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PRINCIPAL REAL ESTATE

The industrial sector remains the foundation of the global economy

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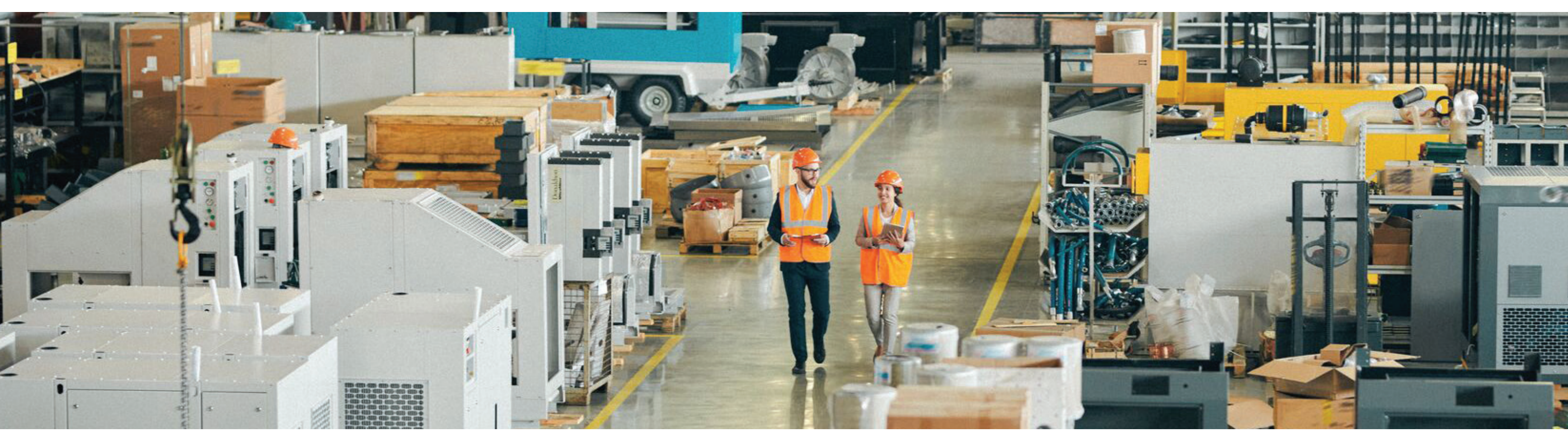
The industrial and warehouse sectors have been among the most sought-after by real estate investors since the U.S. economy recovered from the Global Financial Crisis (GFC). The sustained increase in global trade, the proliferation of e-commerce retail, and the continued evolution of the North American supply chain have necessitated new and innovative development as well as created new opportunities for real estate investors to engage in the sector over the past decade. While the industrial market today faces both cyclical headwinds stemming from high levels of new supply due to lofty valuations following the pandemic and capital market challenges that are facing most sectors, we believe that the sector is well-positioned to capitalize on long-term structural demand drivers over the longer term. In fact, given that industrial values today are 12% below the peak it may be an attractive entry point into the sector for investors.

In this paper, we will discuss the current state of the market as well as some of the structural themes and dynamics of the U.S. industrial sector with an emphasis on growth drivers, which will be the key to sustained and broad-based demand.



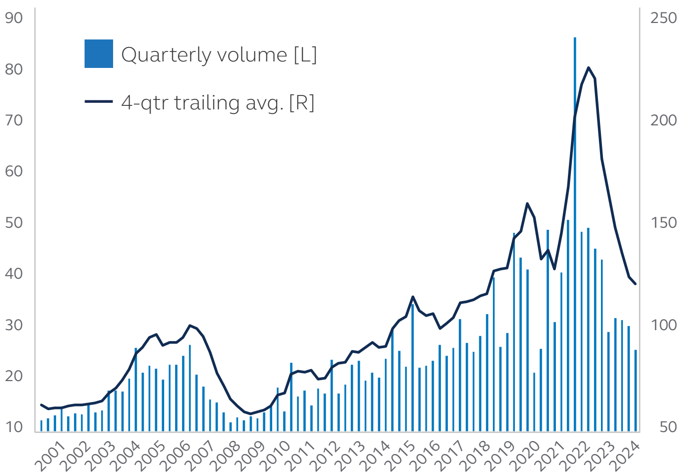
Near-term challenges

Over the past several years, our analysis has suggested that the industrial sector was fast becoming the emerging star of the commercial real estate asset class, and our call has been correct. Before the Federal Reserve's latest tightening cycle, the sector had dramatically outperformed all its primary peers and nearly all niche property types, experiencing perhaps its most prolific period of performance on record. During the period between 2019 and 2024, capital values for industrial properties increased by 60.5% according to the NCREIF NPI.

Strong performance tends to have strong feedback effects, and the industrial sector is feeling the impact of those today. First and foremost, the industrial sector set record volumes for sales as it became the favorite for investors starting in 2020 (see Exhibit 1). Investors and portfolio managers increased their allocations to the industrial sector at a near-exponential pace over the past five years—as other sectors such as office and retail fell out of favor. The sector now accounts for nearly 31% of the NCREIF's newly expanded NPI—the largest share of any single property type.

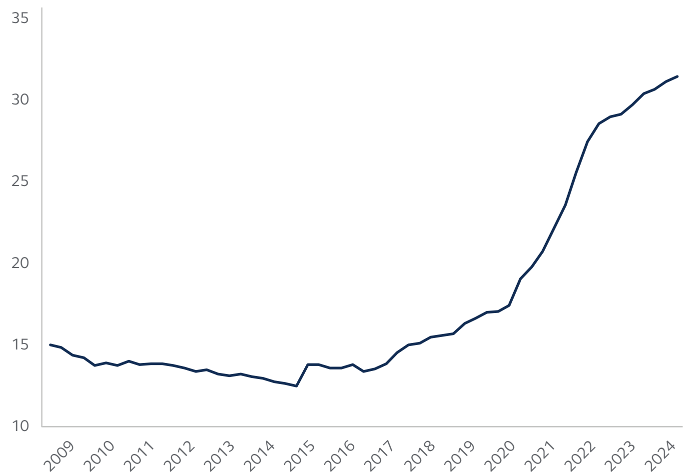
EXHIBIT 1: Industrial has become the favorite of private equity investors

Industrial transaction volume, $ billions



Source: MSCI Real Capital Analytics, Principal Real Estate Q1 2024

Industrial share of expanded NCREIF NPI, %

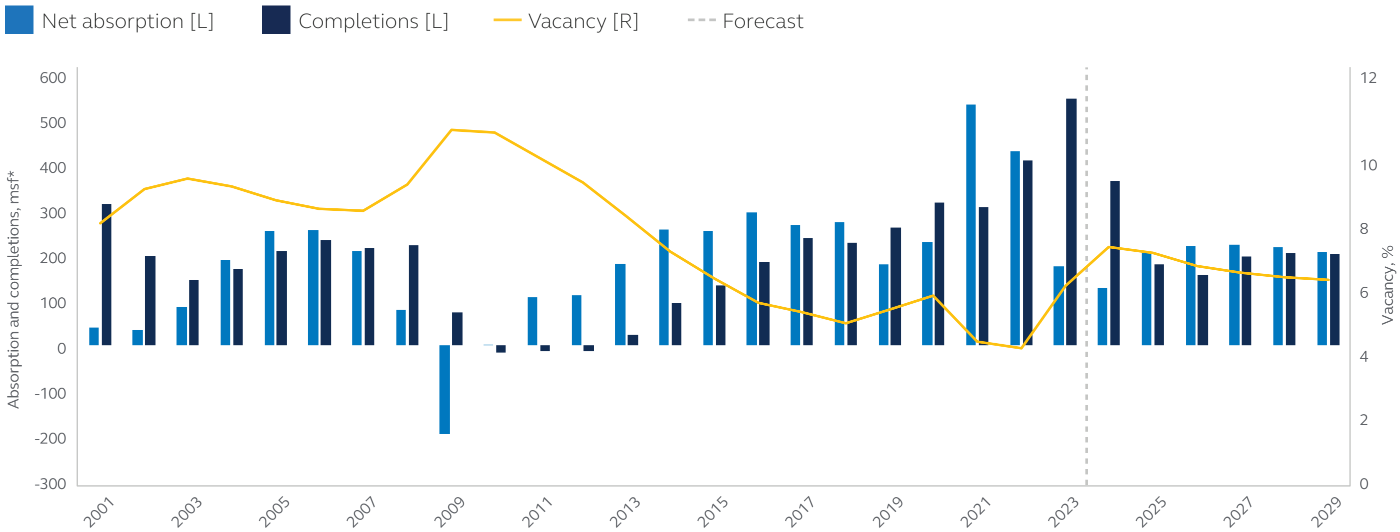


Source: NCREIF NPI, Principal Real Estate, Q1 2024

While the industrial sector remains favored both by private equity and debt investors alike, large inflows of capital have always had the predictable impact of excess levels of new supply in markets and this cycle is no different. Completion rates in roughly half of all markets in the U.S. are at or above their 20-year historical averages today which have pushed the national vacancy rate from a cyclical low of just under 4% in 2022 to nearly 7% today.

EXHIBIT 2: Industrial fundamentals are under pressure due to elevated supply

Industrial fundamentals



*thousand square feet
Source: CoStar, Principal Real Estate, Q1 2024

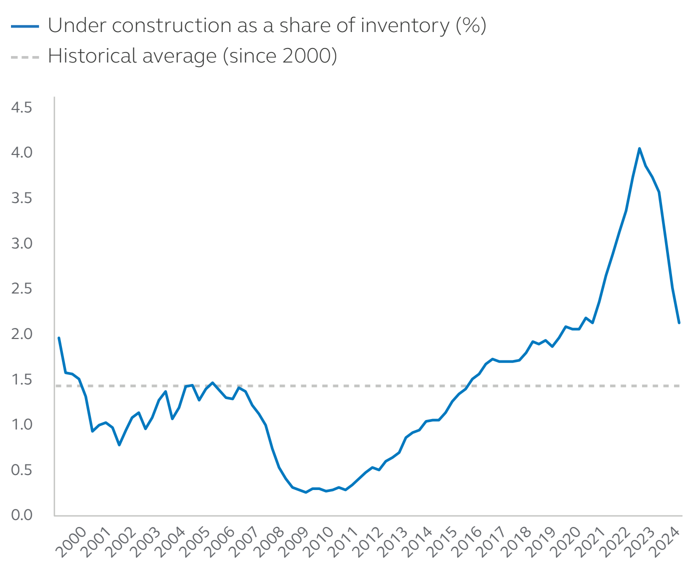
While demand has slowed, however, it is generally not the problem. During the pandemic, an outsized amount of net absorption in 2020 and 2021 was the direct result of a surge in e-commerce spending that fueled the expansion of major operators as well as third-party logistics operators (3PLS). During that period, e-commerce alone accounted for as much as a third of overall net absorption[1], and those figures would be even more robust if they included omnichannel retailers who were supported by 3PLS. The retrenchment that began in 2023 following the depths of the pandemic has had an impact on demand—resulting in a normalization toward longer-term historical trends but has not been overly determinantal.

Abstracting from exogenous shocks, such as the pandemic, on a cyclical basis, warehouse demand is most highly correlated to macro and regional economic growth phenomena such as GDP, industrial production, employment, and spending growth. All of these have been present in the current expansion and auger well for a sustained recovery in demand, particularly at a time when a reduction in property values and more restrictive lending will conspire to restrain a more active development market over the next couple of years.

As shown in Exhibit 3, the amount of new industrial stock under construction has declined significantly over the past several months suggesting a rebalancing of market conditions in favor of landlords and stronger operating fundamentals. As demand normalizes and new development begins to ease, vacancy rates will start to fall further below their equilibrium levels in most markets facilitating stronger rent and net operating income (NOI) growth trends allowing investors to approach the market with more confidence.

EXHIBIT 3: New development approaches their historical norm

Industrial under construction, % of inventory



Source: CoStar, Principal Real Estate, Q1 2024

[1] Source: Cushman & Wakefield, 2022

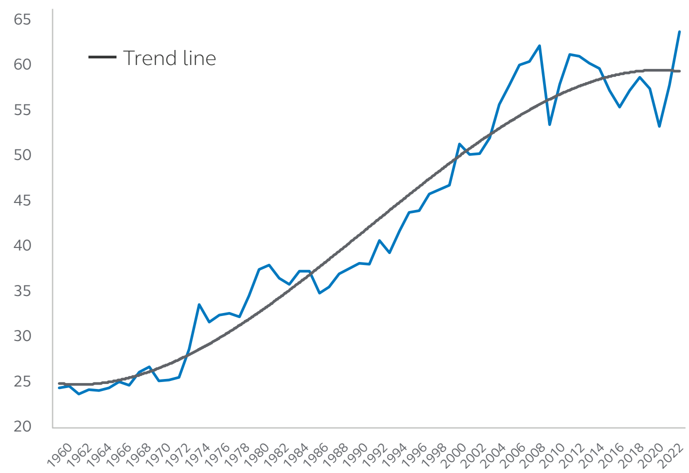
Global trade is here to stay and so is structural demand

Although a shifting global economy has raised questions surrounding the sustainability of globalization and the level of trade flows, we have seen scant evidence of its demise. While we are among the first to admit that the period of hyper-globalization that characterized the post-World War II era has gradually come to an end, the benefits of global trade to economic growth and productivity are undeniable. While trade as a share of global GDP was compromised during the pandemic due largely to port shutdowns in the Asia Pacific region, by 2022 data from the World Bank shows that global trade had established a new all-time high (Exhibit 4).

Trade in the U.S., which is among the most important direct drivers of new industrial demand, is also establishing new highs, particularly for imports of goods that are arriving through port facilities, which are stored in warehouses and moved along the North American supply chain. From a global trade perspective, we have recently noticed shifts from where that trade originates. Since 2003, for example, China has been the top originator of goods imported into the U.S., but in 2024 that changed when Mexico once again took over the top spot (see Exhibit 5). While Mexico and Canada have long been among our top trading partners due to regional proximity, they have become increasingly more prominent since the pandemic as global supply chains have become more diversified—a trend we anticipate will continue in the future.

EXHIBIT 4: Global trade re-accelerates

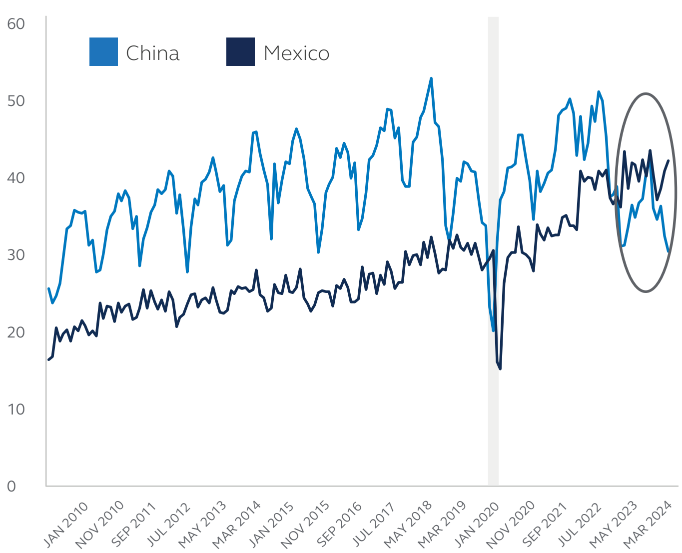
Trade as a share of GDP (%)



Source: World Bank, Principal Real Estate, 2022

EXHIBIT 5: Global trade will continue to expand and diversify

Imports: Customs value - from China and Mexico, $ billions



Source: Moody's Analytics, U.S. Census Bureau, Principal Real Estate, March 2024

Top 10 U.S. trading partners, $ billions unless otherwise indicated

Rank	Country	Exports	Imports	Total trade	Percent of total trade
	Total, all countries	171.7	271.4	443.1	100.0%
	Total, top 15 countries	122.4	210.6	332.9	75.1%
1	Mexico	29.4	43.1	72.5	16.4%
2	Canada	30.6	34.9	65.5	14.8%
3	China	11.5	31.6	43.2	9.7%
4	Germany	6.2	14.4	20.6	4.6%
5	Japan	6.0	12.7	18.7	4.2%
6	Korea South	5.1	11.6	16.8	3.8%
7	Taiwan	4.0	9.1	13.1	3.0%
8	United Kingdom	6.9	5.7	12.6	2.8%
9	Ireland	1.5	10.2	11.7	2.6%
10	India	3.4	8.0	11.4	2.6%

Source: U.S. Census Bureau, Bureau of Economic Analysis, Principal Real Estate, Q1 2024

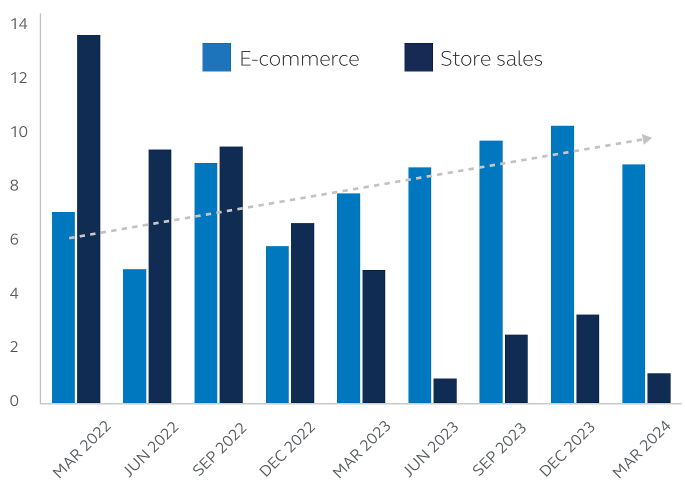
E-commerce has regained its footing and is here to stay

As discussed earlier, e-commerce has been a key component of the growth of industrial demand over the past several years. During the pandemic, it was often the case that net absorption of industrial space was comprised largely of e-commerce companies looking to expand their leasing footprint and planning for future expansion. For some context, CBRE published an analysis which estimated that for every incremental increase of $1 billion growth in e-commerce sales, there needs to be an additional 1.25 million square feet of distribution space to support the additional capacity. The implication, of course, is that the logistics industry will need new and more modern warehouses to facilitate the expansion of e-commerce retail. It also suggests that online retail sales growth will be an important source of demand growth for the sector going forward.

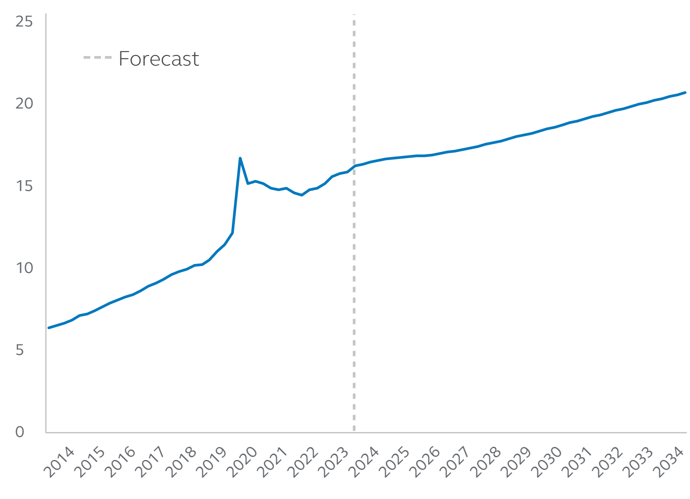
In the two years since the peak of industrial demand, there has been a retracing of strategic planning among e-commerce majors. The pull-back in expansion was largely driven by a period of slower growth in e-commerce penetration as households and individuals returned to brick-and-mortar shopping after a period of extended isolation. As Exhibit 6 shows, however, growth in e-commerce retail sales has once again re-accelerated, and with it so has the demand for space among its operators in recent quarters. While retail sales overall have been somewhat volatile as households have seen savings rates normalized following the pandemic, e-commerce sales have surged, posting a gain of 8.6% to start 2024. The share of e-commerce has also continued its growth after a brief decline following its COVID surge and now stands at just under 14% nearly 300 basis points above its pre-pandemic level and is expanding at just above its historical trend.

EXHIBIT 6: E-commerce will remain a driving force for warehouse demand

Retail sales growth:
E-commerce vs. store sales, yoy % chg.



E-commerce as a % of total retail sales



Source Census Bureau, Moody's Analytics, Principal Real Estate, Q1 2024

For its part, the growth in e-commerce is good news for increases in demand for the industrial sector over the next several years. The outlook for online sales penetration remains healthy, as it is forecast to hit 20% over the next ten years. In the near-term, e-commerce leasing is also showing signs of increase with CBRE reporting leasing by e-commerce-only companies accounted for 12 million square feet in Q1 2024, or 10.7% of overall demand, a 156%increase on a year-over-year basis.[2]

[2] CBRE EA, Q1 2024 Industrial Overview and Outlook Report

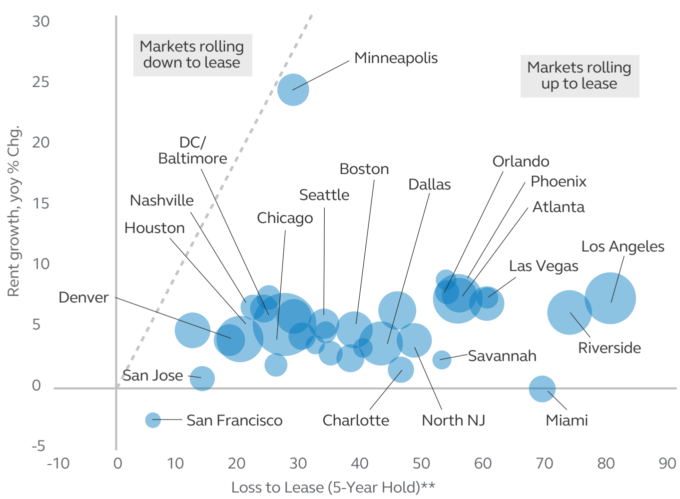
Strong performance and a bright outlook

We believe the industrial sector is well-positioned for improved performance over the next several years. Though the sector continues to face headwinds from capital markets and strong supply, it remains one of the most sought-after by investors. While the primary property has faced difficulty over the past couple of years, industrial assets have performed well as fundamentals have supported healthy rental and net operating income growth despite moderate increases in vacancy rates. Industrial rental growth continues to average in the 4% range on an annual basis and strong trend rent growth over the past five years has translated into market-to-market gains as leases have expired in most markets (see Exhibit 7).

Recent returns within the industrial sector have been muted, but it has largely outperformed other primary sectors. Over a long history, the industrial and warehouse sectors have benefited from tailwinds from expansion in the U.S. consumer sector and secular shifts in both retail and global trade that have provided long-term investors with healthy returns since the GFC. In the past decade, the sector has averaged an annualized total return of 13.9% compared with 6.4% for all sectors combined. Although the commercial real estate sector today is facing headwinds, we believe that the industrial sector is poised to regain some of the benefits from the secular tailwinds it developed following the last economic crisis.

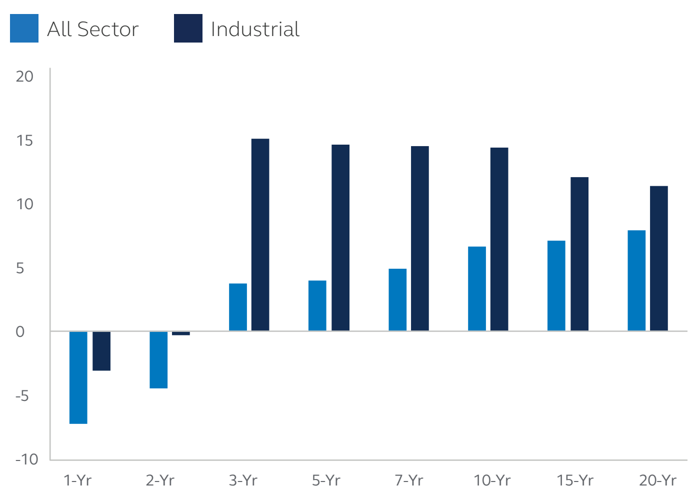
EXHIBIT 7: Industrial outperforms on the strength of income growth

Industrial rent performance



**Loss to lease assumes a 5-year lease length
Source: CBRE EA, Principal Real Estate, Q1 2024

NPI total return, annual %



Source: NCREIF NPI, Principal Real Estate, Q1 2024

Conclusions

We view the challenges facing the industrial sector as purely cyclical and feel that they will be resolved over the shorter-term outlook. Consequently, the industrial sector remains one of our top high-conviction long-term strategies, particularly for investors who are focused on sustainable global and domestic economic demand drivers. While many other property sectors have struggled in the current capital market environment, industrial valuations have generally outperformed, and assets have delivered stronger income growth than other traditional property types. In the longer term, we believe that there are several reasons for optimism for continued outperformance. Globalization remains a resilient trend and U.S. supply chains are reconfiguring to take advantage of the emergence of new leading trade partners as well as selective reshoring of manufacturing processes. The continued evolution of e-commerce will also sustain new demand over the next decade as new technology will continue to alter both the retail and logistics landscape in the U.S. and globally. Though capital market headwinds have made it difficult in some cases to access debt, the industrial sector has remained among the more well-capitalized throughout the cycle. We believe that given the sectors secular demand drivers, a reduction in supply due to capital market headwinds and value corrections that have already occurred will make 2024-25 an interesting entry-point and a unique opportunity to increase investor weighting to the industrial sector.

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