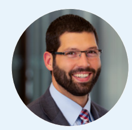
Public real estate debt:

Facing today's challenges

It is no secret that COVID-19 has had a particularly adverse impact on global real estate markets. But even as headwinds persist, there are opportunities worth considering within the public debt markets.

Two of our senior commercial mortgage-backed securities (CMBS) investment experts recently gave a presentation on the CMBS market, providing an overview of the asset class, as well as some key insights into what investors should be considering during this extraordinary time in the real estate markets.

Marc Peterson
Chief Investment Officer
Commercial Mortgage-Backed Securities



Scott Carson
Portfolio Manager
Commercial Mortgage-Backed Securities

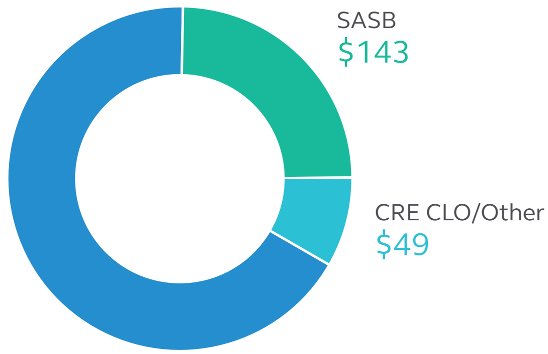
CMBS 101

Given CMBS spans both real estate and fixed income, it's important to start with a bit of background on the market. Principal's core focus in the CMBS space is the conduit market, the largest part of the non-agency market composition with a market cap of $389 billion. Conduit CMBS are bonds typically secured by diversified static pools of 10-year, fixed-rate senior mortgages. Unlike the residential mortgage market, conduit CMBS carries solid prepayment protection. There's typically somewhere between 35-75 loans in a conduit pool secured by a variety of property types in locations across the United States.

The second largest non-agency CMBS component is single asset/single borrower (SASB), which are issuances secured by a single "trophy" property or multiple properties owned by the same borrower. SASB CMBS consists of larger loans historically used as a primary source of large hotel financings, but today are more diversified into the office and industrial sectors. Finally, the third part of the non-agency CMBS market composition is comprised mostly of collateralized loan obligations backed by commercial real estate (CRE CLO). Typically, these are used as a financing vehicle for lenders, with shorter duration, and either static or dynamic pools. This is a much smaller market than conduit or SASB, but it's growing.

CMBS market composition

Private CMBS – market composition ($B)



- **Conduit:** diversified pools of first mortgages, fixed rate, strong prepayment protection
- **SASB:** secured by a single asset or a portfolio of properties with the same borrower. Fixed and floating rate, optionality
- **CRE CLO:** static or dynamic pools, nontraditional loan collateral, financing vehicle

As of 31 October 2020. Sources: JP Morgan Research, Principal Real Estate Investors

Because conduit CMBS present a large and diverse opportunity set, this is where our team remains focused. Within conduit CMBS, retail and office are the largest property type exposures, while the New York metropolitan statistical area (MSA) stands out from a geographic perspective. However, the market does continuously evolve based on investor preference. For example, since 2016 we've seen retail become a smaller part of the new issue market, reflecting investors' concerns about fewer brick and mortar stores as a result of e-commerce.

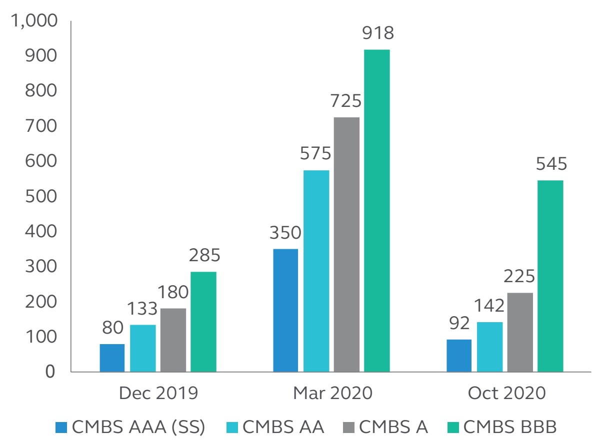
With bond structures, it's important to appreciate that CMBS are a bridge between real estate and fixed income. CMBS are unique in that performance of the bonds is ultimately driven by the underlying real estate. These rated securities are created and driven by how the payments flow from the loan pool as borrowers make their monthly mortgage payments. How these payments are applied to the bond structure is referred to as the "bond waterfall" and is really what creates the different risk/return profiles in CMBS. The bond structure adds an additional layer of protection to senior classes, ensuring that lower rated bonds will absorb potential losses before higher rated bonds are exposed.

Market update: COVID's impact

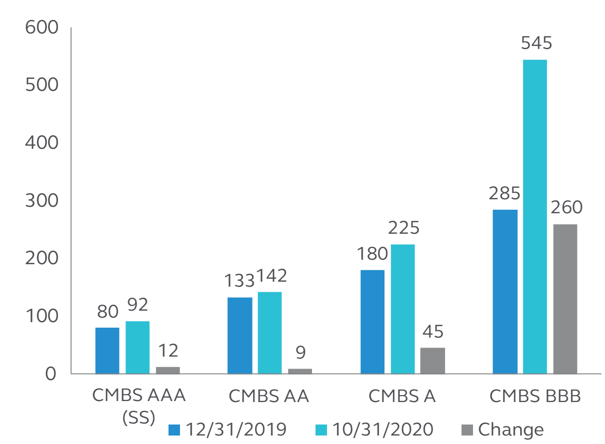
While the impact of the pandemic has been dramatic, a trend of tighter spreads among CMBS was in place prior to this year. With the COVID-induced market disruption, spreads initially widened considerably, driven by the broad market liquidity shock, forced deleveraging, and fundamental credit stress based off extreme scenarios (e.g., every hotel loan would default). Since this initial shock, spreads have recovered in AAA and other higher rated classes but remain relatively wide for single-A and BBB.

CMBS market update

Path of CMBS spreads throughout the year (S+)



Year-to-date spread levels and changes (S+)



As of 31 October 2020.
Sources: JP Morgan Research, Principal Real Estate Investors

Fundamental stress remains concentrated in hotel and retail delinquencies, with luxury, airport, and conference hotels hit especially hard. Distressed loans that had received forbearance will rely on a recovery in travel and business activity if they're to survive over the long term, while stress in retail is an acceleration of an ongoing secular shift that's hurt underperforming malls in particular.

Still, overall delinquency trends have stabilized and are trending downward as the market slowly wraps its hands around risk. The recent positive vaccine news has alleviated some of the tail risk and helped borrowers look through the next 6-9 months.

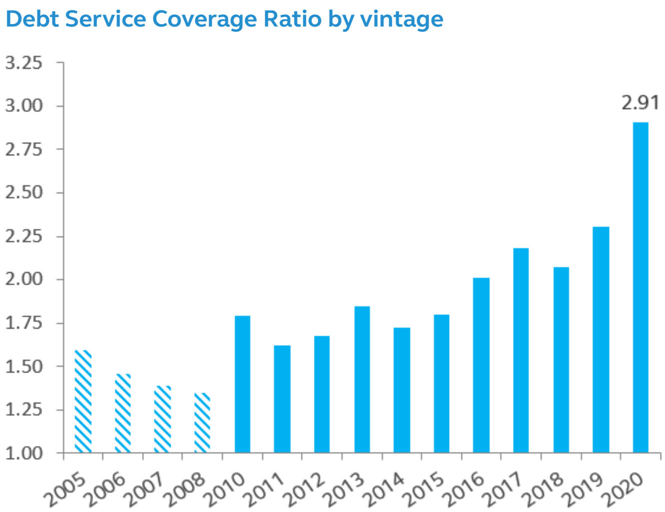
This stabilizing trend in delinquencies applies to hotels as well, and large institutional owners of real estate seem to be in a better position to weather the storm. We've been somewhat encouraged that only 25% of hotel market has gone into default. One in four hotels going into default may seem like a shocking number, but given the dramatic impact of the virus, this number could've been much higher.

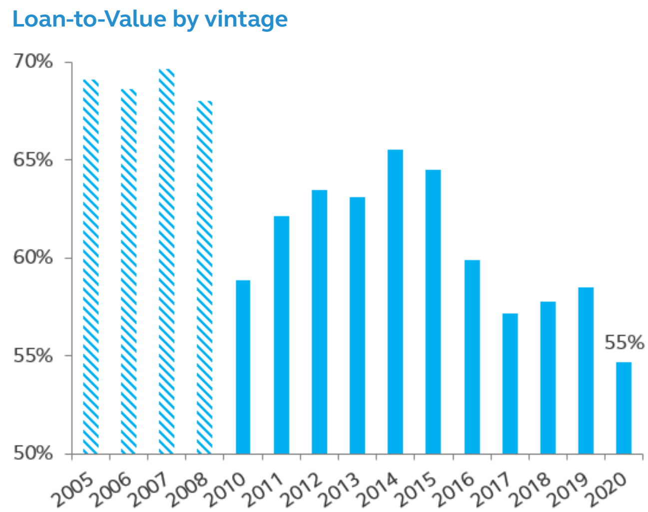
Underwriting and bond structure remain conservative

Identifying and mitigating risk with any loan is done through the underwriting process. Prior to COVID, underwriting standards had become increasingly conservative, which was in stark contrast to the period leading up to the Global Financial Crisis (GFC), when underwriting was getting more aggressive, setting the market up for higher defaults and losses. For offices now, rents may drop 10-15%, but these loans have been underwritten to withstand this type of stress, which is supported by higher debt service coverage ratios. Today, loan-to-value ratios are much lower than pre-GFC as well.

CMBS market evolution

Underwriting metrics have become more conservative over time





As of 30 September 2020. Sources: Wells Fargo Securities, Intex Solutions Inc.

In addition to more conservative underwriting, issuances since the GFC carry higher subordination levels, meaning the amount of credit enhancement required to achieve a given rating has increased significantly. So, the market has changed for the better, which should result in relatively lower losses, fewer defaults, and fewer downgrades. This significant evolution is often referred to as "CMBS 2.0."

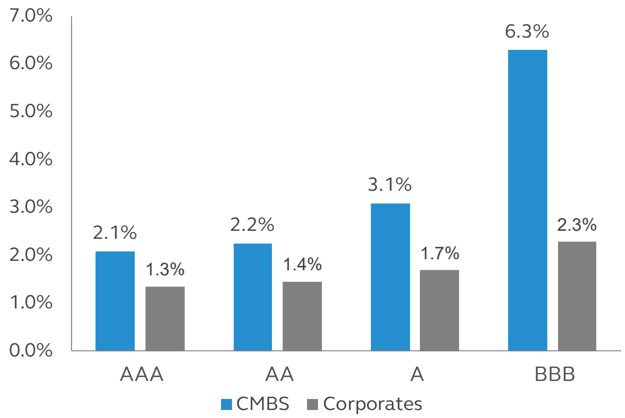
Opportunities in this new world

In the current low rate environment, investors are facing widespread yield starvation. Compared to corporate bonds in aggregate, conduit CMBS carry a significant yield advantage across the ratings spectrum, with yields equivalent to corporate bonds rated several notches lower. Additionally, CMBS have low relative correlations to other fixed income asset classes because CMBS are secured by real estate and each pool is diversified by things like property type, geography, and borrower type. And utilizing a credit-centric CMBS strategy may enhance these diversification benefits significantly. This has made the CMBS market more attractive to investors, something evidenced by demand from money managers and other crossover buyers.

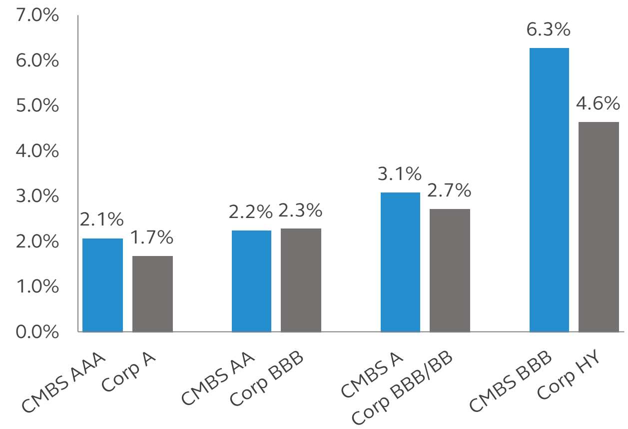
CMBS opportunity

Excess yield in CMBS and widespread yield starvation has attracted investors to the market

CMBS vs. corporate bond yields



CMBS carries yields equivalent to corporate bonds rated several notches lower



As of 31 October 2020. Sources: J.P. Morgan Research, Principal Real Estate Investors. CMBS: J.P. Morgan CMBS New Issue On-the-Run AAA/AA/A/BBB Indices, Corporates: J.P. Morgan JULI AAA/AA/A/BBB Indices.

In thinking about how CMBS may fit within an overall real estate allocation, there are a few potential opportunities worth considering. Pairing CMBS with an equity REIT allocation may help create an alternative risk/return profile, as CMBS may complement REITs through both yield enhancement and diversification. CMBS may also add liquidity to a private debt strategy, allowing for more efficient capital deployment, additional relative value opportunities, and potential yield enhancement relative to senior mortgages. Additionally, during fundamental credit dislocations, public markets tend to reprice quickly while private markets lag, creating an opportunity for CMBS investors to benefit from recovering public market pricing when the private market corrects.

With any CMBS opportunity, don't take a blanket approach. Real estate investments, and these pools, are each unique and carry their own components of credit risk. We manage this risk by using a combination of qualitative analysis and quantitative tools, including relying on our local real estate experts to opine on loan-specific credit risks. Granular underwriting of each unique pool is critical, given that bond performance varies widely.

Going forward: Positioning for opportunity

There are, of course, some potential landmines that investors should be wary of as they consider investing in CMBS. These include the fundamental risks currently playing out in hotel and retail, as well as the risk of downgrades, especially for bonds rated BBB and below. A potential increase in capital requirements for insurance companies, implications of work-from-home trends, and an undisciplined grab for yield that could push prices beyond fundamental value are a few other areas that may present challenges if not approached with caution.

We believe investors should consider a three-pronged approach to effectively position their portfolios for the opportunity in this space going forward. First, from a fundamental credit perspective, we see value in focusing on higher yielding sectors over a longer-term investment horizon. Second, active trading may help enhance risk-adjusted returns by regularly assessing market risk premiums. During market dislocations, active trading may allow for opportunities to improve total return. Finally, with regards to liquidity and risk management, investors should emphasize sectors with good liquidity profiles and more conservative credit characteristics.

Even as uncertainty in the real estate and bond markets persists, taking a fundamental approach, paired with a dynamic relative value assessment, may position investors to potentially benefit from the yield enhancement and diversification benefits of the CMBS market during these challenging times.

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