Principal Real Estate

SPECIAL BULLETIN #4

MANAGING CORE RISK IN EUROPE

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Core strategies remain a preference for real estate investors seeking stable returns and income potential. However, the definition of core continues to evolve as a result of structural and pandemic-induced changes to how we utilise real estate in our lives. This evolution means it is a good time to re-examine the idea of "core" more holistically.

Core investment approaches, by their nature, carry a degree of unmanageable risks. However, obsolescence and other core real estate risks can be minimised by active management that allows assets to be enhanced over time as trends evolve.

Understanding today's risks

The current environment presents challenges and opportunities for real estate markets. Supply chain problems and strong inflationary pressure are creating significant opportunities for logistics owners. However, a lack of clarity over the future of how office and retail space will be utilised are making it hard to predict the direction of demand for these core asset types. Subsequently, the concept of core real estate is changing with some property types—such as industrial and residential—poised for growth in the coming years while office and retail may remain challenged. Given the dramatic evolution in the core investment environment over the past two decades, we suggest investors take a closer look at their existing allocations as they may carry some hidden risks.

A combination of near-term struggles related to the impact of COVID-19 on occupier requirements and an increase in structural headwinds such as e-commerce, has meant significant weakness in some property sectors. This is especially true for CBD office space, high street retail, and large regional shopping centres. As a result, core markets need to be navigated very carefully with the clear expectation that returns are likely to have limited upside and risks are skewed to the downside (e.g., higher yields in 2022).

Low, stabilised cap rates have also squeezed profit margins for core assets even as bond yields are set to potentially increase, forcing underwriting assumptions to be optimistic in order to create reasonable returns. This is being compounded by increased capital expenditures, work from home trends, and environmental, social, and governance (ESG) requirements. As a result, fully leased core assets are likely to be aggressively priced since most investors are prepared to assume that economic activity is likely to be better a few years out when leases rollover.

Key risks to core real estate:

- Short-term uncertainty around living and working trends, e.g., impact of working from home (WFH)
- Rising inflation and economic pressures
- Tight margins for core assets
- Structural changes in how real estate is used (our "DIGITAL" themes)*

Redefine core opportunities

We believe employing a managed approach offers an increased chance of finding mispricing opportunities across sectors and attractive risk-adjusted performance relative to traditional core strategies.

The importance of execution

In this environment, a tactical approach to core is likely to be more successful, one that combines stabilised assets with the opportunity to invest in a tranche of assets that have not historically been considered core. This could include a limited movement up the risk curve, which could incorporate slightly shorter lease terms or non-investment grade tenant covenants; or it could mean taking on some leasing risk in some of our high-conviction "DIGITAL" markets. By combining core and "managed" core strategies, we believe an investor will have a higher probability of achieving enhanced investment performance over and above what a traditional core asset could provide without materially higher risk.

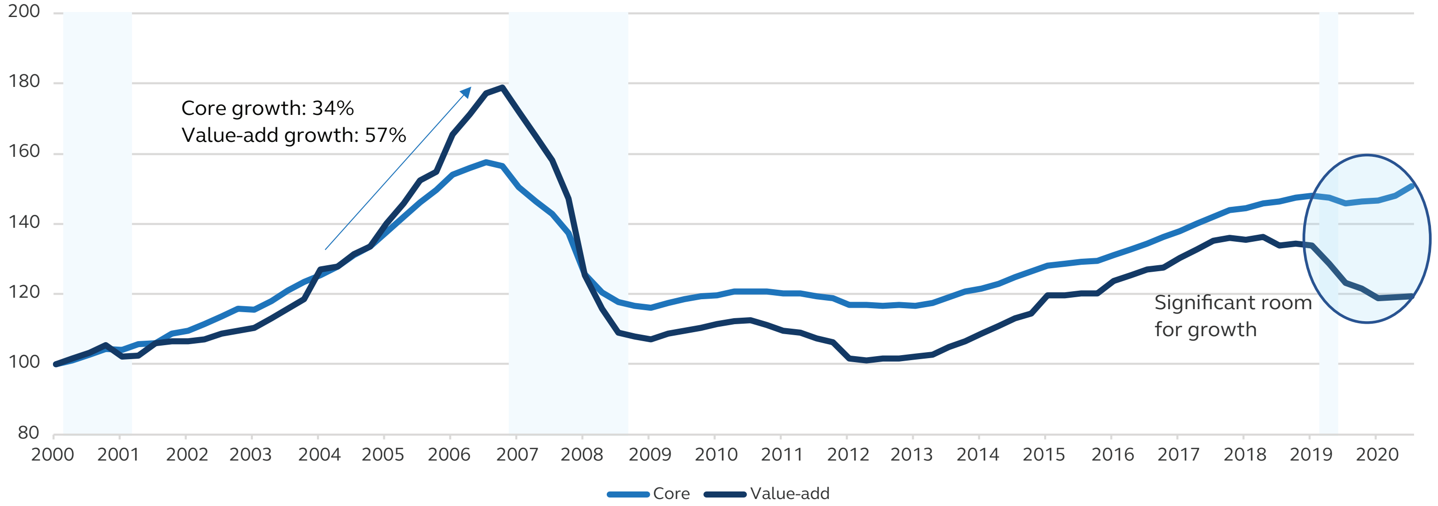
To carry out an effective core strategy today, execution is critical. A managed approach can offer a higher return potential if executed well. One example may be seeking out assets where the risk of vacancy might be mispriced due to a misunderstanding of the impact of the economic recovery on the asset. Additionally, managed strategies often experience steeper discounts during economic downturns. If timed correctly, this presents the opportunity for greater upside potential relative to traditional core strategies (See Exhibit 1).

Something to keep in mind is that while managed approaches offer more cushion—that is, better upside and manageable

* DIGITAL refers to key long -term growth drivers centred around demographics, innovation, globalization, infrastructure, and technology that Principal has identified as metrics of long-term market outperformance.

Value-add offers growth during economic recovery

Capital growth by strategy | Index Q4 2000 = 100



Source: INREV, Q2 2021.

Blue shading represents periods of recession

downside risks—core assets should not be assumed to be less risky than other real estate assets simply because they are well-leased. These properties could deliver less-than-ideal returns because of a limited ability to absorb higher yields. To that end, it's important to remember that managed approaches are not necessarily lower risk strategies but provide opportunities where the risk/reward tradeoff is attractive. Additionally, leverage has a greater potential to amplify downside risks, so investors should use it accordingly.

Redefining core opportunities

Managed core opportunities provide an expanded investment opportunity set that can include some of the fastest growing traditional and non-traditional property types. This may be a new way to re-frame core investing.

We believe employing a managed approach offers an increased chance of finding mispricing opportunities across sectors and attractive risk-adjusted performance relative to traditional core strategies.

The pandemic's impact will remain a fixture of real estate markets for the foreseeable future and longer-term structural changes will continue to shape the real estate investment landscape. The changes we have seen in demand drivers will persist even as COVID-19 becomes less of a public health and economic threat. Regardless of these short- and long-term uncertainties, taking a managed approach to core investing can help ensure that opportunities continue to be uncovered in every corner of these dynamic markets.

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

Risk Warnings

Past performance does not guarantee future results. 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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