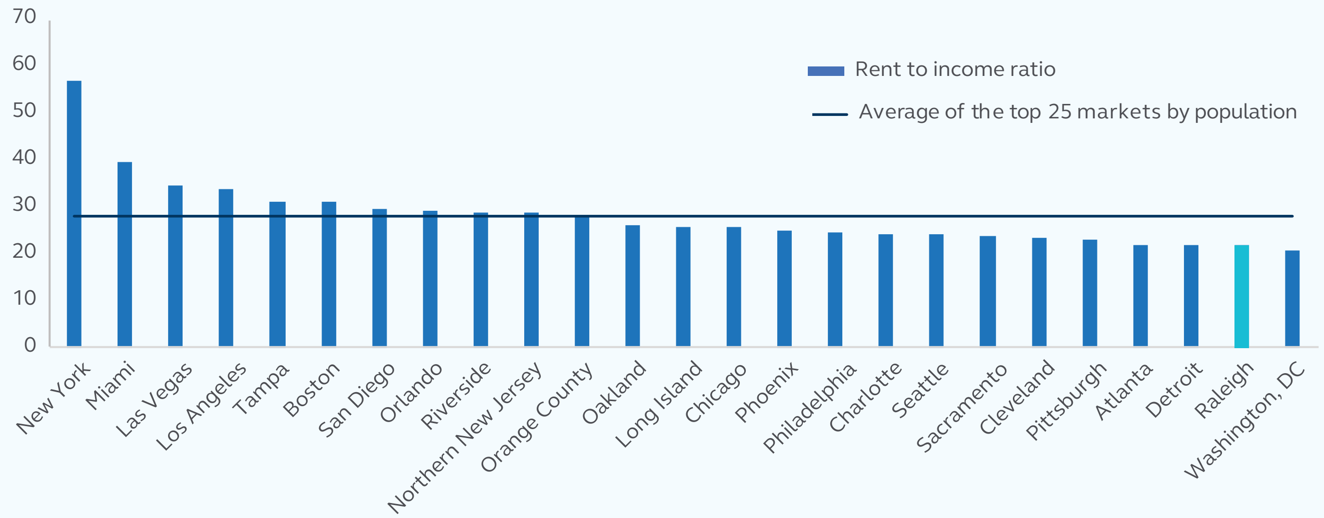
CASE STUDY: Raleigh presents an ideal DIGITAL opportunity

Raleigh is a prime example of a market that offers considerable residential investment opportunities and ticks several of our DIGITAL conviction boxes. A set of key demographic indicators supports Raleigh's outperformance relative to the U.S. through 2025:

- Raleigh's population is projected to grow by 7%, outperforming the U.S. population growth of 2%[6]
- Raleigh's white-collar employment is expected to grow by 6%, outpacing the 4% growth of the U.S.[6]
- Raleigh's household formation will increase by 11%, exceeding that of the U.S. by 7%[6]
- Raleigh's apartment total returns on an annual basis have averaged 12.1% over the past five years, outperforming the national average by 375 basis points[7]

The demographic tailwinds along with Raleigh's strong employment outlook makes it a highly desirable and affordable residential market where we expect investment opportunities to be available. Markets such as Raleigh epitomize the DIGITAL strategy we believe can lead to attractive investment opportunities across multiple property types, particularly residential.

Monthly rent to income ratio, %



Source: Moody's Analytics, REIS, U.S. Census Bureau, Principal Real Estate Investors, Q4 2021

[6] Source: Moody's Analytics, U.S. Census Bureau, Bureau of Labor Statistics, Principal Real Estate Investors, Q4 2021

[7] Source: NCREIF NPI, Principal Real Estate Investors, Q4 2021

Case study is shown for illustrative purposes only and not intended to forecast or predict future events. It does not reflect the actual or expected returns of any portfolio or strategy and does not guarantee future results.

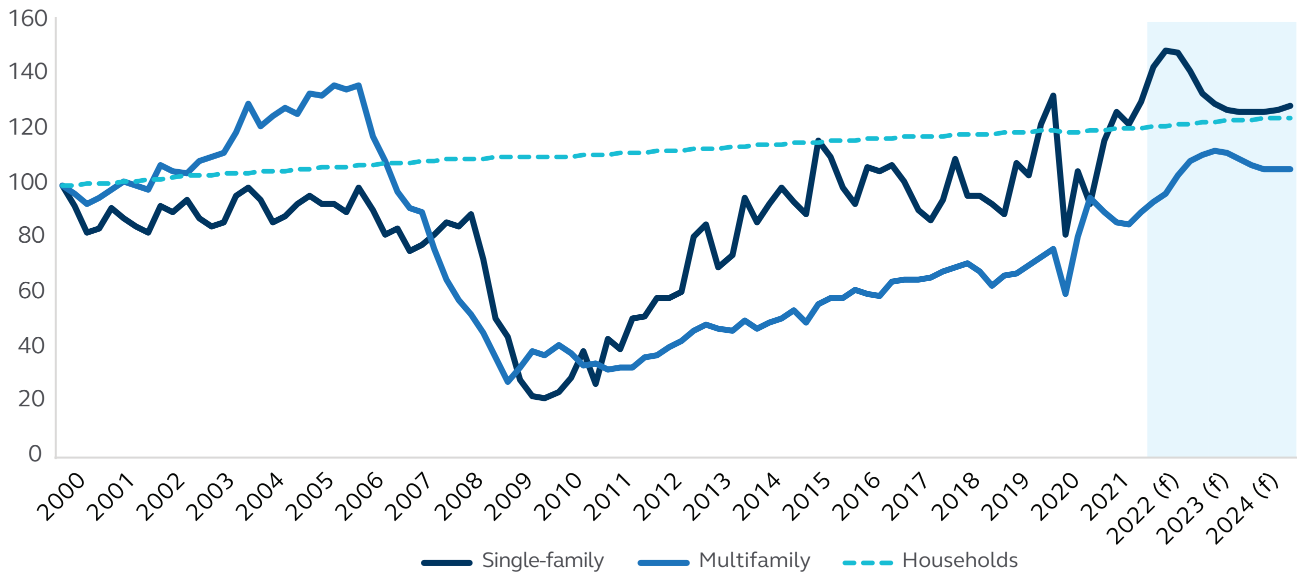
Supply/demand imbalances have set up a large and growing opportunity

Supply has not kept pace with the growth of, and shifts in, U.S. housing demand, thereby creating sizeable development opportunities (Exhibit 5). According to Freddie Mac, the U.S. is undersupplied by 2.5 million units, a number which is likely to grow as the pace of household formation recovers from the pandemic and an increasing number of generation Z renters enter the market. Moreover, COVID-19 has slowed new construction, and with current available supply concentrated in more expensive luxury units, affordable rentals are at a premium.

Exhibit 5: A lack of housing construction over the past decade has led to shortages

Housing starts and household formation

Index (Q1 2000 = 100)



Source: U.S. Census Bureau, Moody's Analytics, Principal Real Estate Investors, Q1 2022

Residential opportunities look most attractive for development strategies

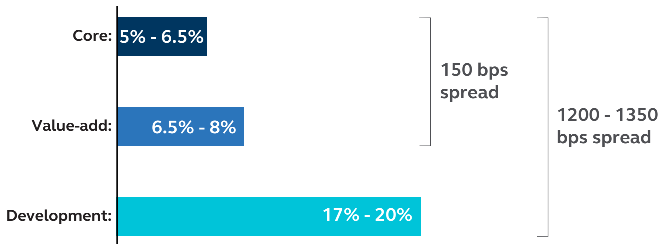
The large and growing residential opportunity set continues to attract investors making this a very liquid property type. In 2021, the residential sector saw $332 billion in transactions, a 121% increase from 2020.[8] The result has been to push pricing metrics for stabilized residential assets; as a result, cap rates have reached record lows in some markets. It is clear to us that structural and COVID-induced shifts in the U.S. residential market make it a very attractive property sector over the foreseeable future. Given pricing levels for core, stabilized assets, and the imbalance between supply and demand, we believe development strategies may offer the best risk-adjusted returns and may also generate higher total returns. Development should offer investors the ability to capture yields in excess of stabilized cap

[8] Based on data from Real Capital Analytics on transactions valued at $5 billion and above through the end of 2021, including apartments, seniors housing, student housing, manufactured housing. Principal Real Estate Investors calculations, February 2022.

rates, particularly in an environment where inflation and bond yields may be pushed higher and sell into the very liquid investor appetite for high-quality residential assets. Development strategies continue to offer attractive absolute and relative returns: Principal Real Estate Investors estimates relatively robust internal rates of return (IRRs) in the range of 15%-20% providing the highest spread over core and value-add levels in more than three decades. If bond yields move higher, the differential could be even greater. (Exhibit 6).

Exhibit 6: Development should outperform other strategies

Forecast internal rates of return (IRRs)**



Source: Principal Real Estate Investors, Q1 2022

We believe development strategies not only offer potentially attractive investment performance relative to core assets but, as importantly, offer other material benefits to investors and occupiers:

a. For investors, merchant-building in the residential sector may be an effective way to add a hedge for inflation by (1) bringing units to market with amenities that are better suited to capture inflationary trends in lease-up phase and, (2) provide potential protection from material and labor cost increases which can be passed through on to stabilized values.

**Estimated gross unlevered total returns (IRR) as of 31 December 2021 and are before fees, transaction costs and other expenses. These are projections given current business plans, expectations and market conditions that Principal Real Estate Investors has observed on the market generally. There is no guarantee that an investor will achieve these projected internal rates of return on any similar properties or real estate asset classes in the future. Projected performance is not a reliable indicator of future performance and should not be relied upon as a significant basis for an investment decision. You should consider whether an investment fits your investment objectives, particular needs and financial situation before making any investment decision.

b. The ability to address and tailor specific ESG-related occupier needs—whether it is the requirement for more energy-efficient appliances or for more open space and wellness facilities. Middle-income housing could be an important contributor to an overall ESG strategy and solve for very strong occupier demand.

c. Provide the nimbleness to pivot towards housing formats most suited to a market's needs. This flexibility facilitates a highly targeted approach to maximizing investment outcomes.

CONCLUSION: Structural shifts make housing a compelling development opportunity

The U.S. housing market is poised for a substantial uptick in demand as the demographic shape of society intersects with COVID-19 induced shifts. Markets with lower costs of living, higher educated workforces, and exposure to some of the DIGITAL drivers are poised for strong household formation and housing demand.

We believe development strategies may offer investors an attractive, risk-adjusted opportunity to harness the potential in this sector and not only provide the potential for excess returns, but also tailored solutions to meet the expanding breadth of evolving ESG and tenant needs.

Risk Considerations
Past performance does not guarantee future results. Investing involves risk, including possible loss of principal. 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. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

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