

U.S. Real Estate sector report

Four quadrant perspectives

SPRING 2024

Sector conditions and outlook

KEY:





- Improving ● Neutral ● Deteriorating
- ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

		Current condition	Outlook
<p>APARTMENT</p>	<p>The apartment sector continues to experience deterioration in market fundamentals, primarily due to oversupply in Sunbelt metros. Demand has remained largely positive but is not strong enough to offset record deliveries. Liquidity remains constrained but is generally favorable relative to other sectors today. The longer-term outlook remains positive despite near-term headwinds.</p>	●	→
<p>HOTEL</p>	<p>Hotel performance remains generally healthy as the recovery from the pandemic continues. Occupancy rates remain within their equilibrium range and RevPAR continues to show positive—albeit slower—growth on a 12-month trailing basis. The sector remains among the most tied to economic activity on a short-term basis and would be at risk if growth slowed materially.</p>	●	→
<p>INDUSTRIAL</p>	<p>The industrial sector is experiencing a slowdown in market fundamentals. Preliminary data throughout the first three months of 2024 show the first negative quarter of net absorption in more than a decade. New deliveries will remain a headwind through the balance of 2024 before easing due to capital market constraints. The sector remains favored by investors today and value declines have been restrained relative to other sectors.</p>	●	↗
<p>OFFICE</p>	<p>The office sector continues to see a deterioration in both market fundamentals and investor sentiment. Private equity valuations are still in the middle of a significant corrective phase, while both liquidity and transactions remain scarce. The outlook is clouded by poor in-office attendance and uncertainty surrounding occupier strategies that will need to focus on a structural reduction in workplace attendance. While in-office visits have improved over the past 12 months they remain well below their pre-COVID trend.</p>	●	↓
<p>RETAIL</p>	<p>Although investors continue to take a cautious approach to the retail sector, it remains among the top performers in real estate. Performance and investor interest continue to be highly bifurcated, favoring grocery-anchored centers with value-oriented tenants. The lack of new development and consistent consumer spending on necessity goods has been supportive of strong occupancy at a time when most other sectors are seeing an erosion in fundamentals.</p>	●	→

Sector conditions and outlook continued

KEY:

● Improving
 ● Neutral
 ● Deteriorating
↑ Positive
 ↗ Moderately positive
 → Neutral
 ↘ Moderately negative
 ↓ Negative

		Current condition	Outlook
SINGLE-FAMILY RENTAL 	The sector continues to benefit from pricing dislocations in the for-purchase market. Demand has remained healthy, and supply is far more restrained than in the traditional apartment sector. Rent growth remains in the mid-single digits and a lack of debt available for new development will prove to be a tailwind for the sector over the next 12 to 18 months.	●	↗
DATA CENTERS 	Data center demand remains robust and continues to outpace newly commissioned power in all major markets. Vacancy rates are near historical lows for the sector, allowing strong rental growth and adding fuel to an already hot sector. Debt availability and the ability to develop space to meet growing demand are the primary headwinds to the sector today.	●	↑
STUDENT HOUSING 	Tenant demand remains healthy and leasing trends and pre-leasing levels for the 2024 academic year are at record highs—a measured improvement over 2023. Occupancy rates remain healthy and are supporting stable rental inflation. Capital market headwinds have prevented investors from being more aggressive in deploying capital into the sector despite strong investment performance relative to other sectors.	●	↗
LIFE SCIENCES 	The life sciences sector continues to experience moderate to severe headwinds following its solid performance over the past few years. Venture capital, which was plentiful during the height of the pandemic, has largely dried up for start-up firms with only well-capitalized companies with established therapeutic pipelines eyeing expansion in the current environment. Market fundamentals have suffered as a result and private equity performance has languished.	●	↘

Source: Principal Real Estate, April 2024.

APARTMENT

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↘	↗	→	↓	↓	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium

Sector overview

The apartment sector continues to experience deterioration in market fundamentals, primarily due to oversupply in Sunbelt metros. Demand has remained largely positive but is not strong enough to offset record deliveries. Liquidity remains constrained but is generally favorable relative to other sectors today. The longer-term outlook remains positive despite near-term headwinds.

Private equity

The apartment sector remains a favorite among private equity investors despite capital market dislocations and rising vacancy rates due to pockets of oversupply—particularly in Sunbelt markets. Despite the erosion in occupancy rates due to high levels of supply, demand has remained positive across most markets. The high cost of debt capital has continued to weigh on investor demand through the first quarter of 2024.

Transaction volume in the apartment sector has declined by 25% through the first three months of the year due to pricing uncertainty and the lack of debt capital available to investors. Although the sector continues to benefit from liquidity through government-sponsored enterprises (GSEs), investors remain deterred by the rising cost of leverage at a time when values are in decline. Upward pressure in cap rates, IRRs, and exit caps have continued to filter through apartment valuations early in 2024, but as interest rates have stabilized, the transaction market is showing nascent signs of stabilization relative to last year.

Deliveries will continue to add to supply throughout 2024 and into 2025. It is taking time for higher costs of capital to slow development activity, and supply relief is unlikely to arrive until 2026. Rent growth is likely to remain tepid until that time, as demand struggles to keep up with the wave of construction deliveries. The positive news for apartment owners is that over the medium-term landlords should experience a period with significantly reduced deliveries and increased pricing power as prohibitively high costs of homeownership and a desire for more space in a post-COVID world will help drive rental demand.

Apartment sector demand will receive a boost due to low levels of affordability in the single-family for-purchase market. Record low affordability due to price increases during the pandemic and higher interest rates today are forcing would-be home buyers to rent at a time when prior generations would have already entered the purchase market. Aside from the costs associated with home ownership, there is some evidence that renters are putting off entering the purchase market temporarily due to the increased flexibility and mobility associated with renting.

Private debt

Apartment loans remain attractive to many lenders today, given the resilient demand for rentals paired with reduced single-family home affordability, but pressure from higher interest rates has strained valuations, debt service coverage ratios (DSCR), and other underwriting metrics. Reduced investment sales activity resulting from capital markets challenges,

APARTMENT (continued)

a reduction in refinancing requests, and tighter underwriting standards continue to hinder multifamily lending volumes. Multifamily financing activity over the past six months is roughly half its year-ago level.

Despite this, broad-based lender interest in apartments paired with competitive pricing and enhanced liquidity provided by GSEs continue to make multifamily lending rates the lowest of all property types. Insurance companies are offering interest rates in the 5.9% range on well-located apartment properties loan-to-values (LTV) between 55% to 65%, with slightly higher rates from many banks. Fannie Mae and Freddie Mac sometimes offer 75% LTV financing with rates in the low 6% range for select multifamily properties, and in some instances, offer more aggressive rates for properties with a strong affordability component for lower-income households.

REITs

Apartment REITs slightly outperformed the index year to date in 2024. In contrast to meaningful performance, bifurcation between coastal (outperformers) and Sunbelt (underperformers) portfolios last year, there has been less differentiation this year. Instead, there has been heightened debate among REIT investors thus far in 2024 about whether demand in Sunbelt markets will be strong enough to absorb peak deliveries, and if REITs focused on the region are attractively priced for a strong medium-term recovery.

Early leasing trends in 2024 are running slightly above REIT guidance. Occupancy and renewal rates are better than expected, driven by healthy labor markets and the relative affordability advantages of renting. Conversely, pricing power on newly signed leases remains weak, especially in the Sunbelt markets due to competition from recent developments undergoing lease-up. Overall apartment fundamentals are not falling off a cliff, but lower rental growth is expected with the potential risk of further declines in heavily

supplied markets. Given mostly flat returns through the first quarter, apartment REITs continue to trade at larger-than-average NAV discounts compared to other sectors.

CMBS

The GSEs continue to be a dominant lender in the multifamily space with \$140 billion of approved lending capacity. Combined agency issuance has been constrained by low transaction volumes. While much smaller in scale, multifamily exposure in conduit and single-asset single-borrower (SASB) CMBS is significant at roughly \$55 billion outstanding. Conduit multifamily lending has been strong to start 2024 as exposure to multifamily loans in conduits issued in the first quarter was 18.5%. Over the past five years, multifamily exposure in conduit deals has ranged from 22.6% in 2021 to 9.1% in 2023. Loan performance has remained very strong in fixed rate, as the conduit multifamily delinquency rate is at 1.3% which is the second lowest by the property sector behind industrial.

Some weakness is emerging in floating rate SASB loans underwritten at tight debt yields when interest rates were extremely low. Rising rates have resulted in large increases in debt service burdens, cooling prospects for NOI (net operating income) growth, and valuation challenges that have resulted in floating rate loans having difficult refinancing. The SASB multifamily delinquency rate is 2.2%, which is being driven by maturity defaults.

Overall, multifamily remains an in-favor sector within fixed-rate conduit CMBS given longer loan terms, fixed-rate coupons, historical NOI growth, poor single-family affordability in the for-purchase market, and low exposure to rent-regulated properties.

HOTEL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	→	↗	↗	↘	↓	→

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The lodging sector continues to benefit from a strong labor market and surprisingly resilient economic growth. Occupancy rates remain healthy and RevPAR (Revenue per available room) growth over the last 12 months has kept pace with broader inflationary trends. Improvements in both business and consumer sentiment early in 2024 auger well for continued improvement in fundamentals as travel is nominally on par with its pre-pandemic levels. The primary headwind for the sector remains the prospect of a cyclical lull in business activity with a concomitant decline in hiring. While risks to the economic expansion remain, the likelihood of a broader recession in 2024 appears lower than it was six months ago.

Another positive is that supply-side pressures are constrained in the near-term. Higher borrowing costs and a lack of ample funding have conspired to keep development pipelines in check. This should help the sector remain on an even keel despite risks of slower economic growth.

Private debt

Hotel debt markets were open during 2023 but experienced muted production levels. Anecdotal evidence suggests a modest uptick in lending activity during the first quarter of 2024, driven largely by CMBS lenders (particularly for SASB executions that sometimes exceeded \$200 million in size). Hotel lending by insurance companies and large banks remains limited, but debt funds and CMBS have been attracted to the relatively higher credit spreads associated with hotels.

Hotel loans today may be structured with either variable or fixed interest rates. As of March 2024, stabilized hotel loans were being financed by CMBS lenders (both SASB and conduit) with spreads in the mid-to upper-200 basis point range over swaps, assuming the collateral features a debt yield over 10% and an LTV under 60%. Debt funds often allow slightly higher loan-to-value ratios with spreads in the mid-300 to 500 basis point range over SOFR or swaps and may consider guarantor recourse as a substitute for higher debt yield requirements.

In the market for distressed hotel debt, private funds have also raised a significant amount of capital targeted toward subordinate debt and rescue capital for hotels. These funds generally seek returns in the high teens to low 20% range for last-dollar LTV ratios up to 85-90% but have placed very little of this money so far due to limited borrower demand.

REITs

Lodging REITs outperformed other property sectors year-to-date due to continued improvements in urban and business hotel demand, partially offset by weakness in leisure activity. During winter, we saw leisure travel demand continue to moderate, with underperformance in resort hotels plus weakness in luxury and economy travel segments. Corporate travel continues to improve and drive the urban hotel recovery, narrowing the underperformance relative to leisure properties, with increases in group demand. Corporate transient also continues to improve and drive mid-week occupancy improvements but lags earlier expectations due to still sluggish return-to-office trends.

HOTEL (continued)

Recent earnings updates were mostly in line or slightly ahead of expectations as group and urban travel demand offset a smaller-than-expected fall in leisure demand. Guidance for 2024 is mostly in the 2% to 4% RevPAR growth range, with the trend expected to slow as the year goes on from the high single digits in several markets early in the year. Margins are still expected to contract year-over-year in 2024 as expense growth is expected to outpace RevPAR. Lodging REITs are trading at a 15% to 20% discount to NAV estimates, a larger magnitude than what is seen across most other REIT sectors, reflecting economic uncertainty, concerns about leisure travel weakness, and general margin erosion.

CMBS

Despite a slowdown in demand from post-COVID highs, hotel operations have continued to show solid performance with loan performance following suit. The conduit hotel delinquency rate peaked near 20% in July of 2020 and now stands at 4.5%, just 0.3% higher than the overall conduit delinquency rate. Leisure travel initially spurred a strong recovery in vacation

destination markets with business travel recovering in turn. Hotel operators have grown RevPAR by raising average daily rates, while occupancies are lower than four years ago, which is especially prevalent in higher-end categories. RevPAR growth appears to be leveling out year-over-year as consumers have mostly burned through excess savings.

CMBS issuances in 2020 and 2021 included very little hotel exposure due to underwriting challenges and investor skepticism. As fundamentals have improved, hotel loan contributions have grown to 12% of 2023 conduit issuance, 10% of 2024, and over 16% of SASB collateral issued year-to-date, showing that capital is available for better-positioned properties. While the recent macro trends have been supportive, hotel performance is highly correlated to economic growth and could be negatively impacted by a slower growth scenario where discretionary spending trends become challenged warranting a more conservative approach to both underwriting and forward-looking credit assessments.

INDUSTRIAL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	↘	→	↗	↘	↘	→

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The industrial sector is experiencing a slowdown in market fundamentals. Preliminary data as of the end of Q1 2024 shows that the sector experienced its first quarter of negative net absorption in more than a decade. New deliveries will remain a headwind through the balance of 2024 before easing due to capital market constraints. Near-term headwinds notwithstanding, the sector remains favored by investors today and value declines have been restrained relative to other sectors.

Private equity

The industrial sector has remained one of the top-performing property sectors over the past year, but a wave of new supply and slowing demand are conspiring to push availability rates higher. The industrial availability rate increased to 7.8% in Q1 2024 and is projected to rise to 8.9% by 2028—for context, equilibrium availability for the market remains in the 9% to 10% range, meaning that we should still see moderate rental inflation in most markets over the five-year forecast horizon.

Demand for warehouses in the United States is not what it was during the pandemic, but that pace was bound to normalize. Preliminary data through the end of Q1 shows that the sector posted -26.5 msf on net absorption, the first quarter of negative demand since 2010. We remain confident that the demand for warehouse space will rebound in 2024 even in a slower macroeconomic growth environment, due to strong structural drivers.

Regionally, space market fundamentals have diverged in the past 12 months with some markets, like Los Angeles, Miami, South Central PA, and Louisville, retaining availability rates below 6% as supply and demand has remained finely balanced. Other markets such as San Francisco, Austin, Dallas, and Phoenix have seen availability rates gap out significantly, which will require as many as five years of positive net absorption to get back to equilibrium.

On a more positive note, we anticipate a much more restrained development environment due to capital market headwinds and more moderate increases in NOI than were experienced post-pandemic. The high cost of capital and restrained lending on the part of banks and life companies concerned with real estate exposure is starting to have a material impact on development pipelines. Industrial square footage under construction in Q1 2024 declined to 391 msf, which is a 41% drop from 668 msf in Q1 2023.

Industrial transaction activity dropped for a second consecutive time, going from \$167.9b in 2021 to \$87.1b in 2023. This level of transaction volume is more in line with pre-pandemic levels, which is to be expected as the pandemic era was unsustainable. This price discovery period has continued to push asset values downward in the sector, but with a bit of luck, we feel that 2024 has the potential to be a year of transition.

Private debt

The industrial sector – along with apartments – remains a favored sector among lenders due to its relatively healthy market fundamentals and

INDUSTRIAL (continued)

portfolio diversification benefits. Well-located, high-quality warehouses and larger logistics properties in major markets today often garner 10-year, fixed-rate financing with 55-60% LTV ratios and interest rates near 5.95%. Pricing tends to be somewhat less competitive than those offered by lenders for multifamily, perhaps due to competition from the GSEs that does not exist in the industrial sector. Nevertheless, industrial remains a very close second to multifamily in terms of lender preference and aggressive pricing.

REITs

Industrial REITs have underperformed the broader index year-to-date following a strong performance in late 2023 that was in part sparked by a positive long-term outlook from Prologis. The company issued 3-year guidance at its investor day in December which called for high single-digit to low double-digit annual property income and earnings growth derived from 4-6% growth in market rents from 2024 to 2026. While near-term rental growth is anticipated to be more inflationary due to supply pressures and softer demand, growth is expected to rebound as supply headwinds fade. Southern California continues to be one of the weaker markets but should benefit from a rebound in port volumes thanks to the ratification of a new union labor contract last summer and issues affecting other ports (e.g., Panama Canal drought, Suez Canal safety concerns, and potential East Coast port strikes).

Recent earnings updates were ahead of expectations and driven by strong operating performance. While guidance for 2024 came in in line or slightly below street estimates, it pointed to growth that is still well above the REIT sector average. Also, initial guidance is

typically conservative and there appears to be upside from external growth. Management teams continue to take a measured approach to developments, but acquisition activity has picked up. More properties are coming to the market, the bid-ask spreads are narrowing, and REITs have good access to capital. Industrial REITs trade in line with consensus NAV on average which enables them to issue equity for acquisitions.

CMBS

Industrial loans currently carry the lowest delinquency rate within the CMBS universe and continue to be viewed positively, especially relative to other traditional sectors. This view is supported by the current economic outlook, market fundamentals, and availability of capital. The CMBS SASB market provided over \$42 billion of floating-rate debt to industrial owners since 2020, offering an efficient source of financing for very large portfolio deals. With a significant increase in floating rate refinancing SASB loans, capital markets have improved which allowed Blackstone to refinance three industrial portfolios in 2024.

In the conduit space, industrial allocations since COVID have increased to 10% to 12% compared to 6% to 7% before 2020. Conduit CMBS industrial loans are generally smaller than the large SASB deals and in some instances, exhibit exposure to tertiary locations, less functional layouts, and non-investment grade tenancy (often via sale and leasebacks). Because of this, underwriting metrics for conduit industrial loans have typically been more conservative than SASB industrial loans. Overall, historically strong NOI growth, relatively durable cash flows, and positive investor sentiment should benefit the space.

OFFICE

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↓	↗	↓	↓	↓	↓	↓

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The office sector continues to see a deterioration in both market fundamentals and investor sentiment. Private equity valuations are still in the middle of a significant corrective phase, while both liquidity and transactions remain scarce. The outlook is clouded by poor in-office attendance and uncertainty surrounding occupier strategies that will need to focus on a structural reduction in workplace attendance. While in-office visits have improved over the past 12 months they remain well below their pre-COVID trend.

Private equity

Office remains the most challenged property sector today, with headwinds stemming from capital markets, space markets, and looming debt maturities that will test its resilience. Additionally, the sector remains challenged by poor workplace attendance and still weakening market fundamentals. Net absorption remains negative, and the national vacancy rate reached 19.0% as of Q1 2024, well above the sector's equilibrium rate which is consistent with rent growth on par with broader inflation.

Investor demand for office acquisitions is scant. Fund managers continue to dial down their exposure to the sector as evidenced by the current NFI-ODCE 18% weight to the sector, which was in the high 30% range just before the Global Financial Crisis (GFC). Despite the denominator, which has been declining since 2022, sales of office properties declined by 41% through the first quarter of 2024 on a 12-month trailing basis.

We anticipate another year of weak demand as most leases signed just before the pandemic have yet to expire and workplace attendance remains well off its

pre-COVID peak. With a three-day in-office mandate emerging as the new standard, many occupiers will be looking to offload unused or underutilized space. The silver lining is that there is little new speculative supply in the pipeline and the lack of debt capital for the sector will act as a strict governor on further development. In the past 12 months as an example, just 30 msf have been added to existing stock, a low-water mark since 2012.

Stabilization in the office sector is not a sure bet for 2024, although there are nascent signs of small improvements in workplace attendance and a bottoming of demand, as well as pricing for the cycle. High vacancies and declining rents are contributing to mounting distress in both private equity and debt markets. Negative cash-flow events further serve to undermine property valuations, which are in the most severe correction since the GFC.

Private debt

Few lenders are willing to finance office properties today, even on the most conservative basis, due to weak property market fundamentals and elevated existing portfolio exposures. Some CMBS conduits are financing office properties that feature a combination of favorable tenancy, longer remaining weighted average lease terms, strong physical utilization of space, healthy rent collection experience, and that conform with emerging design preferences. However, even that capital is quite limited and is not sufficient to fill the pending refinance gap. Certain debt funds have expressed a willingness to provide loans for office properties, although their required yields are typically greater than the properties' existing economics will support.

OFFICE (continued)

Most office financing today involves existing lenders refinancing their own debt or sellers providing seller financing in connection with a disposition. Seller-financed transactions typically provide buyers low-to-moderate leverage at interest rates unavailable in the market while allowing sellers to reduce their exposure to the property type.

REITs

Office REITs have modestly underperformed the broader index year-to-date, giving back some of the outperformance of late 2023. Volatility remains high with stock price movements largely driven by the macro-economic outlook and expectations for interest rates. Fundamentals continue to be weak as leasing volumes remain well below pre-pandemic levels and availability is at or near record high levels. New York continues to be an outperformer relative to the West Coast and Sunbelt where tech demand remains lackluster.

Recent earnings updates were better than expected but guidance for 2024 came in slightly below expectations pointing to a high-single digit decline in earnings. Misses vs. consensus estimates came from a combination of higher interest expenses, lower occupancy, and conservatism. On a positive note, after four years of steadily rising vacancy, several REITs expect portfolio occupancy to be approaching a trough. Cautious optimism is driven by healthy leasing pipelines and increased tour activity which should eventually drive improved leasing activity. REITs also benefit from the flight-to-quality trend. Another recent change is that transaction activity has picked up with several REITs buying out joint venture partners at discounted prices, taking advantage of partners' reluctance to invest any additional capital in leasing and redevelopment and a general desire to reduce office exposure. Office REITs are trading on average at a 25% to 30% discount to NAV, reflecting potential further downward pressure on property values.

CMBS

Office exposure continues to face scrutiny due to ongoing secular headwinds. Conduit CMBS has historically averaged roughly 30% office exposure; however, issuers have responded by limiting office exposure, which declined to 20% in 2023 and to just 13% year-to-date in 2024. Delinquency rates remained remarkably stable throughout the pandemic but have trended up since 2022 from 1.9% to 5.1% for fixed-rate conduit transactions. Long-term leases, diversified rent rolls, and high underwritten DSCRs help to significantly mitigate term default risk. However, refinance risk is elevated given NOI pressure, constrained capital markets, and higher interest rates.

Floating rate SASB loans are much more exposed to near-term default risk given the significant increase in short rates and a corresponding drop in DSCRs, which has led to several high-profile defaults and pushed the SASB office delinquency rate to 7.3% with almost 70% of the defaults occurring at maturity. Given the difficult refinance environment, CMBS servicers are working with borrowers by providing loan extensions in exchange for fresh equity contributions, cash flow sweeps, and other lender-friendly requirements. This approach seeks to improve bondholder outcomes, although it does create timing uncertainty which is adding to pricing concessions. Recently constructed class A office assets are performing quite well, exhibiting positive net absorption and significantly higher market rents. Importantly, nearly 50% of conduit CMBS office exposure is considered Class A, a fact that is not reflected in highly elevated market risk premiums. Investors who can approach office exposure with a more discerning viewpoint are positioned to benefit from current pricing levels over the longer term.

RETAIL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↑	↗	→	↘	↘	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

Although investors continue to take a cautious approach to the retail sector, it remains among the top performers in real estate. Performance and investor interest remain highly bifurcated, favoring grocery-anchored centers with value-oriented tenants. The lack of new development and consistent consumer spending on necessity goods has been supportive of strong occupancy at a time when most other sectors are seeing an erosion in fundamentals.

Private equity

Retail was the strongest performer over the past year within both NFI-ODCE and NPI Indexes, a reflection of solid fundamentals but also of the higher nominal valuation metrics coming into this period of repricing. Market fundamentals are healthy, but demand is tapering across most sub-sectors, as consumers are showing signs of stress. Discretionary sales categories have wavered over the past several months as household balance sheets are weakening due to higher price levels.

While retail is typically a more cyclical sector, we continue to favor shopping centers with essential and value-oriented retail tenants. While we continue to believe that the economy will avoid recession, retail centers focused on discretionary spending could face challenges in 2024 due to modest weakening in household balance sheets relative to the past few years.

Hybrid shopping centers featuring experiences and combining in-person stores and online shopping have put themselves in a position to capitalize on the shifting consumer preference from goods to services. At the same time, work-from-home has limited the

number of commuters patronizing many retail shops and stores in downtown locations and has shifted demand closer to suburban-focused shopping centers.

The lack of material supply remains a tailwind for the retail sector. Inventory once again remained flat during 2023, where new construction only accounted for 0.3% of existing stock. Availability rates in the retail sector continue to decline at a time when other sectors are struggling to maintain occupancy levels. The national availability rate for neighborhood and community centers remained unchanged in Q1 2024 at 6.5%.

While positive space market fundamentals have given landlords pricing power in many segments, re-tenanting costs have escalated substantially with medium to large boxes now costing \$125-\$150 per square foot to build out to current market specs vs \$40 to \$50 per square foot a few years ago.

Private debt

Lenders continue to pursue new investments in neighborhood and community shopping centers with well-positioned operators achieving healthy sales. Properties featuring creditworthy tenants including major grocers, discounters, and home improvement stores often find receptive lenders willing to compete for financing assignments somewhat aggressively. Nonetheless, interest rates for the highest quality retail properties remain perhaps 10 to 15 bps higher than debt for similarly leveraged apartment and industrial properties.

Debt for high street properties, power centers, and lifestyle centers remains difficult to procure even at lower leverage levels, and significant loan structure (e.g., escrows and amortization) is often required. Debt for regional malls remains unavailable for all

RETAIL (continued)

but the very best assets with top operators. Lenders continue to focus heavily on tenant creditworthiness, tenant sales history, remaining weighted-average lease terms, and sponsor quality, with widely disparate loan terms offered.

REITs

Retail performance has been mixed so far this year with mall REITs continuing to outperform while shopping center REITs have underperformed the broader index. Mall REITs benefited from solid operating results with strong NOI growth driven by occupancy gains and healthy lease rent spreads. Fundamentals for the mall sector could remain supportive over the next 12 months as the economic expansion has shown remarkable durability. Conversions of short-term leases signed during the pandemic into permanent leases should boost organic growth and make cash flow streams more resilient. Department store closures remain a risk but is not expected to be a major headwind for mall REITs which generally own better-quality malls. After trading at a discount for most of the past decade, mall REITs are now trading at a 5% to 10% premium to NAV, reflecting the improved operating environment.

Shopping center REITs also benefit from strong market conditions with availability rates at post-GFC lows after more than a decade of very little new supply. Retailer demand remains robust and broad based. However, earnings growth is underwhelming at only 2% to 3% as headwinds from 2023 bankruptcy activity and higher interest expenses offset the favorable underlying trends. REITs have sizeable pipelines of signed-not-open leases which is a source of highly visible growth over the next 12 to 24 months. Little impact or disruption is expected from 2024 bankruptcy announcements given low exposure and limited store closings expected. Barring any major additional tenant issues, earnings growth should

accelerate to the mid-single digits in 2025. For now, the market is not willing to pay for the better earnings growth ahead with the shopping center sector trading at an average discount to NAV of 15%.

CMBS

Retail's image has recovered significantly, fueled by a resilient consumer base, the spending drawdown in excess savings, and a robust labor market. Store closures have slowed dramatically over the past two years, and the entertainment-oriented transformation of malls has gotten back on track post-COVID. In conjunction with conduit transaction office exposures falling in 2023, retail exposure has increased back toward historical averages with 2023 and 2024 exposure at 29% and 36% respectively. Interestingly, once out-of-favor malls grew to 13% of conduit issuance in 2023 relative to 3% in 2022, supported by generally positive sales trends along with conservative underwriting metrics of >2.0x DSCR and sub-50% LTV on average.

Maturity stress from loans originated in 2012 and 2013 is still weighing on the conduit retail delinquency rate, which stands at 3.6%. CMBS servicers continue working with retail operators as loans approach maturity by providing loan extensions on performing properties, typically in exchange for fresh equity contributions. This approach seeks to maximize bondholder outcomes by keeping strong operators in place while avoiding near-term foreclosure at a time when valuations are depressed. Several regional malls currently facing refinancing challenges from these vintages have debt yields higher than 10%. Like the hotel sector, retail has benefited from the recent upside in economic activity. However, the health of the consumer and a potential pullback in spending need to be closely monitored for turning points.

SINGLE-FAMILY RENTALS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	→	↑	↑	↘	↘	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

The sector continues to benefit from pricing dislocations in the for-purchase market. Demand has remained healthy, and supply is far more restrained than in the traditional apartment sector. Rent growth remains in the mid-single digits and a lack of debt available for new development will prove to be a tailwind for the sector over the next 12 to 18 months.

Low levels of inventory in the single-family-for-purchase market have continued to push home prices upwards despite a slowdown in sales activity. Higher mortgage rates have dissuaded existing homeowners from giving up their lower rates and a resilient economy and job market have forestalled distress sales that were endemic to the GFC.

All these factors have led to an environment favorable to renting, and single-family rentals are continuing to offer younger would-be home buyers a more affordable entry point to the housing market.

Private debt

The decline in bank lending activity has had a significant impact on the single-family rental debt market. Developers and institutional investors who own non-stabilized properties are often limited to debt fund capital for their financing needs, which increases their cost of funds. For stabilized single-family rental properties, Fannie Mae and Freddie Mac remain the dominant lenders in the market.

REITs

The single-family rental sector continued to outperform other property types thus far in 2024, benefiting from the stickier renter base, limited new supply, and favorable affordability over home ownership. Additionally, the market reception for platform expansion through active build-for-rent programs and entry into third party management relationships remained positive.

Recent operation updates from the REITs indicate the solid sequential trends of high occupancy, low turnover, and steady pricing power, with some offset from continued growth in property taxes. Most market participants view single-family rental REITs as having a superior growth outlook for the year compared to traditional apartment owners and most other sectors. However, single-family rental REITs trade at modestly larger NAV discounts than average.

DATA CENTERS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	→	↑	↑	↘	↑	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

Demand within the sector remains white hot with the North American market experiencing a 32.9% increase in commissioned MWHs on a year-over-year basis, according to datacenterHawk. Demand in Northern Virginia and Phoenix alone accounted for over half of all data center net absorption over the past 12 months, with the Dallas/Fort Worth, Chicago, Atlanta, and Salt Lake City markets also seeing year-over-year growth over 25%. The largest demand drivers include the continuing growth of the cloud and the recent fervor around artificial intelligence (AI), as users begin to deploy space for the training and use of the latest AI models.

On the supply side of the market, concerns and uncertainty continue to cloud the outlook. The vacancy rate is approaching 2% and much of that space continues to be in small blocks under 5 MW, leaving little space for larger deployments, which tenants are looking for in the market today. Pricing and rental growth continue to remain strong, driven by the supply and demand fundamentals. Capital markets continue to be challenged by interest rate volatility.

Private debt

Private debt capital remains available for data center properties with long-term leases to investment-grade tenants. The very large loan sizes associated with the property sector mean that borrowers typically need to work with investment banks to arrange that financing. Funding terms and pricing are quite lender-friendly today.

REITs

Data center REITs have outperformed the broader real estate index year-to-date, driven by continued optimism that artificial intelligence will provide significant tailwinds for the sector. To date, data center REITs do not appear to be chasing artificial intelligence model-training demand but are seeing early deployments in their footprint. From a broader fundamental perspective, REITs are benefiting from favorable supply and demand dynamics in many key markets, which continues to provide an uplift to both rents and pricing.

Data center REIT management teams are positive on the current and future demand environment, particularly as more applications are developed from current artificial intelligence training models. Meanwhile, supply constraints and low vacancy in key markets offer a more landlord friendly pricing environment. From a valuation perspective, data center REITs valuation multiples continued to expand year-to-date with the property type trading at premiums to NAVs and relative to other property types.

STUDENT HOUSING

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	→	↗	↗	↘	NA	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Tenant demand remains healthy as pre-leasing for the 2024 academic year has established a record high. This represents a reversal from 2023 when occupancy fell by 1.5% as newly delivered properties missed the prime lease-up window. Occupancy remains stable and is in the mid-90% range and rental inflation is 8.4% on a year-over-year basis as of Q1 2024. Strong market fundamentals are supported by a 1% increase in enrollment for the academic year.

Capital market headwinds remain pervasive across commercial real estate and student housing is no exception. Persistently high interest rates have continued to sideline investors. Transaction activity through March was down 64% relative to a year ago on a 12-month trailing basis—though the notable lack of portfolio deals to date in 2024 may be partially responsible for the sharp decline. Nevertheless, we anticipate the same headwinds affecting other sectors to continue to affect capital flows toward student housing until investors have more clarity interest rates.

☐ LIFE SCIENCES

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↘	↘	↘	→	↘	↓	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

The life sciences sector continues to experience moderate to severe headwinds following its solid performance over the past few years. Venture capital, which was plentiful during the height of the pandemic has largely dried up for start-ups with only well-capitalized and companies with established therapeutic pipelines eying expansion in the current environment. Market fundamentals have suffered as a result and private equity performance continues to languish.

Demand appears to be approaching a bottom at a time when supply is nearing its peak for the current cycle. While vacancy rates remain elevated and sector performance has mirrored that of traditional offices more recently, forward-looking estimates suggest that new supply will be more muted. Debt availability for new development remains both costly and difficult to obtain, while near-term capital values do not support speculative development.

If there are any green shoots on the horizon it would be a nascent uptick in venture capital focused on the health and life science sectors. Several key markets, including Boston-Cambridge, Seattle, San Diego, and San Francisco, are seeing a modest uptick in funding. Longer-term we feel that education corridors will be the most attractive markets since they benefit from deep pockets of talent.

Private debt

Lender appetite for the life sciences sector has been quite limited recently. Lenders have increased their focus on tenant creditworthiness and the sector's reliance on venture capital financing. Life sciences

properties in major research hubs may still find receptive lenders, but those located in secondary markets are likely to have trouble procuring financing without offering recourse or other substantial credit enhancements.

REITs

The two main life sciences-focused REITs have had split performance relative to the broader REIT index year-to-date. Notably, leasing activity has not yet materially picked up, but green shoots are emerging in the form of an improved underlying tenant funding backdrop, which includes public equity biotech funding. Meanwhile, higher space availability (both direct and sublease) and elevated new supply under construction in many of the key markets remain a key investor concern.

Messaging from the life sciences-focused REIT management teams indicates that 2024 and 2025 may be peak years for new supply deliveries in key markets. The REITs do have some rent cushion on in-place portfolio cash rents which have a 5% to 15% embedded mark-to-market opportunity. As it relates to valuations, the REITs have seen a contraction in valuation multiples relative to the beginning of the year and the respective stocks are trading at meaningful discounts to NAV, although above trough levels seen in 2023.

CMBS

Life sciences properties continue to represent a bright spot in the CMBS office landscape, and the sector continues to play a prominent role in the SASB market. Investors are still requiring elevated risk

LIFE SCIENCES (continued)

premiums to compensate for the fact it is categorized as office, but we have seen that trend moderate somewhat as the sector starts to reach critical mass and gravitates towards becoming its own specific property sector. Location, tenancy, and sponsorship are becoming increasingly important as more square footage continues to be added to the life sciences sector.

Risk considerations

Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. 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.

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. 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 (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") 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 PGII, PGIE or PGII may delegate management authority to affiliates that are not authorised 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 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).

- 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").
- 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 2001. 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 and is only directed at wholesale clients as defined under Corporations Act 2001.
- This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
- Hong Kong SAR (China) by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission.
- Other APAC Countries/Jurisdictions, 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 Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

Principal Funds are distributed by Principal Funds Distributor, Inc.

© 2024 Principal Financial Services, Inc. Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc. Principal Asset ManagementSM is a trade name of Principal Global Investors, LLC. Principal Real Estate is a trade name of Principal Real Estate Investors, LLC, an affiliate of Principal Global Investors.