Principal Asset Management®

Principal Real Estate

INDUSTRIAL REALIGNMENT:

Navigating trade policy, port disruption, and an increasingly selective market

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EXECUTIVE SUMMARY

The U.S. industrial sector has been at the center of the debate over deglobalization for the past half decade. While there is still significant debate over a potential reversal of globalization, the paucity of data supporting claims and economic reliance of increasingly integrated supply chains suggests that we are entering a period of realignment of global supply chains.

Recently, policy shifts in the U.S. toward global trade agreements suggest that the industrial and warehouse sectors in the U.S. are facing a period of transition. Although the full implications of a more restrictive trade—at least in the near term—have not been fully observed in the data, they have placed the sector under increased scrutiny.

In this paper, we examine the industrial sector's changing landscape, highlighting the key implications for investors and operators as the environment becomes more complex and selective. We will also discuss the longer-term implications for the sector, which we believe remains a vital part of the global economy's infrastructure.

Market performance and capitalization

After a decade of strong performance powered by sustained growth in global trade and e-commerce, the industrial sector is adjusting to new realities. While it remains a leading performer and highly sought after by investors within commercial real estate, elevated levels of new supply—combined with recent changes in trade policy and an increasingly uncertain economic outlook—have tempered near-term investor expectations.

As a result, investors' due diligence has become more critical and is creating a growing divide between high-quality, well-located assets and those that are less competitive. In short, the industrial sector, which was until recently a can't miss proposition for investors, is becoming much more a stock picker's market. The ability to identify and invest in properties with enduring appeal and strong fundamentals in the current environment will be a critical differentiator for success.

Evolving income dynamics

Despite recent challenges, the sector benefits from solid underlying demand and healthy occupancy rates. Future income growth, however, will depend more heavily on careful asset selection and less on broad market momentum, as new development slows and tenant preferences shift.

Strategic and tactical imperatives

The era of easy, broad-based gains is giving way to a market where selectivity, local market expertise, and operational excellence are paramount. Investors and portfolio managers must adopt a more nuanced, data-driven approach to capture opportunities and manage emerging risks.

Over the longer term, the U.S. industrial sector is poised to benefit from several enduring structural tailwinds. While the debate around de-globalization persists, global trade volumes remain near record highs, underscoring the continued interdependence of global markets. The U.S. remains a pivotal player in this system—as both a top importer and exporter of goods and services. At the same time, shifting supply chains, policy incentives, and rising demand for e-commerce and nearshoring solutions are reinforcing the strategic value of industrial assets.

For investors, the focus will need to shift toward high-quality, adaptable assets that can respond to evolving logistics networks and policy environments. Despite near term volatility, the industrial sector remains a foundational component of a resilient and forward-looking real estate investment strategy.

Market performance and capitalization trends

Recent shifts in U.S. trade policy have cast a shadow over the industrial sector's outlook. The sector entered 2025 after a challenging year for operators, largely driven by a moderation in demand, active supply pipelines in key markets, and continued capital market challenges that have affected nearly all property sectors. Recent policy changes—particularly the broad-based implementation of tariffs—have the potential to shift the environment dramatically.

The industrial sector's recent history is characterized by outsized returns and surging investor interest. Since the pandemic, the sector has averaged total returns of over 12%, placing industrial assets among the best performers in commercial real estate. The sector, however, has not been immune to the cyclical downturn since 2022, which has seen private equity values decline by 12.3% since peaking in 2022.

While industrial has continued to perform well on a relative basis, over the past couple of years, it has underperformed the retail sector, particularly in the open-air shopping centers, which has been the strongest traditional sector (see Exhibit 1). Furthermore, public REITs, which tend to foretell cyclical shifts in private equity, sent cautionary signals in 2024 as industrial REITs were the worst-performing of 18 REIT subsectors.

EXHIBIT 1: The Industrial sector has lost some of its swagger

NPI total returns by property type, ranked

Rank	2016	2017	2018	2019	2020	2021	2022	2023	2024	1Q25
1	Industrial 12.2%	Industrial 12.8%	Industrial 14.0%	Industrial 13.3%	Industrial 11.5%	Industrial 43.1%	Industrial 14.5%	Strips 1.1%	Strips 5.7%	Strips 2.1%
2	Strips 8.1%	Office 6.2%	Office 6.9%	Office 6.7%	Office 1.9%	Apartment 20.0%	Apartment 7.1%	Industrial -4.1%	Industrial 2.6%	Industrial 1.3%
3	Apartment 7.3%	Apartment 6.1%	Apartment 5.9%	Apartment 5.4%	Apartment 1.8%	Strip 7.2%	Strips 5.5%	Apartment -7.6%	Apartment 1.2%	Apartment 1.2%
4	Office 6.3%	Strips 6.0%	Strips 4.7%	Strips 2.8%	Strips -3.6%	Office 6.4%	Office -2.8%	Office -16.9%	Office -7.3%	Office 0.9%

Source: NCREIF, Principal Real Estate, 1Q 2025.

This shift in the industrial sectors relative performance has been driven by a combination of:

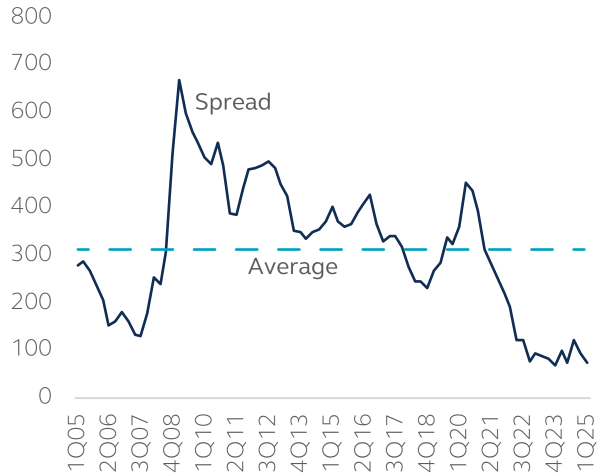
Moderating 12-month rent growth that slowed from a peak of nearly 10% in Q2 2022 to between 2.5% to 3.5% more recently, according to data from CoStar; and

Nominal cap rates, which have increased as interest rates rose from around 3.5% in 2022 to approximately 5% today. That shift has created a rift in the capital stack, causing bid ask spreads to widen and values to reset.

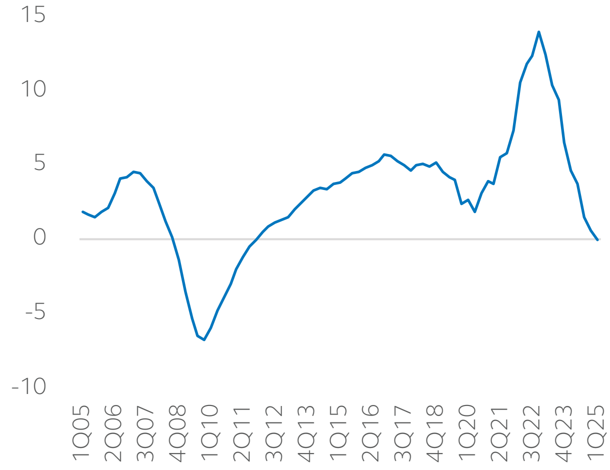
Initially, nominal cap rates were low at 3.5% because the market anticipated that strong and sustained rent and net operating income (NOI) growth would effectively allow investors to "grow their way out" of higher valuations. However, as rent growth has moderated significantly, these expectations have been revised downward as assumptions of continued double-digit income growth were not realistic. This recalibration has led investors to demand higher cap rates, resulting in a corresponding adjustment in property values.

EXHIBIT 2: Cap rate compression and falling rent growth have constrained valuations

Industrial cap rate spread to 10-year UST, Bps



YoY asking rent growth, %



Source: Green Street, CBRE-EA, Federal Reserve, Principal Real Estate, 1Q 2025.

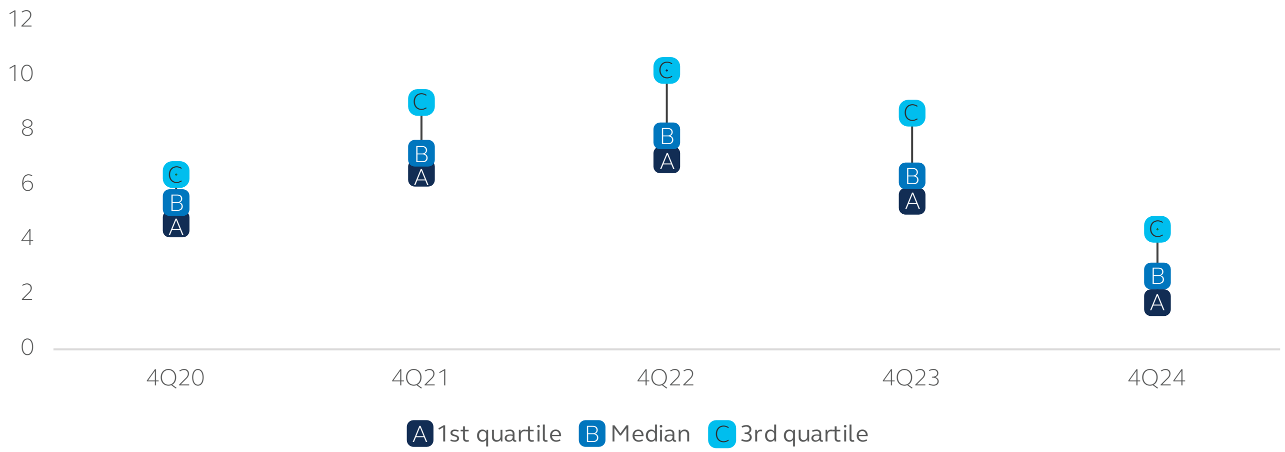
Wider bid-ask spreads and a reticence of investors to enter a market in the middle of a recalibration in pricing have translated into a decline in sales volume of nearly 50% since the 2021 peak. The decline is on par with the drop in total real estate transactions of roughly 51% over the same period and compares to declines of 58% for apartments, 56% for office and 32% for retail.

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 3: Industrial is increasingly a stock picker's sector

YoY market rent growth by quartile, %



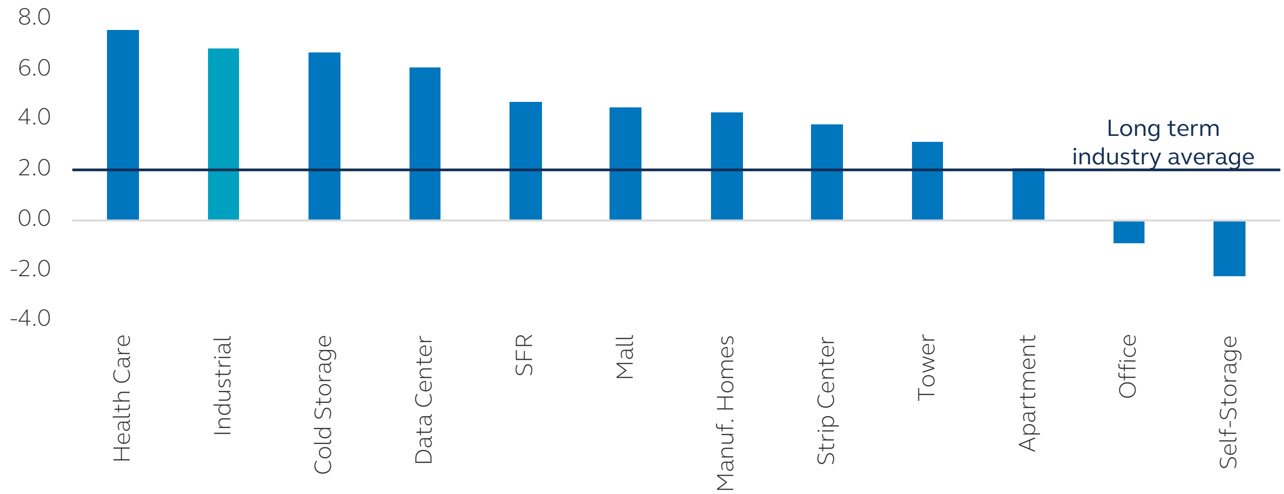
Source: CoStar, Principal Real Estate, 1Q 2025.

Net operating income growth and rent dynamics

Despite challenges to the sector, strong rent and occupancy over the past several years continue to translate into healthy and, in some cases, robust NOI growth. In 2024, for example, the sector experienced 6.8% NOI growth on a year-over-year basis, which is more than twice the historical trend of 3.2%. We anticipate NOI growth to remain solid over the next five years at 4% annualized in the base case and nearly 3% in a downside scenario. Such stability, even under a more challenging scenario, is due to current market rents holding an 8% premium over in-place rents in Q1 2025. This spread indicates that tenants renewing face higher rents than those with existing leases, boosting NOI prospects in the short term.

EXHIBIT 4: Income growth will play a key factor in forward-looking returns

Same property NOI growth by property sector, %, *as of 2024*

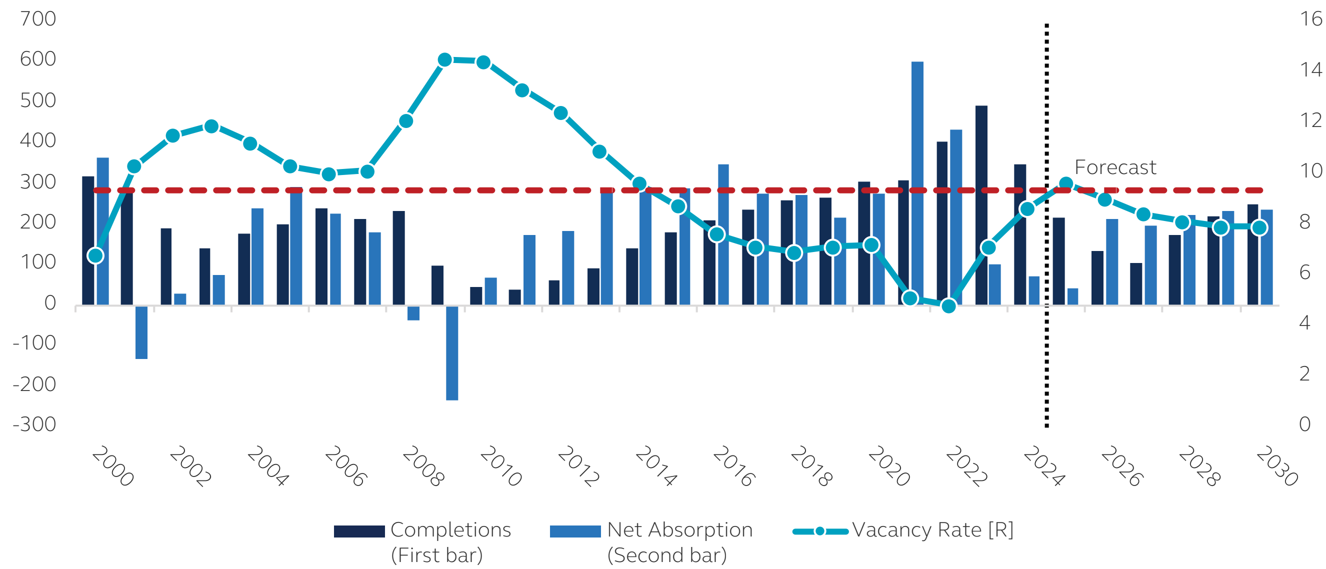


Source: Green Street Advisors, Principal Real Estate, 1Q 2025.

That said, recent moderation in industrial rent growth and uncertainty surrounding future economic growth have raised questions surrounding the durability of such robust NOI projections over the longer term, or whether investors should adjust underwriting assumptions to better align with trend growth levels. In the short term, it is important to understand that the sector is emerging from a year in which vacancy rates increased to 8.6%, however, it remains within its historic equilibrium range, which is supportive of more moderate but sustained real rental growth.

EXHIBIT 5: Industrial fundamentals remain in equilibrium

Absorption and completions, msf (left axis), vacancy, % (right axis)



Source: CBRE-EA, Principal Real Estate, 1Q 2025.

Further supporting the outlook of stability in sector fundamentals is the retrenchment of new projects started over the past year. The decline in investor activity and valuations, along with higher capital costs, has altered the calculus on opportunistic development. At present, square footage under construction as a share of existing inventory has declined by more than 50% and will continue to decline over the next 12 months.

On the demand side of the equation, e-commerce and third-party logistics providers, who had stepped back from the market in 2023, have gradually increased their leasing in 2024. This represents a significant share of warehouse demand, and we believe it will help steady occupancy levels over the next year and support stable income generation for landlords.

Bottom line, given the prevailing level of cap rates, we think selectivity is key as our internal discounted cash flow (DCF) analysis suggests that long-term NOI growth of between 3% and 4% is likely needed to drive compelling unlevered IRRs. This compares to the historical annualized NOI growth from 2001 to 2024 of 2.3% for the U.S. overall.

Trade policy shifts, port activity, and supply-chain reconfiguration

Amid the nascent recovery in industrial occupancy, the looming question for the sector remains the impact of tariffs on warehouse demand. Policy lag suggests that it is too soon for us to witness any hard data on the impact of the Trump administration's tariff policy, however, the industrial sector appears to be squarely in the crosshairs should effective customs rates remain elevated. It is also important to consider that longer-term strategic impacts will need to focus on the length and magnitude of increases in customs fees, which appear even today to be a moving target.

While our view remains that the sector will continue to see strong secular demand over the long term, in the near-term policy uncertainty is a concern. Our view is that the tactical narrative is one of quality asset selection. More recently, larger warehouses and modern logistics spaces have experienced healthy demand, while older functionally obsolete facilities remain challenged.

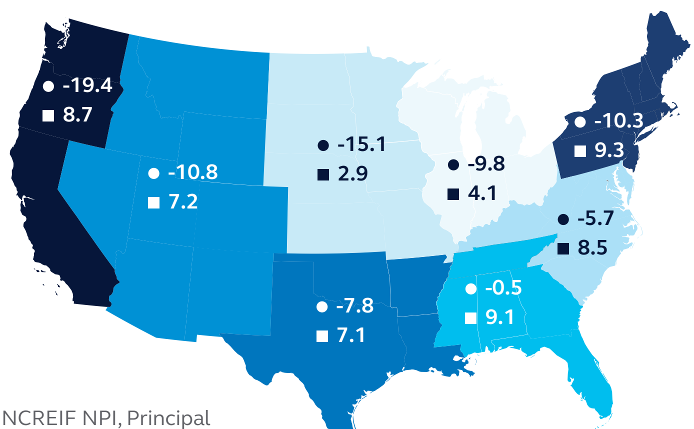
The flight-to-quality trend supports rent growth potential in newer, higher-quality assets. Small warehouses have also maintained tight vacancies, while big-box facilities saw higher vacancies due to the new supply, particularly older commodity-based assets. Smaller industrial spaces have historically performed well even in less-than-ideal cyclical environments, particularly those that are located in urban infill locations, which cater to last-mile distribution.

Manufacturing investments in the U.S. have grown considerably in recent years, primarily for manufacturing facilities that produce semiconductors, electric vehicles, and solar panels; all of which are considered strategic, high-value goods that have benefited from government subsidies. In the long term, as these manufacturing capabilities continue to grow, industrial demand will likely grow in secondary and tertiary markets where land is affordable, and labor is available.

The divergence in regional performance has become increasingly pronounced. Coastal markets, particularly in the East and West, have seen their industrial total return indices decline from their peaks in 2022. For instance, Los Angeles, the nation's largest port market, has experienced a sharp rise in availability rates—from just 1.8% post-COVID to 7% in early 2025—alongside negative net absorption and downward pressure on asking rents.

EXHIBIT 6: Regions supported by key global ports have underperformed (appreciation return %)

● **Peak to current (cumulative)**
■ **5-year annualized**



NCREIF NPI, Principal Real Estate, 1Q 2025.

Where do we go from here?

Are these short-term fundamental trends indicative of NOI growth normalizing to lower levels? The answer depends on economic growth and consumer spending patterns. With macroeconomic growth expectations revised downward narrowing the margin for error between expansion and recession, there are legitimate concerns about future demand. A significant headwind to growth stems from demographic constraints, including limited immigration and population growth to support a sustained expansion, though technological advancements, particularly artificial intelligence (AI), which is still evolving, represent potential tailwinds.

In the long term, it is difficult to assess whether structural risks associated with tariffs represent a lasting headwind for industrial demand.

The uncertainty surrounding global trade patterns seems more relevant as a consideration rather than an immediate influence on fundamentals. However, this uncertainty may temporarily pause major capital investments, especially in seaport markets. Looking to the past, Trump's initial tariffs resulted in a shift in the share of imports from U.S. trading partners, with less from Asia—due to the decline in Chinese goods—offset by higher volumes from partners such as Mexico and Europe. Changing the mix of trade partners will impact various logistics markets according to their current geographic exposure, a trend experienced since 2017, where the East and Gulf Coast gained import market share compared to the West Coast.

EXHIBIT 7: Shifts in trade flows may alter demand patterns for port markets

Goods imports $, 2024

Port	World total	China	Share of goods imported from China
Total All Ports	**3,267,388,705,988**	**438,947,386,145**	**13.43%**
Los Angeles, CA (District)	490,016,861,594	175,919,058,187	35.90%
New York City, NY (District)	377,579,571,649	38,075,522,151	10.08%
Laredo, TX (District)	287,909,237,694	2,476,029,747	0.86%
Chicago, IL (District)	277,358,071,119	57,335,115,673	20.67%
Savannah, GA (District)	179,485,872,204	23,191,006,002	12.92%
Detroit, MI (District)	158,057,662,486	6,547,542,781	4.14%
Houston-Galveston, TX (District)	125,154,272,047	17,299,170,942	13.82%
San Francisco, CA (District)	116,145,183,338	17,347,676,742	14.94%
Seattle, WA (District)	103,854,927,670	19,071,954,872	18.36%

Source: U.S. Census Bureau, Principal Real Estate, 1Q 2025.

CONCLUSION

Looking ahead, the long-term prospects for the industrial sector will depend on the interplay of these regional trends, ongoing trade policy developments, and the pace of technological change. Over the longer term, we do not subscribe to the theory that globalization is dead; rather we are in the midst of a reconfiguration of trade flows facilitated by shifts in the global supply chain.

In the near term, the U.S. industrial sector is undergoing a period of cyclical adjustment. Investors will need to focus more intently on fundamentals—such as sustainable demand drivers, access to infrastructure, and favorable business conditions—to position for future growth. While the sector's underlying strengths remain intact, the era of easy, broad-based gains is behind us.

We believe the industrial market is entering a more complex phase—one that demands a deeper understanding of global interdependence, evolving trade policy, and shifting supply chains. Continued long-term global cooperation will be essential, as both domestic and international distribution networks require realignment and investment.

For portfolio managers willing to do the work, compelling opportunities still exist—but they are increasingly found in the details, not the averages.

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