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Principal℠

Insights into REITs in 2022:
A check-in on year-to-date performance and current valuations

Q&A with
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Chief Investment Officer
Principal Real Estate Securities

Highlights

- REITs are under pressure from the forces of rising rates, recession fears, and elevated valuations.
- The sell-off is broad-based, including non-traditional REITs with superior growth prospects.
- Public REITs are trading at large discounts to private real estate, an opportunity to rotate to REITs over direct real estate.
- Resilient growth, higher dividends, inflation protection, and potential privatizations are advantages to owning REITs today.

Q: MARKET VOLATILITY HAS INCREASED YEAR-TO-DATE. CAN YOU DESCRIBE THOSE FORCES AND HOW REITS HAVE FARED?

It's really about interest rates and the Fed's battle with inflation. The year started with markets re-pricing a more rapid and aggressive Fed rate hike cycle to tame inflation that was clearly higher and more persistent than previously anticipated. The sharp rise in bond yields in January and later months, particularly higher real yields, has acted as a valuation headwind for all investment markets, not just REITs. With real yields moving higher, investor required returns (i.e. discount rate) for risk assets will tend to go up and prices down, unless there is a meaningful offset via improved cash flow growth prospects. REIT earnings growth expectations[1] have gone up since the start of the year, approximately 100 bps; however, this upward revision in growth hasn't been enough to offset the impact of rising rates and other important headwinds.

Another big headwind has been public markets pricing in the real possibility we are on a path to a recession. While the Fed believes that it will be able to avoid recession, in 12 major tightening cycles since 1954, the Fed only managed a "soft-landing" (avoided recession) on three occurrences: 1965, 1984, and 1994.

Valuations in this environment have been another headwind. At the beginning of the year REIT market valuations were pricing in a lot of positives in the future. While REIT earnings are typically quite resilient compared to many other sectors, this new reality of a meaningful macro slowdown was not priced into the stocks. REITs sold off in the first quarter primarily due to interest rates; however, REIT implied capitalization rates[2] didn't actually go up as much as U.S. 10 year treasury yields. With even tighter spreads compared to treasuries at the end of the first quarter, and concerns of a recession quickly mounting in May, this drove another sell-off in the market.

Finally, investor nervousness around issues such as a large online retailer slowing their investment in logistics properties, potentially a normalization of demand for sectors like self-storage, and higher gas prices, which could dampen retail spending at shopping malls, also contributed to the sell-off.

[1] Currently, consensus estimates forecast U.S. REIT earnings to grow 9.4% and global REIT earnings to grow 8.7%, annualized in 2022 and 2023. This compares to growth estimates of 8.4% for U.S. REITs and 7.9% for global REITs at the start of the year. Source: FactSet, 31 May 2022.

[2] Capitalization rate is the estimated rate of return that is expected to be generated by a real estate investment. It is calculated by dividing property net operating income by the property asset value and is expressed as a percentage.

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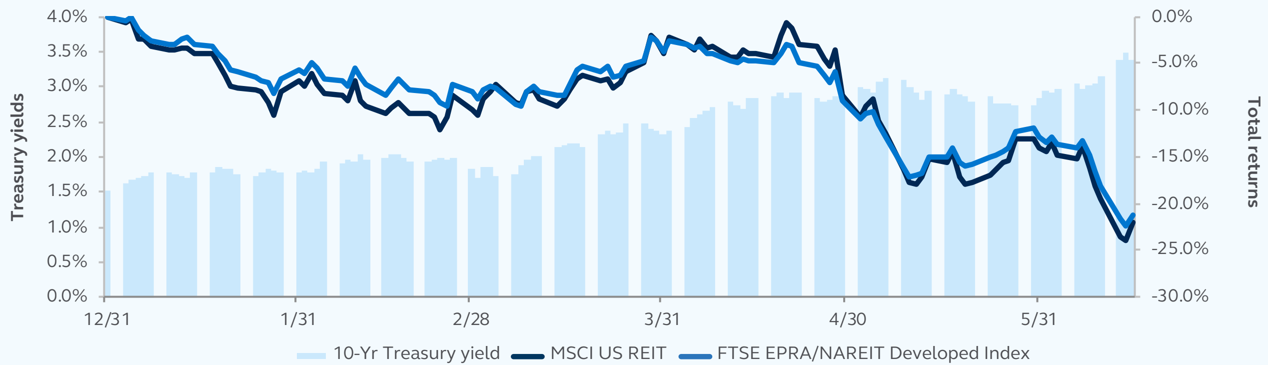
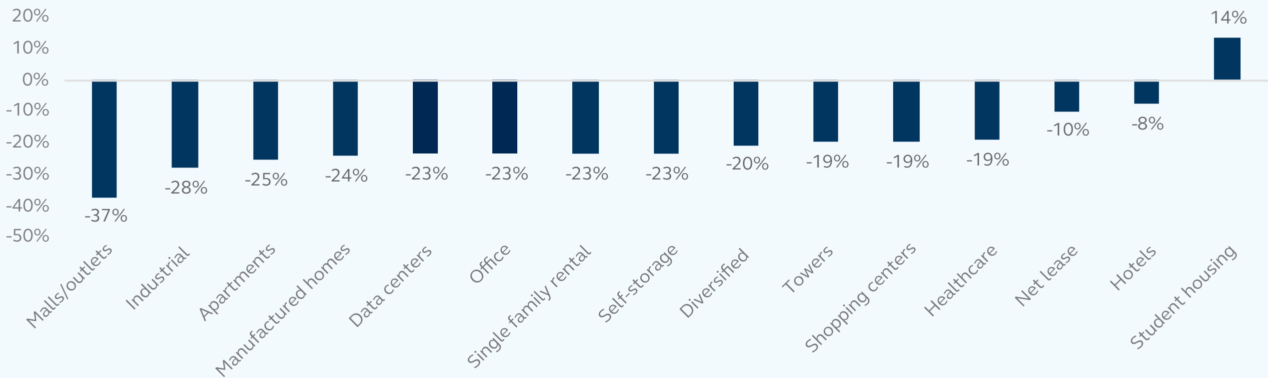
EXHIBIT 1: Year-to-date returns: U.S. and Global REITs



Source: FactSet. MSCI U.S. REIT Index, FTSE EPRA/NAREIT Developed Index, U.S. 10-year treasury yields. As of 15 June 2022. Returns in USD. Past performance is not a reliable indicator of future performance and should not be relied upon to make investment decisions. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

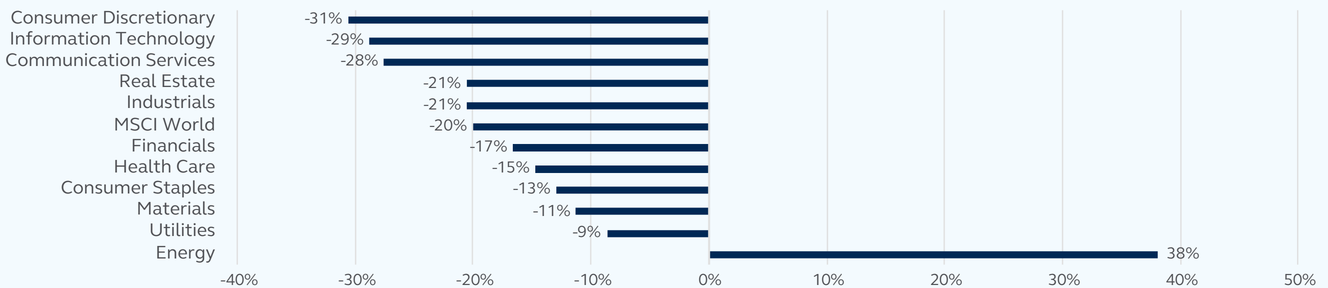
EXHIBIT 2: U.S. REIT year-to-date sector returns



Source: FactSet. as of 15 June 2022. FTSE NAREIT All Equity REITs Index YTD returns by REIT subsectors.

EXHIBIT 3: Returns for equity indices have been supported by strong returns by energy and more defensive sectors such as utilities and consumer staples

Global equities: Year-to-date total returns by GICS sector



Source: FactSet. MSCI World Index YTD returns by GICS economic sectors. As of 31 May 2022.

Q: RISING RATE CONCERNS HAVE BEEN A KEY REASON WHY THERE'S BEEN PRESSURE ON REITS YEAR-TO-DATE, AND WE'RE NOW SEEING THE FED TREND EVEN MORE HAWKISH. WHAT'S YOUR CURRENT OUTLOOK ON RATES AND THE POTENTIAL IMPACT ON REITS?

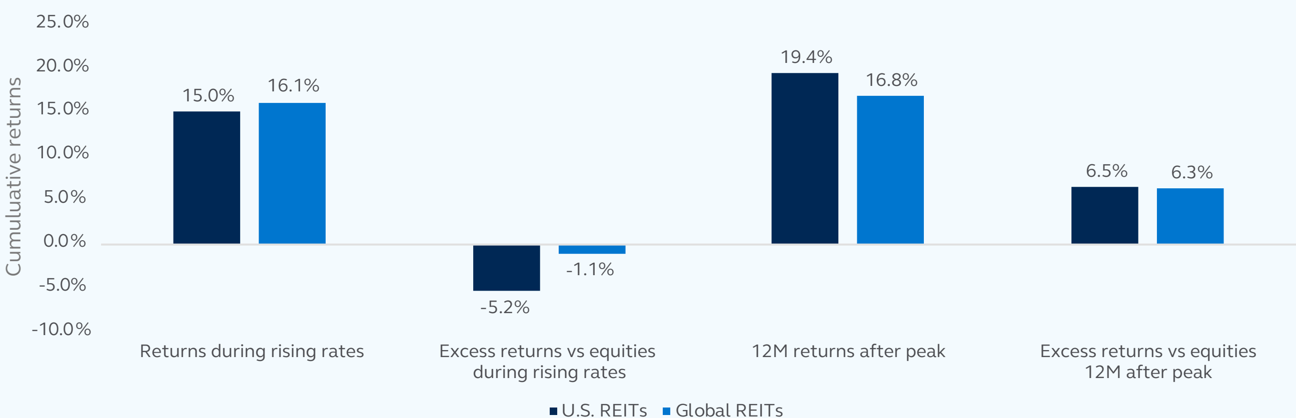
The outlook for U.S. interest rate policy is exceedingly clear in the near term as the Fed prioritizes reducing inflation pressures. Short-term rates will move higher over the balance of the year and possibly into 2023. We believe many central banks around the world will face the same circumstances as they battle inflation. The one major exception could be China, which is in a slowdown already and may take measures to stimulate growth.

We believe the path of long-term interest rates is the more important driver of property pricing given investor time horizons and financing strategies. The outlook for long-term rates is far less certain as higher short-term rates will usher in adverse effects on future demand and growth. The composition of long-term interest rates—between real yields and expected inflation— will also likely be an influential driver of future returns. Recently there has been a sharp upward movement in real interest rates that has acted as a valuation headwind. However, inflation is typically a tailwind and we have observed previously that rising nominal yields generally present less of a headwind to REITs than rising real yields.

Historically, REITs have been able to generate strong positive returns, driven by higher cash flow growth, from the trough to peak rally in interest rates, yet on a relative basis lag the broader equity market. While rising rates are likely to continue in the near-term, we must also consider the possibility that a peak in long-term yields could occur over the coming year as the yield curve flattens and a growth slowdown takes hold. It's in periods of declining rates after 10-year treasury yields have peaked that REITs have been strongly in favor and generated even higher total returns. As Exhibit 4 shows, REITs have on average outperformed equities over the twelve months following the peak in 10-year treasury yields.

EXHIBIT 4: On a relative basis to equities, REITs lag in rising rate periods but are outperformers after interest rates peak

U.S. and Global REITs and rates



Source: FactSet. As of 30 April 2022. Returns data is showing FTSE EPRA/NAREIT Developed index and FTSE NAREIT Equity REITs average cumulative total returns and excess returns over the MSCI World and S&P 500 during the last 10 periods of rising rates (an increase of at least 100 bps represented by the US 10-year treasury yield) and during the 12 months after the peak of the rising rate period.

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Q: LAST YEAR YOUR OUTLOOK HIGHLIGHTED STRUCTURAL TRENDS WOULD DOMINATE THE REITS LANDSCAPE, BRINGING NON-TRADITIONAL SECTORS TO THE FORE. IS THIS STILL A TREND TODAY?

Yes, we continue to view this as an enduring, long-term trend—the pandemic accelerated or created new structural tailwinds that have been very beneficial for some property types, particularly non-traditional sectors, which have been more resilient through the pandemic. We continue to see some of the strongest and most resilient earnings growth are from REITs in these sectors and investor private equity capital is flowing into these sectors at a faster rate than traditional sectors like retail or office.

Despite these long-term positives, we have observed a rotation in public REIT markets away from some non-traditional sectors since interest rates started to rise this year. Rising interest rates have pushed up the discount rates investors use in valuing securities. The superior long-term growth outlook for these companies makes them more susceptible to the rise in interest rates because a meaningful portion of their value is derived from future cash flows discounted back to present value. This trend has caused companies with superior long-term growth to lose favor among investors.

Following this period of under-performance, we continue to favor many non-traditional real estate sectors with superior long-term growth. This includes single-family rental, manufactured homes, wireless towers, and medical offices. We also believe over time these sectors are likely to be viewed as relatively safe havens in a weakening macro environment as we expect their cash flows streams to be more resilient.

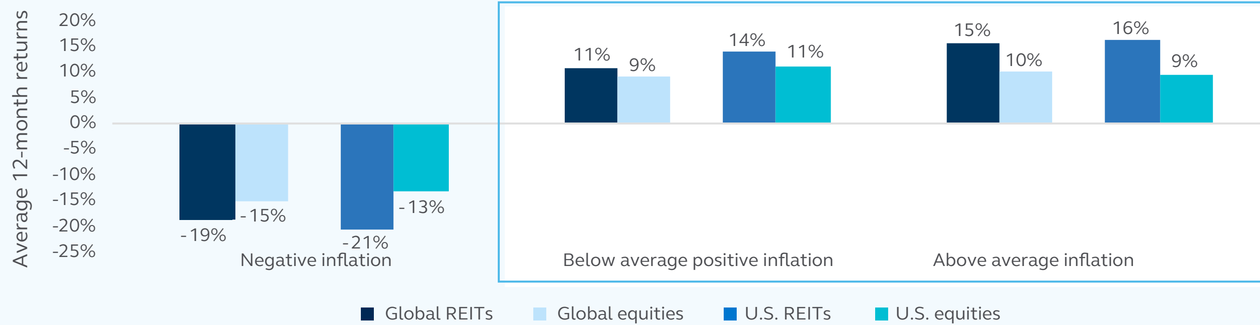
Q: INFLATION IS TOP OF MIND FOR INVESTORS GLOBALLY, HOW DO YOU SEE THAT AFFECTING REITS THIS YEAR?

Looking at historical periods of rising inflation as seen in Exhibit 5, REITs have done a decent job acting as an inflation hedge and have outperformed equities in all positive inflation environments. Real estate may offer a hedge against inflation because not only do rents and occupancies rise with growth, but inflation also increases the replacement costs of property assets and hence property values. REITs have tangible hard asset exposure and many leases with linkages to CPI, allowing varying degrees of hedging by property type. Most importantly, investors need to invest in the sectors that have pricing power and can grow earnings above the rate of inflation.

We must of course caveat that any historical analysis on REITs and inflation will have shortcomings given that today's high inflation environment is rather unprecedented for the modern REIT era. This type of inflation is presenting the dual headwinds of higher input costs and higher interest rates, ushering in a period that may be unfavorable for all risk assets, including real estate. Amidst this backdrop, assets that offer some type of inflation hedge, pricing power, and some degree of defensives in the late cycle are likely to perform well on a relative basis. We believe this makes the case for REITs relative to other investment options.

EXHIBIT 5: Real estate has performed quite well as an inflation hedge vs. equities

Performance during different inflationary environments



Source: FactSet, U.S. Bureau of Labor Statistics. As of 30 April 2022. Indices represented: FTSE EPRA/NAREIT Developed, MSCI World, FTSE NAREIT Equity REITs, and S&P 500 indices. Rolling 12 month time periods from 1 January 2000 – 30 April 2022. Inflation represented by the YoY CPI (with an average of 2.3%). Past performance does not guarantee future results. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

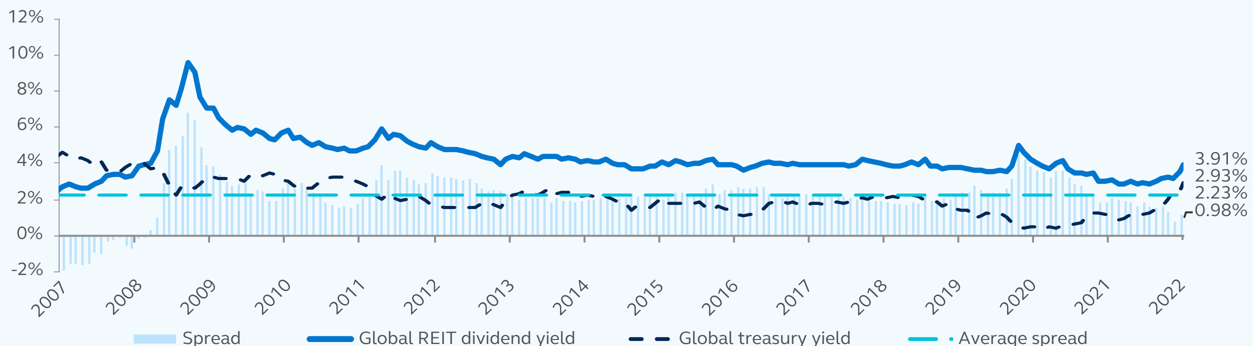
Q: WHERE ARE REIT VALUATIONS TODAY COMPARED TO HISTORICAL VALUATIONS? WHAT CAN PUBLIC REIT VALUATIONS TELL US ABOUT WHERE PRIVATE REAL ESTATE VALUE MIGHT BE GOING?

Despite the big sell down, REITs are still screening expensive when making historical comparisons. We gauge valuation using a proprietary tool that combines three metrics (dividend yield spreads, implied cap rate spreads, and price to FFO multiples). Today this composite is signaling REITs are expensive compared to their historical averages since 2000, with a ranking of the 4th percentile (100th = cheap, 1st = expensive).

All three measurements suggest the stocks are expensive today. Interest rates have gone up while dividend yields have remained steady and implied capitalization rates have not gone up enough to offset the interest rate increases. Meanwhile, price to FFO multiples have declined but not below 20+ year averages, which is a trend generally consistent with P/E multiples in the broader equity market.

EXHIBIT 6: Tighter than average spread between dividend yields and 10-year treasury rates is one example of the tight spreads for REIT valuations

Global REIT Dividends Yields vs. Global Treasury Yields



Source: Principal Global Investors, FactSet, FTSE. As of 15 June 2022. The Global REIT Dividend Yield percentage shown above is the weighted average dividend yield of the FTSE EPRA/NAREIT Developed index. The Global Treasury Yield is calculated as a weighted average 10-year yield based on each company's country's historical weight in the FTSE EPRA/NAREIT Developed Index. The historical average spread represents 15 years. Chart does not represent any investment strategy or reflect fees, taxes or expenses. Investors cannot invest directly in an index. Past performance is not a reliable indicator of future return.

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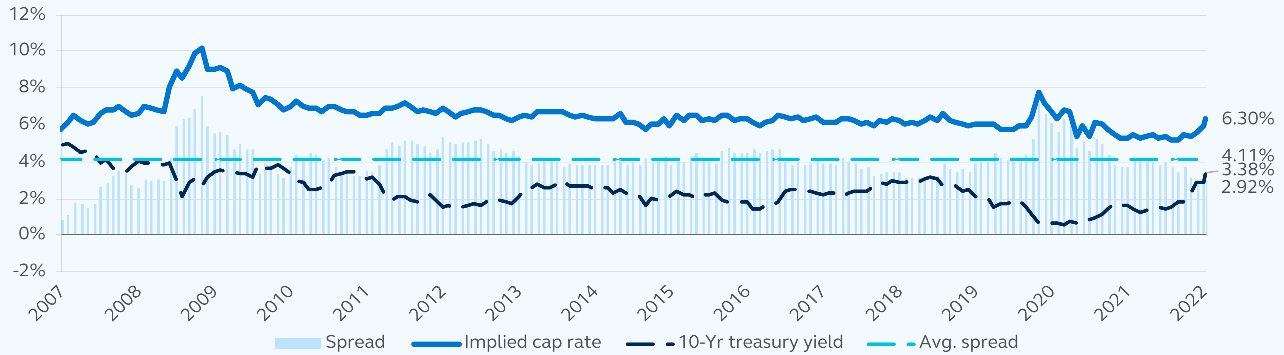
EXHIBIT 7: Tighter than average spread between implied cap rates and 10-year treasury rates also shows expensive REIT valuations

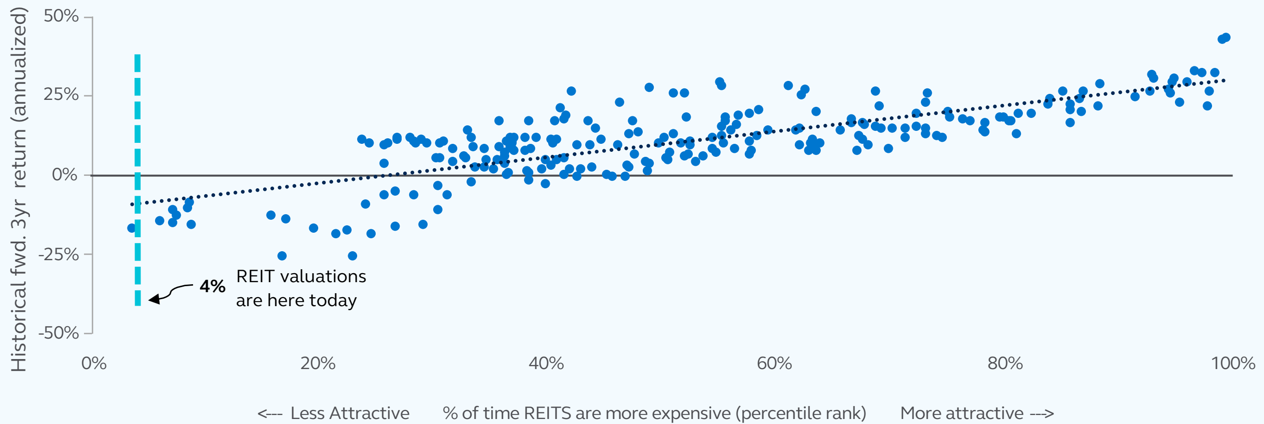
U.S. REIT implied capitalization rates vs. 10-year U.S. treasury yield



Source: Citi, FactSet. As of 15 June 2022. The historical average spread represents 15 years. Past performance is not a reliable indicator of future performance and should not be relied upon to make investment decisions. Does not represent any investment strategy.

EXHIBIT 8: Percentile rank of U.S. REIT market historical valuations and the forward 3-year returns generated when REITs traded at those valuations

The relationship of REIT valuations and historical returns

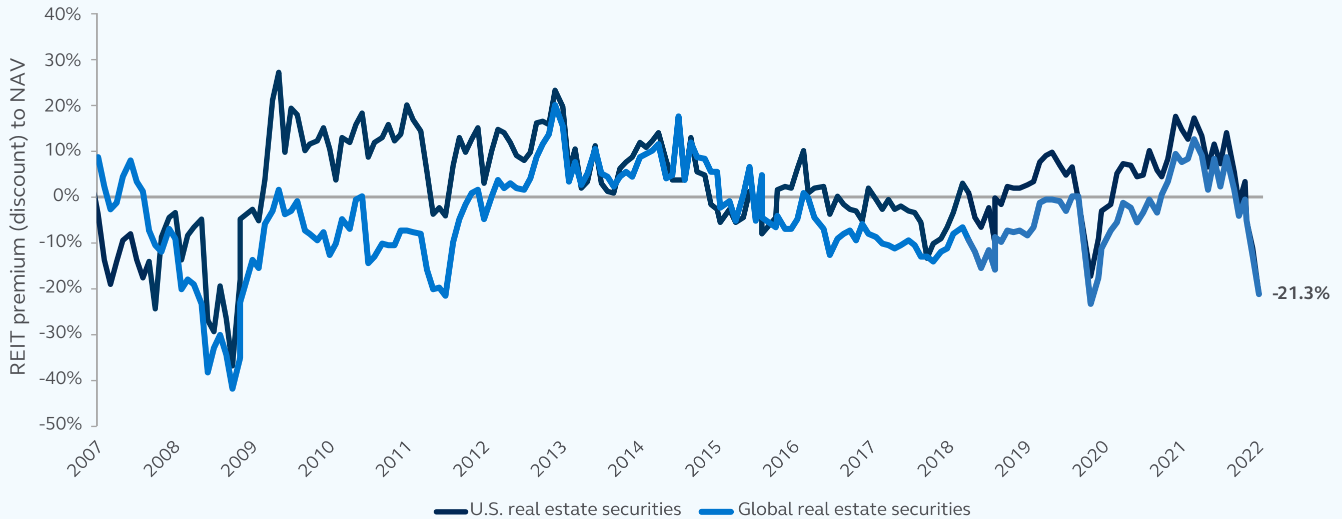


Source: FactSet, MSCI U.S. REIT Index, Citi. As of 15 June 2022. Returns in USD. Chart shows as of January 2000 – May 2022. Past performance is not a reliable indicator of future performance and should not be relied upon to make investment decisions. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

The one outlier in today's environment is private equity real estate which has yet to experience a price correction like public REITs, equities, and bonds. Public REITs have sold off as investors have anticipated future reductions in private real estate values given rising capital costs. The public REIT markets often foreshadow what may lie ahead as private market valuation marks tend to lag public REIT stocks prices by roughly nine to twelve months. The premium or discount REITs are trading relative to Net Asset Value (NAVs) is a useful ratio to compare public REIT pricing with current estimates of property values. Currently, public REIT markets are now trading at an approximate 21% discount to those private market value estimates. (Exhibit 9).

Given this large discount, we believe public REITs represent a very attractive opportunity for an investor who is choosing between public REITS or an allocation to direct private real estate. This dislocation in pricing between private and public real estate markets can offer a great advantage for select investors with the liquidity to allocate between them. We would be strongly supportive of investors in this situation making the allocation decision to public REITs today.

EXHIBIT 9: Public REIT market valuations look attractive compared to private equity real estate values



Source: Principal Global Investors, FactSet, FTSE, MSCI. As of 15 June 2022. This chart illustrates the weighted average Price/Net Asset Value of the stocks in MSCI U.S. REIT Index and FTSE EPRA/NAREIT Developed Index. Past performance is not a reliable indicator of future return. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. Does not represent any investment strategy.

The discounted valuations of REITs compared to private real estate may create a ripe environment for private equity takeovers of public REITs. Large private equity investors have raised record-breaking amounts of capital targeted to be invested in real estate. Public REITs owning large, attractive portfolios, including some with highly coveted non-traditional property types, with valuations at discounted prices are bound to attract the attention of private equity investors. A pick-up in public estate company privatizations should provide downside price support and could act as a positive catalyst for public real estate stocks.

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Q: TO SUM UP, WHAT ARE SOME POTENTIAL REASONS TO OWN REITS TODAY AND HOW ARE YOU MANAGING THE PORTFOLIO IN THESE CONDITIONS?

The concerns of elevated valuations in a rising bond yield environment, where fears of a both untamed inflation and a global recession are growing, are commonly held concerns associated with nearly all risk assets, including REITs. In this environment we must then consider the relative advantages of REITs with the most attractive features being:

- Real estate companies offer resilient income growth. Contractual leases—many with built-in annual increases and varying expiration dates—will act as a source of steady earnings growth.
- Real estate companies tend to offer above average dividend yields which investors usually favor when sentiment is cautious.
- Real estate has historically offered protection against inflation.
- There may be downside protection for real estate stocks today based on the prospects of potential privatization activity.

We continue to take the same bottom-up, fundamental approach towards portfolio management that has served our clients for the past 20 years. While the evolution of long-term interest rates and macro events will be impactful going forward, we are primarily focused on constructing our portfolio in a bottom-up fashion with appropriate diversification, given inherent unpredictability in macro dynamics. With that said, we do have to adjust to the dynamic environment in which we invest. In the current conditions we generally favor stocks with the following characteristics:

- Shorter lease duration sectors, which have greater ability to quickly pass on inflation pressures
- Sectors with structurally-driven demand that are less economically sensitive due to superior pricing power
- Companies with attractive dividend yields
- Potential privatization candidates in sectors that are to be likely targets
- Higher quality companies with lower leverage and strong management teams as a source of defense if the economy slips into a recession.

Importantly, we believe active management will be key to manage risk and find selective mispriced opportunities during these uncertain times.

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. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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Indices used: **MSCI U.S. REIT Index** - a free float-adjusted market capitalization weighted index that is comprised of equity Real Estate Investment Trusts (REITs) and is based on the MSCI USA Investable Market Index (IMI), its parent index, which captures the large, mid and small cap segments of the USA market; **FTSE EPRA/NAREIT Developed Index** - is a free-float adjusted, market capitalization-weighted index designed to track the performance of listed real estate companies in developed countries worldwide; **FTSE NAREIT All Equity REITs Index** - is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs; **MSCI World Index** - is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries; **S&P 500** - is a stock market index tracking the stock performance of 500 large companies listed on exchanges in the United States.

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