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Principal Real Estate

The case for industrial development in the next cycle

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The U.S. industrial sector has moved beyond its 2022–23 correction and is showing early signs of recovery. Values declined less than other property sectors during the downturn, and operational metrics—particularly net operating income growth—remained resilient. However, success in the next phase of the cycle will depend on selectivity in market, asset quality, and timing:

1. **Fundamentals: Resilient but diverging**
   - NOI growth: Is in the mid-6% average, driven by 40% lease mark-to-market gains over the last five years.
   - Pipeline reset: Projects under construction are down nearly 70% from their 2023 peak, normalizing supply.
   - Winners vs. losers: Modern logistics facilities continue to attract demand; older assets are facing occupancy losses.
2. **Trade and supply chains: Adaptation, not retreat**
   - U.S. trade flows remain near record highs despite tariff volatility.
   - Policy shifts are reshaping supply chains, rather than shrinking them—as a result re-shoring and nearshoring are fueling demand in select markets.
3. **Performance gap is widening**
   - Premium pricing: The spread between top and bottom quartile assets has widened 66% since 2020.
   - Income advantage: Top-quartile assets generate ~90% more NOI per square foot.
   - Rent growth is concentrated in top-tier markets; weaker locations are delivering flat or negative results.

Amid this backdrop, a window is opening for industrial development. While rising costs remain a challenge, the pullback in new construction sets the stage for an attractive 2026–27 opportunity, as limited deliveries meet renewed demand. We believe investors who focus selectively on modern facilities with strong tenant demand are positioned for attractive returns. Recent performance underscores this trend: assets built since 2010 experienced total returns of 6.3% over the past year, nearly double that of older properties. We believe targeted industrial development offers a compelling investment approach.

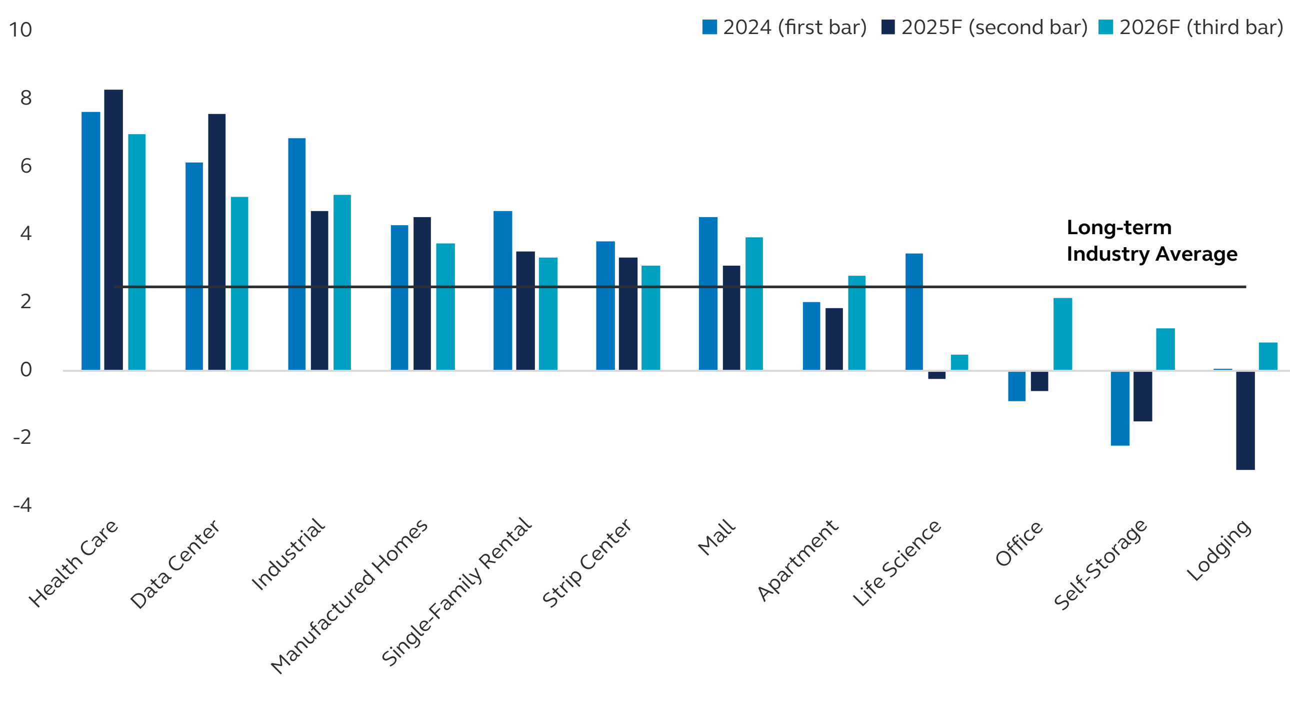
State of the industrial market and potential recovery

The industrial sector has emerged from a correction that began in 2022 and reverberated across the broader commercial real estate landscape. The primary driver was the Federal Reserve's aggressive monetary policy response to inflation, which peaked near 8.5% that year. While the broader economy proved resilient—supporting risk assets such as equities—real estate valuations, which are highly sensitive to interest rate shifts, declined nearly 20% from their peak (NCREIF NPI). For industrial, the drop was a more moderate at 12.3%, smaller than all major property sectors except retail.

Operationally, the sector held up relatively well. Challenges stemmed primarily from excess development and policy uncertainty around tariffs and global trade. Even so, industrial remains a favored allocation for investors, given its central role in domestic and international supply chains. Demand has stayed broadly stable, and asking rents have generally kept pace with—or slightly exceeded—headline inflation.

Notably, the sector has maintained attractive income performance. Net operating income (NOI) growth has averaged in the mid-6% range, supported by significant mark-to-market gains. Nationally, in-place leases have reset roughly 40% higher over the past five years, providing durable cash flow growth (see Exhibit 1).

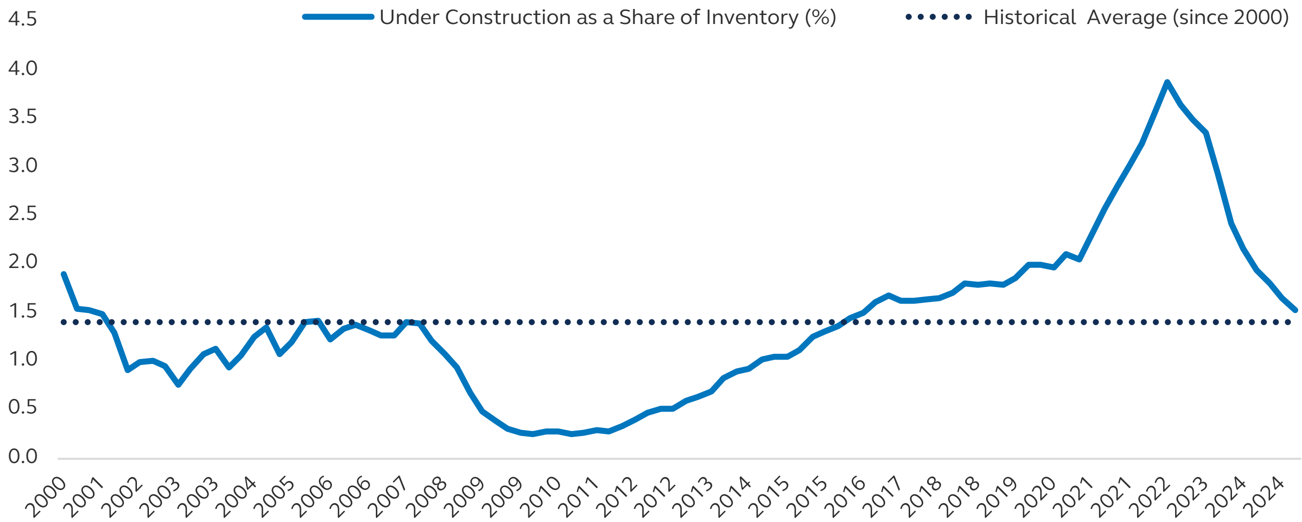
EXHIBIT 1: Industrial NOI growth stands across real estate sectors
Same Unit NOI Growth, annual % change



Source: Green Street, Principal Real Estate, August 2025.

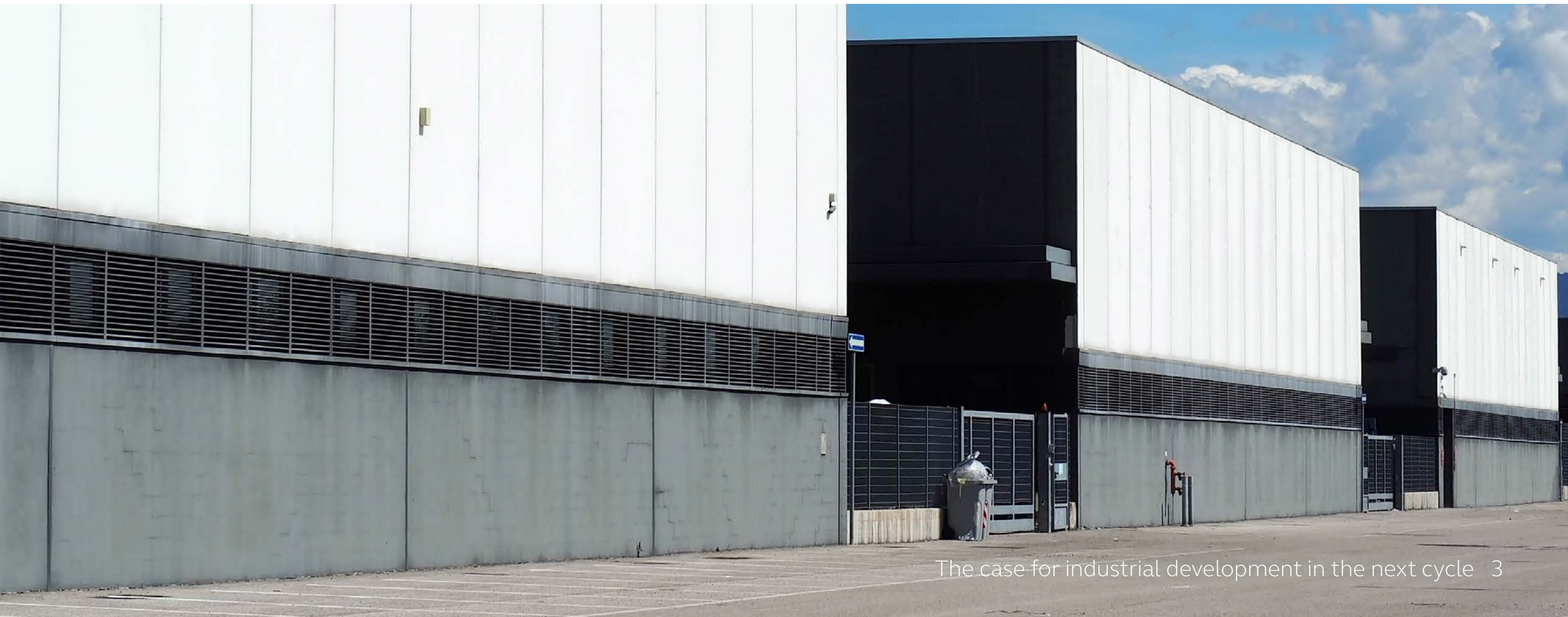
The sector's strong post-pandemic appreciation and tight market conditions did encourage overbuilding, particularly in key port markets. But higher rates and weaker valuations have forced developers to retrench. Projects under construction are now down nearly 70% from their 2023 peak and back to long-term historical norms (see Exhibit 2).

EXHIBIT 2: Easing under construction will allow a swifter recovery
Industrial under construction, % of inventory



Source: CoStar, Principal Real Estate Q1 2025.

Looking ahead, while near-term challenges remain, the industrial sector appears well positioned to regain momentum over the next 12 to 18 months. While investors' approach to the sector will require more rigorous accounting, we remain highly productive on industrial warehouses. The pullback in new supply, combined with resilient demand drivers, should create attractive opportunities for both investors and developers. In the following sections, we will explore the long-term fundamentals and market dynamics that will shape the next phase of recovery and expansion.

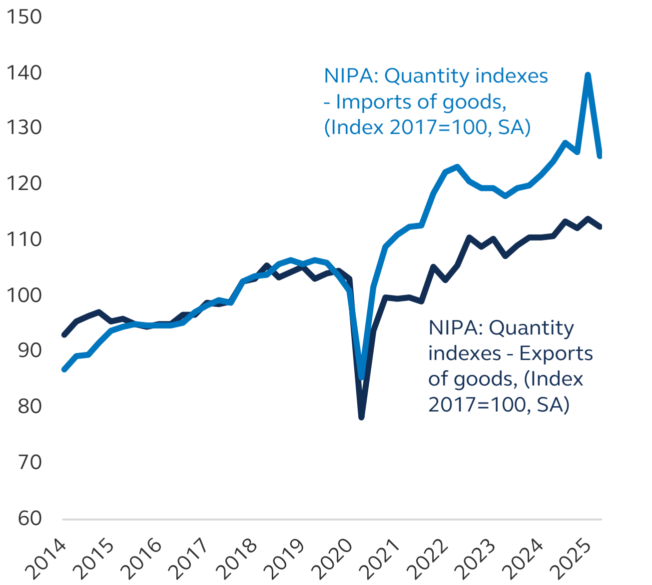


Globalization and its future

Among many of the tailwinds industrial has experienced over the past several cycles have been the expansion of global trade. While recent tariff policies and a more nationalistic undertone from Washington, DC have raised concerns of transition away from trade, toward more domestic production and consumption. While these arguments have gained traction including a slowdown in the pace of globalization as measured by global trade flows as a share of GDP, it is unlikely to come to fruition.

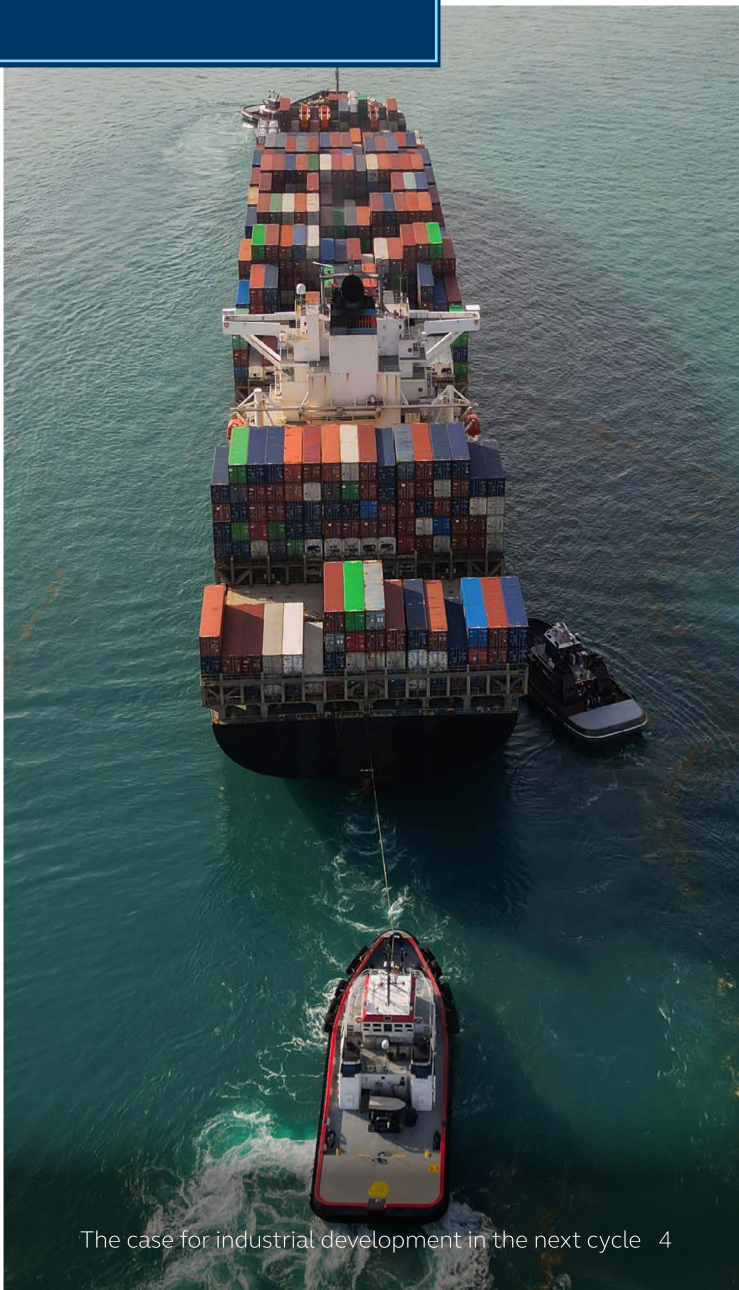
Today, imports and exports in the U.S. remain at near all-time highs, as shown in Exhibit 3 below. While recent volatility is a function of policy uncertainty, it remains unlikely that the aggregate trade profile changes significantly over the long-run. In fact, over the past 80 years, supply chains have become increasingly integrated, allowing for more efficient allocation of resources. Domestic manufactures in the U.S. for example source far more commodities for production than today they did just 30 years ago, allowing them to import disinflation while increasing production.

EXHIBIT 3: Trade remains an important element of the U.S. economy
U.S. imports and exports, quantity index (2017=100)



Source: Bureau of Economic Analysis, Principal Real Estate, Q2 2025.

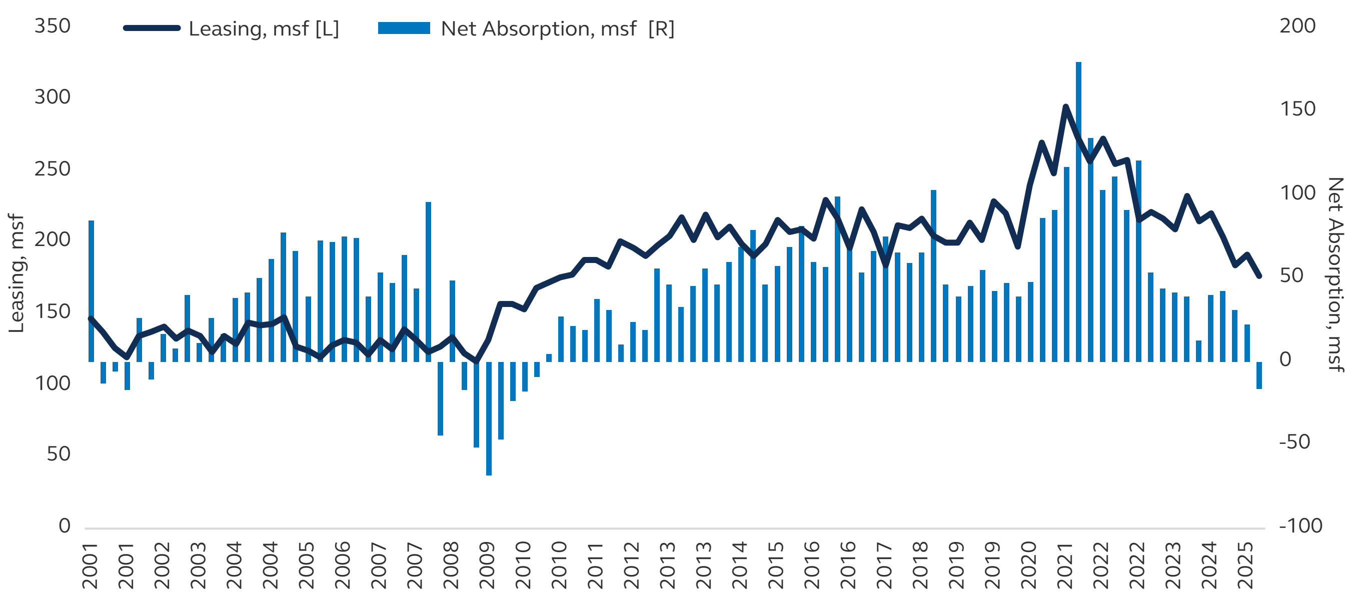
While higher frequency data show that recent policy has slowed port traffic, it is likely a short-term phenomenon and one that may require a reconfiguration of supply chains. For example, the 2018 Chinese tariffs resulted in a material decline in imports originating from China in favor of other trading partners such as Mexico and Canada. In the end it did little to reduce trade on aggregate.



Demand growth among newly developed warehouses

More recently, the sector has faced additional headwinds from tariff uncertainty and more cautious consumer behavior, both of which have made leasing decisions more difficult for occupiers. As a result, leasing activity has fallen to its lowest level since 2010—just after the Global Financial Crisis—leading to the first quarter of negative net absorption in 15 years, according to data from CoStar. We believe that this dislocation is largely the result of near-term uncertainty on the part of importers and manufacturers who need to match longer-term leasing and strategy decisions with policy shifts. Over the longer term, sustained economic growth and consumer spending will likely create pent up demand for warehouse space—combined with a reset of the development cycle, this will potentially create unique opportunities for investors and developers to enter the market.

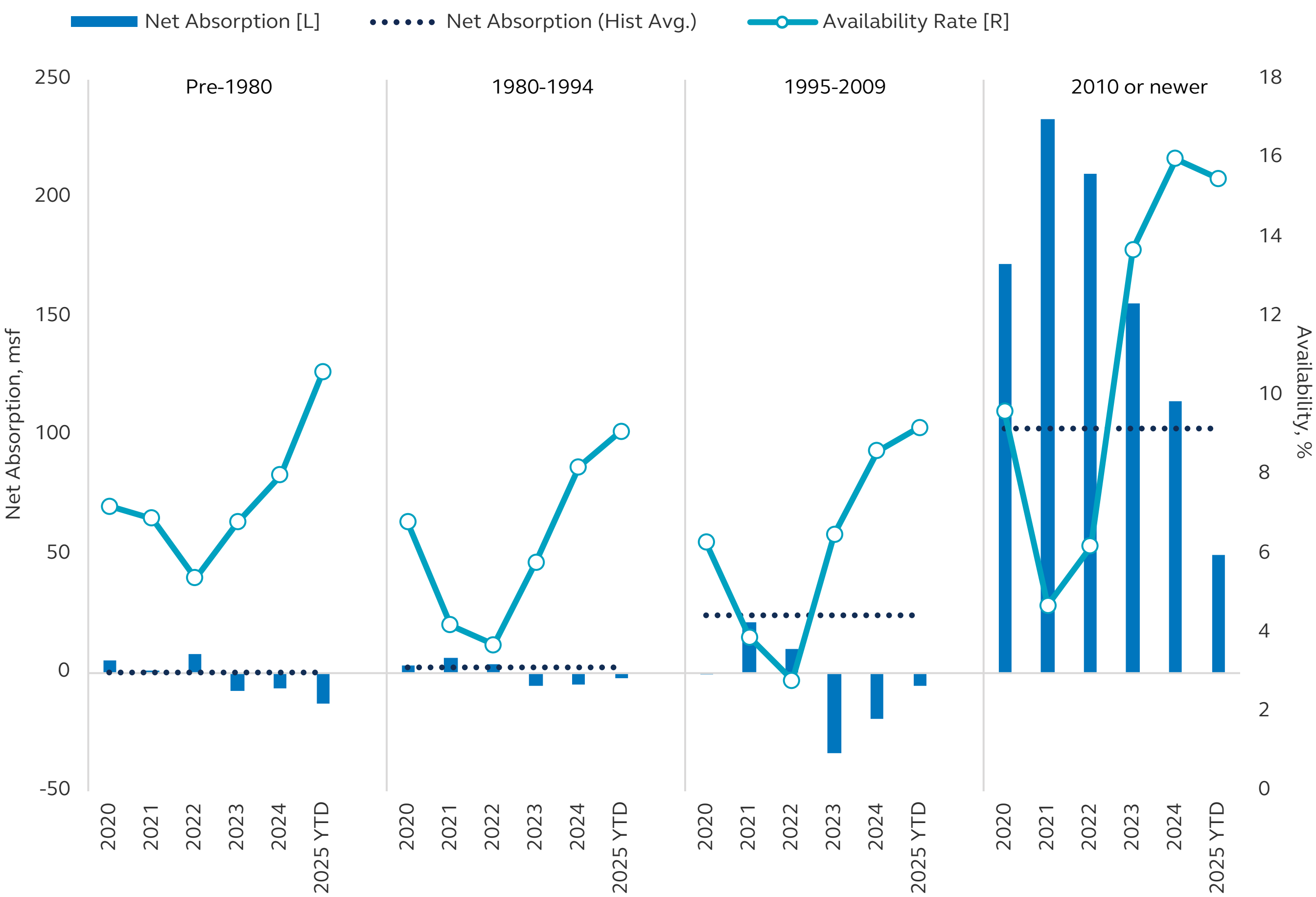
EXHIBIT 4: Leasing slows…for now
Industrial leasing and net absorption, msf



Source: CoStar, Principal Real Estate, Q2 2025. msf = million square feet

While aggregate demand has experienced challenges more recently, a more nuanced look at the sector shows that performance is highly dependent on asset age and quality. Historically, legacy industrial warehouses particularly in urban infill areas have boasted very low availability rates relative to larger and more modern space owing to their ability to act as fulfillment centers for population centers. In the past two years, however, the demand has shifted for older assets (see Exhibit 5). Since 2022, demand has been either flat of negative or occupancy levels have declined as a result, which has weighed on overall sector performance today.

EXHIBIT 5: Demand remains healthy for newer modern warehouse facilities
Warehouse net absorption and availability by age cohort



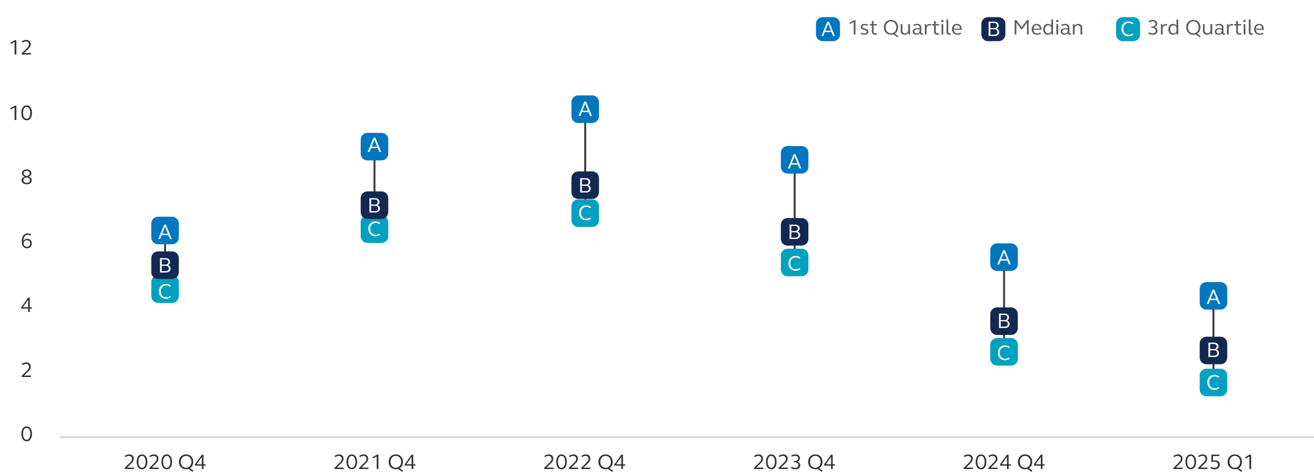
Source: CBRE EA, Principal Real Estate, Q2 2025.

The story is very different for newly developed assets which have accounted for nearly all warehouse demand over the past two years. Net absorption across this period has slowed but remains either above or very close to historical trend. Warehouses delivered in 2010 or afterwards have averaged annual net absorption of 177 million square feet annual between 2020 and 2024, well above the historical average of 103 million square feet. Year to date in 2025 this segment has seen 50 million square feet of positive net absorption. While the current market vacancy rate of 15.5% is elevated, it includes assets that are in the process of stabilization and should not be taken as underperformance.

The case for a more nuanced approach within the sector

The industrial sector is experiencing increasing differentiation, with significant implications for investors. The price gap between the top and bottom quartiles of industrial properties has widened dramatically, indicating that investor preference has shifted toward higher-quality institutional-grade assets in the current environment. The gap between the top and bottom quartiles has increased from $85 per square foot before 2020 to $142 per square foot today—a 66% increase. This growing divide is also mirrored in performance, as top-quartile, higher-quality properties are generating 89% more net operating income per square foot than those in the bottom quartile. Indeed, our analysis of market rent growth for industrial properties across nearly 400 markets shows that it has steadily declined since its peak in 2022. In Q4 2021, the bottom quartile of markets achieved rent growth of more than 6%, but in 2024 only markets in the top quartile averaged better than 4%. While this represents a seemingly simple example, as it ignores the unique attributes of individual properties, we believe it illustrates that selecting higher quality assets in top-tier markets is increasingly important in the current environment.

EXHIBIT 6: Rent growth and potential income returns are at a premium for core assets
YoY market rent growth by quartile, %



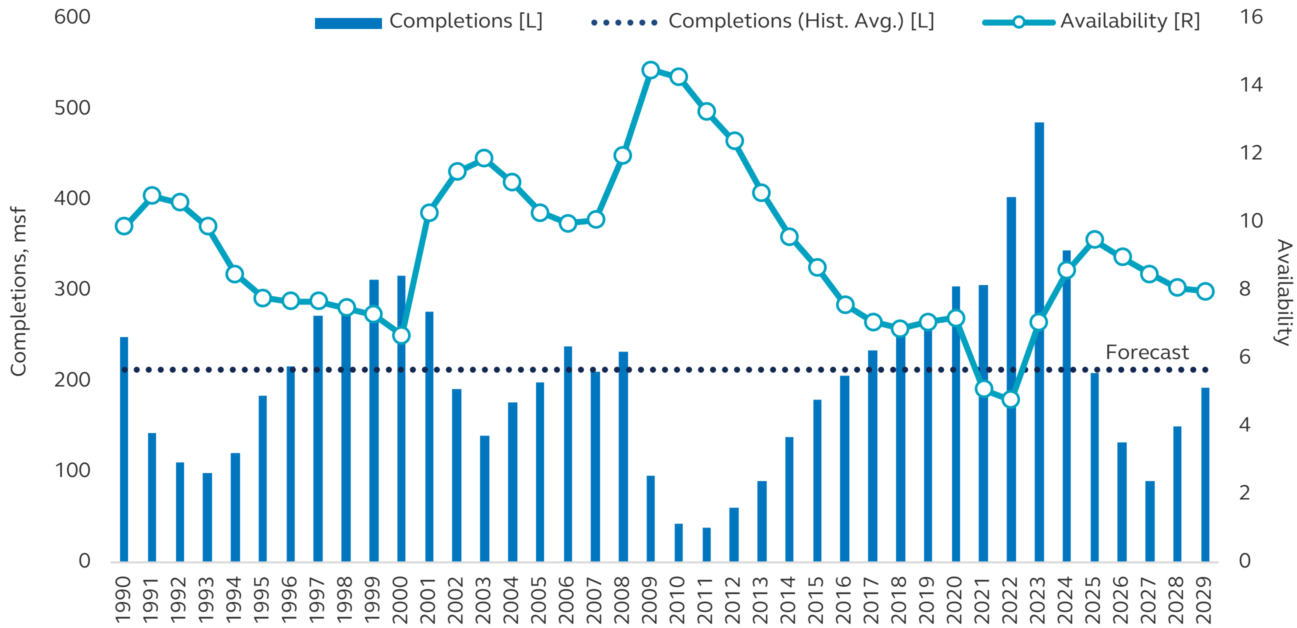
Source: CoStar, Principal Real Estate, 1Q 2025

Opportunities for new development

The case for development is often difficult as it relates to a myriad of factors including replacement costs, which today remain elevated on a relative basis. This paper has also highlighted several challenges to the industrial sector today, but seasoned real estate managers understand that timing and positioning remain critical to a successful opportunistic strategy. Putting the current state of the market in context, more subdued demand may be a function of short-term uncertainty but easing supply pipelines and strong interest in newer vintage assets presents opportunities today.

According to data from CBRE EA, new supply will slow to its lowest level since the Global Financial Crisis by 2027 with vacancy rates falling over the same period. We continue to have a high degree of conviction that those assets delivered will stabilize quickly as there will be pent up demand for modern facilities. In fact, only 25% of industrial stock has been delivered since 2010 meaning that there is a lack of modern logistics facilities to accommodate the growth in demand from third party logistics providers and key e-commerce companies.

EXHIBIT 7: Favorable market balance will draw investor interest in 2026
Industrial completions and availability

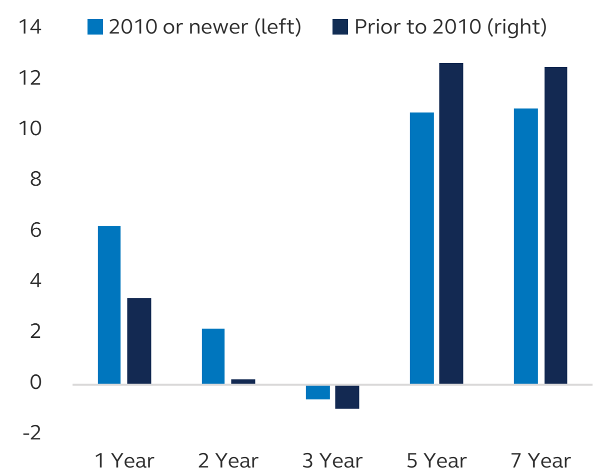


Source: CBRE EA, Principal Real Estate, Q2 2025

Availability of industrial space has increased since 2023, however, it remains well below recessionary levels and in line with broader historical averages. This will support stronger rental growth trends over the next two years and opens the potential for developers to help fill the doughnut hole in development in 2026 and 2027 where a lack of new space will have a significant impact on the availability of warehouse space that meets current requirements.

Recent return data from NCREIF suggest that newer stabilized assets have begun to outperform older assets, particularly those facing functional obsolescence. In the past year industrial assets built since 2010 have a total return of 6.3%, nearly double that their older peers. We believe that developers who can adequately track market conditions and focus on deal level economics can show excess returns on their investment as the market tightens over the next 12 to 18 months.

EXHIBIT 8: Newer assets have begun to outperform their peers
Annualized total returns for industrial, %



Source: NCREIF NPI (Query Tool), Principal Real Estate, Q2 2025.

CONCLUSION

Industrial remains a core allocation, but the recovery will be uneven, and broad, undifferentiated exposure risks will likely lag returns. The greatest opportunities lie in selective development, enabling investors to curate portfolios of next-generation assets in markets with durable, long-term tenant demand. Investment performance will ultimately hinge on targeted exposure—modern facilities, prime logistics hubs, and disciplined development strategies.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. Commercial real estate lending involves several risks, including market volatility, credit risk, operational challenges, and legal/regulatory compliance. Additionally, rising interest rates, refinancing pressures, and potential defaults can exacerbate these risks.

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