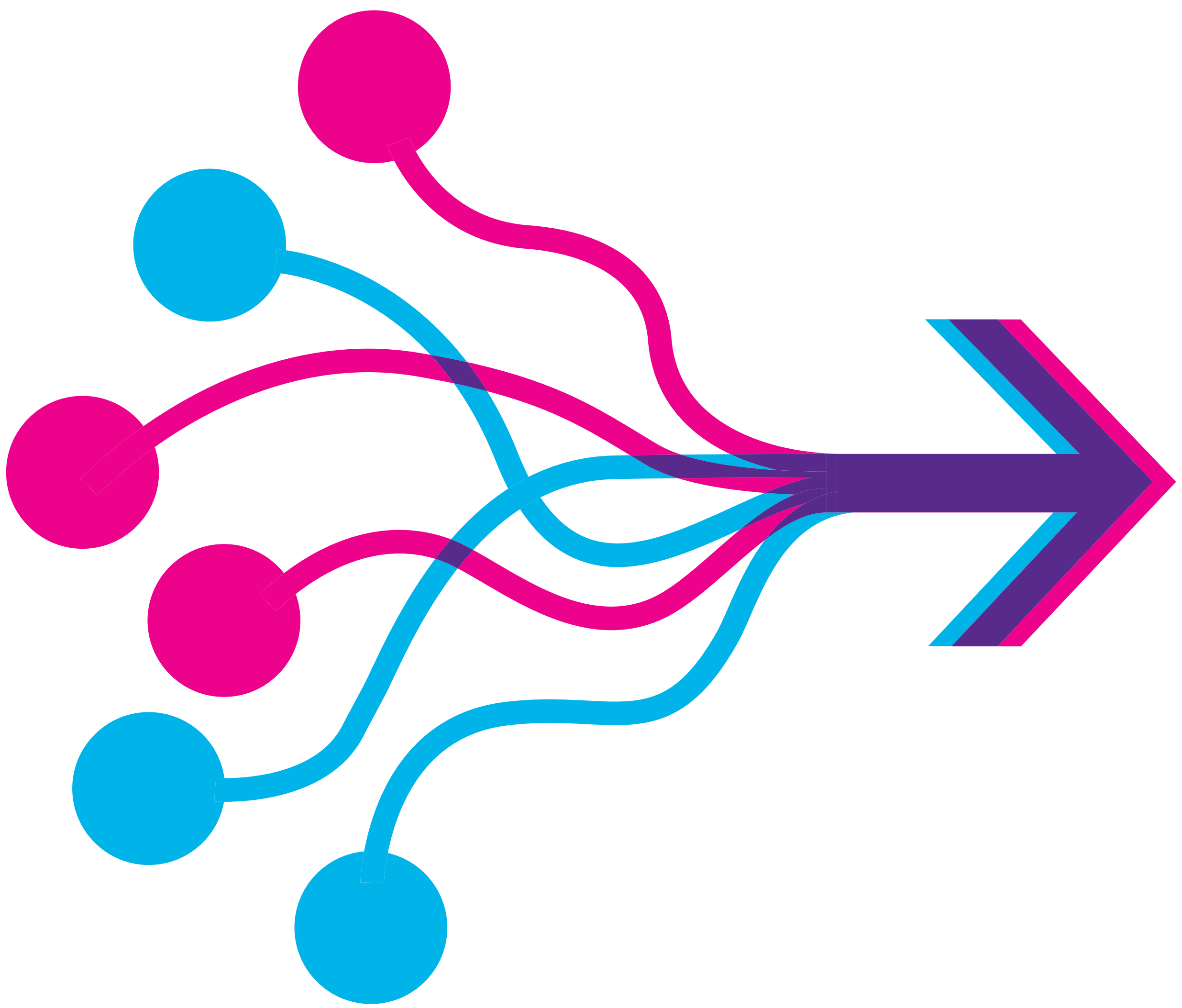
NON-TRADITIONAL IS GOING MAINSTREAM



By Indraneel Karlekar, PhD
Global Head, Research and Strategy
Principal Real Estate Investors

The mainstreaming of non-traditional property types is well on its way within institutional investing, which will materially broaden the real estate investment universe.

Historically, institutional real estate investors have allocated capital to five property types in the US—office, retail, multifamily, industrial, and hotel. But, in recent years, several niche and emerging property types have seen a significant increase in investor interest and capital allocated, in both the public and private real estate quadrants. According to Real Capital Analytics, as of year-end 2020, these non-traditional property types accounted for approximately 24% of all transaction volume in the US and approximately 56% of total REIT market capitalization.

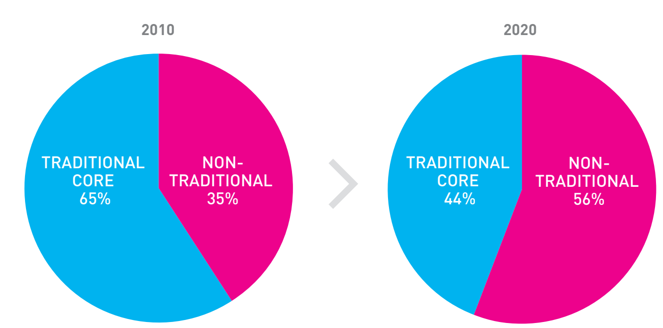
The listed REIT market has spearheaded the push into non-traditional property types *(Exhibit 1)*, greatly expanding the investment universe and improving the diversification outcome for investors. Many of the largest REIT companies by market capitalization belong to the non-traditional property type category. Their stable and steady cash flows could augment the growing case for inclusion in a real estate portfolio.

PRIVATE REAL ESTATE INVESTORS ARE RAPIDLY EMBRACING NON-TRADITIONAL PROPERTIES

The past couple of years have seen a significant uptick in investment into non-traditional property types by private real estate investors. Currently non-traditional property types sit at 5–6% within the National Council of Real Estate Investment Fiduciaries (NCREIF) ODCE Index. One expectation is that, on a conservative basis, non-traditional property types could comprise 15% of the ODCE Index by 2030, nearly tripling from current levels. This increase would still trail the experience of listed real estate and be quite comparable, for example, to the growth in the industrial sector in the ODCE Index, which increased from approximately 14% in 2010 to around 20% in 2020 *(Exhibit 2)*.

EXHIBIT 1: REITS SPEARHEAD GROWTH OF NON-TRADITIONAL PROPERTY TYPES

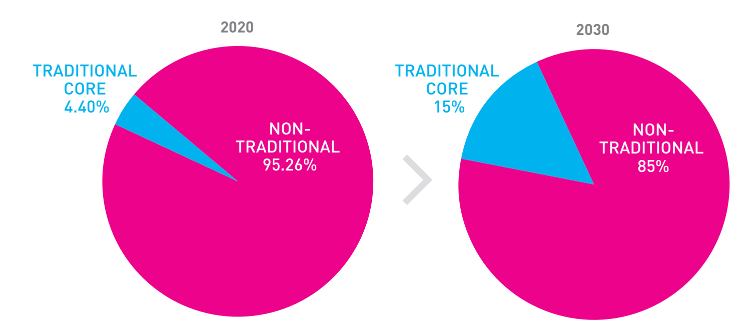
Source: FactSet, NCREIF, MSCI, NCREIF ODCE Index, MSCI US REIT Index; as of 31 December 2020.



Note: Traditional core consists of apartment, retail, office, industrial, and diversified (public market only). Non-traditional consists of specialized residential (public market only), self-storage, hotels and resorts, healthcare, net lease (public market only), data centers (reported within industrial in private market), and other. Due to rounding, figures and percentages shown may not add to the totals or equal 100%. May not reflect current allocations.

EXHIBIT 2: FORECASTED INCREASE IN NON-TRADITIONAL PROPERTY TYPES IN THE NCREIF ODCE INDEX

Source: NCREIF, Principal Real Estate Investors, April 2021



THE GROWTH OF NON-TRADITIONAL PROPERTIES REPRESENTS A SECULAR SHIFT IN DEMAND DRIVERS

The rapid and significant adoption of non-traditional property types in both the listed and private real estate universe is not just a cyclical rotation: it may reflect a structural shift within the economy wherein "DIGITAL" drivers of growth and demand—Demographics, Infrastructure, Globalization, Innovation, and Technology—have become more dominant in recent years.

The pandemic further accelerated these structural changes, in some cases rapidly upturning how consumers and businesses behave and occupy space. These drivers have a clear impact on the growth of both traditional and nontraditional property types—directly and indirectly—given their sheer scale. But diving a little deeper, there are specific sub-themes within the broader DIGITAL framework that tie in to the rise of non-traditional property types and their increasing importance, briefly spotlighted below.

- Demographics: senior living, medical offices and lab spaces, single-family rentals, manufactured housing, self-storage, affordable housing
- Infrastructure: data centers, logistics, warehouses
- Globalization: logistics, warehouses, last mile distribution, cold storage
- Innovation and Technology: life sciences, lab spaces, medical office buildings

EXHIBIT 3: NON-TRADITIONAL PROPERTY TYPES HAVE DELIVERED SOME OF THE STRONGEST ABSOLUTE RETURNS

Source: NAREIT, Principal Real Estate; as of May 2021

	TRADITIONAL PROPERTIES					NON-TRADITIONAL PROPERTIES				
	APARTMENT	OFFICE	RETAIL	INDUSTRIAL	HOTEL	SELF STORAGE	HEALTH CARE	MANUFACTURED HOMES	DATA CENTERS	INFRAST-RUCTURE
TOTAL RETURNS										
3-YEAR	4.6%	-2.0%	-2.9%	18.8%	-4.6%	9.5%	4.3%	18.6%	16.1%	22.1%
5-YEAR	5.7%	2.7%	-3.8%	20.7%	2.7%	4.6%	5.3%	16.8%	15.8%	19.8%
10-YEAR	9.1%	4.9%	5.1%	15.1%	4.1%	15.2%	7.0%	19.3%	NA	NA
15-YEAR	8.1%	3.4%	2.6%	5.6%	1.5%	12.7%	9.1%	14.3%	NA	NA
20-YEAR	10.9%	6.9%	8.9%	10.1%	4.5%	16.5%	12.3%	13.2%	NA	NA
STANDARD DEVIATION										
3-YEAR	20.9%	16.8%	31.7%	12.7%	36.3%	13.7%	26.8%	16.8%	16.0%	12.2%
5-YEAR	16.6%	15.0%	27.1%	12.8%	30.2%	17.6%	21.8%	14.5%	14.3%	11.2%
10-YEAR	16.3%	13.4%	22.9%	14.8%	25.7%	16.5%	18.5%	13.4%	NA	NA
15-YEAR	26.7%	25.9%	30.8%	28.6%	42.6%	21.4%	21.8%	19.1%	NA	NA
20-YEAR	24.2%	23.7%	29.1%	25.6%	39.3%	21.1%	24.4%	18.2%	NA	NA

LISTED REITS SHOW NON-TRADITIONAL PROPERTIES CAN BENEFIT TRADITIONAL REAL ESTATE PORTFOLIOS

Investors need to understand the benefits to portfolio diversification that non-traditional property types may bring to an existing real estate allocation. The early and rapid adoption of non-traditional property types in listed REITs provides a robust data set of performance metrics and indicates that non-traditional property types have delivered some of the strongest absolute returns over a twenty-year history *(Exhibit 3)*. Self-storage, healthcare, and manufactured homes are the property types that stand out for their strong absolute performance over nearly all time periods.

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Correlation analysis further demonstrates the diversification benefit of adding non-traditional property types to a portfolio. While intuitively it would seem that return correlations between traditional and alternative property types would vary, the data does indeed confirm it *(Exhibit 4)*.

Despite the growth and maturation of non-traditional property types, correlations have stayed low, indicating the variability of business and operating models that are brought into a portfolio with purely traditional property types. In fact, it is the operating model of many of these underlying companies that helps bring in added diversification to a more traditional portfolio comprised of income-oriented real estate.

Mirroring a similar analysis in the private real estate quadrant is hampered by lack of data but we can infer a certain degree of similarity between the performance of listed and unlisted real estate given the underlying operating and business models are the same. Data centers, self-storage facilities, or SFRs, for example, operate under similar models whether held in listed or private ownership. Most importantly, REIT historical data demonstrates that allocation towards non-traditional property types addresses two key investor requirements: performance and diversification, both of which ultimately benefit portfolio construction.

EXHIBIT 4: NON-TRADITIONAL PROPERTY TYPES ARE PORTFOLIO DIVERSIFIERS

Source: NAREIT, Principal Real Estate; as of May 2021

15-YEAR CORRELATIONS	APARTMENT	OFFICE	RETAIL	INDUS-TRIAL	HOTEL	SELF STORAGE	HEALTH CARE	MANUFAC-TURED HOMES	REGIONAL MALLS	SHOPPING CENTERS	DATA CENTERS	INFRAST-RUCTURE	DIVERSIFIED
APARTMENT	1.0000	0.9093	0.8828	0.7158	0.7963	0.8108	0.8028	0.7762	0.7034	0.8347	-0.0586	0.2263	0.9405
OFFICE	0.9093	1.0000	0.8953	0.8283	0.9049	0.7092	0.8126	0.7088	0.6547	0.7489	0.1972	0.2902	0.9706
RETAIL	0.8828	0.8953	1.0000	0.7524	0.8533	0.8028	0.8693	0.7020	0.9659	0.9802	-0.2919	0.0875	0.9376
INDUSTRIAL	0.7158	0.8283	0.7524	1.0000	0.6914	0.5870	0.6339	0.6525	0.1905	0.6156	0.5915	0.6334	0.7776
HOTEL	0.7963	0.9049	0.8533	0.6914	1.0000	0.5762	0.7256	0.5834	0.7337	0.7937	-0.2359	-0.0660	0.8951
SELF STORAGE	0.8108	0.7092	0.8028	0.5870	0.5762	1.0000	0.6760	0.6219	0.6500	0.7221	-0.1652	-0.1540	0.7628
HEALH CARE	0.8028	0.8126	0.8693	0.6339	0.7256	0.6760	1.0000	0.5997	0.7422	0.8793	-0.1058	0.3320	0.8816
MANUFACTURED HOMES	0.7762	0.7088	0.7020	0.6525	0.5834	0.6219	0.5997	1.0000	0.3720	0.5940	0.2216	0.4395	0.7212
DATA CENTERS	-0.0586	0.1972	-0.2919	0.5915	-0.2359	-0.1652	-0.1058	0.2216	-0.3980	-0.1333	1.0000	0.5532	0.0345
INFRASTRUCTURE	0.2263	0.2902	0.0875	0.6334	-0.0660	-0.1540	0.3320	0.4395	-0.0708	0.2106	0.5532	1.0000	0.2350

INVESTORS WILL BE WINNERS AS NON-TRADITIONAL PROPERTIES GO MAINSTREAM

In our view, the mainstreaming of non-traditional property types is well on its way within institutional investing with several positive implications. Non-traditional property types will materially broaden the real estate investment universe and in turn attract a wider array of investors.

The shift and expansion of the universe should also allow investors to generate additional alpha by making conscious investment decisions on their strategies pertaining to alternative property types. Ultimately, we believe the growth and assimilation of non-traditional property types will be a material benefit to the asset class, attracting additional capital and enhancing investment opportunities—and ensuring that investors will emerge as winners.

ABOUT THE AUTHOR

Indraneel Karlekar, PhD, is Global Head of Research & Strategy, Principal Real Estate Investors, the dedicated real estate investment group within Principal Global Investors, which builds on a vertically integrated platform that incorporates all disciplines of commercial real estate.