Principal Real Estate

SPECIAL BULLETIN #1

European Core investing: Looking beyond the pandemic

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It's hard to argue that there's been a more disruptive period for real estate markets than the last 18 months. The pandemic created unprecedented challenges that will remain a fixture of these markets for the foreseeable future. However, much of today's real estate landscape has resulted from longer-term structural changes that were brought to light and accelerated by the pandemic.

Investing in core real estate has also evolved alongside this structural shift. The changes in demand drivers will remain even as COVID-19 becomes more manageable and less of an immediate public health and economic threat.

The long-term thematic drivers that are pushing this paradigm shift fall within our "DIGITAL" framework, a set of factors that helps explain what is driving returns in real estate (exhibit 1). These factors include demographic considerations, such as the desire from Generation Z for coworking spaces or Baby Boomers' demand for independent senior living facilities. These drivers also include innovations like "smart city" initiatives aimed at expanding the digitisation of services, improving energy efficiency, and attracting global talent.

The modern core portfolio, at a glance:

- Specialist assets are playing a more important role.
- ESG considerations are a necessity.
- Investing outside of home country assets (i.e., geographical diversification) is increasing the set of opportunities.
- Consider fund size and tax implications.

Exhibit 1: DIGITAL-driven property types prove resilient

Demographics

- Ageing population
- Shifting migration patterns
- Housing affordability
- Inequality and cost of living
- Seaports
- Tunnels

→ Suburban housing
Single family rentals
Manufactured housing
Self storage
Senior living/care homes
Grocers, discounters, DIYs

Innovation & tech

- AI/Big data and a circular economy
- Flexible working/WFH
- Innovation "hubs"
- Retail disruption
- ESG prioritisation

→ Life sciences
Lab space/ Medical offices
Data centres
Cold storage
Self storage
New format retailers

Globalisation

- Secular increase in trade & capital flows
- Global technology supply chains
- Mobile human capital and remote workforces
- Satellite towers

→ Data centres
Warehouse/Logistics
Last mile facilities

Infrastructure

- Communication
- Physical assets
- Transportation
- Energy and utilites
- Social infrastructure

→ Data centres
Warehouses
Affordable housing
Care homes, medical office
ESG focus

Technology in particular, is changing our relationship with real estate. For instance, work-from-home (WFH) initiatives may be a large part of many workplaces going forward and is highlighting the obsolescence risk to office and retail.

Collectively, these thematic drivers of demand underscore the importance—and necessity—of targeted investment selection in core real estate.

Core investing today

While core real estate sectors such as industrial and residential are poised for growth in the coming years, the traditional core areas of retail and office properties are set to become less prominent. The shift towards non-traditional sectors continue to expand and the aforementioned DIGITAL themes are becoming the dominant drivers of growth in these markets, directly or indirectly.

This means that in the post-COVID-19 world, a high allocation to sectors like retail and office can present a big risk. Many funds are committed to exposures of 30% or more in each of these areas and, as a result, are ill-equipped to adjust to the impact of both long-term secular changes and the more near-term fallout from the impact of COVID-19. Going forward, funds need to be nimble enough to move away from these sectors and take measured, targeted risks to find opportunity in non-traditional sectors. This can include specialised sectors like data centres and health care, which are two examples of areas that have benefited in the short term from the pandemic environment but are also benefiting from many longer-term structural changes here to stay. These types of opportunities will become increasingly important to generate portfolio returns.

In addition to the potential for enhanced return, non-traditional sectors can also provide important diversification benefits. Despite the growth and developing maturation of specialist and non-traditional property types, correlations have remained low. For an income-oriented core real estate portfolio, the varying business and operational models of the underlying companies making up non-traditional sectors like data centres or manufactured homes can help bring in important diversification benefits. Our May 2021 analysis of 15-year correlations between traditional and non-traditional sectors supports this point, showing that many specialist sectors have demonstrated negative correlations with traditional real estate.

Exhibit 2: Non-traditional property types are portfolio diversifiers

15-Year Correlations	Apartment	Office	Retail	Industrial	Hotel	Self-Storage	Health Care	Manufactured Homes	Data Centres	Infrastructure
Apartment	1.0000	0.9093	0.8828	0.7158	0.7963	0.8108	0.8028	0.7762	-0.0586	0.2263
Office	0.9093	1.0000	0.8953	0.8283	0.9049	0.7092	0.8126	0.7088	0.1972	0.2902
Retail	0.8828	0.8953	1.0000	0.7524	0.8533	0.8028	0.8693	0.7020	-0.2919	0.0875
Industrial	0.7158	0.8283	0.7524	1.0000	0.6914	0.5870	0.6339	0.6525	0.5915	0.6334
Hotel	0.7963	0.9049	0.8533	0.6914	1.0000	0.5762	0.7256	0.5834	-0.2359	-0.0660
Self-Storage	0.8108	0.7092	0.8028	0.5870	0.5762	1.0000	0.6760	0.6219	-0.1652	-0.1540
Health Care	0.8028	0.8126	0.8693	0.6339	0.7256	0.6760	1.0000	0.5997	-0.1058	0.3320
Manufactured Homes	0.7762	0.7088	0.7020	0.6525	0.5834	0.6219	0.5997	1.0000	0.2216	0.4395
Data Centres	-0.0586	0.1972	-0.2919	0.5915	-0.2359	-0.1652	-0.1058	0.2216	1.0000	0.5532
Infrastructure	0.2263	0.2902	0.0875	0.6334	-0.0660	-0.1540	0.3320	0.4395	0.5532	1.0000

Source: NAREIT, Principal Real Estate, May 2021

Additional considerations for core investors

For investors in core real estate, looking beyond traditional sectors for opportunity is one of a number of important factors to consider in the current environment. Another consideration is geographical diversification, which can provide essential benefits given the differences in property types in individual countries. While geographical diversification is critical, investing across countries should be done in line with the size of the particular market. This will help prevent liquidity issues in the event of an economic or market downturn. From a geographical perspective, it's also important to understand how individual countries or regions have been impacted by and responded to the pandemic. For example, the UK was the first country in the world to begin a vaccination effort while the process has been slower in many European countries.

Environmental, social, and governance (ESG) policies and initiatives, including the implementation of carbon neutrality proposals, will remain a top priority for occupiers and landlords, as well as investors. In real estate investing, ESG considerations can help to improve investment outcomes by aligning stakeholder interests, facilitating operational excellence, and reducing overall risk. ESG strategies and other forms of impact investing remain as important now as they were pre-pandemic and are only growing in importance.

Another thing to evaluate is fund size, and whether certain funds are able to obtain exposure to the industries that are benefiting from structural changes. Many larger funds have significant exposure to traditional sectors at the expense of specialist sectors, while many smaller funds are able to be more flexible in the areas where they invest. Investors should also consider the drag on returns that can occur from ongoing exposure to sectors that, at this time, have been most impacted by the pandemic. These include retail, hospitality, and leisure.

Tax considerations, within both countries and sectors, are another factor for investors to keep front-of-mind as policies evolve. The complexities of real estate tax policy can be challenging to comprehend, and as governments seek new areas for revenue generation, we anticipate the tax landscape will continue to evolve within individual countries but also for the EU as a whole.

Finally, there are many other outstanding questions that will impact core investing, including around the benefits of benchmarking, the importance of location over all other factors, the inflationary environment, and potential legacy issues resulting from COVID-19. These uncertainties underscore the importance of investing in a fund that can adjust accordingly to new environments.

Going forward

While structural and COVID-19-driven changes have altered the landscape for core investments, what hasn't changed is what makes a good investment: understanding an asset's covenants and the risks to income from that asset.

The pandemic environment has made flexibility and the ability to react to take advantage of opportunities as they arise increasingly important. We believe rigid investment strategies will not work today or over the long term. By allocating to non-traditional and specialist assets, and maintaining less exposure to sectors where cash flows have been weak, we believe we are positioned to benefit from the changing thematic drivers in the real estate markets. In addition, our fund size grants us the ability to more quickly take advantage of pricing corrections, helping ensure that portfolio returns are maximised while maintaining the income-producing characteristics of a core portfolio.

For more information on **Principal Real Estate's capabilities** in the European Core space, visit **principalreeurope.com**.

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MM12358 | 09/2021 | 1805061 | 092022