Principal Real Estate Investors

Special bulletin #6: **Economic and real estate outlook in the context of COVID-19**

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At a glance – Novel coronavirus impact on commercial real estate four quadrants:

- REITs: U.S. and Global REITs have rallied in April on news that COVID-19 infections and deaths may be leveling off in the U.S. and Europe
- CMBS: Spreads have tightened for higher quality bonds, driven in part by AAA CMBS being included in TALF, while distressed selling continues down in credit
- Private Equity: Transactions have halted in Europe and the U.S. while rent relief requests are increasing
- Private Debt: Government-Sponsored Enterprises (GSE) remain active and some life companies and banks are cautiously re-entering the market; others remain sidelined

As of mid-April, the extent of the full devastation being wreaked by the COVID-19 pandemic across the global economy is becoming evident. The global economy is expected to see the greatest contraction in growth since the Great Depression with the IMF indicating that cumulative loss in global GDP this year and next could be approximately 6.1% for developed economies or about $9 trillion –an amount larger than the economies of Japan and Germany combined. Even factoring in the IMF's forecast for a sharp rebound in 2021, the world economy will still be 5% off pre-pandemic levels, indicating the depth of this recession.

High frequency data does support the deep gash to growth. Initial unemployment claims in the U.S. surged to 16 million in just three weeks with the anticipation that an additional surge in claims is likely in the coming week. A collapse in retail sales (-8.7% in March) also points to the unprecedented economic slowdown. Unemployment in southern European countries most impacted (Italy and Spain) has also risen exponentially with lockdowns effectively closing entire swathes of the economy. With signs of hope that many countries are near the peak level of new infections, thoughts are pivoting towards re-opening parts of economies (provided no resurgence in cases). No clear path forward has been yet established though signs are emerging that countries with effective testing resources are examining a rolling re-opening.

Will Europe show a path forward for re-opening the economy?

Hope is emerging that some parts of Europe may pave the way to a potential playbook to the gradual re-opening of economies worldwide. This is being sparked by hopeful signs that the rate of new infections in the two most impacted countries in Europe – Spain and Italy – are slowing, and the curves are "bending". In Spain, the government has announced plans to allow "essential" workers in construction and factories to go back to work. Some other countries that were earlier to impose lockdowns and thus experienced a smaller level of infections (Austria, Germany) are experimenting with re-opening small shops and then larger establishments in early May. Denmark is also looking to re-open schools this week.

The progress made in the re-opening will be closely watched in other countries, particularly the U.S. which appears to have seen a peak in the rate of new infections in New York, the most impacted metropolis. The federal government has indicated a desire to re-open parts of the economy and has indicated that it will be guided by medical advice, but no doubt will be considering the evidence from Europe in its overall decision-making. A clearly defined U.S. re-opening may be more complicated; however, given the recent news that governors of key states on the east and west coasts are going to coordinate the timing of the gradual opening of their economies. Ultimately, a combination of testing, mitigation and rolling re-openings targeting "essential" industries may be the way forward.

Global policy responses get bigger

Until there are signs that economic activity can be resumed and importantly maintained, fiscal and monetary policy responses will be the two most important pillars of security for businesses and workers. Thankfully, the policy response across the world continues to increase in scale and scope with the most significant developments in the past week being the Federal Reserve's expansion of its 13(3) emergency credit programs and the Eurogroup finance ministers reaching agreement on an expected package of interim measures to address the virus shock. The Fed identified an additional $2.3 trillion of support by:

- Bolstering the Small Business Administration's Paycheck Protection Program by supplying liquidity through term financing

- Purchasing $600 billion in loans through its Main Street Lending Program to ensure flow of credit
- Supporting credit backed instruments, including CMBS, via its Primary and Secondary Market Corporate Credit Facilities (PMCCF and SMCCF) as well as the Term Asset-Backed Securities Loan Facility (TALF)
- Establishing a Municipality Liquidity Facility offering up to $500 bn to help state and local government manage cash flow challenges

In Europe, achieving political agreement to providing rescue financing has been more challenging, but consensus was finally reached by which:

- Precautionary credit lines of up to 2% of GDP (€240 bn) will be available within two weeks to finance pandemic related healthcare costs
- The European Investment Bank (EIB) will be allowed to provide up to €200 bn in financing to small and medium enterprises
- Support extended for the European Commission's unemployment re-insurance scheme (SURE) which backs national unemployment and partial activity schemes

Implications for real estate: Volatility remains pervasive in the public quadrants as daily news and policy initiatives provide ever changing context. Importantly, CMBS got some relief from the provisions of TALF though more likely needs to be done to ensure smooth functioning of the securitized real estate bond markets going forward. Price discovery in the private equity real estate quadrant continues to lag with preliminary reports suggesting a very modest price correction in the U.S. NCREIF Property Index (NPI) of 0.05% in Q1, but a more robust price correction in the U.K. (down 3%). The future path of price discovery will likely be guided by the extent of the duration and depth of the recession; however, these price corrections could potentially be offset with the tantalizing potential of a medical palliative or announcement. Such good news could lead to a surge in global confidence and thereby negate the very worst private real estate drawdown in value and anchor the public quadrants.

Four quadrants: impact to date

Our investment professionals on the front lines in each of the real estate quadrants have the following updated observations regarding current market conditions.

Private Equity

Current status:

- Pockets of new leasing activity have been limited primarily to the industrial sector, with only short-term renewal activity in other property sectors.
- Landlords continue to respond to the spike in rent relief requests, driven in part by new financial relief programs available to tenants.
- In the U.S. April rent collections vary materially among property sectors and geographies with retail and areas the hardest hit by COVID-19 cases, such as New York, trailing the rest of the country.
- In Europe, valuation declines are expected to vary significantly with countries like Germany and Austria being the least impacted while the southern countries could face steeper declines due to being hardest hit by the pandemic and having generally smaller economies.
- Transaction volume has essentially ground to a halt and pipeline for new deals is thin across Europe and the U.S.
- Government actions limit landlord actions with respect to evictions and rent increases in certain jurisdictions.
- Construction projects are generally continuing to move forward, except in a few locations.

Next steps:

- Monitor government-imposed orders on sheltering in place and shutdowns on construction activity.
- Evaluate tenant-by-tenant rent relief requests.
- Assist tenants with information on relief available from government programs.
- Increase surveillance on property and portfolio level cash flows for potential impact on NOI and debt service.
- Leverage relationships in search of off-market new transaction procurement opportunities.
- Elevate property preparations for tenants and employees to return to their traditional workplace.

Private Debt

Current status:

- Availability of credit remains muted as many lending sources are sidelined given the continued market volatility.
- Logistical challenges of completing due diligence remain amid wide-spread travel restrictions and social distancing guidelines.
- Cost of debt shows signs of stabilizing although remains elevated relative to pre COVID-19 levels.
- Most life companies have re-entered the market to some degree, focusing on high quality, defensive assets with known sponsorship. Lack of deal flow is a challenge with extremely limited investment sales activity and patient borrowers unwilling to refinance at wider levels.
- Debt funds and other alternative lenders remain largely sidelined given material pressures on liquidity. Those that have re-entered are focused on subordinated debt and/or are quoting senior loans with wider spread levels to compensate for the lack of available financing options.
- CMBS originations remain extremely challenged given market instability and lack of pricing visibility.
- Larger banks have reduced lending activity. Local and regional banks remain active although constrained in loan size given syndication challenges. All banks are generally reserving liquidity for top customers.
- GSE lending activity remains robust and rates have contracted. Both agencies are requiring upfront debt service escrows in most new loans.

Next steps:

- Selectively resume lending for clients with a higher quality strategy focused on dollar cost averaging into market and selecting top-tier assets and borrowers.
- Majority of clients remain sidelined given lack of pricing and credit visibility.
- Watch for increased deterioration in the private real estate credit markets (reduced levels of liquidity, exit of market participants).
- Closely monitor corporate bond spreads in both the investment grade and high yield space.
- Continue elevated surveillance of investments with prioritization focused on most “at risk” property types and markets.
- When appropriate to re-enter market for clients, select investments with a keen focus on staying up in quality on more defensive property types and careful market selection.
- Our clients are positioned to take advantage of material dislocations in the credit markets as appropriate levels of visibility emerge.

Public Equity (U.S. and Global REITs)

Current status:

- To date in April, U.S. and Global REITs have rallied 8% and 6%, respectively (as represented by the FTSE NAREIT All Equity REIT Index and FTSE EPRA/NAREIT Developed Index). The REIT market is reacting positively to news that COVID-19 infections and deaths may be leveling off in the U.S. and Europe (i.e. the curve is flattening from social distancing measures) as well as renewed focus on how quickly economies can be re-opened.
- Market leadership during the bounce back has come from Australia, United Kingdom, and the U.S. as previously those countries came under significant pressure due to perceived slow or inadequate medical responses to COVID-19.
- The theme of mean reversion was also on display in terms of performance by property type in these countries. Sectors and stocks that had been under the most pressure over the past month, such as retail, healthcare, and office, have displayed powerful bounces higher. More defensive sectors, such as self-storage and data centers, have lagged.
- In the U.S., REIT news from the week included positive data on the percentage of rent collections received from several apartment REITs. Prologis, a large industrial REIT, also offered a business update indicating demand trends are still healthy in its logistics portfolio and leasing activity continues at a good pace.
- Asia bucked the trend of peaking COVID-19 cases elsewhere with new waves of infections being reported in Singapore, Japan and Hong Kong. These countries have announced new lockdowns of differing degrees of severity and, as result, the stocks have lagged this month with flat to modestly positive returns on average.
- Valuations for REIT stocks have narrowed with the rally in stock prices but remain at levels that have seldom occurred historically, trading at an approximate 20% discount to NAV globally. U.S. price to NAV discounts are 10% on average, supported by higher valuations in structural or defensive sectors, but the majority of stocks are still trading at sizeable discounts. Potential downside risk still exists (such as the extended lockdown measures), but these valuations are attracting the attention of investors looking to take advantage of pricing dislocations between public and private real estate markets.

Next steps:

- Expect volatility to remain elevated in the days ahead and study relative valuation changes in search of opportunity.
- Closely monitor economic data, capital market pricing, and our contacts with companies and Principal's private real estate colleagues. If changes in either economic or real estate conditions are observed, make the appropriate changes to our valuation models.
- First quarter earnings results will start to be announced soon for many REITs. Digesting new information on these calls on current conditions and expected changes in REIT portfolios will be important.
- Most importantly, keep our long-term focus. Any significant changes to the portfolio positioning will need to be motivated by big changes in either our long-term economic outlook or larger changes in relative valuation.

Public Debt (CMBS)

Current status:

- AAA-rated conduit CMBS was added to TALF, which ratcheted AAA spreads tighter by 40-50 bps. TALF CMBS program features include:
  - AAA conduit CMBS only (excludes SASB and outstanding CRE CLOs).
  - Only bonds issued prior to 3/23/2020 are eligible (future new issue not included).
  - Maximum 3-year loan term with 15-19% haircuts with pricing of 125 basis points over the fed funds overnight index swap rate (OIS).
  - Program runs through September 30th unless extended.
- Distressed selling continues to occur by investors needing to meet capital calls on their financing vehicles, primarily focused on lower rated investment grade (BBB/BBB-) and the below investment grade segments.
- Spreads for higher quality investment grade bonds (AA to A) continue to compress as investors reassess their longer-term fundamental outlook against the level of subordination in each of those classes and reflect AAA spreads tightening in response to TALF and increased liquidity.
- The market is reconsidering fundamental credit risk, especially in the consumer-driven hotel and retail sectors due to minimal near-term consumption, and in the office sector longer term, as permanent changes in behavior may result due to the substantial increase in the remote work force.
- Spread changes over swaps since the end of February:

S+	04/14/2020	04/03/2020	03/26/2020	03/19/2020	03/09/2020	02/28/2020
CMBS AAA (SS)	150	195	300	245	132	90
CMBS AA	450	450	575	400	202	145
CMBS A	725	600	900	535	267	190
CMBS BBB	1020	1250	1350	800	425	325
CMBS BB	2000	2000	2000	1250	717	595
CMBS IO	475	550	625	450	190	125

Next steps:

- Continue to monitor investor flows and spreads on other fixed income sectors as material outflows will continue to pressure CMBS spreads in the near term. TALF support for IG and HY corporate bonds has helped to stabilize those markets and bring flows back into fixed income.
- Run updated analysis of our CMBS holdings across portfolios with the following revised assumptions:
  - Stress hospitality properties for longer term impact from travel and conference bans.
  - Stress retail properties in expectation of high defaults of service tenants in the near term and increased challenges from ecommerce going forward.
  - Adjust economic conditions in our CMBS model to reflect the potential for material job losses in a prolonged economic shutdown scenario.
- Review revised results and update our buy/sell/hold decisions given current market pricing.
- Look for near-term opportunities in AAA-A bonds.

Principal Real Estate Investors will continue to monitor the virus and its impact on the U.S. and European economies and real estate markets. We will provide further updates to our clients on the impact of COVID-19 as the situation continues to evolve and are happy to have discussions with investors as helpful.

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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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