Principal Real Estate

SPECIAL BULLETIN #2

European core real estate: The importance of investing outside of domestic markets

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Investors have a history of wariness when it comes to investing in real estate outside their home country. Concerns about excessive risk in non-domestic markets, and a lack of local language skills, have led many real estate investors to be solely exposed to real estate in their home countries.

However, avoiding home biases can help strengthen real estate portfolios by adding a new opportunity set of properties without taking on excessive risk. We believe that non-domestic exposure to European core real estate can benefit portfolios by improving diversification and adding exposure to liquid markets, while maintaining the stable income characteristics of a core real estate approach.

European core real estate is defined as those geographical locations which have dynamic and vibrant economies; feature dominant base industries; reflect strong consumption and/or export of goods and services; and in turn, underpin strong real estate performance over the long term.

Key benefits of European core real estate:

Diversification: Investing in properties across geographies helps minimise exposure to correlated assets.

Liquidity: European real estate remains one of the largest, most liquid markets in the world.

Stable income: In addition to providing relative value, European core's income characteristics can protect against inflation.

ESG considerations: Gaining exposure to European real estate can help investors meet ESG goals and requirements.

Improved diversification

While core real estate generally provides attractive and stable risk-adjusted returns, home biases can lead to more idiosyncratic risks, dependent on a property's geographic location. These asset-specific risks could be influenced by a host of factors, including demographics, industry concentration, or local rules and regulations regarding tenants.

To achieve the broader set of benefits that core real estate can provide, more exposure to properties across geographic boundaries is critical when building a portfolio of minimally correlated assets. For U.S. investors, investing in European markets can offer this type of exposure, enhancing overall portfolio diversification.

One instructive example of these diversification benefits is the office segment in Europe which, in recent years, has demonstrated a low correlation to the NCREIF Property Index (NPI), a benchmark used to measure commercial real estate returns in the U.S. In fact, this correlation for total returns over the past 10 years has been -0.11.[1] A low negative correlation like this may help U.S. investors, since property cycles between the regions can become increasingly desynchronized, helping U.S. investors navigate down cycles.

In addition, niche or non-traditional property types (e.g., data centres, health care) are growing rapidly and becoming more mainstream throughout Europe, allowing U.S. investors to gain diversification benefits while maintaining a core approach.

Emerging property types have generated significant investor interest, seeing more capital allocations in recent years. In the United Kingdom, there's significant demand for e-commerce, while other non-traditional sectors such as health care are more prevalent in countries with ageing demographics, such as Germany, Portugal, and Finland. Indeed, given their higher purchasing powers, Germany and Finland populations are better able to afford health/aged care specialist accommodation.

These differences allow for targeted opportunities that can add diversification value to a portfolio. Country-specific opportunities are especially important as individual European nations emerge from the pandemic at different paces, and with uneven outcomes.

Access to new large, liquid markets

Even in the wake of COVID-19, European real estate remains one of the largest and most liquid real estate markets in the world. Asset values have held up even as interest rates have fallen and tenants, supported by stimulus and work schemes, continued to pay rent.

[1] INREV/NCREIF-NPI, Principal Real Estate, June 2021

Today, we estimate the European real estate market is roughly €8.4 trillion and constitutes nearly 45% of nominal GDP—similar in scale to U.S. commercial real estate. The two markets also share core investments across office, industrial, and retail.[2] Europe even saw resilient transaction activity in 2020, despite the pandemic limiting transactions.

Other potential liquidity factors make Europe an attractive market. Office-based employment in Europe is growing and labour markets remain on solid ground as most economies continue to add jobs. These dynamics coincide with relatively constrained office supply in many markets, as completion rates in Europe are below long-term averages compared to the U.S., where there has generally been more development and new supply.

Taken together, these potential liquidity dynamics present opportunities across the largest real estate sectors and property types, as well as the more niche sectors.

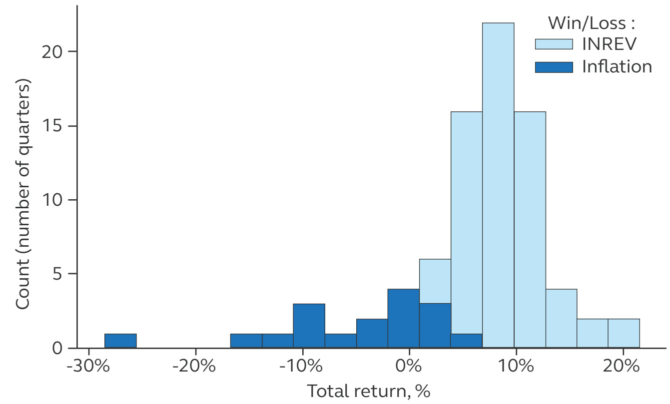
Attractive relative value along with income potential

The extraordinary policy stimulus that resulted from the pandemic has led to a significant boost of capital into global markets. While a great boon for equities and other risk assets, the flood of liquidity has lowered fixed income yields and made it more difficult for investors to find products that can generate stable income.

Although global bond yields are beginning to rise, this is no match for the ever-increasing need for income. In this environment, European core real estate can provide income, while also offering greater relative value than the U.S., as sovereign bond spreads are greater in Europe. In addition, debt financing costs are much lower in Europe. For example, German banks are able to lend at an all-in cost of 100 basis points (bps), while they're much higher in the UK (150-170 bps) and the U.S. (290 bps).[3]

The income characteristics of European core real estate can also provide additional inflation benefits. This is because many European countries' rents are increasingly indexed to inflation, a practice less common for U.S. leases. Looking at the distribution of INREV[4] total returns relative to inflation as shown in the chart, we see that since 2000, positive quarterly returns have far exceeded the number of quarters with negative returns and typically exceed inflation.

Distribution of total returns relative to inflation since 2000



Source: INREV, Q1 2021, quarterly annualized returns

Moreover, the cost of materials and labour for new development also acts as a natural hedge to inflation. Because real estate has the potential to provide a stable income return to investors, this hedge is critical for pensions and other investors with active capital requirements.

Additional considerations

Non-domestic investments provide real estate investors access to new sectors and strategies, as well as the potential to take advantage of mispricing in these markets. Other notable benefits include avoiding home country biases and investing in non-domestic markets. Another consideration is environmental, social, and governance (ESG). Europe has been at the forefront of ESG in commercial real estate buildings. Gaining exposure to this region is one way to help real estate investors meet ESG goals and requirements.

Additionally, Europe's current debt environment—relative to the U.S.—is creating an attractive opportunity to generate returns through the use of leverage. While using leverage to help boost returns can be additive, investors should be wary of strategies that rely too heavily on the cheap debt environment. The wrong balance of leverage in a portfolio can quickly diminish risk-adjusted returns.

[2] World Bank, Principal Real Estate, September 2021

[3] German and UK data: Principal Real Estate, Q2 2021; U.S. data: ACLI, 2Q 2021. U.S. lending costs are based on quotes to life insurance companies.

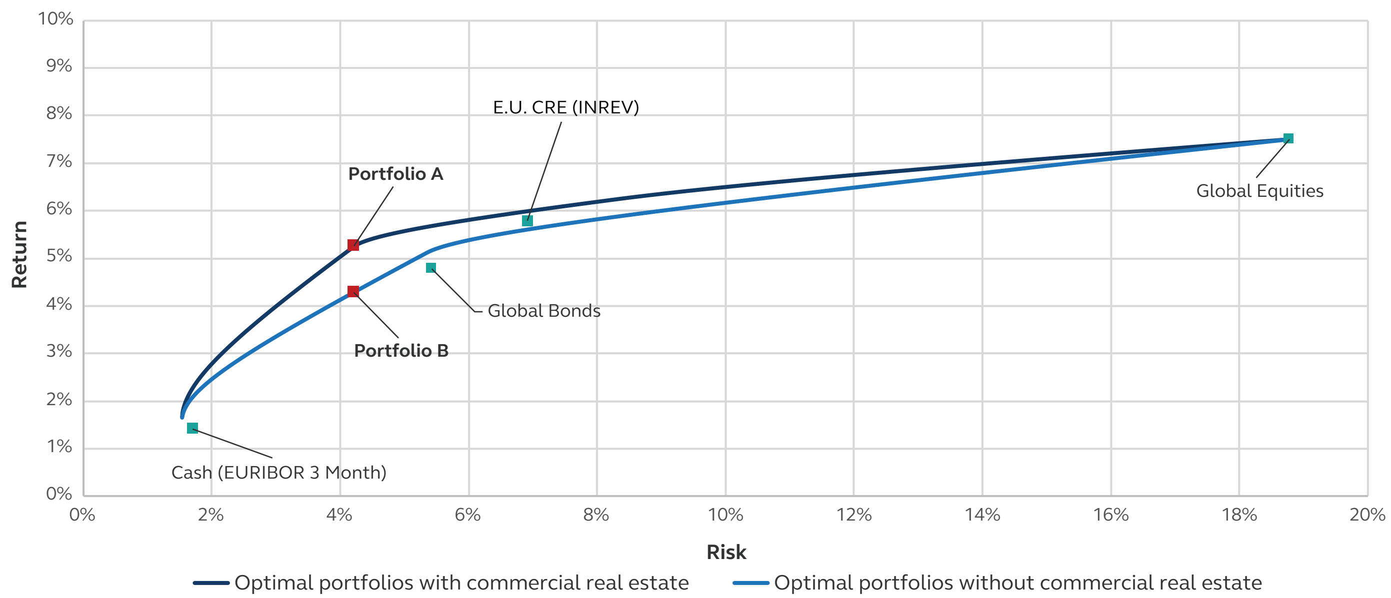
[4] The European Association for Investors in Non-Listed Real Estate Vehicles (INREV), Q1 2021

The end result: Improved portfolio outcomes

Ultimately, we believe exposure to European core real estate improves portfolio outcomes for long-term investors. We conducted a recent analysis which modeled the addition of European core real estate to a portfolio. The addition led to an expansion of the efficient frontier due to an improved risk/return profile.

Going forward, we believe strategies that remain too focused on domestic investment will miss out on a broader set of opportunities that will help build more resilient portfolios. By investing outside of home markets, investors will find they're able to capture more of the opportunity arising from thematic drivers as well as from geographic idiosyncrasies.

Portfolio risk/Return allocations



Source: INREV, Bloomberg Barclays, Moody's Analytics, MSCI-IPD, Q1 2021

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

Risk Warnings

Investing involves risk, including possible loss of principal. 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.

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