Principal Asset Management[SM]

Principal Real Estate

Inside Real Estate Outlook

Waiting for Godot

SEPTEMBER 2023

Waiting for Godot

In Samuel Beckett's play ***"Waiting for Godot"***, two characters engage in an endless discussion while awaiting the titular Godot who never arrives. A similar parallel appears to beset global investors waiting for central bankers to signal the end of monetary tightening. Several false dawns later, it seems that the period of waiting may be in sight with inflation subsiding allowing central bankers to bring an end to monetary policy tightening. Godot, it appears may arrive in 2024.

The prolonged period of elevated inflation and borrowing costs has not been without cost however. While major economies have avoided recession, households savings are eroding and businesses are beginning to lose some pricing power setting in place conditions for a mild recession or slower growth.

Amid this backdrop, in this edition of ***Inside Real Estate***, we discuss our strategic framework and high-conviction ideas that we believe may help to drive and protect investors' portfolios and prepare for the next cycle. Identifying the most attractive position in the capital stack and overweighting structurally resilient property types are the two building blocks of our strategy that we are pleased to present in this report.

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Economic outlook

U.S. and Europe burdened by tight monetary policies face a weaker outlook.

The outlook for the global economy looks challenging as we await the lagged impact of monetary policy tightening. Although most economies have escaped recession and unemployment levels remain close to record lows, growth prospects are under pressure due to tight credit conditions and weak growth in China.

Divergence in growth emerging

2023-2024

- Globally, growth is set to remain low while downside risks continue
- China's economic prospects are weakening

NEGATIVE POSITIVE

Scenario	Outlook	Inflation	Monetary policy	Consumers	Business	Employment
United States						
Eurozone						
Asia Pacific						

Source: Principal Real Estate, August 2023

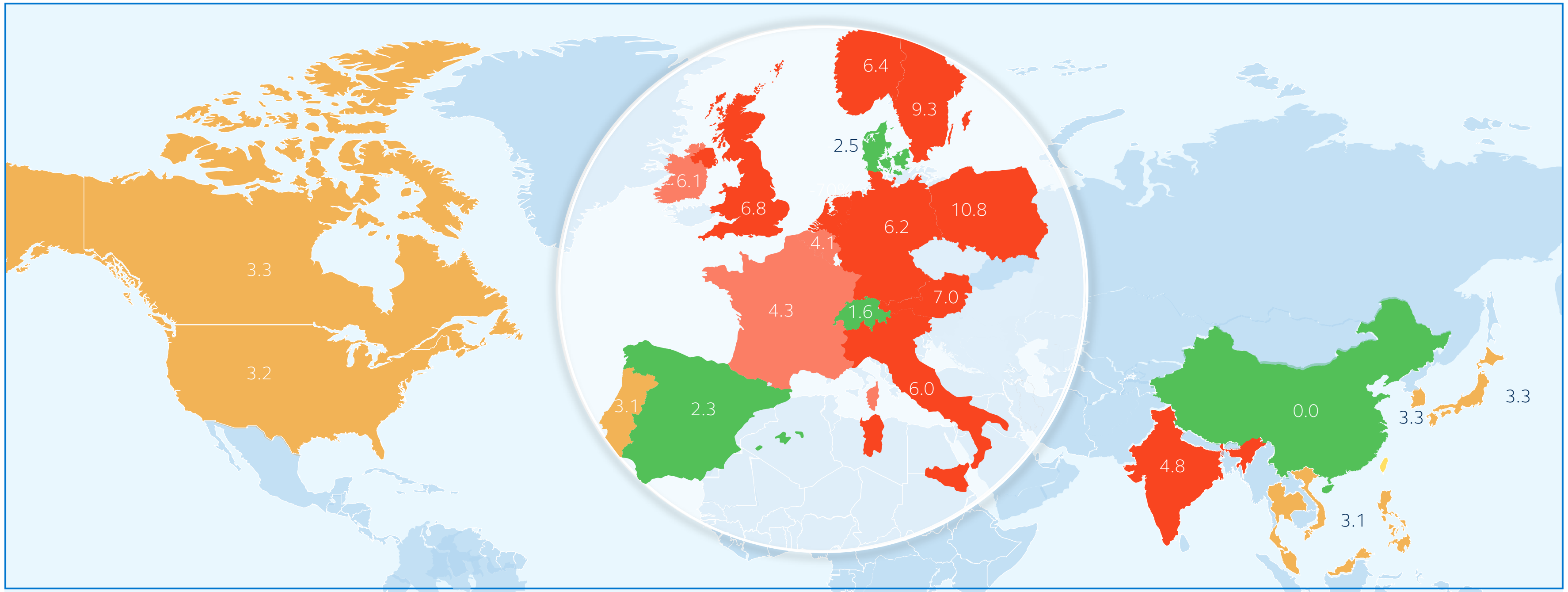
Price pressure is receding, but it may remain above target for longer in some regions.

In our view, inflation is transitioning from a global to a regional problem. This is because its nature and its drivers have changed.

The first wave of inflation stemmed from common global roots such as the reopening of the economies after two years of the pandemic, expansionary fiscal and monetary policy responses, supply-chain bottlenecks, and a spike in the cost of commodities and fossil fuels. This first impulse of price pressure has now faded, primarily reflecting the base effect and the lagged impact of rate hikes.

In the coming months we expect the world economy to experience a disinflationary trend, but with increasing divergence across countries, as the forces that will determine price pressure going forward are more localized and idiosyncratic.

Headline inflation



Inflation components

	Services	Goods
	5.7	-0.9
	4.3	2.3
	7.4	6.1
	5.4	5.5
	1.6	4.8
	3.3	2.0
	0.4	0.2
	6.3	5.8

Source: Macrobond, Principal Real Estate, August 2023

Monetary policy: Interest rates near peak?

Markets increasingly believe we are closer to the end of tightening but not everywhere…

As inflation recedes at various speeds across economies, we expect global central banks to take their foot off the tightening brakes. Among developed economies, the Federal Reserve and the Bank of Canada may have already reached, or be very close to, the peak of their interest rate hiking cycle.

In the U.K., the Bank of England is still battling with persistent price pressure, the highest among G8 economies, forcing the central bank to extend its tightening cycle further. All other nations sit somewhere in the middle between the U.S. and the UK.

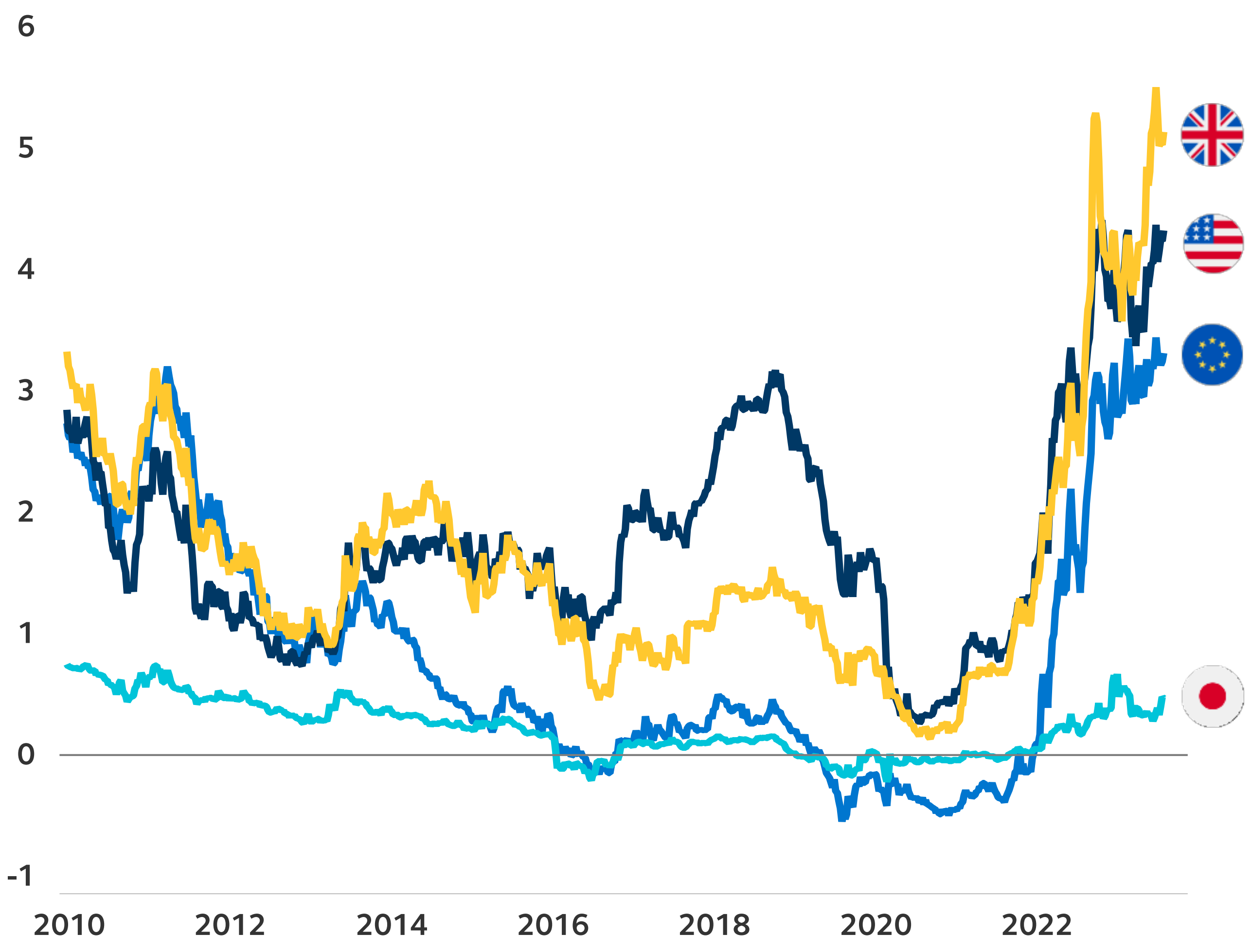
Major central banks path to terminal rates

	North America/EMEA					Asia Pacific			
	Fed	ECB	BoE	BNC	SNB	BoJ	BOK	PBoC	RBA
Current rate	5.5%	4.25%	5.25%	5.0%	1.75%	-0.1%	3.5%	3.45%	4.1%
Further hikes[1]	25 bps	25 bps	25 bps 25 bps		25 bps			25 bps 25 bps	25 bps
First cuts	1Q24	3Q24	2Q24	2Q24	3Q24		4Q23	1Q24	1Q24

[1]Further hikes based on Bloomberg consensus. Cyan shading to show Federal Reserve and PBoC path is data dependent.
Source: Macrobond, Bloomberg, Principal Real Estate, August 2023

Cost of capital: Debt is expensive to borrow

5-year swap rates, percentage



Source: Macrobond, Bloomberg, PMA, Principal Real Estate, August 2023

Rising rates have filtered into higher borrowing costs.

For real estate, the impact of sustained monetary policy tightening has increased borrowing costs sharply. Moreover, lenders are more selective about borrowers, wary that weakening economic activity may put pressure on businesses.

The combination of the high cost of capital and constrained debt market has had a profound impact on commercial real estate over the past several months. Property valuations have fallen and capital markets activity deeply abated.

While this hasn't translated into a high level of distressed property sales levels yet, with commercial real estate loans coming to maturity in 2023 and 2024, the number of troubled assets is likely to increase.

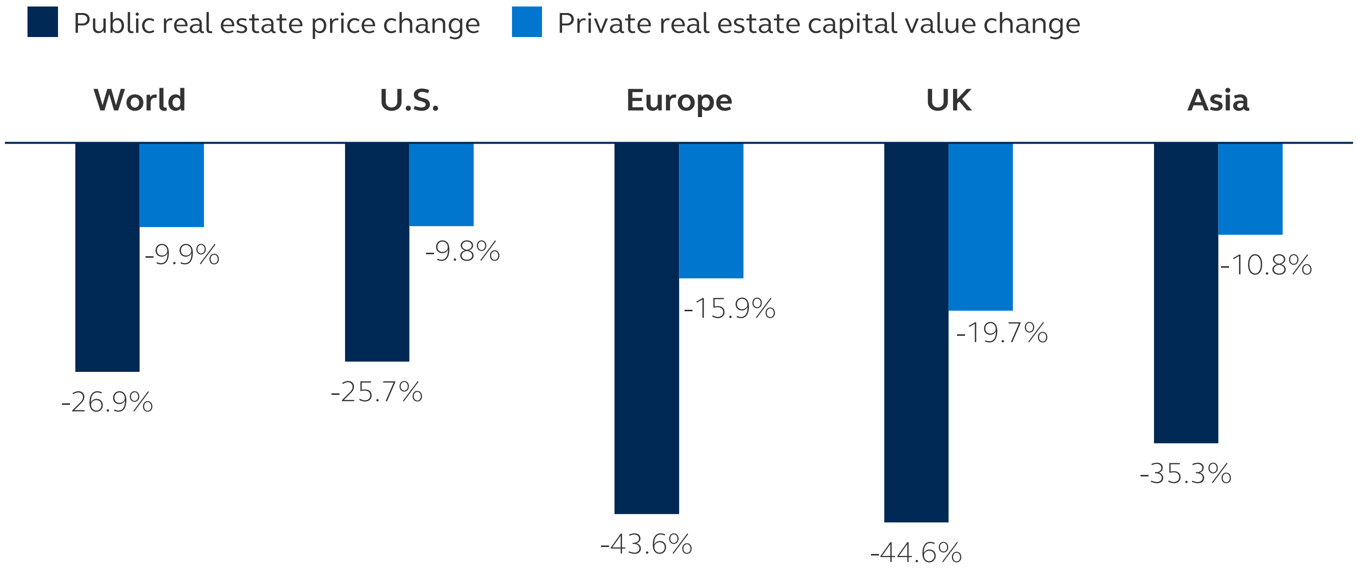
Public markets led price declines, and privates are following.

Higher interest rates have pushed real estate values down with public REITs seeing sharp, initial dislocation. We expect that once there is more clarity regarding the path of inflation and interest rates, public REITs and private real estate prices will converge somewhere in the middle.

Value change from the last peak

Peak to date

Based on REITs share price (Sep 23) and MSCI Property and PFI capital value indexes (2Q23), USD



Source: Bloomberg, MSCI, PFI, Principal Real Estate, September 2023

Capital markets: deals are scarce and selective

Declines are broad-based across regions and sectors.

Real estate transaction volume was down across the board in the first half of 2023, and we expect activity to remain muted for the rest of the year. During the global pandemic capital markets were strong while occupiers struggled. Today's environment is exactly the opposite.

The rapid spike in interest rates and borrowing costs has set an end to the property investment cycle and led to a period of low liquidity and price dislocation. The market is being forced to adapt to a new paradigm where interest rates are higher, and investors can no longer depend on a wave of capital to depress yields and boost returns. Until markets reset to this new environment, the spread between buyers and sellers will remain too wide for transaction activity to normalize.

Commercial real estate transaction volume change: 1H23 vs 1H22

Exclude development sites, dollar, percentage change

> 60% decline

< 25% decline

	U.S.	E.U.	U.K.	ASIA PACIFIC	WORLD
Offices	-62%	-56%	-65%	-50%	-62%
Retail	-47%	-40%	-25%	-38%	-49%
Industrial	-48%	-64%	-64%	-38%	-52%
Hotels	-52%	-3%	-58%	-41%	-47%
Apartments	-66%	-57%	-48%	-9%	-66%

Source: RCA, Principal Real Estate, August 2023

Given this backdrop, our high-conviction ideas focus on **structurally resilient strategies**

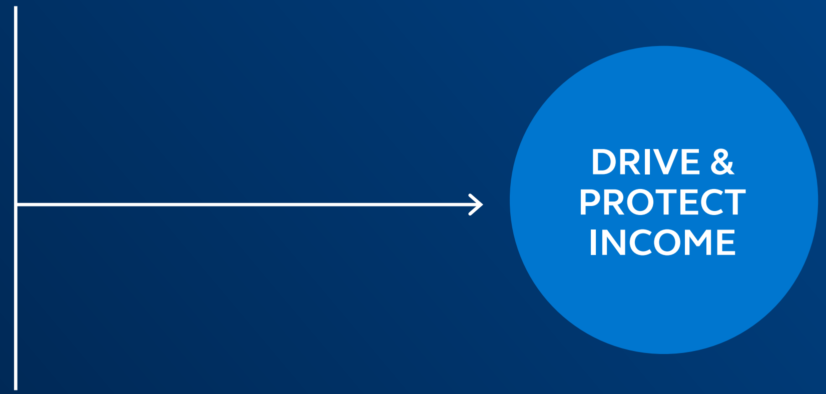
Our high-conviction ideas focus on two main structurally resilient strategies that help to drive and protect income.

1. *Identify the most attractive position in the capital stack: Debt*. The strategic relative value of debt is very compelling. A key bookend in our investment strategy is debt with its defensive position in the capital stack and a focus on current cash flow.

2. *Identify and overweight structurally resilient property types*. As market conditions change and evolve, investors should be ready to pivot to private equity real estate. We suggest taking this opportunity to anchor portfolios around structurally resilient property types and locations. These include data centers, logistics, apartments, life sciences, and student housing. Additionally, the coming months may offer some interesting opportunistic investment possibilities as deals get re-priced and capital stacks need recapitalization. We believe investors should keep dry powder available to deploy to take advantage of dislocation.

Identify the most attractive position in the capital stack

The strategic relative value of debt is very compelling



Identify and overweight structurally resilient property types

As market conditions change and evolve, be ready to pivot to private equity real estate

Source: Principal Real Estate, August 2023

High-conviction tactical strategies

Overweight debt and keep an eye on emerging equity opportunities.

We believe real estate debt offers compelling absolute and relative value making it our pick for preserving capital values while generating income. Careful asset selection is important however given the stress expected in certain property types as well as the probability of a mild recession.

With rates peaking and values expected to trough in the next six months, we will increasingly focus on the public and private equity real estate quadrants as means of gaining exposure. As real estate repricing completes with rates peaking, transaction activity will resume, and investors should take this opportunity to add equity real estate exposure to participate in the new cycle.

Regardless of quadrant, we recommend an overweight to "structurally resilient" property types and markets, with their strong tenant drivers and cash flows which are presented in more detail in the next pages.

Tactical outlook: an overweight to debt guides our income focus but we are sharpening our pencils to add public and private equity real estate across the risk spectrum

Sector	Investment preference Cautious < < Neutral > > Positive				
Private debt					
U.S.					
Senior	○	○	○	● (previous) →	●
Subordinate	○	○	○	●	○
Eurozone					
Senior	○	○	○	●	○
Subordinate	○	○	○	○	●
U.K.					
Senior	○	○	●	○	○
Subordinate	●	○	○	○	○
Public debt					
U.S.					
CMBS	○	○	○	○	●

Sector	Investment preference Cautious < < Neutral > > Positive				
Private equity					
U.S.					
Core	● (previous) →	●	○	○	○
Value-add	●	○	○	○	○
Opportunistic	● (previous) →	●	○	○	○
Eurozone					
Core	● (previous) →	●	○	○	○
Value-add	○	●	○	○	○
Opportunistic	○	● (previous) →	●	○	○
U.K.					
Core	○	● (previous) →	●	○	○
Value-add	○	● (previous) →	●	○	○
Opportunistic	○	● (previous) →	●	○	○
Public equity					
Global					
REITs	○	○	●	○	○
U.S.					
REITs	○	●	○	○	○
Eurozone					
REITs	●	○	○	○	○

Viewpoints reflect a 12-month horizon.

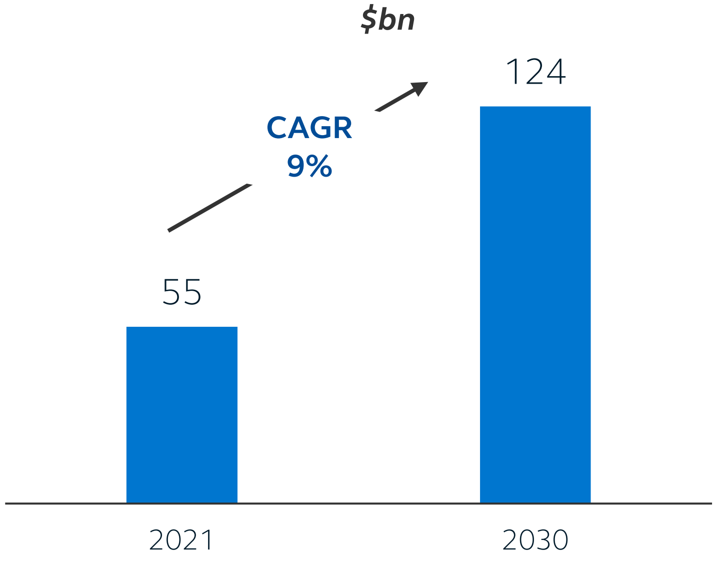
● → ● indicates a change in preference from the previous quarter (light blue) to the current quarter (darker blue).

Source: Principal Real Estate, May 2023. The recommendations above reflect our tactical views on relative opportunities over a 12-18 month horizon.

Ongoing growth of e-commerce and the internet continues

One of the most sought-after property sectors of the past year has been data centers. The global economy is increasingly more dependent on digital technologies, which in turn will fuel the growth of data storage and processing. This sector is poised to see a secular increase in demand, while on the other side, higher construction costs, constrained lending market and power supply bottlenecks will increase the barriers to entry. Take-up remains strong, driven by hyperscalers operators, the largest cloud computing providers, who continue to aggressively expand their presence to accommodate end users' needs.

Global data center market



Source: Verified Market Research, Principal Real Estate, June 2023.

Data center market growth drivers

Legislations: Governments initiatives, data localization laws and moratoriums

5G: Rollout of 5G services by telecom companies is likely to drive exponential growth in data consumption

AI, IoT and Gaming: Artificial intelligence, smart devices, homegrown video and gaming platforms in the midst of robust growth

E-commerce: Increased e-commerce adoption and spend by consumers

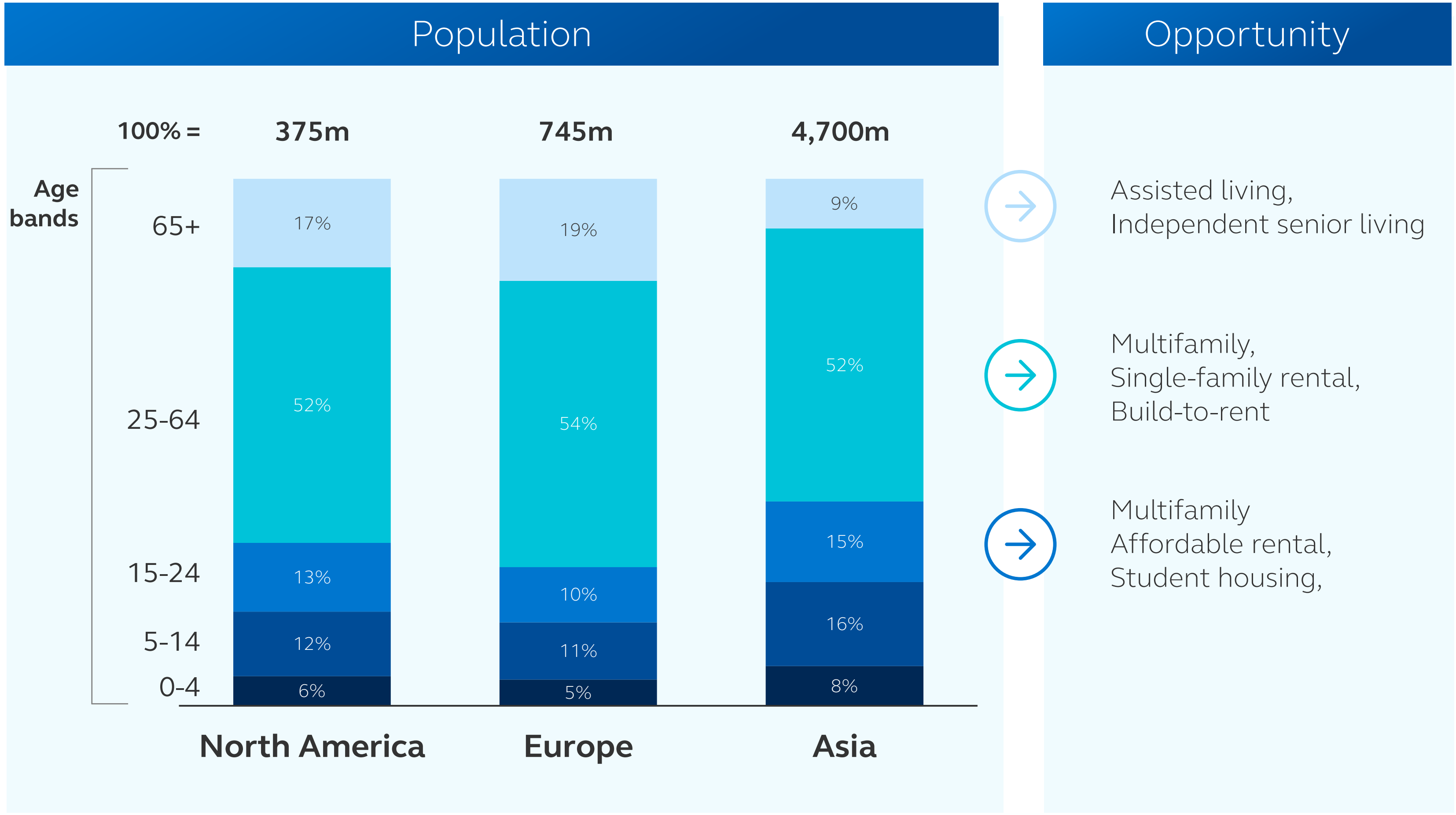
Digital penetration: Increasing digital usage emerging from distributed workforce, growing data security concerns and business disruptions

Creating a substantial global investment universe

Across all regions, individuals in the prime rental age group comprise the lion's share of the population. Understanding shifting demographics and incomes as a demand driver of different sub-types presents even more opportunities to expand investment strategies.

The reality of the housing market in the bulk of developed economies, is that it makes more sense to rent than to own a home. Housing prices, supply, and mortgage rates have propelled demand for multi-family units in all regions. As owning a home becomes more unaffordable, more and more people have joined the renter pool for longer. This has become apparent in a slew of statistics, including the rising median age at the birth of a first child, the age of a first-time home buyer, and the age at which children move out on their own.

Multiple age cohorts present a large, diverse investment opportunity



Source: United Nations, Principal Real Estate, June 2023.

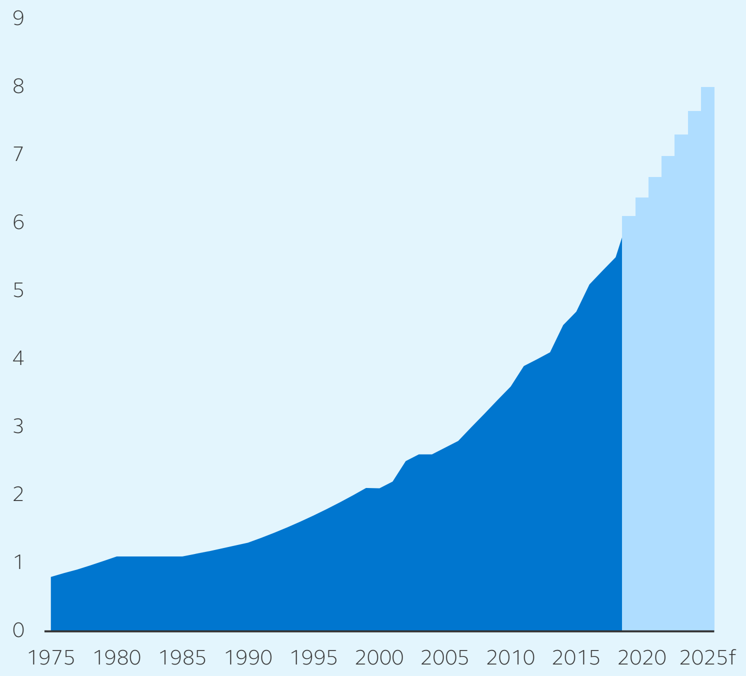
Global students' mobility set to surge through 2030

In our view, student housing offers an attractive investment opportunity, especially in Europe and Asia, due to strong fundaments and severe undersupply.

Macroeconomic and demographic data indicate global demand for higher education will continue to expand significantly over the next several decades. Second, global mobility for higher education is set to increase from a pre-pandemic level of five million students to as many as eight million students abroad by 2030. Third, even under the current climate of economic uncertainty, the sector remains attractive due to its potentially counter-cyclical nature, particularly in Europe: historically demand for education tends to increase during economic downturns.

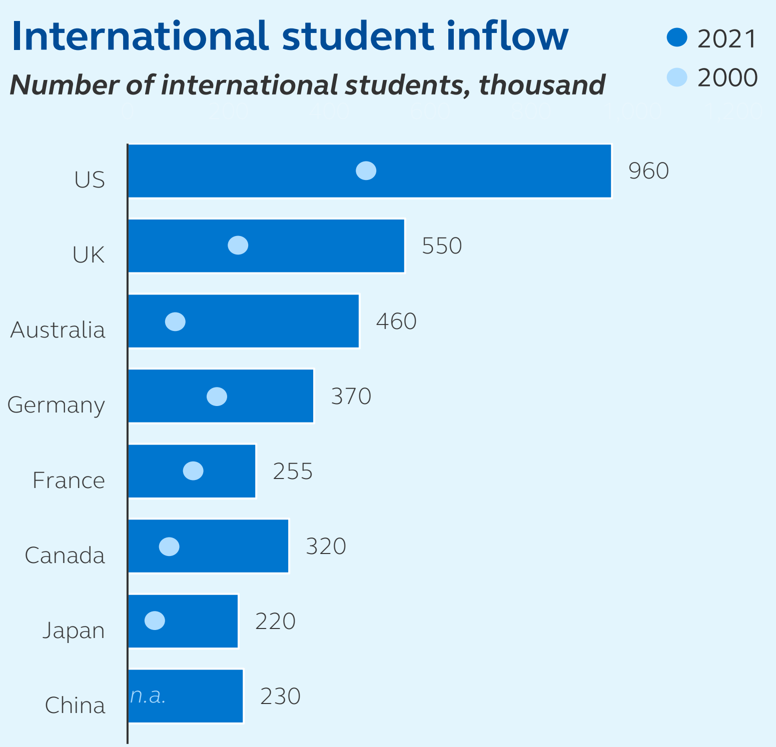
Global student mobility

Number of students, million



International student inflow

Number of international students, thousand



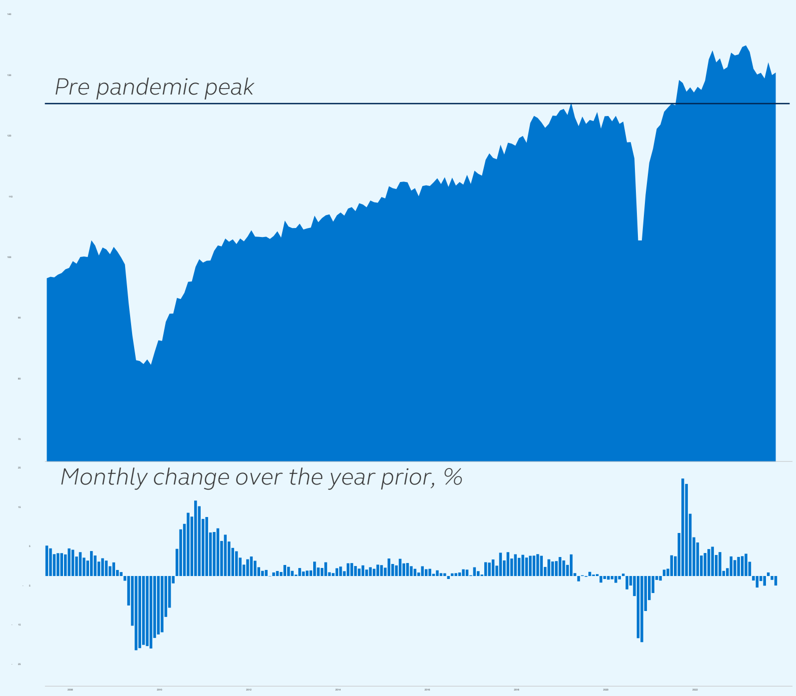
Source: OECD, PMA, Principal Real Estate, August 2023

E-commerce and trade driving fundamentals

Industrial is perhaps the sector where the divergence between capital markets and occupier demand is most evident. On one hand, underlying fundamentals are healthy, and rental dynamics continue to exhibit strength across all regions, sustained by supply chain restructuring and the prospect of growing e-commerce penetration. On the other side, European capital values repriced quicker and more sharply compared to other property types over the last twelve months, largely due to low nominal cap rates given the high level of investor demand which ramped up since the global pandemic. We believe ongoing correction and strong fundamentals may lure investors back sooner than in other sectors due to secular tailwinds.

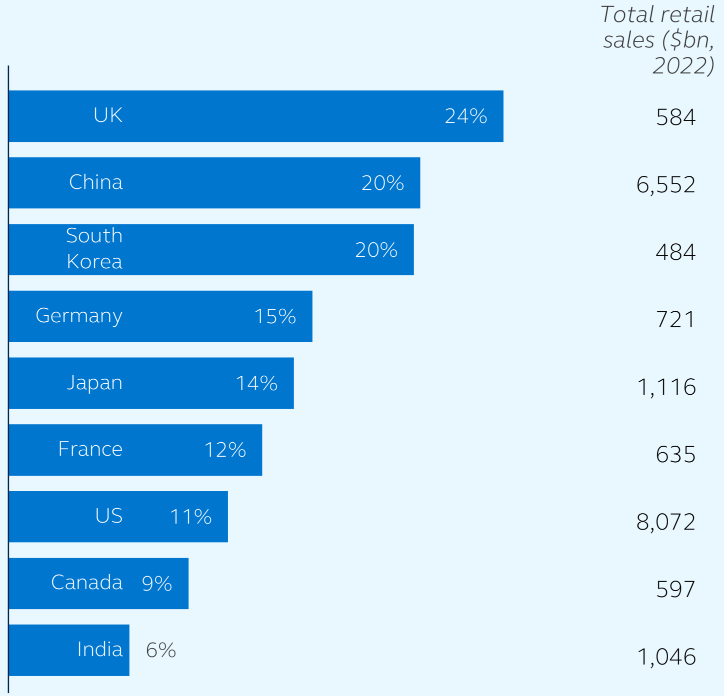
World foreign trade

Index, total volume, monthly, seasonally adjusted



E-commerce share of total retail sales

E commerce share (%, 2022)



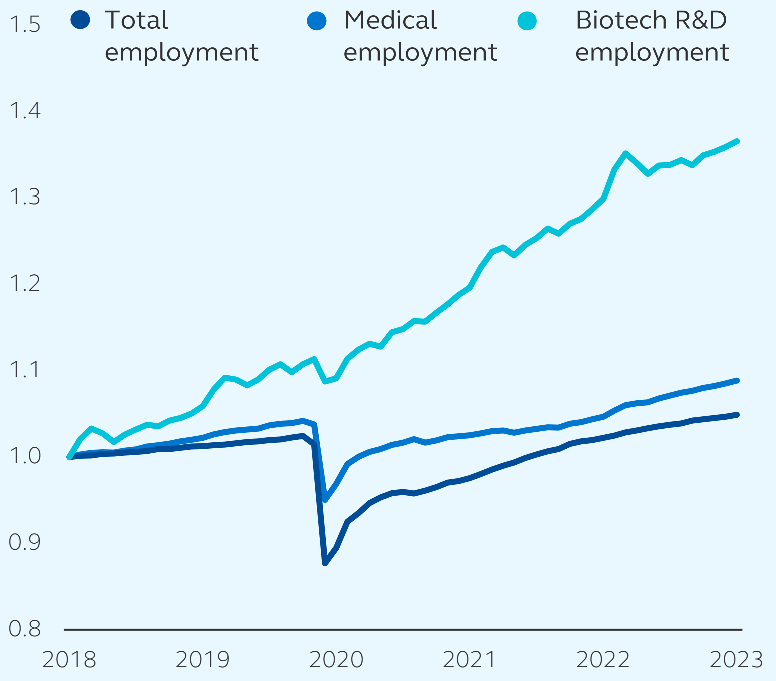
Source: Macrobond, Moody's, Statista, Principal Real Estate, August 2023

Pharma and biotech driving innovation and capex

Despite a cyclical pull back in venture capital funding, underlying fundamentals remain in good shape across all regions, particularly in the U.S. and the UK where the life sciences sector benefits from world-leading biotech clusters, top-tier research universities, and generally ample availability of funding. Looking ahead advances in bioscience and accelerating development of computing and AI are likely to fuel a “bio revolution” that will have radical impacts on all aspects of our lives and economies. Therefore, the life sciences sector remains among our favorites.

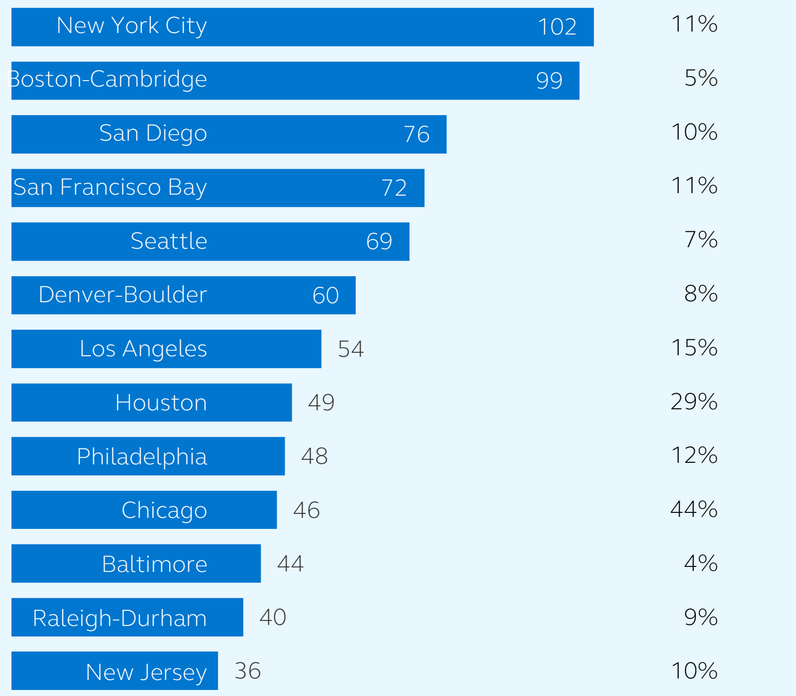
Total and life sciences employment

U.S. only, May 2018 = 1



Asking rent and vacancy rate

Average asking rent ($) *Vacancy rate*



Source: Moody’s, CBRE, Principal Real Estate, May 2023.

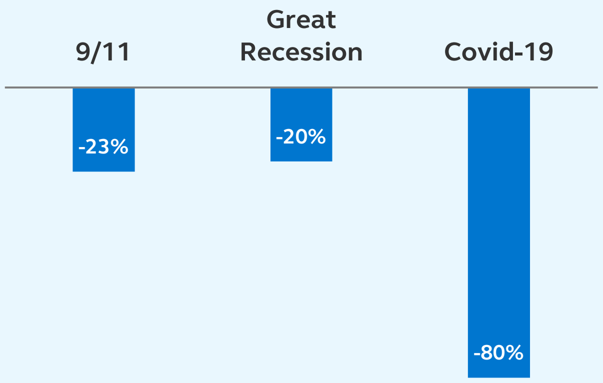
HOTELS/EUROPE:

Recovery is completed and long-term growth lies ahead

The hotel industry suffered a near-death experience during the pandemic due to the travel containment measures imposed by governments all around the world. Since then, the recovery of the travel and tourism industry has been equally spectacular. Most hotel markets have returned to pre-pandemic revenue levels, driven by a strong increase in average daily room rates, which has increased more than inflation in many markets. Travel and tourism are set to resume their long-term upward trajectory, underpinned by global mobility growth, rising middle class in developing countries, and a mounting desire to devote more time to leisure activities and memorable experiences. Our investment thesis pivots around identifying markets and owners in cities with strong leisure components, as our analysis suggests this segment should benefit the most from favorable structural trends over the upcoming investment cycle.

Demand shock comparison

Europe, RevPAR, percentage change, y-o-y

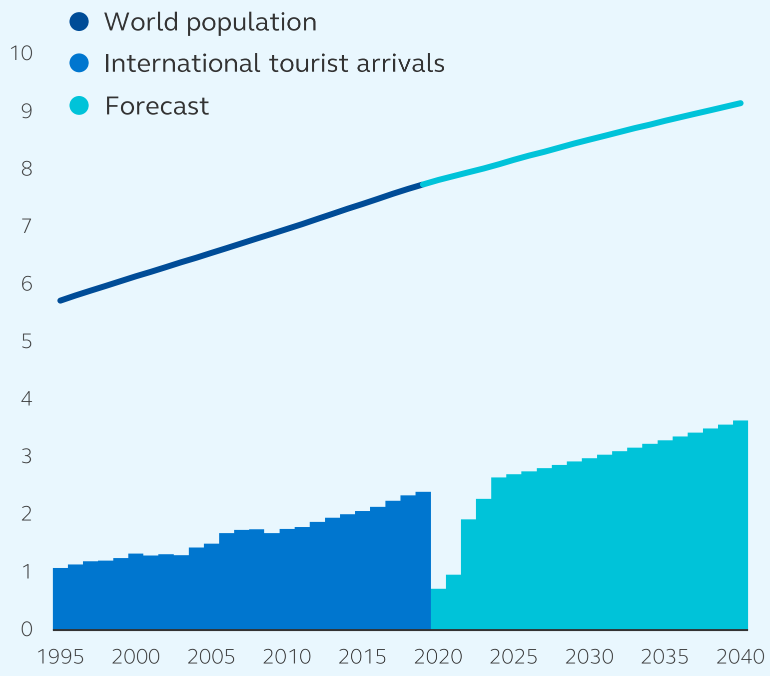


The Covid 19 pandemic was a shock like no other but by mid 2023 most European markets had fully recovered their RevPAR 2019 levels as pent-up demand for leisure travel surged.

International tourism is forecast to resume its growth at 2-3% p.a., driven by growing world population (ca.1% p.a.), increasing middle class, and life-style changes.

World's international tourism

World population and number of arrivals, billion



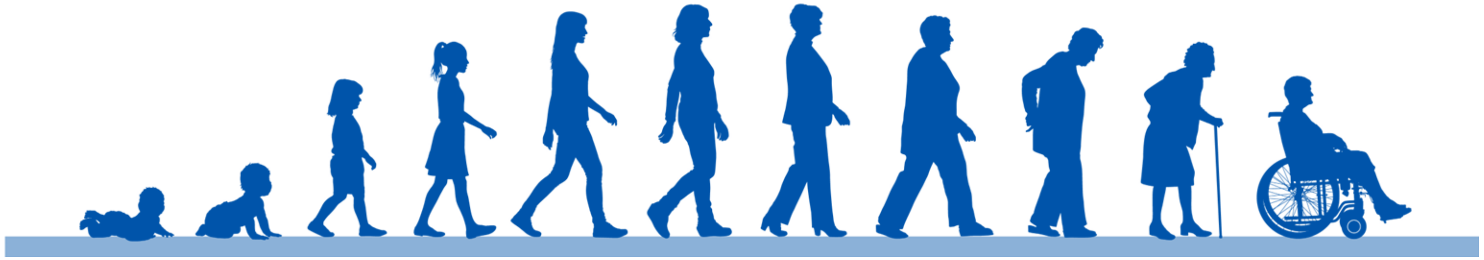
Source: Macrobond, STR, Principal Real Estate, August 2023

Investment is set to rise as demographics drive demand

Long-term structural forces are set to significantly drive up the demand for health care services and related real estate facilities over the next several decades, including an aging population, the reduction in informal care provisions, the increase of chronic diseases, and the growing privatization of care services. Population projections show that the demographic structure of several developed countries is relentlessly moving towards an inverted pyramid shape with a preponderance of elderlies at the top. And demand for health care services will increase accordingly. However, in this current cycle, we recommend caution and investors should approach the sector purely on an opportunistic basis, should compelling price dislocation opportunities emerge. This is particularly the case in the European care homes market where a growing imbalance between costs and revenue has already led to a significant number of insolvencies. In an environment where yields are still adjusting, income security is paramount.

Socio-demographic developments, in particular the aging population, are leading to a greater need for health care services over the coming years, and thus to high demand for corresponding real estate in the long term.

27% OECD average share of population aged 65+ by 2050



Share of 65+ population								
2019	15	12	28	22	20	19	18	17
2050	40	26	38	28	28	25	24	22
Difference	**+25ppt**	**+15ppt**	**+9ppt**	**+7ppt**	**+8ppt**	**+6ppt**	**+7ppt**	**+6ppt**

Source: Moody's, Principal Real Estate, August 2023

Let's talk about U.S. office….

Employees reluctant to return to office in the U.S:

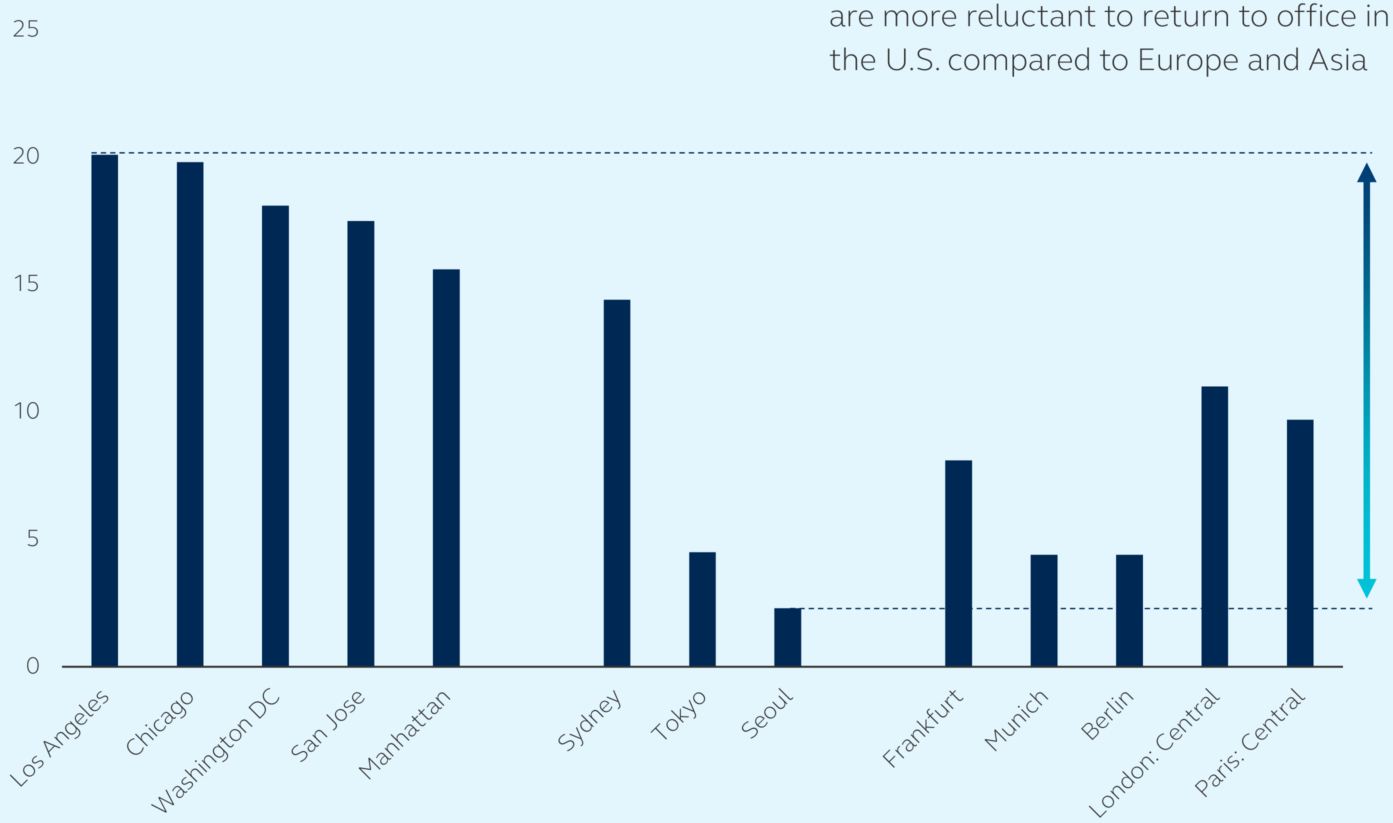
Office's global fundamentals vary by geography. The U.S. trails behind Europe and Asia, a gap that can be explained by cultural differences and the highly transitable, dense infrastructure that exists in countries outside of the U.S.

For U.S. office markets, as is always the case in commercial real estate, context is key. The fundamentals for the property type on the aggregate are bleak, but there exist pockets of success. Buildings of an older vintage with poor amenities will likely not fare well. New, high amenity, ESG compliant office spaces, often with tech tenants, as well as office spaces for medical and research purposes, are experiencing healthier fundamentals.

Vacancy rates in selected office markets

U.S., Asia, and Europe, percentage (%)

U.S. gateway markets are struggling with high vacancy levels as employees are more reluctant to return to office in the U.S. compared to Europe and Asia



U.S. Source: CBRE EA, Principal Real Estate, Q2 2023. Australia Source: JLL, Principal Real Estate, Q2 2023. Japan Source: Cushman Wakefield, Principal Real Estate, Q2 2023. South Korea Source: Colliers, Principal Real Estate, Q2 2023. Europe Source: PMA, Principal Real Estate, Q2 2023.

Conclusion

"A new cycle is forming and investors should stay defensive and keep dry powder to deploy in the coming vintages."

Investors should stay cautious but nimble and be prepared to add risk selectively.

Although the disinflationary trends and the end of the tightening cycle are in sight, the lagged impact of these recessionary forces has yet to fully unfold on the real economy, which will invariably affect demand for commercial properties and may extend the time needed for commercial assets to re-price.

While we feel this will create new challenges, it will also offer a unique set of opportunities for those investors who are able to see beyond the current clouds and recognize the long-term potential that structural property types and markets have to offer.

The pause and ending of monetary policy tightening, which appears more imminent, should be a powerful positive catalyst for commercial real estate. A new cycle is forming and investors should stay defensive and keep dry powder to deploy in the coming vintages.

About Principal Real Estate

Access the full spectrum of today's commercial real estate investment opportunities.

Principal Real Estate is the dedicated real estate investment group within Principal Asset Management.

We have a 360° view of real estate, with capabilities that span the spectrum of public and private equity and debt investments. We seek to maximize opportunities and find the best relative value on behalf of our clients using our specialized market knowledge, dedicated and experienced teams around the globe, and extensive connections across all four real estate quadrants.

- Top 10 global manager of real estate[1]
- Over $97 billion in real estate assets under management[2]
- Over 60 years of real estate investment experience[3]
- More than $122 billion in real estate debt and equity transactions over the past decade[4]
- Recognized globally as a leader in sustainable investing[5]

PrincipalAM.com/realestate

See next slide for footnote references

Important information

[1]Managers ranked by total worldwide real estate assets (net of leverage, including contributions committed or received, but not yet invested; REOCs are included with equity; REIT securities are excluded), as of 30 June 2022. "The Largest Real Estate Investment Managers," Pensions & Investments, 3 October 2022.

[2] As of 30 June 2023. Includes clients of, and assets managed by, Principal Real Estate Europe Limited and its affiliates. Does not include assets that are managed by Principal International and Retirement and Income Solutions divisions of Principal. Due to rounding, figures shown may not add to the total.

[3] Experience includes investment activities beginning in the real estate investment area of Principal Life Insurance Company and continuing through the firm to present.

[4] As of 31 December 2022. Excludes public REIT transaction volume.

[5] As recognized by Global Real Estate Sustainability Benchmark (GRESB) assessment: 4-Star rating seventh consecutive year, 2022. 2016-2022 Global Real Estate Sustainability Benchmark (GRESB) assessments for Principal Real Estate's U.S. Core strategy representing data from 31 December 2015 to 31 December 2021; 4-star rating reflects top 40% worldwide performance. In order to receive a ranking, the Firm paid GRESB an application fee to be evaluated and rights to use the rating. Principal Real Estate recognized as ENERGY STAR Partner of the Year 2016-2023, Sustained Excellence Award 2018-2023; as of April 2023

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