REITs 2020 Outlook

Q&A with Todd Kellenberger, Client Portfolio Manager, Principal Real Estate Securities

As a guidepost to the REITs markets globally in 2020, Todd Kellenberger, Client Portfolio Manager on the Principal Real Estate Securities team, provides answers to some of the questions he has been fielding from investors to start the year.

Q. After a strong year from REIT stocks in 2019, what are some factors or events that you believe will play out in 2020 in support of REIT stocks?

Real estate market fundamentals and REIT earnings will need to meet or exceed current market expectations for stable, positive growth. The set-up is a good one. Supply and demand are balanced on average, rents are still rising in certain markets and sectors, and REITs can generate external growth through acquisitions or new development. Real estate capital markets and transaction activity are robust, which should keep cap rates low and asset prices high, further supporting REIT valuations. The greater uncertainty is always the macro environment, but if long-term interest rates stay lower for longer and economic growth stabilizes, that will be a favorable backdrop for REITs. We don’t believe the outsized returns REITs delivered in 2019 will be replicated, but 2020 can be another good year for the asset class.

Q. What are some risks you are monitoring that could negatively impact REITs?

We may see short-term downward pressure on the stocks should bond yields rise sharply from a market optimism towards a larger rebound in economic activity. We would expect REIT stocks to lag other sectors with greater economic sensitivity. On the other hand, if economic growth relapses to the downside, triggering a recession, then all risk assets would likely trade down, but we’d envision REIT stocks would hold up better due to their defensive attributes and above average dividend yields. Finally, credit spreads are historically tight today and should they widen, for any number of reasons, it would likely have negative valuation implications for all equities but may impact property stocks more, given their sensitivity to short-term interest rate changes.

Q. Do you expect capital flows into REITs to continue and where have you seen strong client interest in REITs?

Yes, provided our base case outlook unfolds we expect the robust inflows into REITs will continue. With regard to where flows have come from, it’s been really diverse, both by client type and location. For investors with traditional stock and bond portfolios we have seen allocations to REITs to provide diversification, especially for real asset investments that provide high quality, stable growth characteristics with attractive yields. That’s a pretty fitting description of REITs right now, which should continue to be attractive in the current market environment.

Demand from traditional private real estate investors, such as pension plans, is also increasing. These investors are seeking the liquidity REITs offer and access to many non-traditional sectors (data centers, single family rental, manufactured housing, senior housing, etc.) which are difficult to access in private markets and often outperforming traditional sectors today. We expect this to be a longer trend that unfolds over future years.

Q. Is exposure to some of these niche property sectors an important part of your strategy?

Yes, stocks in “niche property sectors” currently comprise some of our favorite ideas. Stocks in these niche areas represent “structural growers;” companies benefitting from structural or secular changes that are driving above average growth in demand. These include: single-family rental REITs which benefit from a structural shift toward lower U.S. homeownership and a preference for renting; life sciences office REITs which cater to the rapidly growing pharmaceutical and biotech industry; and data center and tower REITs, which are seeing strong demand for technology-related reasons such as increased mobile

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data usage and cloud computing storage. The industrial warehouse sector isn’t a niche sector anymore, but squarely falls into the structural growth thematic due to ecommerce trends and continues to be one of our favorite ideas both in the U.S. and globally.

**Q. Outside the U.S. where you do find compelling opportunities today?**

In Europe, while manufacturing data has been weak, economic data related to the services side of the European economy has remained robust, guiding us to conclude that employment growth in major European cities remains on a positive trajectory. This in turn is leading to an excess of demand for office and apartment space in many cities across Continental Europe, so we have exposure to this positive trend. Other sectors are benefitting as well, such as self-storage and industrial.

In Japan, monetary and fiscal policies should support demand for REITs while improving corporate governance is a positive for the Japanese developers. In Australia and across the region we are also positive on the industrial sector for the same reasons as the U.S., an increase in ecommerce and modernization of logistics.

**Q. What would be your recommendation on whether investors should invest in a U.S. or global REIT strategy in the upcoming year?**

Geographically, we have a benign view on the U.S. versus Global question. No one country is exhibiting sufficiently strong or weak trends relative to others to warrant a meaningful geographic tilt. We are finding compelling ideas in all regions, with similar return expectations, and investors should take into account their overall portfolio exposures when making that decision.

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**Forward 24 month internal earnings outlook***

<table>
<thead>
<tr>
<th>Soft</th>
<th>Balanced</th>
<th>Strong</th>
<th>Key items of note</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>North America-Core Sectors</strong></td>
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<tr>
<td>Hotels, Retail, Senior Housing</td>
<td>East Coast Office, Medical Office, Skilled Nursing</td>
<td>Apartments, Industrial, West Coast Office</td>
<td>Structural concerns for retail; structural tailwinds for industrial; healthcare generally steady but continued supply concerns for seniors housing segment.</td>
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<tr>
<td><strong>North America-Niche Sectors</strong></td>
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<tr>
<td>Self-Storage</td>
<td>Net Lease, Student Housing, Wholesale Data Centers</td>
<td>Manufactured Homes, Retail Data Centers, Single-Family Rental, Towers</td>
<td>Robust trends for niche residential sectors; structural growth tailwinds for tech sectors; storage supply risk.</td>
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<tr>
<td><strong>Europe</strong></td>
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<tr>
<td>Retail</td>
<td>U.K. Office</td>
<td>Office, Industrial, Apartments, Self-Storage, Student Housing</td>
<td>Structural concerns for retail; structural tailwinds for industrial; self-storage and student housing remain strong, growing demand/low supply present a great runway for office rent growth in most cities; confidence is returning to the U.K. office market.</td>
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<tr>
<td><strong>Asia ex-Japan</strong></td>
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<tr>
<td>HK Discretionary Retail, Office and Hotels</td>
<td>HK Non-Discretionary Retail, Singapore Retail and Residential</td>
<td></td>
<td>The performance of groups of stocks will be heavily influenced by macro conditions, Coronavirus, currencies, interest rates, and geopolitics.</td>
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<tr>
<td><strong>Japan</strong></td>
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<tr>
<td>Hotels</td>
<td>Residential</td>
<td>Office and Industrial</td>
<td>Continued strong demand for office space leads to multi-year low vacancy rate; inbound tourism figures weak due to Japan-South Korea tensions.</td>
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<tr>
<td><strong>Australia</strong></td>
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<tr>
<td>Retail</td>
<td>Office and Residential</td>
<td>Industrial</td>
<td>Structural concerns for retail; structural tailwinds for industrial; recovering residential markets; office fundamentals slowing but capital values strong.</td>
</tr>
</tbody>
</table>

*PGI REIT team internal forecasts for recurring earnings growth as of 31 December 2019. Internal earnings are defined as recurring, unlevered earnings (net operating income) of a company. These are the current views and opinions of Principal Real Estate Investors and is not intended to be, nor should it be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.
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