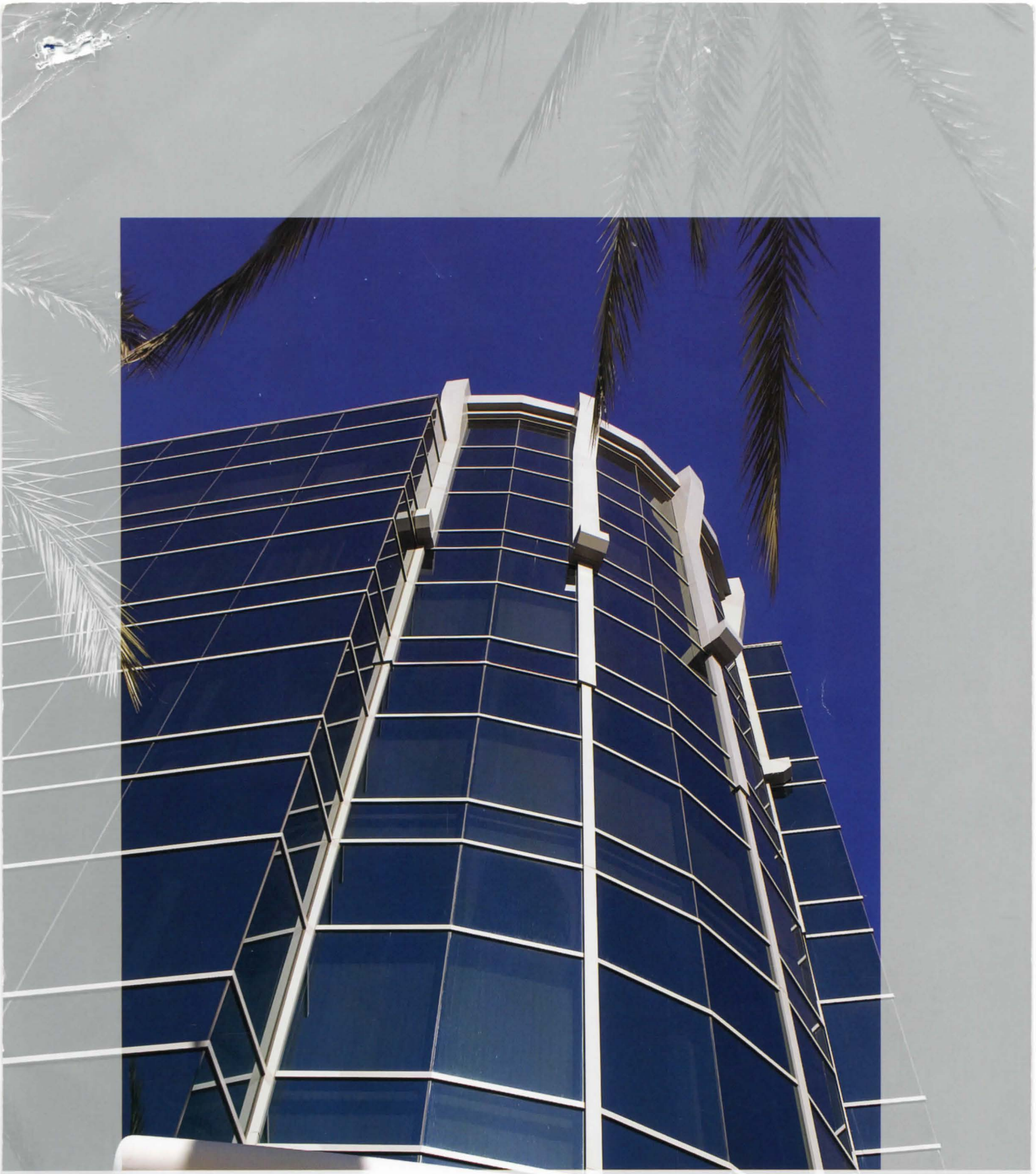


2007 Annual Report | Principal Real Estate Investors

# Principal U.S. Property Account

The Principal U.S. Property Account has three primary objectives:

1) to invest in a well-diversified real estate portfolio that reflects the overall performance of the U.S. commercial real estate market;

2) to maintain appropriate liquidity so that clients can make daily contributions or withdrawals subject to certain limits; and

3) to generate private real estate returns that meet or exceed the Open-End Fund Component of the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index.

Above: Camden Court Apartments – Baltimore, Maryland

# Background | Philosophy

## The Principal U.S. Property Account Background

Since 1982, The Principal Financial Group® (The Principal®)[1] U.S. Property Account (the Account) has been offered to clients as an open-end, commingled real estate fund sponsored by Principal Life Insurance Company and managed by Principal Real Estate Investors. The Account is a diversified real estate equity fund consisting primarily of high quality, well-leased real estate properties in the multi-family, industrial, office, retail and hotel sectors. The Principal U.S. Property Account is available to qualified retirement plans and is open to contributions and withdrawals daily, subject to certain limits.

## Philosophy

The Principal U.S. Property Account is a core real estate fund designed to have a low to moderate risk profile compared to other open-end real estate funds. This risk profile has two components: 1) a low to moderate real estate property risk profile; and 2) a low to moderate risk fund-level operating profile. Low to moderate real estate property risk is accomplished by investing primarily in well-leased properties on an unleveraged or low leverage basis. Low to moderate fund-level risk is accomplished by operating with a strong liquidity focus, client diversification, and limited fund-level obligations, such as forward commitments and fund level debt.



[1] "The Principal Financial Group" and "The Principal" are registered trademarks referring to Principal Financial Group. The Principal U.S. Property Account is a commingled separate account managed by Principal Real Estate Investors, LLC and maintained by Principal Life Insurance Company as the Principal U.S. Property Separate Account. It is available through group annuity contracts of Principal Life Insurance Company.

170 King Street is a 198-unit condominium project located in San Francisco, California. The asset, developed by the U.S. Property Account and completed in early 2007, has 57 remaining units available for individual purchase.

# Portfolio Highlights

| KEY STATISTICS | | DECEMBER 31, 2007 | |
|---|---|---|---|
| Inception Date | January 1982 | Number of Investors | over 14,700 |
| Gross Asset Value | $7.9 billion | Institutional Investors >$5M | 74 |
| Net Asset Value | $6.3 billion | Cash to Gross Assets | 2% |
| Number of Investments | 166 | Leverage Ratio[1] | 16% |
| Number of Markets | 46 | Portfolio Occupancy | 86% |
| Size (square feet) | 42.1 million | Occupancy Excluding Value-added Properties | 94% |

| SECTOR | CURRENT ALLOCATION | NCREIF | TARGET ALLOCATION |
|---|---|---|---|
| Office | 40% | 39% | 30% – 45% |
| Multi-family | 24% | 23% | 15% – 25% |
| Retail | 18% | 21% | 15% – 25% |
| Industrial | 17% | 15% | 15% – 25% |
| Other (Hotel and Land) | 1% | 2% | 0% – 4% |

| PERFORMANCE | GROSS FUND[2] | NET FUND[3] | PROPERTY[4] | BENCHMARK[5] |
|---|---|---|---|---|
| 1 year | 14.7% | 13.4% | 14.4% | 15.2% |
| 3 year | 17.0% | 15.7% | 16.7% | 16.5% |
| 5 year | 14.8% | 13.5% | 14.7% | 14.3% |
| 10 year | 12.2% | 11.0% | 12.6% | 12.2% |
| Since Inception | 9.1% | 7.9% | 9.4% | 8.3% |

[1]Total debt (both property and portfolio) divided by total assets

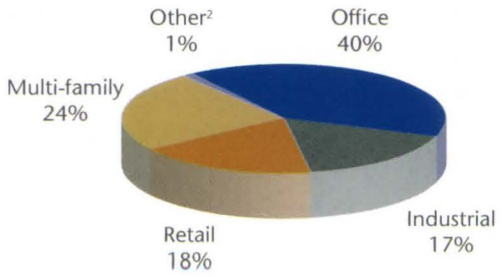
[2]Gross fund returns are levered and pre-fee

[3]Net fund returns include an investment management fee assuming the highest fee schedule of 1.15%

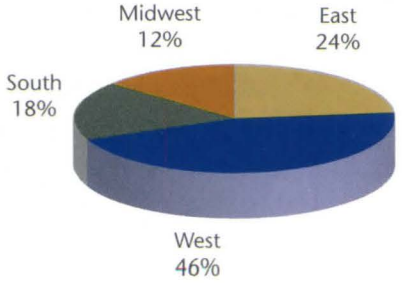
[4]Property returns are unlevered, before fees and calculated in accordance with NCREIF property return methodology

[5]Property level performance is benchmarked against the Open-end Fund Component of the NCREIF Property Index

SECTOR WEIGHTINGS[1]




GEOGRAPHIC WEIGHTINGS




[1] Based on consolidating a prorata share of the single shared control joint venture and 100% of all controlled joint ventures.

[2] Hotel and land investments each comprise < 1% of real estate assets.

# Portfolio Manager Commentary

The Principal U.S. Property Account continued progress on many strategic fronts in 2007, while generating competitive nominal and relative investment performance. The total gross return for the Account was 14.7% for the year, with strong appreciation continuing for the private real estate equity asset class. The Account also continued its twenty-five year history of honoring all redemption requests on a daily basis.

The Account maintained its strategic overweight to the office sector throughout 2007 at a time during which office was the best performing property type in the NCREIF Property Index (NPI). In addition, the Account maintained its strategic underweight to the retail sector during 2007 while retail underperformed the NPI.

The Account's net asset value grew by approximately $1.0 billion in 2007, to $6.3 billion. This growth was a combination of continued investor interest in the Account and strong asset appreciation. The gross asset value of the Account grew from $6.5 billion to $7.9 billion in 2007. Account diversification was enhanced during the year, growing from 143 properties in 43 markets to 166 properties in 46 markets. The Account's risk profile remained low with overall debt obligations of 16% of assets and investments in non-stabilized properties comprising only 11% of the portfolio at year-end.



The active management of the Account continued in 2007 with 29 property acquisitions for $1.4 billion and 23 property sales (including 5 partial sales) for $690 million. The acquisitions offered attractive risk-adjusted returns, improved portfolio quality and contributed to desired property type and geographic allocations. Each of the dispositions capitalized on market pricing imbalances, enhanced portfolio quality, contributed to rebalancing of the portfolio or finalized the business plan for the property. A client entry queue was used intermittently throughout the year to effectively manage Account growth and the transaction pipeline. The continued use of a client entry queue in addition to the flexibility of the Account and the reputation and longstanding relationships of Principal Real Estate Investors should allow for disciplined Account growth in 2008.

Three main themes will govern the investment strategy for the Account in 2008, with the ongoing objective of delivering solid risk-adjusted returns to our investors. First, we desire to own properties with sustainable landlord pricing power. These properties will be best positioned to deliver appreciation in a stable or increasing capitalization rate environment. Second, we will continue to focus our investment activities primarily in urban, infill locations with supply constraints. Third, we will seek investment activities that result in attractive relative value along the risk spectrum in areas mis-priced by the capital markets (e.g. selling apartments to condo converters in 2006 or buying high quality properties at attractive prices from distressed sellers today). In addition to these strategic initiatives, tactical business plan execution at the property level will assume increased importance in 2008, as effective asset management will be a primary contributor to performance.

While 2007 yielded another year of outsized financial results for investors in core property, a material shift occurred between the beginning of the year and the end of the year. The environment in early 2007 was characterized by improving space market fundamentals, accelerating transaction activity and rising asset prices fueled by ultra-accommodative lending practices and reduced

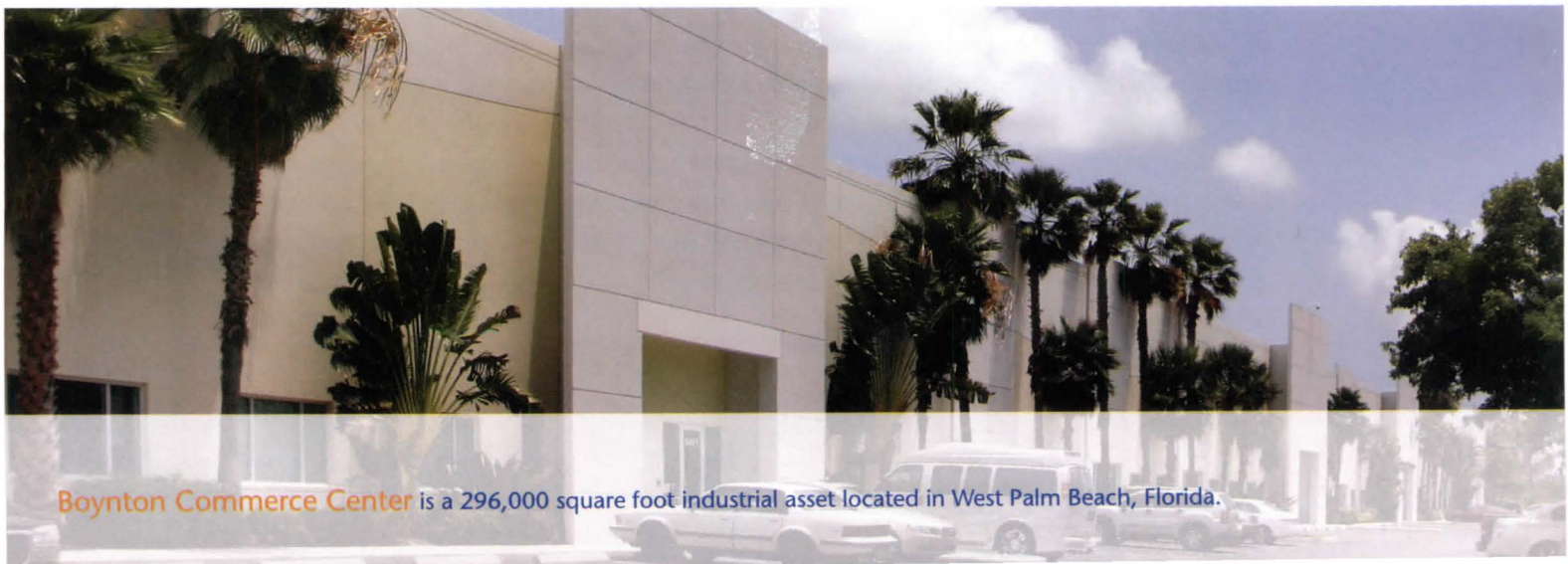
investor risk premiums for moving up the risk spectrum toward value-added and opportunistic investments. The end of 2007 was characterized by stable space market fundamentals in most markets, although uncertainty surrounding the economic outlook has led to an expectation of a moderate deterioration in space market fundamentals in some markets in 2008. Significant volatility in the public quadrants of real estate – publicly traded REIT prices and CMBS spreads – and an increased risk of recession have influenced a change in market sentiment and less risk complacency among investors. Much more conservative lending practices resulting from credit market turmoil and a significant slowdown in transaction activity due to widening bid-ask spreads has resulted in a flattening of asset prices and in some cases, especially lower quality assets in secondary and tertiary markets, a decline in asset prices.

As space market and capital market conditions continue to adjust to domestic and global economic uncertainties and less accommodative debt markets in 2008, thoughtful navigation of the real estate investment landscape will be imperative. In addition to effective management of the portfolio through capital and space market volatility, the evaluation of regional economic health will be a critical element of portfolio strategy, given that even if a national recession is avoided there is a strong likelihood of regional or subregional recessions. Through this, the Account will continue to place equal emphasis on return generation and risk management, while maintaining our focus on liquidity management. The nominal returns generated by core real estate in the past several years are unsustainable. However, with real estate securely positioned as an intergral component of a multi-asset class investment portfolio, and the portfolio consisting primarily of high quality properties in major markets, the Account should generate competitive core property returns in 2008.

Thank you for your support and consideration of the Principal U.S. Property Account. We look forward to working with you in the future.

John T. Berg
Portfolio Manager





Boynton Commerce Center is a 296,000 square foot industrial asset located in West Palm Beach, Florida.

# U.S. Economic Outlook

U.S. economic growth, as evidenced by fourth quarter GDP growth of only 0.6%, slowed dramatically toward the end of 2007. This sluggish level of growth brought full year 2007 GDP growth to just 2.2%, the slowest since 2002. Responding to rapidly weakening global market sentiment and growing fears of a U.S. recession, the Federal Open Market Committee moved aggressively in late January 2008, cutting the Fed Funds rate twice, first by 75 basis points in their first emergency rate cut since 2001 and by an additional 50 basis points at the Fed meeting a week later. These actions brought short term rates to 3%, a decline of 225 basis points since the start of credit market turmoil in the second half 2007, with the Fed Funds futures market suggesting that additional rate cuts are likely forthcoming.

The trigger point for the credit market turmoil and volatility has been the increasing level of reported subprime mortgage losses, especially among large financial intermediaries, including bond insurers. But the issue goes well beyond the negative consumer wealth effect of declining home prices and the impact of subprime losses on the earnings outlook for these companies. The predominant concern relates to uncertainty as to the functionality of the overall credit market, the timing of its eventual restoration, and the resultant impact on broader economic activity.

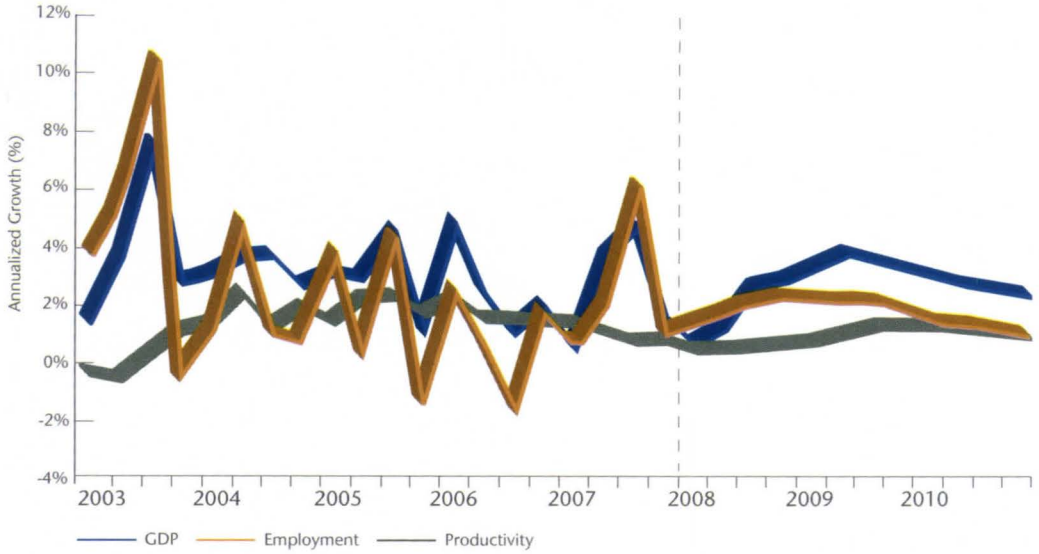


Further, fears regarding the impact of the credit market disruption have occurred coincident with several other unfavorable variances in other sectors of the economy, including a very weak U.S. dollar, slowing employment growth, and record high nominal oil prices (and close to all-time high real oil prices). These events have contributed to a significant decline in risk tolerance in many sectors of the market, as the capital markets have rotated toward safe harbor investments, shifting quickly from an emphasis on maximizing return on investment to ensuring return of investment. As a result, spreads have subsequently widened to record levels on many credit-oriented investments, especially more complex structured and securitized bonds.

Amidst this challenging environment, the willingness and ability of sovereign wealth funds to infuse equity into struggling financial intermediaries has been a favorable economic development, helping to partially restore the health of financial intermediaries' balance sheets and hopefully allowing them to return to credit lending activities in a more timely manner. In addition, there are a number of positive economic factors that, even if a recession cannot be avoided, should serve to allow the subsequent recovery to be stronger. Not only has monetary policy become much more accommodative, causing consumer borrowing rates (including home mortgage rate resets) to decline, Congress and the White House have agreed to enact a Federal fiscal stimulus package. And while consumer spending will not be a driver of economic growth, low unemployment rates should help support consumer spending levels and reduce the risk of them going negative. In addition, exports should continue to show signs of growth, lean inventory levels could provide some upside elements to an economic recovery, and (except for the financial services sector) most businesses remain well capitalized.

# U.S. Economic Outlook

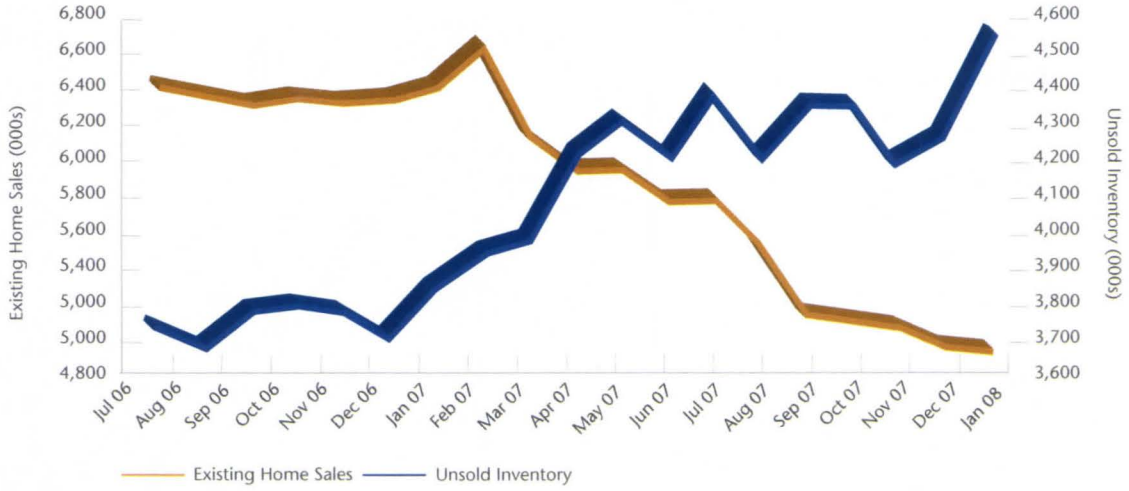
## U.S. Economic Activity




Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Principal Global Investors



## Home Sales




Source: National Association of Realtors

The capital markets have rotated toward safe harbor investments, shifting quickly from an emphasis on maximizing return on investment to ensuring return of investment.

150 Spear Street is a 257,000 square foot office building acquired in 2007 and located in the central business district of San Francisco.

# Property Sector Highlights[1]

**Office** The office sector delivered strong performance and gained attention due to large portfolio trades during 2007, with the volume and pricing of transactions exceeding expectations throughout the first half of the year. The credit market turmoil is anticipated to impact the sector as tenant demand in markets heavily exposed to financial services and other credit market dependent industries slows. Additionally, pricing based on ultra-accommodative financing no longer available in the market may lead to price corrections in some areas, while a flight to quality may help to keep yields compressed in other markets. Although a slight increase in supply is expected over the near-term, the credit market turmoil has limited the ability to finance the construction of office projects and will hold supply to reasonable levels. Overall, space market fundamentals for the sector continue to be strong, and office assets will likely continue to see positive, yet slower growth in rental rates.

**Industrial** Strong export growth fueled by a weak dollar has positioned the industrial sector for solid performance in the coming years. Rental rate growth, while moderating, is anticipated to continue, especially in markets linked to global trade. As such, port locations are anticipated to perform well in addition to those secondary markets that serve as stopping points for distribution and offer lower occupancy costs. Further, as the sector is viewed as a safe haven in the market, continued investor demand will help to mitigate negative valuation risks.



**Retail** Demand for retail space was strong during 2007 with net absorption totaling 54.8 million square feet. Excess supply coupled with a deceleration of retail sales will present challenges for the sector in 2008. The question that will define retail performance in the coming year lies with the consumer segment and its ability to withstand the housing market downturn, slower job growth and high energy prices. If a recession can be avoided, continued low unemployment and resulting growth in household income will aid performance within the sector.

Costco Way is a 1.2 million square foot industrial property located in Edison, New Jersey.

# Property Sector Highlights[1]

**Multi-family** Multi-family sector fundamentals are expected to remain relatively strong throughout the credit market turmoil and housing market downturn as properties in some markets may benefit from both economic considerations. The credit market turmoil has made it more difficult for many first-time home buyers to enter the market, and while median home prices have come down in most markets, they are still significantly above historical levels. Demand, buoyed by an increasing population of renters by necessity including college students and foreign immigrants, is expected to moderate and drive lower rent growth going forward as supply remains near peak levels. Competition from shadow condominium units in addition to single-family homes offered for rent will also limit additional rent growth over the near-term.

**Hotel** Fundamentals within the hotel sector are expected to remain strong throughout 2008, driven by asset-level performance of increasing revenues and maximization of operating income. Further appreciation via yield compression is not likely to occur as mortgage debt has become more scarce, especially in the CMBS marketplace which has been greatly affected by credit market turmoil. While supply has increased in the sector, it will remain at reasonable levels due to long lead times on new projects, high construction costs and wide diversification of hotel formats in the development pipeline.



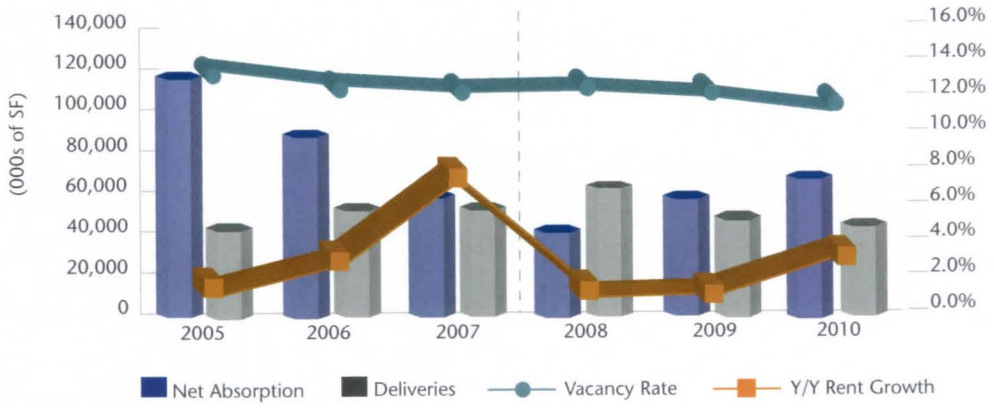
[1]Expectations & Market Realities in Real Estate: 2008 published by Principal Real Estate Investors, Torto Wheaton Research and Real Estate Research Corporation. The full report is available upon request.

The Collection at Vanderbilt is a 109,000 square foot retail asset located in Naples, Florida.

San Portella is a 308-unit multi-family property completed in 2007 and located in Phoenix, Arizona.

# Property Sector Highlights

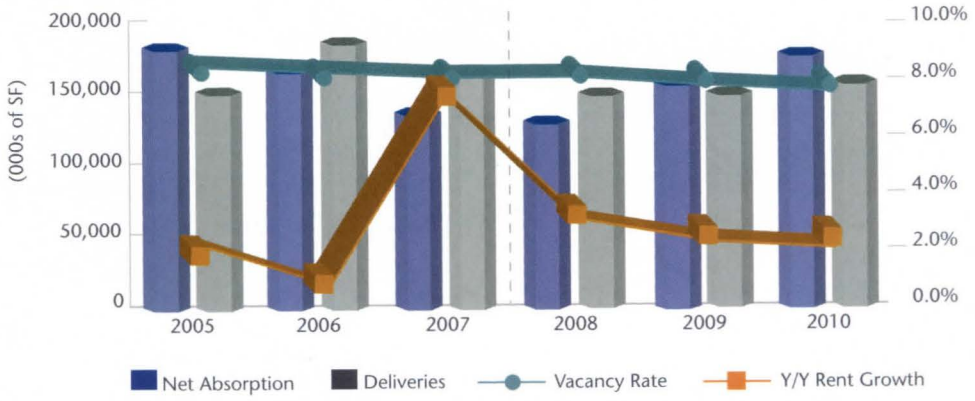
## Office Fundamentals




Source: CoStar, Principal Real Estate Investors



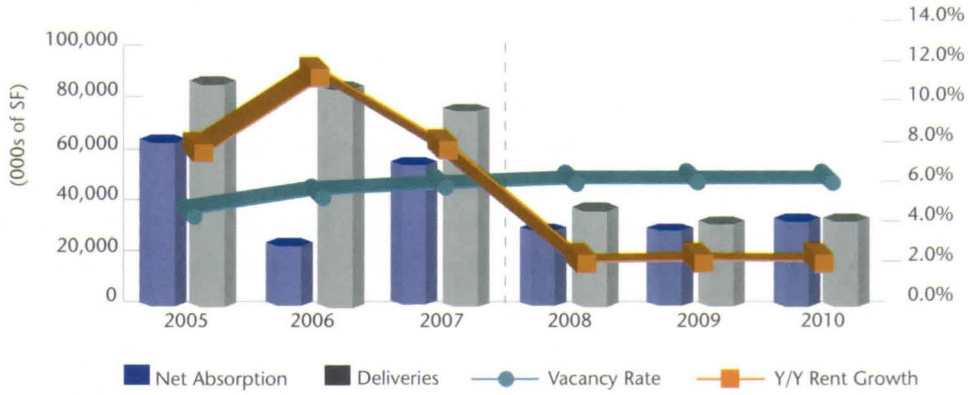
## Industrial Fundamentals




Source: CoStar, Principal Real Estate Investors

# Property Sector Highlights

## Retail Fundamentals




Source: CoStar, Principal Real Estate Investors



## Multi-family Fundamentals


Source: Reis, Inc., Principal Real Estate Investors

# Principal U.S. Property Account Performance

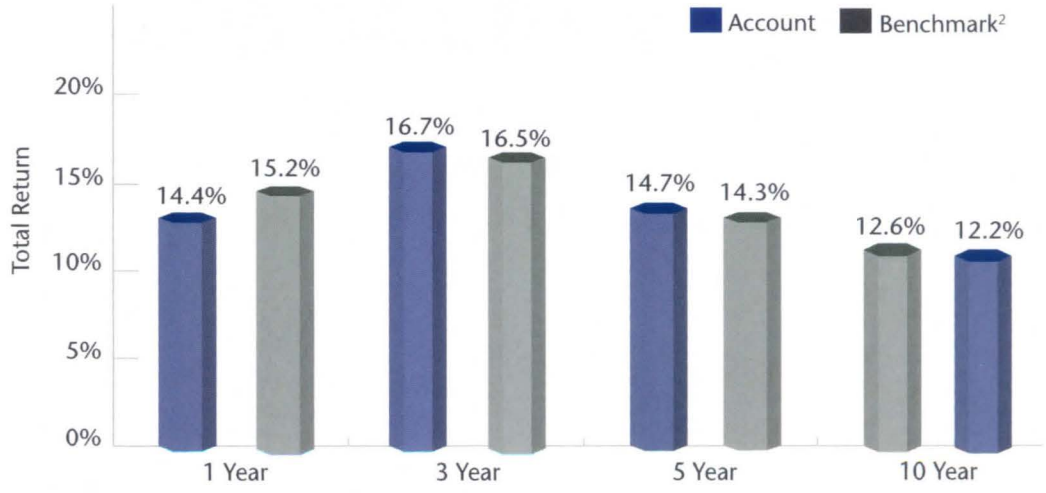
The Account generated solid nominal investment performance during 2007, ending the year with a total return of 14.7%. The total return was comprised of income of 4.9% and appreciation of 9.4%[1]. Positive performance at the property level was driven by the well-leased, high quality, infill assets that characterize Account holdings.

Performance for time periods ending December 31, 2007 exceeded the benchmark, the Open-end Fund Component of the NCREIF Property Index over the three, five and ten year time periods, but trailed the benchmark over the one year time period. Material outperformance in market selection drove returns, in addition to the Account's strategic overweighting to the office sector. The Account capitalized on buyers' desire to deploy money into value-added strategies by selling several value-added transactions and redeploying capital into well-leased, high quality, infill assets throughout major markets. The Account increased leverage slightly during the year from 14% to 16% and the benefits of leverage with respect to returns were positive and significant. Account returns were negatively impacted by cash balances as well as partner promote accruals for joint venture partnerships. One year returns for assets within joint venture partnerships, including those sold during the year, were 17.6%.



Office sector returns of 19.3% for the year led property performance. The Account continued its strategic overweighting to the sector relative to the benchmark in 2007. Assets in major markets such as Los Angeles and New York contributed the most to the sector's performance, in addition to infill assets located in Phoenix and Austin. Account strategy includes eventual sector rotation that will gradually reduce weighting to the office sector and base further investment decisions upon supply and demand fundamentals within each market.

## Property-level Performace




[1]Income and appreciation returns do not sum to total return due to the chain linking of quarterly returns.

[2]Property level performance is benchmarked against the Open-End Fund Component of the NCREIF Property Index.

# Principal U.S. Property Account Performance

The industrial sector within the U.S. Property Account posted a one year total return of 12.0%. Industrial assets in the south led performance for the Account, benefiting from solid supply and demand fundamentals, strong rental rate growth and continued investor interest throughout south Florida and Texas. The Account increased its industrial holdings during 2007 and will look to acquire high quality, infill assets in major ports and distribution centers poised to benefit from continued growth in exports as a result of strong global trade and a weak dollar. Nearly equal-weighted today, the Account will look to overweight the industrial sector relative to its benchmark in the coming years.

The east region displayed the strongest performance within the multi-family sector led by a high-rise asset located two blocks from Times Square in New York and a recently developed and stabilized asset located within the Kendall Square neighborhood of Cambridge that benefits from strong tenant demand associated with its proximity to MIT. Multi-family sector returns of 11.1% are slightly ahead of the benchmark over the one year time period, but trail over longer time periods due to value-added acquisitions with business plans that have not been fully executed. This underperformance is expected to dissipate as the business plans for those assets are fully implemented.



Retail sector performance delivered a total return of 10.4% during 2007. Retail assets held within a Florida programmatic joint venture displayed strong performance both through redevelopment of assets and the re-tenanting of multiple centers. Additional retail sector performance within the south region came from a retail property in Houston that includes a newly developed, fully stabilized parcel in addition to a parcel currently under development and 40% pre-leased. The Account is underweighted to the sector and will maintain this underweighting over the near term as consumer spending decelerates and consumer sentiment regarding economic conditions weakens.

Performance at the property level was driven by the well-leased, high quality, infill assets that characterize Account holdings.

# Value-added Properties

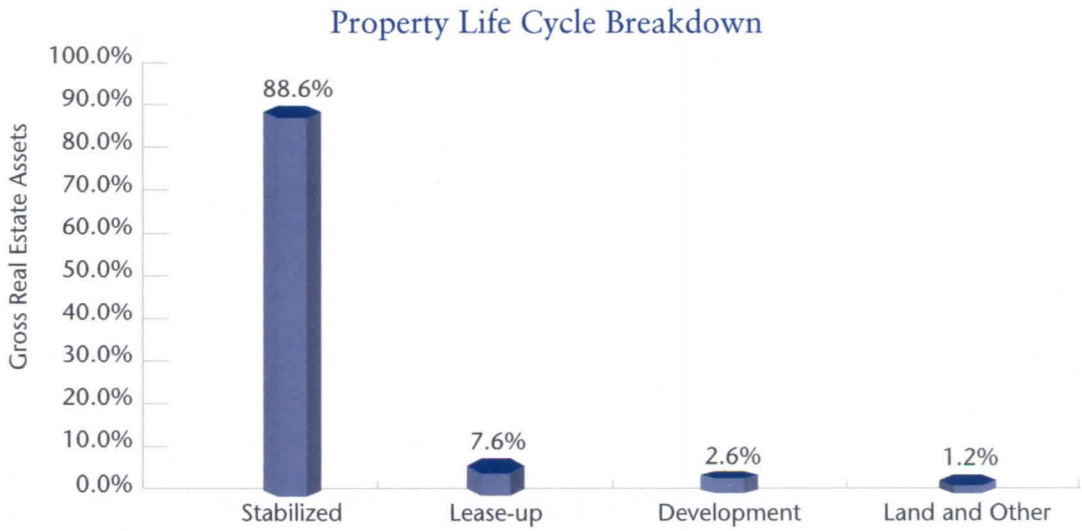
Value-added properties within the U.S. Property Account equated to approximately 11% of gross real estate assets as of December 31, 2007. Value-added properties posted a 16.7% annualized return in 2007 (including acquisitions and dispositions). Value-added assets include those assests acquired at less than 85% leased, new property development, land holdings and condominium conversions. The Account may hold up to 15% of gross assets within this classification and the value-added assets are expected to garner higher returns than other assets within the Account.

During 2007, the Account acquired over $500 million of value-added investments and stabilized or sold approximately $430 million of value-added assets. Notable value-added transactions include the lease-up of multi-family assets developed by the Account and located in Baltimore and Cambridge and the sale of condominium units in San Francisco located directly across from AT&T Park.

Primary value-added strategies include:

- Developing office and industrial properties in markets where tenant demand exceeds new supply and risk-adjusted return expectations are greater for the development of new product versus the acquisition of existing assets
- Taking calculated leasing risk by acquiring under-leased properties (primarily office and warehouse) in markets with fast growing demand fundamentals where high asset quality, strong location and attractive price compensate for leasing risk
- Building apartments in vibrant urban locations with healthy renter demand and barriers to entry
- Developing or redeveloping retail centers in markets experiencing high levels of population growth and discretionary income



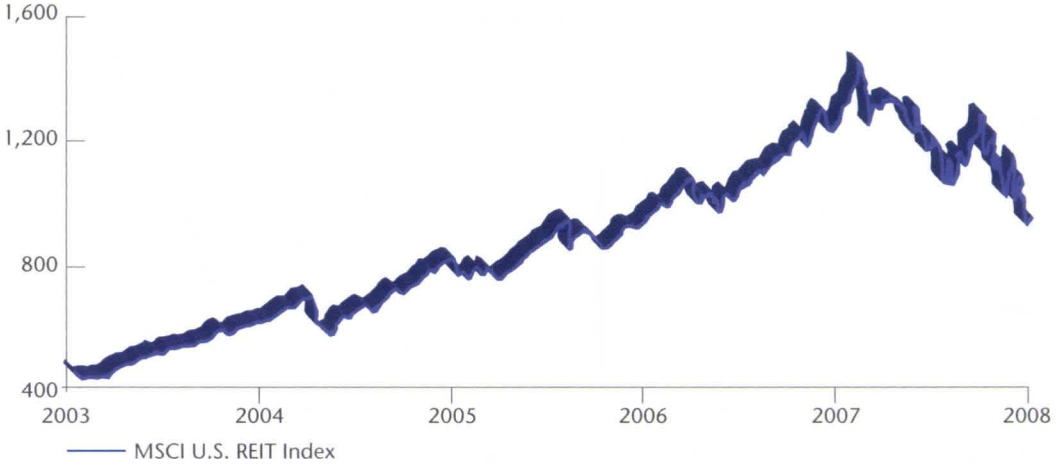


# Capital Market Activity

## Capital Market Overview

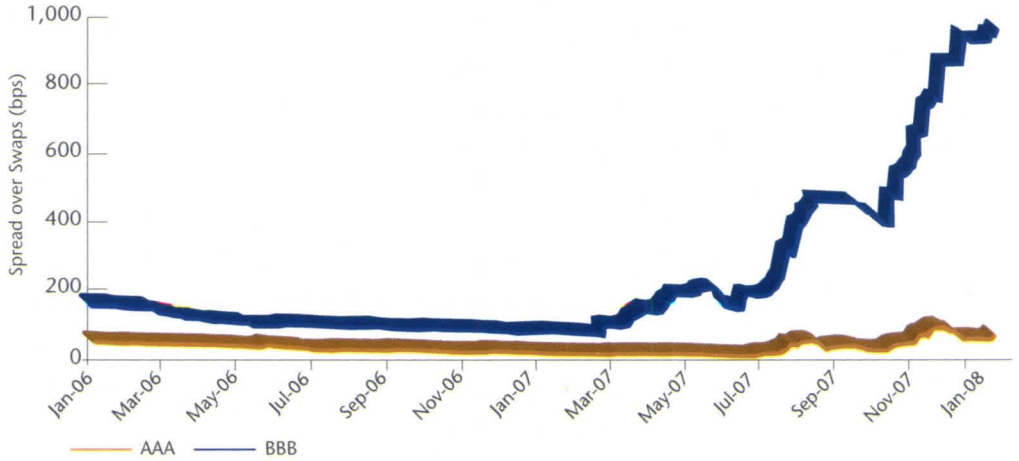
The onset of the credit market turmoil and resulting re-pricing of risk has impacted the commercial real estate market as investors re-evaluate risk premiums in certain market segments and continue their flight to quality. The public sectors of the commercial real estate market suffered dramatically during the latter half of 2007, evidenced by widening in spreads for commercial mortgage-backed securities (CMBS) and a material erosion of REIT share prices. Despite this, the private equity sector continued to show strong space market fundamentals in most markets and overall positive performance. While capitalization rate compression has ended and will likely trend upward in the coming year, the commercial real estate market will be buoyed by strong space market fundamentals, high commodity prices driving up replacement costs and continued interest from investors in the real estate asset class. Transaction activity slowed at year end in response to market volatility and transaction pipelines are unlikely to increase until the second half of 2008.

### REIT Performance




Source: IDC, Exshare, January 2008

### CMBS Spreads




Source: Lehman Brothers, January 2008

# 2007 Transaction Activity

## 2007 Transactions

2007 marked the single largest year of acquisition activity in the Account's 26-year history, closing 29 acquisitions across 22 markets totaling nearly $1.4 billion. Acquisition activity included the purchase of three portfolio transactions: a retail portfolio in Washington, D.C., a multi-family portfolio with assets located throughout the central and east regions and a three building office portfolio in Denver. Activity also included the Account's first hotel investment – the joint venture development of a J.W. Marriott located in San Antonio, Texas, developed in conjunction with a partnership that includes Marriott International and the Professional Golfers' Association of America (PGA). Strategic acquisition themes executed throughout the year included buying high quality assets in infill locations with strong space market fundamentals. The Account accessed transactions through successful local market contacts and increased industrial asset exposure via forward commitment structures. In 2007, 97.5% of the Account's acquisitions were acquired via an off-market feature including private deals not fully bid to the market, repeat transactions with the seller in which Principal Real Estate Investors has transacted or transactions in which Principal Real Estate investors has previously represented a lender in transacting with the seller. In addition, the Account is enhancing its focus on the sustainable or green nature of both the existing portfolio and acquisition opportunities by assessing the combination of building features and market demand for sustainable projects on economic performance.



## Transaction Strategy

Specific property type strategies that led transaction activity in 2007 and are anticipated to continue in 2008 include:

- **Office:** Acquire primarily in major markets and urban locations. Selectively invest in suburban assets if a discount to reproduction cost exists.
- **Multi-family:** Select non-commodity properties in urban locations in markets experiencing strong population and household formation growth. Develop apartment communities where existing product is difficult to access and the added return supports taking development risk. Enter joint venture partnerships with local experts to employ asset-level redevelopment strategies. The Account will avoid markets in which an oversupply of condominiums will result in an upward trend in real vacancy rates and downward pressure on rents.
- **Industrial:** Remain primarily invested in the warehouse sub-type, identifying specific transactions in the flex or service center sub-types where additional yield exists. Accumulate in major port and transportation hubs. Build versus buy in markets where material differences exist between construction costs and stabilized asset pricing.
- **Retail:** Hold a diversified portfolio of retail formats. Enter joint venture partnerships with local experts to re-develop existing assets through re-tenanting space and/or adding square footage to increase property level income streams.
- **Hotel:** Due to the investment in the J.W. Marriott in San Antonio, the Account will have limited capacity for additional hotel investments in 2008.

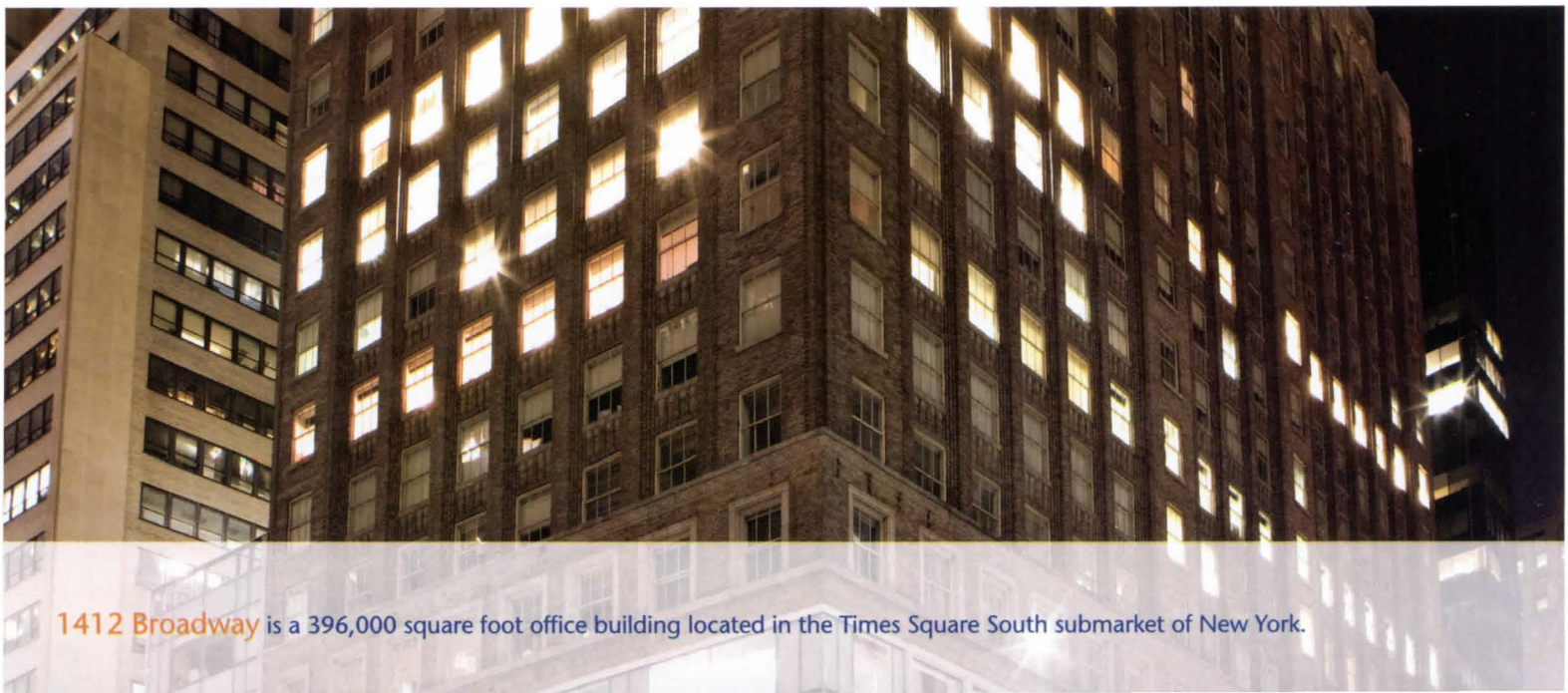
# 2007 Transaction Activity

## 2007 Office Acquisitions

Office investments included four acquisitions and represented 34% of Account transaction activity during 2007.

- 104 West 40th Street overlooking Bryant Park in Midtown Manhattan was purchased 86% leased. The asset level business plan includes completion of renovations and lease-up of available space.
- 150 Spear Street is located in the San Francisco CBD, a market anticipated to benefit from lack of available space, constraints to new supply, strong tenant and investor demand and rising rental rates.
- Denver Technology Center Portfolio includes three, class-A office buildings totaling over 450,000 square feet located in the Denver Tech Center, a prominent location for office tenants within the Denver market.
- Hacienda Business Park is a 380,000 square foot mixed-use project consisting of office, industrial and retail buildings. Located in Pleasanton, California with access to both Interstate 580 and Interstate 680, it is expected to benefit from increasing tenant demand.





1412 Broadway is a 396,000 square foot office building located in the Times Square South submarket of New York.

# 2007 Transaction Activity

## 2007 Multi-family Acquisitions

Acquisitions within the multi-family sector included six transactions totaling 2,100 units representing 24% of acquisition activity.

- Riverside Station, a 304-unit property in Washington, D.C. is anticipated to experience increasing tenant demand as it is located near Fort Belvoir and Quantico Marine Base, both expected to benefit from a combined total of over 20,000 new jobs resulting from the Base Realignment and Closure (BRAC) implementation. In addition to the completed asset, 11 acres of developable land were included in the transaction.
- Hardin House and West Campus Phase I are multi-family assets totaling 700 units primarily used as student housing and located within three blocks of the University of Texas at Austin. The campus has one of the lowest on-campus student housing ratios in the nation, providing ample demand for this infill location.
- Multi-family Portfolio includes nearly 1,400 units in five properties located in Chicago, Richmond and Pittsburgh. The assets were acquired via a joint venture and are in submarkets in which renter demand outpaces the supply of high-quality, yet affordable rental units.
- The Pointe at Chapel Hill is located in the Chapel Hill submarket of Durham, North Carolina and was acquired through an existing relationship with the seller. The 240-unit asset is expected to benefit from significant student and hospital employee demand.
- Carrington at Brier Creek, located in Raleigh, North Carolina was identified as a short-term hold and acquired below reproduction cost on an off-market basis. The business plan contemplated a full marketing of the asset for disposition immediately upon acquisition. It was subsequently marketed and sold by the Account during the fourth quarter of 2007.



West Campus Phase I is a 482-unit property in Austin, Texas. The property, located three blocks from the University of Texas campus, is primarily utilized as student housing.

# 2007 Transaction Activity

## 2007 Industrial Acquisitions

The Account executed 11 industrial acquisitions during 2007 representing 22% of transaction activity. Account strategy at the beginning of the year dictated an increase in industrial activity; however, product has been difficult to access in recent years due to investor demand frequently driving acquisition prices above reproduction cost. During 2007, the Account was also successful in accessing properties through forward commitments and joint venture partnerships.

- O'Brien Drive is a four-building property totaling nearly 70,000 square feet located in Menlo Park, California, a submarket of San Francisco. The asset is located directly adjacent to Menlo Business Park, a major hub for research and development life sciences tenants within the area.
- University Crossings and Bedford Park, both located in Chicago total 456,000 and 431,000 square feet, respectively. The assets were developed via forward commitment structures and were purchased at cost from the developers.
- Costco Way and 100 West Manor Way together include over 2.1 million square feet of newly developed space in the Northern New Jersey markets of Edison and Trenton. The assets, developed via forward commitment structures and purchased vacant, are expected to benefit from close proximity to the New Jersey Turnpike.
- 1500 Rahway and 1980 U.S. Highway 1 are located in Edison, New Jersey and purchased in a joint venture with a local operating partner. The business plan for both assets includes renovations and re-tenanting in order to capture current market rental rates.
- Boynton Commerce Center includes four buildings totaling over 295,000 square feet in the West Palm Beach submarket. The asset is currently 94% leased and benefits from excellent access to Interstate 95, Palm Beach International Airport, the Port of Palm Beach, Port Everglades and the Fort Lauderdale International Airport.
- Airspace I, II and III is a 780,000 square foot, three-building portfolio located near the Louisville International Airport, which ranks as the third busiest cargo airport in North America and ninth in the world[1].
- Technology Park and West Technology Park, located in Detroit and consisting of approximately 500,000 square feet, were acquired off market in a joint venture with a local partner and priced below reproduction cost with attractive projected risk-adjusted returns.

[1]Airports Council International



University Crossings, located in Chicago, Illinois, totals 456,000 square feet and was acquired in 2007.

# 2007 Transaction Activity

## 2007 Retail Acquisitions

The Account executed seven retail transactions in 2007 representing 19% of acquisition activity.

- Watermark Retail includes 25,000 square feet of space located within an existing multi-family asset held by the Account in Cambridge with close proximity to MIT.
- Sunshine Square, London Square and Miramar Square located in West Palm Beach, Miami and Ft. Lauderdale, respectively, were acquired as part of an existing programmatic joint venture with a local Florida partner. The business plan includes redevelopment of Sunshine Square and completing the development of London Square and Miramar Square.
- Washington, D.C. Retail Portfolio is comprised of 529,000 square feet of retail assets and one office property, all of which are located in the Washington, D.C. metro area. The portfolio was acquired via a joint venture partnership and is expected to provide enhanced returns through multiple property renovations and moving below market rental rates to market.
- Lake Worth Marketplace is a newly constructed power center that benefits from a strong tenant roster and is located in a high growth area of Fort Worth with excellent access and visibility.
- Fischer Marketplace Addition located in Minneapolis is a 2.3 acre parcel of land adjacent to an existing Account asset on which the Account is developing a 20,000 square foot build-to-suit for a Staples office supply store.



Lake Worth Marketplace is a newly constructed 197,000 square foot retail center located in Fort Worth, Texas.

# 2007 Transaction Activity

## 2007 Additional Acquisitions

Additional transactions during 2007 include the acquisition of two land parcels for approximately $16 million.

- 100 East Las Olas is a 0.9 acre parcel of land purchased in a joint venture and located in downtown Ft. Lauderdale with close proximity to amenities and multiple barriers to entry for future developments.
- J.W. Marriott Resort in San Antonio is a to-be-developed 1,002-room resort including four restaurants, two 18-hole PGA golf courses and a full service spa. The Account partnered with an experienced hotel developer in addition to both Marriott and PGA in order to begin development of the asset, expected to open in early 2010.



The to-be-developed 1,002 room J.W. Marriott Resort in San Antonio, Texas will be completed in 2010.

# 2007 Transaction Activity

## 2007 Dispositions

It was an active year in dispositions for the U.S. Property Account with over $690 million in assets sold through 18 sales and 5 partial sales. Dispositions included the sale of several value-added assets for which investor demand was strong, resulting in attractive sale prices. The Account also sold multiple lower quality assets located in secondary markets in an effort to continue to upgrade the overall quality of the portfolio.

Strategic disposition themes employed during 2007 and expected to continue throughout 2008 include:

- **Employ** sales process to strategically reduce exposure to selected property types or markets
- **Capitalize** on market pricing imbalances to sell properties when premium pricing is available
- **Enhance** portfolio quality by selling properties of lower quality or properties in declining locations and re-investing proceeds in higher quality properties
- **Execute** sale after a property's business plan has been completed and value maximized




104 West 40th Street is a 202,095 square foot office property overlooking Bryant Park in Midtown Manhattan.

# 2007 Transaction Activity

## ACQUISITIONS

| PROPERTY | SECTOR | MSA | PRICE ($ MILLION) | STRUCTURE |
|---|---|---|---|---|
| 104 West 40th Street | Office | New York, NY | $141.4 | Joint Venture |
| 150 Spear Street | Office | San Francisco, CA | $142.9 | Wholly Owned |
| Denver Technology Center Portfolio | Office | Denver, CO | $106.0 | Wholly Owned |
| Hacienda Business Park | Office/Industrial/ Retail | Oakland, CA | $71.4 | Joint Venture |
| Total Office | | | $461.7 | |
| Riverside Station | Multi-family/Land | Washington, D.C. | $73.6 | Wholly Owned |
| Hardin House | Multi-family | Austin, TX | $15.7 | Joint Venture |
| West Campus Phase 1 | Multi-family | Austin, TX | $64.0 | Joint Venture |
| Multi-family Portfolio | Multi-family | Multiple | $113.9 | Joint Venture |
| The Pointe at Chapel Hill | Multi-family | Durham, NC | $29.1 | Wholly Owned |
| Carrington at Brier Creek | Multi-family | Raleigh, NC | $32.3 | Wholly Owned |
| Total Multi-family | | | $328.6 | |
| O'Brien Drive | Industrial | San Francisco, CA | $8.5 | Joint Venture |
| University Crossings | Industrial | Chicago, IL | $15.6 | Wholly Owned |
| Bedford Park | Industrial | Chicago, IL | $16.5 | Wholly Owned |
| Costco Way | Industrial | Edison, NJ | $52.8 | Wholly Owned |
| 100 West Manor Way | Industrial | Trenton, NJ | $57.9 | Wholly Owned |
| 1500 Rahway | Industrial | Edison, NJ | $30.8 | Joint Venture |
| 1980 U.S. Highway 1 | Industrial | Edison, NJ | $12.5 | Joint Venture |
| Boynton Commerce Center | Industrial | West Palm Beach, FL | $37.7 | Wholly Owned |
| Airspace I, II, III | Industrial | Louisville, KY | $34.2 | Wholly Owned |
| Technology Park & West Technology Park | Industrial | Detroit, MI | $41.0 | Joint Venture |
| Total Industrial | | | $307.5 | |
| Watermark Retail | Retail | Cambridge, MA | $6.7 | Joint Venture |
| Sunshine Square | Retail | West Palm Beach, FL | $29.7 | Joint Venture |
| London Square | Retail | Miami, FL | $45.2 | Joint Venture |
| Miramar Square | Retail | Ft. Lauderdale, FL | $23.5 | Joint Venture |
| Washington, D.C. Retail Portfolio | Retail | Washington, D.C. | $128.5 | Joint Venture |
| Lake Worth Marketplace | Retail | Ft. Worth, TX | $32.4 | Wholly Owned |
| Fischer Marketplace Addition | Retail | Minneapolis, MN | $1.6 | Wholly Owned |
| Total Retail | | | $267.6 | |
| 100 East Las Olas | Land* | Ft. Lauderdale, FL | $15.0 | Joint Venture |
| J.W. Marriott Resort | Land/Hotel* | San Antonio, TX | $1.1 | Joint Venture |
| Total Land | | | $16.1 | |
| 2007 Acquisitions | | | $1,381.5 | |

*Future development

Denver Office Portfolio is a three-building office portfolio totaling 456,000 square feet located in the Denver Technology Center.

# 2007 Transaction Activity

DISPOSITIONS

| PROPERTY | SECTOR | MSA | PRICE ($ MILLION) |
|---|---|---|---|
| Executive Centre III | Office | Milwaukee, WI | $5.4 |
| Research Park Place | Office | Austin, TX | $44.8 |
| Glendale City Center | Office | Los Angeles, CA | $146.4 |
| Deer Creek Park | Office | Milwaukee, WI | $12.1 |
| Plaza Quebec | Office | Denver, CO | $10.0 |
| Brookside | Office | Seattle, WA | $16.6 |
| Total Office | | | $235.3 |
| Avanti Apartments | Multi-family | Anaheim, CA | $30.9 |
| Greenhaven Lake | Multi-family | Sacramento, CA | $18.8 |
| Carrington at Brier Creek | Multi-family | Raleigh, NC | $34.6 |
| Parkwood Place* | Multi-family | Atlanta, GA | $3.2 |
| Buckhead Place* | Multi-family | Nashville, TN | $5.2 |
| 170 King Street* | Multi-family | San Francisco, CA | $83.2 |
| Total Multi-family | | | $175.9 |
| Oak Grove Shoppes | Retail | Orlando, FL | $29.2 |
| Murdock Carousel | Retail | Punta Gorda, FL | $29.3 |
| Marketplace Shopping Center | Retail | San Antonio, TX | $29.2 |
| Flagler Park | Retail | Miami, FL | $93.3 |
| Normandale Village | Retail | Minneapolis, MN | $15.5 |
| Beacon Centre | Retail | Miami, FL | $15.3 |
| Calhoun Square | Retail/Office | Minneapolis, MN | $46.6 |
| Total Retail | | | $258.4 |
| Southpoint Distribution Center | Industrial | Atlanta, GA | $11.2 |
| Plainfield Warehouse | Industrial | Indianapolis, IN | $8.0 |
| Total Industrial | | | $19.2 |
| AmberGlen Business Center* | Land | Portland, OR | $0.1 |
| Fountainhead Corporate Park* | Land | Phoenix, AZ | $2.6 |
| Total Land | | | $2.7 |
| 2007 Dispositions | | | $691.5 |

*Partial Sale

# Independent Auditors' Report

To the Account Management and Contractholders
Principal Life Insurance Company U.S. Property Separate Account
Des Moines, Iowa

We have audited the accompanying consolidated statements of assets and liabilities of Principal Life Insurance Company U.S. Property Separate Account ("USPSA"), including the schedules of investments, as of December 31, 2007 and 2006, and the related consolidated statements of operations, changes in net assets, cash flows, and the financial highlights for the years then ended. These consolidated financial statements and financial highlights are the responsibility of USPSA's management. Our responsibility is to express an opinion on these consolidated financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of USPSA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of USPSA as of December 31, 2007 and 2006, the results of its operations, changes in its net assets, its cash flows, and financial highlights for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the financial statements include real estate investments valued at $7,718,617,362 (97% of total assets) and $6,269,193,453 (96% of total assets) as of December 31, 2007 and 2006, respectively, whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on independent appraisals or cash flow projections.

Deloitte & Touche LLP

Des Moines, Iowa
January 28, 2008

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES
DECEMBER 31, 2007 AND 2006

| | 2007 | 2006 |
|---|---|---|
| **ASSETS** | | |
| Investments at estimated fair value: | | |
| Real estate investments | | |
| (cost: 2007 – $6,243,606,944; 2006 – $5,198,305,474) | $7,709,754,500 | $6,268,756,000 |
| Investment in real estate joint ventures | | |
| (cost: 2007 – $8,585,893; 2006 – $437,453) | 8,862,862 | 437,453 |
| | 7,718,617,362 | 6,269,193,453 |
| Investments at fair value: | | |
| Short-term investments | | |
| (cost: 2007 – $94,970,033; 2006 – $143,210,618) | 94,970,033 | 143,210,618 |
| Total investments (cost: 2007 – $6,347,162,870; 2006 – $5,341,953,545) | 7,813,587,395 | 6,412,404,071 |
| Cash | 31,157,295 | 18,815,359 |
| Accrued investment income and other assets | 90,925,204 | 75,515,170 |
| Total assets | 7,935,669,894 | 6,506,734,600 |
| **LIABILITIES** | | |
| Debt | 1,305,837,921 | 897,313,983 |
| Accounts payable and accrued expenses | 60,469,028 | 62,653,887 |
| Accrued property taxes | 27,114,837 | 26,264,288 |
| Security deposits | 18,219,605 | 13,536,154 |
| | 1,411,641,391 | 999,768,312 |
| Minority interest | 176,469,973 | 138,499,915 |
| Total liabilities | 1,588,111,364 | 1,138,268,227 |
| **NET ASSETS** | $6,347,558,530 | $5,368,466,373 |



See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED SCHEDULE OF INVESTMENTS
DECEMBER 31, 2007

| | FAIR VALUE |
|---|---|
| **REAL ESTATE INVESTMENTS – 98.7%** | |
| United States: | |
| Total office – 40.0% (cost $2,549,808,959) | |
| 1370 Avenue of the Americas, New York, NY | $345,100,000 |
| 333 Market Street, San Francisco, CA | 397,000,000 |
| Other office | 2,379,592,000 |
| | 3,121,692,000 |
| Total land – 0.8% (cost $45,582,407) | 62,784,000 |
| Total retail – 17.6% (cost $1,125,748,307) | 1,373,790,000 |
| Total industrial – 16.6% (cost $989,594,142) | 1,301,431,000 |
| Total multi-family – 23.7% (cost $1,532,873,129) | 1,850,057,500 |
| Total real estate investments (cost $6,243,606,944) | 7,709,754,500 |
| **INVESTMENT IN REAL ESTATE JOINT VENTURES – 0.1%** | |
| United States: | |
| Total hotel – 0.1% (cost $8,585,893) | 8,862,862 |
| **SHORT-TERM INVESTMENTS – 1.2%** | |
| United States: | |
| Blackrock TempFund – 0.5% (cost $38,317,000) | 38,317,000 |
| Money market separate account – 0.7% (cost $56,653,033) | 56,653,033 |
| Total short-term investments (cost $94,970,033) | 94,970,033 |
| Total investments (cost $6,347,162,870) | $7,813,587,395 |



See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED SCHEDULE OF INVESTMENTS
DECEMBER 31, 2006

| | FAIR VALUE |
|---|---|
| **REAL ESTATE INVESTMENTS – 97.8%** | |
| United States: | |
| Total office – 39.3% (cost $2,231,371,979) | |
| 333 Market Street, San Francisco, CA | $370,150,000 |
| Other office | 2,151,421,375 |
| | 2,521,571,375 |
| Total land – 0.4% (cost $16,098,824) | 27,185,500 |
| Total retail – 19.7% (cost $1,012,542,550) | 1,262,326,125 |
| Total industrial – 14.2% (cost $649,662,674) | 906,660,000 |
| Total multi-family – 24.2% (cost $1,288,629,447) | 1,551,013,000 |
| Total real estate investments (cost $5,198,305,474) | 6,268,756,000 |
| **INVESTMENT IN REAL ESTATE JOINT VENTURES – 0.0%** | |
| United States: | |
| Total office – 0.0% (cost $437,453) | 437,453 |
| **SHORT-TERM INVESTMENTS – 2.2%** | |
| United States: | |
| Blackrock TempFund – 0.4% (cost $ 28,285,000) | 28,285,000 |
| Money market separate account – 1.8% (cost $114,925,618) | 114,925,618 |
| Total short-term investments (cost $143,210,618) | 143,210,618 |
| Total investments (cost $5,341,953,545) | $6,412,404,071 |



See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

| | 2007 | 2006 |
|---|---|---|
| **INVESTMENT INCOME** | | |
| Rental and other income | $557,921,229 | $487,982,973 |
| Real estate taxes | (70,472,851) | (66,017,939) |
| Other operating expenses | (152,419,185) | (141,023,867) |
| Net operating income from real estate investments | 335,029,193 | 280,941,167 |
| Net operating income (loss) from investment in real estate joint ventures | (289,390) | 1,360,610 |
| Interest income on short-term investments | 18,661,885 | 10,061,963 |
| Total investment income | 353,401,688 | 292,363,740 |
| **EXPENSES** | | |
| Interest expense | 64,258,683 | 51,459,340 |
| Investment management fees | 65,474,671 | 53,526,632 |
| Professional and other fees | 4,907,240 | 5,802,800 |
| Total expenses | 134,640,594 | 110,788,772 |
| **MINORITY INTEREST IN NET INVESTMENT INCOME** | 2,633,039 | 1,101,588 |
| **NET INVESTMENT INCOME** | 216,128,055 | 180,473,380 |
| **REALIZED AND UNREALIZED GAIN** | | |
| Proceeds from real estate investment sales | 691,508,943 | 498,792,935 |
| Cost of real estate investments sold | (530,244,853) | (400,756,483) |
| Realization of prior period unrealized gain on real estate investments sold | (85,346,318) | (39,571,321) |
| Net gain recognized from real estate investment sales | 75,917,772 | 58,465,131 |
| Net gain recognized from investment in real estate joint ventures | – | 93,312,800 |
| Unrealized gain on investments and debt | 492,736,161 | 403,569,042 |
| **NET REALIZED AND UNREALIZED GAIN** | 568,653,933 | 555,346,973 |
| **MINORITY INTEREST IN NET REALIZED AND UNREALIZED GAIN** | 47,641,988 | 48,320,861 |
| **NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS** | $737,140,000 | $687,499,492 |

See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

| | 2007 | 2006 |
|---|---|---|
| **NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS:** | | |
| Net investment income | $216,128,055 | $180,473,380 |
| Net gain recognized from real estate investment sales | 75,917,772 | 58,465,131 |
| Net gain recognized from investment in real estate joint ventures | – | 93,312,800 |
| Unrealized gain on investments and debt | 492,736,161 | 403,569,042 |
| Minority interest in net realized and unrealized gain | (47,641,988) | (48,320,861) |
| Net increase in net assets resulting from operations | 737,140,000 | 687,499,492 |
| **NET INCREASE IN NET ASSETS RESULTING FROM NET CONTRACTHOLDER CONTRIBUTIONS** | 241,952,157 | 318,790,534 |
| **INCREASE IN NET ASSETS** | 979,092,157 | 1,006,290,026 |
| **NET ASSETS AT BEGINNING OF YEAR** | 5,368,466,373 | 4,362,176,347 |
| **NET ASSETS AT END OF YEAR** | $6,347,558,530 | $5,368,466,373 |



See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

| | 2007 | 2006 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net increase in net assets resulting from operations | $737,140,000 | $687,499,492 |
| Adjustment to reconcile net increase in net assets resulting from operations to net cash provided by operating activities: | | |
| Net realized and unrealized gain | (568,653,933) | (555,346,973) |
| Minority interest | 50,275,027 | 49,422,449 |
| Net operating (income) loss from investment in real estate joint ventures | 289,390 | (1,360,610) |
| Changes in: | | |
| Accrued investment income and other assets | (4,349,628) | 3,127,086 |
| Accounts payable and accrued expenses | 12,478,642 | 4,866,268 |
| Accrued property taxes | 850,549 | 2,568,106 |
| Security deposits | 4,683,451 | 2,412,599 |
| Total adjustments | (504,426,502) | (494,311,075) |
| Net cash provided by operating activities | 232,713,498 | 193,188,417 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Proceeds from real estate investment sales | 691,508,943 | 498,792,935 |
| Purchases of real estate investments and improvements | (1,502,563,469) | (1,163,107,964) |
| Distributions from (investment in) real estate joint ventures | (8,585,893) | 205,434,353 |
| Net change in short-term investments | 48,240,585 | (77,580,521) |
| Net change in escrows and other restricted assets | (6,913,406) | (37,614,687) |
| Net cash used in investing activities | (778,313,240) | (574,075,884) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Net repayments on line of credit | – | (45,000,000) |
| Repayments of debt | (99,504,033) | (142,172,112) |
| Issuance of debt | 427,798,523 | 255,547,860 |
| Net contractholder contributions | 241,952,157 | 318,790,534 |
| Contributions from minority interest partners | 23,162,787 | 39,944,535 |
| Distributions to minority interest partners | (35,467,756) | (29,826,771) |
| Net cash provided by financing activities | 557,941,678 | 397,284,046 |

See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

| | 2007 | 2006 |
|---|---|---|
| **NET CHANGE IN CASH** | 12,341,936 | 16,396,579 |
| **CASH AT BEGINNING OF YEAR** | 18,815,359 | 2,418,780 |
| **CASH AT END OF YEAR** | $31,157,295 | $18,815,359 |
| **SUPPLEMENTAL DISCLOSURE OF CASH PAID FOR INTEREST** | $62,870,568 | $50,308,153 |

**SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:**

USPSA had noncash purchases of real estate investments and improvements of $25,315,378 and $39,978,879 in 2007 and 2006, respectively.

USPSA assumed mortgages payable of $71,077,495 and $208,696,303 in 2007 and 2006, respectively, in connection with the purchase of real estate investments.



*Concluded*

See notes to consolidated financial statements

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICES

General – Principal Life Insurance Company U.S. Property Separate Account ("USPSA") is an open-end, commingled real estate account and a separate account of Principal Life Insurance Company ("Principal Life") established in 1982 in accordance with the provisions of the State of Iowa insurance laws. Pursuant to such laws, the net assets of USPSA are not chargeable with liabilities arising out of any business of Principal Life. Participation in USPSA is available through the purchase of certain group contracts and policies issued by Principal Life. The investment advisor is Principal Real Estate Investors, LLC ("Principal Real Estate"), a wholly-owned subsidiary of Principal Life.

Basis of Presentation – USPSA follows the provisions contained in the American Institute of Certified Public Accountants ("AICPA") Audit and Accounting Guide "Investment Companies" ("Investment Company Guide"). Under the Investment Company Guide, assets and property-level debt are presented at fair value. Debt which is not collateralized by a specific real estate investment is presented at amounts payable, net of any unamortized premium or discount.



Real Estate Investments – An independent consultant (the "Valuation Consultant") selected by Principal Real Estate oversees and administers the appraisal process for USPSA. Real estate investments are stated at estimated fair value as determined by the Valuation Consultant and approved by USPSA management. Appraisals are performed for each investment annually by independent third party MAI certified appraisers with all appraisals being performed in accordance with the Uniform Standard of Professional Appraisal Practice. The appraised values are updated on at least a monthly basis by the Valuation Consultant based on changes in factors such as occupancy levels, lease rates, overall market conditions and capital improvements. Determination of estimated fair value involves subjective judgment because the actual fair value of real estate can be determined only by negotiation between the parties in a sales transaction.

Sale transactions are accounted for using the full accrual method in accordance with Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate." All costs incurred to complete the sales of the properties are included in the computations of the gain or loss on sale. USPSA does not record depreciation.

Included in real estate investments are real estate investments under development or redevelopment which are stated at estimated fair value as determined by management. Upon completion and stabilization of occupancy, the property is appraised externally.

# Audited Financial Statements



Real Estate Improvements – Amounts expended in connection with acquisitions, physical improvements and other capital expenditures, are capitalized as part of the cost of real estate investments. Maintenance and repair expenses are charged to operations as incurred.

Investment in Real Estate Joint Ventures – Investment in real estate joint ventures is comprised of joint ventures which USPSA does not control, but over which it has significant influence. The investments are included in the consolidated statements of assets and liabilities at USPSA's ratable share of the estimated fair value of the underlying net assets of the joint ventures, adjusted for the terms of the joint venture agreements. Net operating income (loss) from investments in real estate joint ventures represents USPSA's share of the current year's joint venture income (loss) as provided for under the terms of the joint venture agreements. Joint venture income (loss) is not reduced by depreciation or amortization expense. USPSA's ratable share of the change in the fair value of the joint ventures is reported in net realized and unrealized gain in the accompanying consolidated statements of operations. Distributions from the joint ventures are recorded on the ex-dividend date.



Deferred Costs – Leasing costs paid to third parties to obtain tenants are capitalized as a component of the cost of real estate investments. The cost of real estate investments presented in the accompanying consolidated statements of assets and liabilities includes approximately $75,000,000 and $59,000,000 of such deferred costs as of December 31, 2007 and 2006, respectively. USPSA does not record amortization.

Cash – Cash includes cash on hand and demand deposit accounts.

Short-Term Investments – Short-term investments are comprised of money market funds and are carried at fair value based on quoted market prices of the fund or underlying assets, which represent the net asset value of shares held by USPSA.

Fair Value of Debt – The fair value of debt is based on the present value of estimated cash flows and prevailing interest rates for borrowings with similar risk and terms. The debt fair value adjustment was $10,694,764 and $1,542,811 as of December 31, 2007 and 2006, respectively.

Minority Interest – USPSA has entered into joint development relationships with other investors to acquire and develop real estate properties. USPSA is the majority owner in such projects and has control over decision-making. Accordingly, the underlying assets and liabilities of the projects are consolidated into USPSA's financial statements, with the external investors' net share reflected

as minority interest. Certain external investors earn additional equity if the estimated rate of return of the real estate property that they are invested in exceeds a contractually determined rate. This additional equity allocation is accrued at the same time that the underlying real estate property appreciates and is recorded in minority interest in net realized and unrealized gain in the accompanying consolidated statements of operations. The additional equity accrual included in minority interest in the consolidated statements of assets and liabilities was approximately $64,820,000 and $48,970,000 as of December 31, 2007 and 2006, respectively.

Revenue Recognition – Rental income is recognized as income when earned in accordance with the terms of the respective leases. Reimbursements from tenants for common area costs are recognized monthly based on an estimate of annual costs, subject to periodic adjustments to reflect actual costs.



Income Taxes – According to current provisions of the Internal Revenue Code pertaining to tax qualified separate accounts, no income taxes are attributable to the activities of USPSA. As a result, income taxes are not reflected in the accompanying consolidated financial statements.

New Accounting Pronouncements – In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. USPSA is currently evaluating the impact of this pronouncement on its consolidated financial statements.

Use of Estimates – The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 2. INVESTMENT MANAGEMENT FEES

Principal Life charges USPSA annual management fees based upon its net assets, with such fees deducted daily. These fees totaled $65,474,671 and $53,526,632 in 2007 and 2006, respectively.

## 3. INVESTMENT COMMITMENTS

As of December 31, 2007, USPSA had outstanding commitments to purchase 14 properties for approximately $557,374,000. Certain properties will be under construction with USPSA agreeing to purchase the completed development subject to attaining certain development and leasing thresholds. It is anticipated that USPSA will acquire these properties between 2008 and 2010.

As of December 31, 2007, USPSA had outstanding commitments to sell one property for approximately $17,247,000. It is anticipated that USPSA will sell this property in 2008.



## 4. DEBT

Mortgage Notes Payable – Mortgage notes payable totaled $1,034,276,664 and $714,312,687 as of December 31, 2007 and 2006, respectively. These notes mature between 2008 and 2028 with fixed and variable interest rates ranging from 2.00% to 7.97% at December 31, 2007 and from 3.75% to 7.97 % at December 31, 2006. The notes are collateralized by mortgages on real property and all rents and profits of the underlying properties.

Construction Notes Payable – Construction notes payable totaled $122,009,000 and $42,487,877 as of December 31, 2007 and 2006, respectively. These notes mature between 2008 and 2010. Variable interest payments are due monthly ranging from 6.50% to 7.25% at December 31, 2007 and 6.75% to 7.08% at December 31, 2006. The notes are collateralized by the underlying properties.

Note Payable – Note payable totaled $65,000,000 as of December 31, 2007 and 2006. The note matures in 2011. Interest accrues at a fixed interest rate of 6.60%. The note agreement contains financial and non-financial covenants, including requirements regarding net assets, leverage ratio, debt service coverage ratio and unencumbered assets. USPSA was in compliance with all covenants as of December 31, 2007.

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

Assessments – Assessments consist of amounts owed to the City of Pleasanton, California, and the City of New York, New York. The assessments totaled $73,857,493 and $73,970,608 as of December 31, 2007 and 2006, respectively. These assessments mature between 2015 and 2032 with fixed and variable interest rates ranging from 1.28% to 3.48% as of December 31, 2007 and 3.9% to 5.1% as of December 31, 2006. The assessments are recorded as liens on real property.

As of December 31, 2007, aggregate contractual maturities of debt were as follows:

| YEAR ENDING DECEMBER 31, | |
|---|---|
| 2008 | $ 110,347,185 |
| 2009 | 84,794,784 |
| 2010 | 179,756,136 |
| 2011 | 285,265,708 |
| 2012 | 250,972,800 |
| Thereafter | 384,006,544 |
| | 1,295,143,157 |
| Debt fair value adjustment | 10,694,764 |
| | $ 1,305,837,921 |



## 5. LINE OF CREDIT AND LETTERS OF CREDIT

USPSA maintains an unsecured line of credit. Maximum availability under this line of credit was $300,000,000 as of December 31, 2007 and 2006 (reduced to $295,075,000 and $284,455,000, respectively, by the letters of credit described below). At December 31, 2007 and 2006, there were no borrowings outstanding on this line. Interest on outstanding borrowings accrues at LIBOR plus the applicable margin, as defined (5.395% and 5.97% at December 31, 2007 and 2006, respectively). Additionally, USPSA pays a quarterly commitment fee of .15% per year, based on the total amount of the line of credit.

# Audited Financial Statements



The line of credit includes a $100,000,000 letter of credit sub facility at December 31, 2007 and 2006. At December 31, 2007 and 2006, there were letters of credit issued with a maximum availability of $4,925,000 and $15,545,000, respectively, of which $0 was outstanding. Interest on outstanding borrowings accrues at LIBOR plus the applicable margin, as defined (5.395% and 5.97 % at December 31, 2007 and 2006, respectively). Additionally, USPSA pays a commitment fee of .125% plus the applicable margin per year, as defined, based on the unused amount of the letters of credit issued. The letters of credit expire in October 2008.

The line of credit agreement contains financial and non-financial covenants, including requirements regarding net assets, leverage ratio, debt service coverage ratio and unencumbered assets. USPSA was in compliance with all covenants as of December 31, 2007.

## 6. TENANT LEASES



USPSA leases space to tenants under operating lease agreements. These agreements include renewal options and expire at various dates. At December 31, 2007, future minimum base rentals on non-cancelable leases related to USPSA's properties were as follows:

| YEAR ENDING DECEMBER 31, | |
|---|---|
| 2008 | $ 353,031,158 |
| 2009 | 324,247,326 |
| 2010 | 286,592,791 |
| 2011 | 230,903,314 |
| 2012 | 185,780,676 |
| Thereafter | 761,556,488 |
| | $ 2,142,111,753 |

The above future minimum base rental payments exclude residential lease agreements that accounted for approximately 23.1% of USPSA's annual rental income for the year ended December 31, 2007. Rental income for the year ended December 31, 2007 and 2006 included approximately $87,367,000 and $84,418,000, respectively, recovered from tenants for common area and other reimbursable costs.

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 7. REAL ESTATE JOINT VENTURES

A summary of the financial information for the joint ventures are as follows:

| | 2007 | 2006 |
|---|---|---|
| **ASSETS:** | | |
| Real estate investment at estimated fair value | $62,900,000 | $ – |
| Other assets | 13,434,901 | 1,188,652 |
| Total assets | $76,334,901 | $1,188,652 |
| **LIABILITIES AND EQUITY:** | | |
| **LIABILITIES:** | | |
| Debt | $23,075,046 | $ – |
| Other liabilities | 26,893,209 | 72,701 |
| Total liabilities | 49,968,255 | 72,701 |
| **EQUITY** | 26,366,646 | 1,115,951 |
| Total liabilities and equity | $76,334,901 | $1,188,652 |
| Revenues and other income | $161,557 | $23,723,993 |
| Expenses | (1,043,356) | (20,947,238) |
| Net gain recognized from real estate investment sale | – | 225,840,989 |
| Unrealized gain on investment and debt | 114,635 | – |
| Net income (loss) | $(767,164) | $228,617,744 |

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 8. FINANCIAL HIGHLIGHTS

| | Nonprovider | | PGI>$25 Million | | Provider | | SIP<$25 Million, no comm. | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Per Share Operating Performance | | | | | | | | |
| Net asset value, beginning of year | $636.99 | $553.22 | $29.17 | $25.29 | $332.08 | $292.33 | $28.73 | $24.99 |
| Original issuance of shares in class | – | – | – | – | – | – | – | – |
| Income from investment operations: | | | | | | | | |
| Net investment income | 24.75 | 21.66 | 1.20 | 1.04 | 7.98 | 7.10 | 1.07 | 0.93 |
| Net realized and unrealized gain | 60.75 | 62.11 | 2.79 | 2.84 | 31.54 | 32.65 | 2.74 | 2.81 |
| Total from investment operations | 85.50 | 83.77 | 3.99 | 3.88 | 39.52 | 39.75 | 3.81 | 3.74 |
| Net asset value, end of year | $722.49 | $636.99 | $33.16 | $29.17 | $371.60 | $332.08 | $32.54 | $28.73 |
| Total Return | 13.42% | 15.14% | 13.65% | 15.37% | 11.90% | 13.60% | 13.25% | 14.97% |

| | Client A | | FIA Advisors Select | | Retirement Accum. Contract | | FIA Signature | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Per Share Operating Performance | | | | | | | | |
| Net asset value, beginning of year | $649.97 | $562.80 | $553.79 | $483.80 | $28.65 | $24.92 | $591.23 | $515.02 |
| Original issuance of shares in class | – | – | – | – | – | – | – | – |
| Income from investment operations: | | | | | | | | |
| Net investment income | 27.40 | 23.91 | 17.91 | 15.77 | 1.06 | 0.92 | 21.00 | 18.46 |
| Net realized and unrealized gain | 62.05 | 63.26 | 52.72 | 54.22 | 2.73 | 2.81 | 56.34 | 57.75 |
| Total from investment operations | 89.45 | 87.17 | 70.63 | 69.99 | 3.79 | 3.73 | 77.34 | 76.21 |
| Net asset value, end of year | $739.42 | $649.97 | $624.42 | $553.79 | $32.44 | $28.65 | $668.57 | $591.23 |
| Total Return | 13.76% | 15.49% | 12.75% | 14.47% | 13.25% | 14.97% | 13.08% | 14.80% |

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 8. FINANCIAL HIGHLIGHTS *continued*

| | FIA Select | | FIA Preferred | | FIA Advisors Signature | | FIA Advisor Preferred | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Per Share Operating Performance | | | | | | | | |
| Net asset value, beginning of year | $612.50 | $533.12 | $621.36 | $540.18 | $532.78 | $466.05 | $570.57 | $497.57 |
| Original issuance of shares in class | – | – | – | – | – | – | – | – |
| Income from investment operations: | | | | | | | | |
| Net investment income | 22.30 | 19.57 | 23.44 | 20.54 | 16.48 | 14.56 | 19.59 | 17.22 |
| Net realized and unrealized gain | 58.38 | 59.81 | 59.25 | 60.64 | 50.69 | 52.17 | 54.34 | 55.78 |
| Total from investment operations | 80.68 | 79.38 | 82.69 | 81.18 | 67.17 | 66.73 | 73.93 | 73.00 |
| Net asset value, end of year | $693.18 | $612.50 | $704.05 | $621.36 | $599.95 | $532.78 | $644.50 | $570.57 |
| Total Return | 13.17% | 14.89% | 13.31% | 15.03% | 12.61% | 14.32% | 12.96% | 14.67% |

| | PGI>$10≤$25 Million | | PGI≤$10 Million | | Pre 2002 Nonpro | | Client B | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Per Share Operating Performance | | | | | | | | |
| Net asset value, beginning of year | $29.11 | $25.24 | $28.98 | $25.15 | $639.63 | $554.95 | $29.08 | $25.21 |
| Original issuance of shares in class | – | – | – | – | – | – | – | – |
| Income from investment operations: | | | | | | | | |
| Net investment income | 1.18 | 1.03 | 1.14 | 1.00 | 25.56 | 22.34 | 1.17 | 1.04 |
| Net realized and unrealized gain | 2.78 | 2.84 | 2.76 | 2.83 | 61.01 | 62.34 | 2.78 | 2.83 |
| Total from investment operations | 3.96 | 3.87 | 3.90 | 3.83 | 86.57 | 84.68 | 3.95 | 3.87 |
| Net asset value, end of year | $33.07 | $29.11 | $32.88 | $28.98 | $726.20 | $639.63 | $33.03 | $29.08 |
| Total Return | 13.59% | 15.32% | 13.48% | 15.20% | 13.53% | 15.26% | 13.59% | 15.32% |

# Audited Financial Statements

PRINCIPAL LIFE INSURANCE COMPANY
U.S. PROPERTY SEPARATE ACCOUNT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

## 8. FINANCIAL HIGHLIGHTS

| | I3* | | I4* | | I5* | |
|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Per Share Operating Performance | | | | | | |
| Net asset value, beginning of year | $ – | $ – | $ – | $ – | $ – | $ – |
| Original issuance of shares in class | 741.26 | – | 711.36 | – | 739.00 | – |
| Income from investment operations: | | | | | | |
| Net investment income | 0.09 | – | 11.06 | – | 14.08 | – |
| Net realized and unrealized gain | 0.04 | – | 30.62 | – | 31.80 | – |
| Total from investment operations | 0.13 | – | 41.68 | – | 45.88 | – |
| Net asset value, end of year | $ 741.39 | $ – | $ 753.04 | $ – | $ 784.88 | $ – |
| Total Return** | 0.20% | – | 5.86% | – | 6.21% | – |

| FUND LEVEL SUPPLEMENTAL DATA | 2007 | 2006 |
|---|---|---|
| Net assets, end of year | $6,347,558,530 | $5,368,466,373 |
| Ratio to average net assets: | | |
| Fund level expenses | 1.01% | 1.19% |
| Net investment income | 3.73% | 3.78% |

*Share classes I3, I4 and I5 had inception dates of December 29, 2007, July 17, 2007 and July 6, 2007, respectively.

**Total return for newly issued share classes is from inception date.

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