Principal Asset Management℠

Principal Real Estate

Perspectives: Listed REITs update

FALL 2024 EDITION

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REITs remain on course for a recovery

Public REITs have benefited from a great rotation within equity markets since the end of June, with U.S. REITs returning 13.2% vs. S&P 500 3.7%. The economic conditions we cited back in January that could lead to REIT market outperformance are becoming closer to reality.

Clear evidence of a growth slowdown and moderating inflation has increased the market's conviction the Fed will keep cutting rates. Investor rotation into longer duration, resilient cash flows would be a tailwind for REITs relative to other equities.

Lower yields could spur a recovery in real estate prices if the economy doesn't fall too hard. Our outlook for the U.S. economy is balanced between a soft landing and mild recession outcome, both of which are likely to supportive for the return outlook for REITs.

REITs in sectors such as senior housing, single-family rental, cold warehouse storage, and wireless towers are a compelling opportunity with visible, defensive cash flows that offer attractive growth under a variety of economic outcomes.

Despite recent outperformance, REITs remain historically cheap relative to equities. EV/EBITDA multiple spreads of REITs vs broader equity indices are near all-time lows.

Public REIT valuations remain attractive versus private real estate funds. U.S. REIT share prices imply a meaningfully higher cap rate than current average appraised cap rates on private equity funds. When the recovery in real estate prices does come, REITs have the first mover advantage over private real estate given their liquid, publicly traded nature.

As of 30 August 2024. Source: FactSet. Data between 30 June 2024 and 31 August 2024. U.S. REITs represented by NAREIT All Equity REIT Index. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

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REITs should do well under our expected macro-outcomes of a soft landing or mild recession

There are signs that prior central bank rate hikes are slowing the economy. A cooling in labor markets is unmistakable with slower hiring, but layoffs remain tame. This suggests labor markets will weaken but unemployment might not increase significantly.

Meanwhile, the downward trend in inflation looks encouraging and upside risks to inflation appear low. As a result, the U.S. Fed has embarked on rate cuts to stabilize labor markets and engineer a potential soft landing.

	SCENARIO ESTIMATES				EXPECTED OUTCOMES			
State of the world	**Probability**	**Real GDP**	**Inflation**	**Nominal GDP**	**Central bank playbook**	**REIT performance (absolute)**	**Equity mkt performance (absolute)**	**REIT performance (vs. equities)**
Hard landing	10%	<-2%	-2%	<(-4%)	Aggressive easing/fast rate cuts	Negative	Negative	Outperform
Stagflation	5%	<2%	>3.5%	<-1.5%	Rate hikes	Negative	Negative	Underperform
Mild recession	**40%**	**-0.5%**	**0%**	**-0.5%**	**Rapid rate cuts**	**Flat**	**Negative**	**Outperform**
Soft landing	**40%**	**1.5%**	**2%**	**3.5%**	**Slow/mild rate cuts**	**Positive**	**Positive**	**Outperform**
No landing	5%	>2.5%	4%	>6.5%	No rate cuts/rate hikes	Positive	Positive	Underperform

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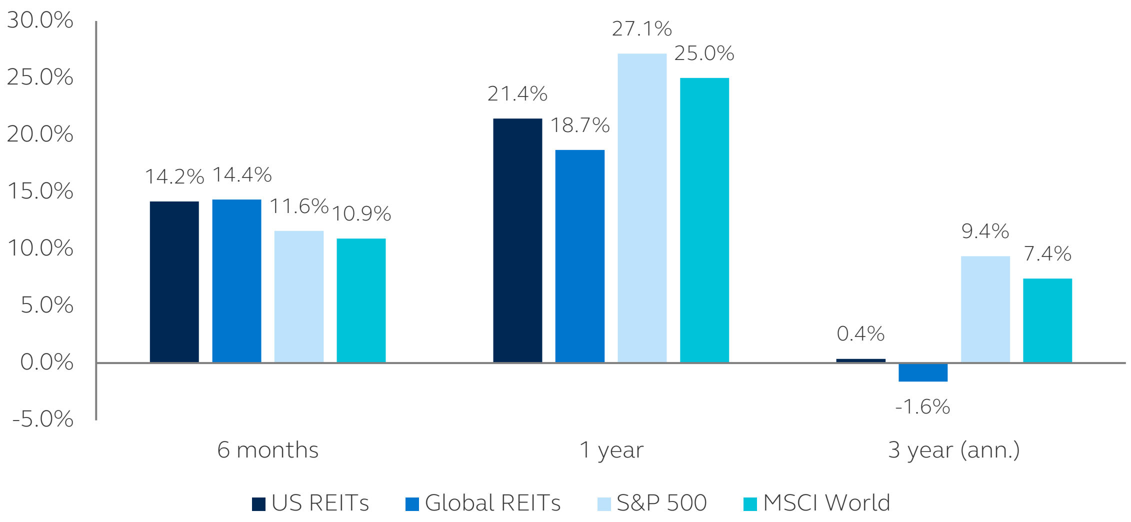
REITs are making a comeback versus equities - driven by cheap valuations, a defensive rotation, and falling yields

REITs provide defensiveness with durable and visible cashflows from staggered lease renewals phased over multiple years. These attributes should draw investors to these long duration stocks as interest rates peak on more visible signs of an economic slowdown. Conversely, a slowdown in the momentum trade for AI stocks has pressured equity markets.

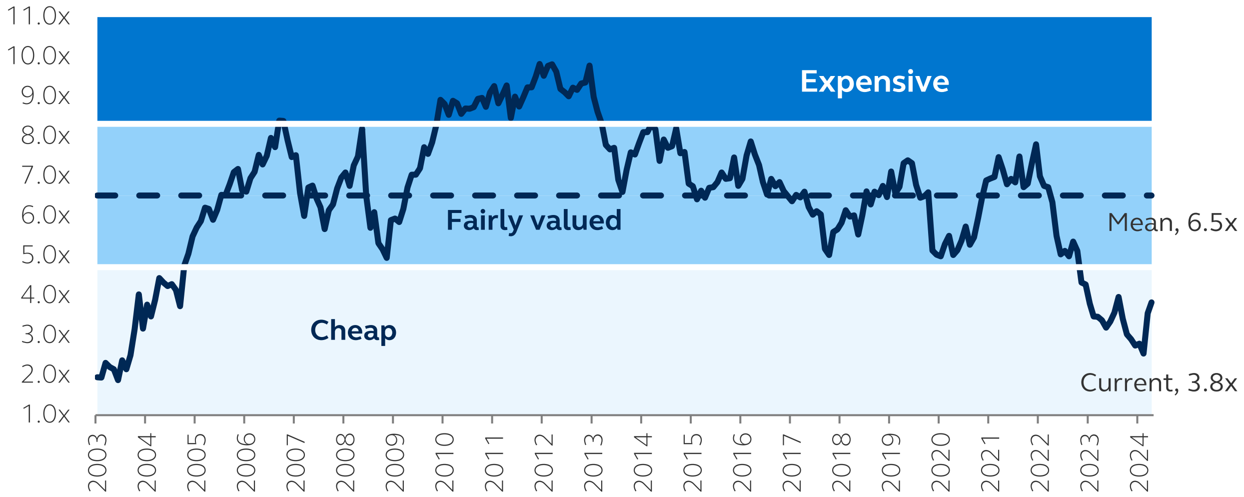
Against public equities, the earnings multiple discount is near historical lows. Such large discounts have historically been a harbinger of an extended period of strong relative performance against equities going forward.

REIT and equity market returns: REITs still trail equities over the past 3 years despite recent outperformance



As of 31 August 2024. Source: FactSet. Returns represented by FTSE NAREIT All Equity REITS (U.S. REITs), FTSE EPRA/NAREIT Developed Index (Global REITs), S&P 500 index, and MSCI World Index. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index.

The current relative valuation of REITs vs the broader equity market remains cheap versus historical average



As of 31 August 2024. Source: FactSet, FTSE, MSCI. Enterprise Value (EV) to EBITDA price multiples are used to measure valuations. Due to data availability, REIT data comes from the MSCI US REIT data till February 2006 and FTSE NAREIT All Equity REITs data onward. The spread plotted is the EV/EBITDA of these indices minus the EV/EBITDA of the S&P 500 index. Expensive and cheap valuations are represented by spreads higher or lower than one standard deviation from the mean, respectively. Fair value is represented by valuations between one standard deviation from the mean. The average is since 31 May 2003.

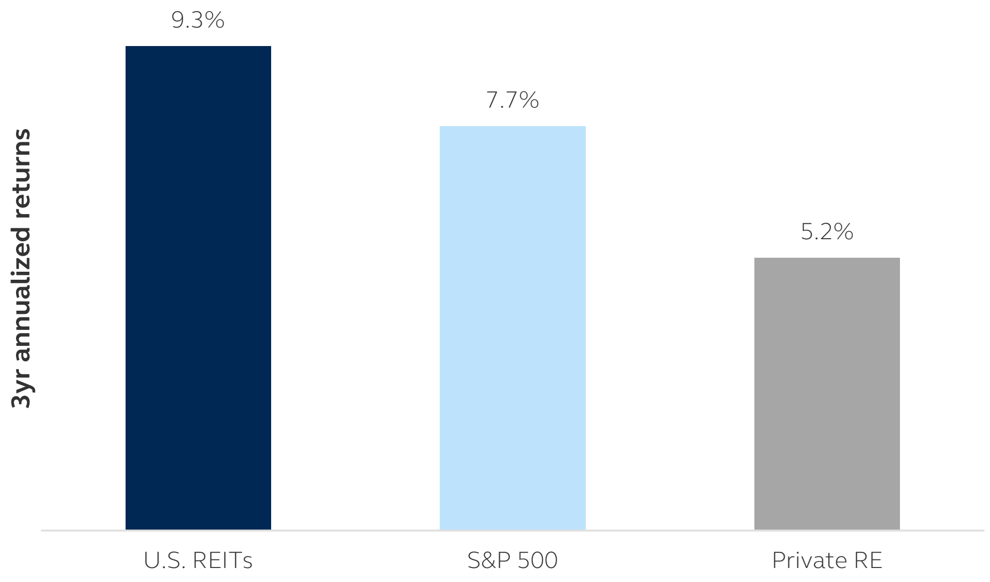
The Fed rate cut cycle will be an important catalyst for REITs

A fall in yields is almost always a tailwind to REIT stocks as discount rates come down and the value of future cash flows goes up. REITs have already started their recovery in anticipation of Fed rate cuts, but history tells us their outperformance can extend longer as rates continue to decline.

We believe the 1999-2003 Fed Fund cycle, accompanied by a mild recession, provides the closest example for how REITs could perform during this next Fed cut cycle. REIT stocks started their rally during the Fed pause in 2000 and continued to outperform materially as the Federal Reserve cut rates and a mild recession occurred.

Historically REITs perform well when the Fed rate cut cycle begins

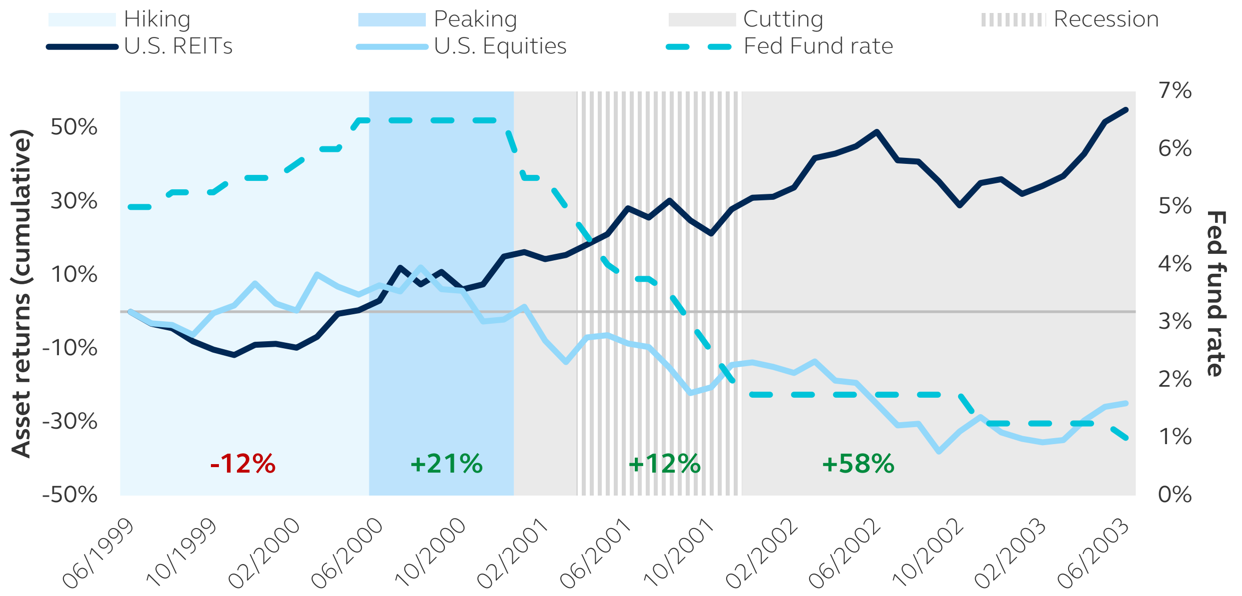
Average 3-year returns following the first cut in a new Fed rate cut cycle



As of 30 August 2024. Source: FactSet, NCREIF. Returns represented by FTSE NAREIT All Equity REITS (U.S. REITs), NCREIF ODCE Index (Private RE), and S&P 500 Index. Average was taken from 3yr total returns following Fed rate cuts in 07/1995, 01/2001, 09/2007, and 08/2019. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs. It is not possible to invest in an index.

The 1999-2003 Fed Fund rate cycle was advantageous for REITs

(Red/green data labels show REIT returns relative to equities at each phase)



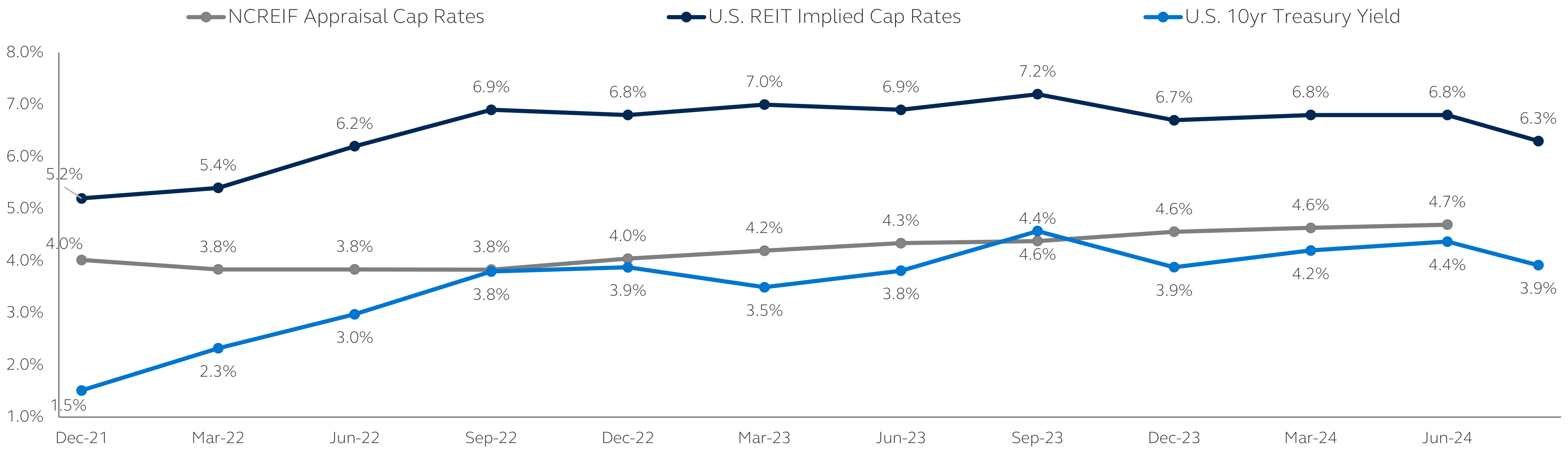
As of 30 August 2024. Source: National Bureau of Economic Research (NBER), FactSet. NBER was utilized to identify past recessions. Returns represented by FTSE NAREIT Equity REITS (U.S. REITs) and S&P 500 (U.S. equities) indices. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs. It is not possible to invest in an index.

REITs are an attractive way to deploy capital into real estate today

A depressed real estate transaction market and rising yields has put downward pressure on values and an increase in real estate cap rates. The trend of higher cap rates for real estate may be coming to an end though as yields have perhaps peaked. This could soon create a bottom for real estate values provided the economy doesn't fall too far.

For investors looking to deploy capital into real estate equity markets the listed REIT market offers compelling relative value. Appraisal cap rates for legacy private equity fund NAVs offer only a modest premium to risk free rates. REIT implied cap rates trade at far larger spread and potentially stand to benefit from greater cap rate compression if yields continue their decline. REITs offer exposure to high quality, stabilized assets at attractive prices and the liquidity some investors may appreciate in their real estate portfolio.

REIT cap rates rose with higher yields and provide a larger spread over treasury yields than appraised private real estate values



As of 30 August 2024. Source: Principal Real Estate, NCREIF, Citi. U.S. REIT implied cap rates sourced from Citi. NCREIF appraisal cap rates are NPI all property equal weighted cap rates and as of 30 June 2024 (latest available data).

Property sectors with lower economic sensitivity and resilient, structurally-driven demand should outperform amidst the prospect of an economic slowdown

Positive global REIT sector preferences reflect where we see the best opportunities to own REITs with visible, attractive growth under a variety of potential economic outcomes. We are cautious on sectors that offer poor risk/reward from either low growth, expensive relative value, or both.

Our geographic preferences are driven by the bottom-up and we see a mix of opportunities both in the U.S. and globally.

	Investment preference				
Sector	Cautious	<	Neutral	>	Positive
Apartments	○	○	○	●	○
Data centers	○	○	○	●	○
Diversified	●	○	○	○	○
Healthcare	○	○	○	○	●
Hotels & resorts	○	○	●	○	○
Industrial	○	○	○	○	●
Malls & outlets	○	●	○	○	○
Manufactured homes	○	○	●	○	○
Net lease	●	○	○	○	○
Office	○	●	○	○	○
Self-storage	○	●	○	○	○
Shopping centers	●	○	○	○	○
Single-family rental	○	○	○	○	●
Towers	○	○	○	○	●

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