



Research Briefing: May 2009

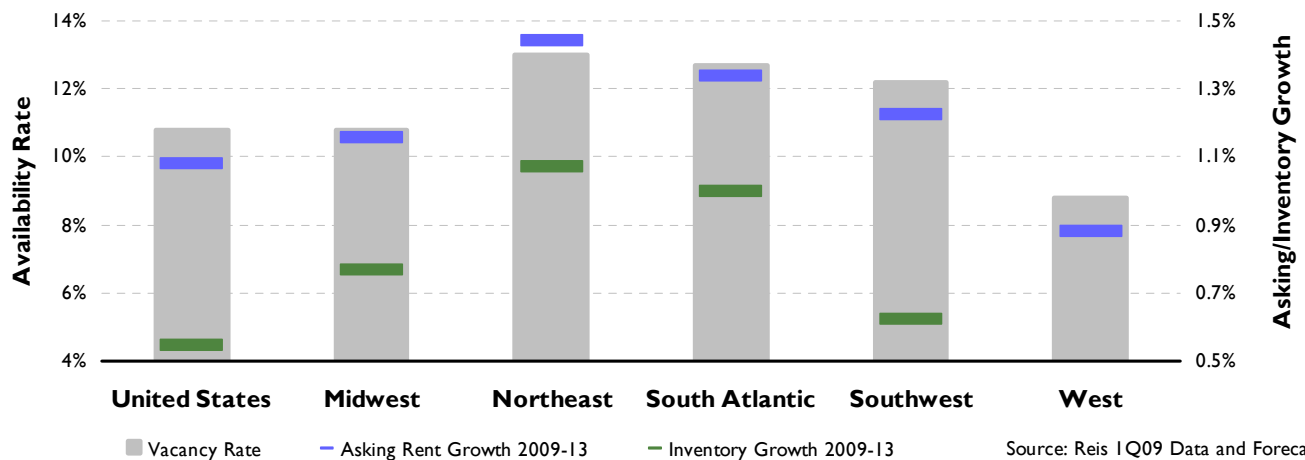
Industrial Real Estate – Evolving Strategies and a Declining Market

The US industrial real estate sector - long a bastion of real estate stability - is rapidly weakening, not only due to the economic environment, but to fundamental shifts in industrial production and distribution. Declines in consumer spending and global trade are weakening demand. More fundamentally, companies are also reducing inventories, placing a greater emphasis on transportation costs and energy consumption, and consolidating operations across lines of business. As a result, lease rates are falling and cap rates are rising, with a significant degree of regional variation. (See Figure One below.) Industrial real estate is typically a more stable investment than commercial office or retail. From 2002 until 2008, the sector had experienced strong rent growth, compressed cap rates, and relatively high investor returns.

Recession Driven Impacts National vacancy, (referred to as “availability” in the industrial sector) is 12.2%, higher than the previous historical high of 11.8% reported in 2004 by TWR. Vacancy is forecast to pass 16% in 2010. Although nominal rents have fallen only to 2006 levels, real rent is at the lowest level in the history of their database (1989). The recession has had an uneven impact across the country. The Midwest and locations in high foreclosure rate states have seen the greatest degree of change from 2007. However, there is practically no new construction coming on line or in the pipeline, so pricing is expected to stabilize by 2011, and begin to rise slowly again by 2012. Interestingly, older stock has a lower vacancy rate than new. **Properties built before 1970 boast a 9.4% vacancy rate, while those built after 2000 have a 21.4% vacancy rate**, perhaps reflecting the tendency for industrial tenants to stay put in a location for a long time.

Changing Strategies Surging oil prices in 2008 spurred companies to alter their distribution networks, such as increasing the number of smaller distribution centers close to customers and transportation. Although oil prices have dropped once again, the emphasis on energy conservation and sustainability may continue to support strategies that more heavily factor in transportation distance and methods. Manufacturers have also become much more disciplined about inventory levels. In prior recessions, inventory levels rose to damaging levels. This time, companies began cutting inventories as early as the first quarter of 2008. Better inventory management systems, mature “just in time” production systems, and increased outsourcing of logistics, all are contributing to a leaner and meaner industrial sector and a more savvy consumer of industrial real estate.

Figure One: National and Regional Differences in Vacancy and Growth



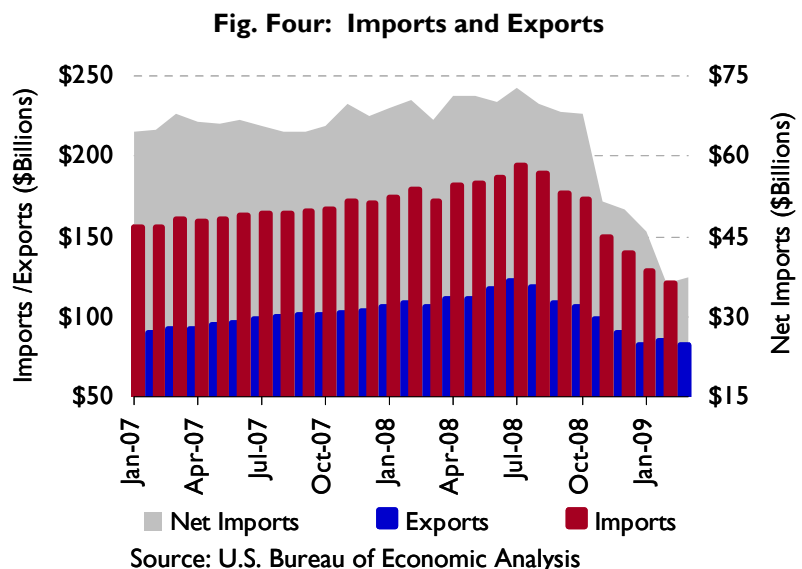
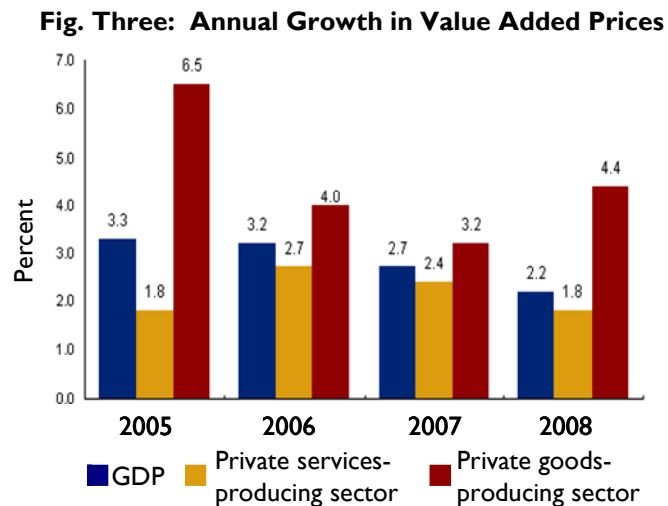
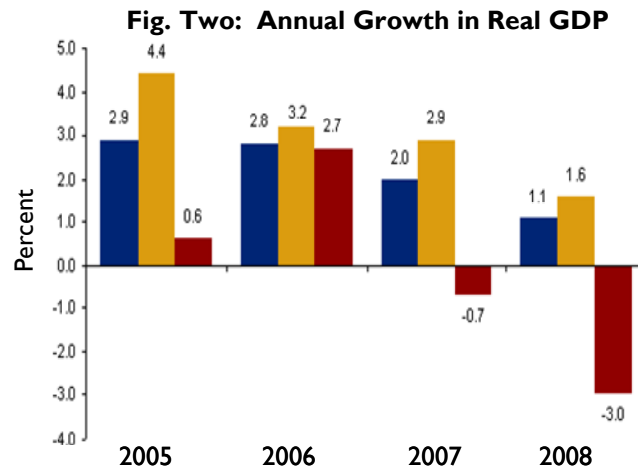
Other Pressures Mount Mature consumer goods and other industrial firms are also feeling the pressure to generate cash from real estate in order to shore up their pension funds. However with real estate lending practically nonexistent, and any potential real estate investors sitting on the sidelines waiting to swoop down on those highly anticipated “distressed assets” that are only beginning to trickle onto the market, buyers are scarce.

What’s Happening?

Manufacturing, the “goods producing” sector of the economy, is hardest hit in the recession, as consumers reign in spending (with the increase in consumer spending earlier this decade largely fueled by credit, see our December 2008 Brief).

Downturns in manufacturing, retail trade, and finance and insurance industries were the leading contributors to the slowdown in U.S. economic growth in 2008. The drop in GDP in 2008 is largely attributable to goods production decreases (Figure Two). Durable-goods manufacturing turned down for the first time since 2001, decreasing 1.3 percent. Nondurable-goods manufacturing fell 4.6 percent, after slowing to 0.4 percent in 2007. While production declined, the cost of goods sold rose in 2008, in large part due to the run up in oil prices (Figure Three).

Both import and export volume has dropped significantly (Figure Four). European countries are in at least as great a recession as the US, and strongly growing economies are growing less. (See our April 2009 Brief on international real estate markets.) The World Trade Organization predicted in March of this year that global trade would decline 9% overall this year, but early indicators are that even that projection is too optimistic. The US trade deficit is at its lowest level in nine years, as American manufacturers reduce spending on foreign made machinery and consumers pull back spending on imported products such as electronics, toys and furniture. Exports from the US declined 30% in the first quarter of 2009, and imports dropped 34%. The increasingly global chain of production means that economic contraction in one country is quickly felt in others. Japan has seen exports dropping 45% year to year amid its worst economy since 1955. Another key trading partner, Mexico, is also suffering sharp decreases in exports and overall economic activity.



Industrial Market Intelligence

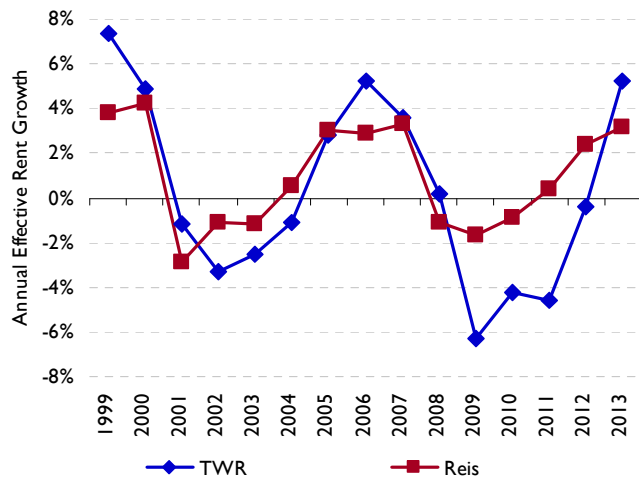
Benchmarking of industrial leases and sales is generally more difficult than office property, due to the wider variation in property characteristics. Warehouse, flex manufacturing and R&D all have different dynamics. Careful micro-market analysis of comparable properties is essential.

Both TWR and Reis provide industrial real estate market intelligence, but they do so quite differently. Both are forecasting declines in rates, but TWR foresees a greater drop (Figure Five). Using data on deals closed by CB Richard Ellis, and CoStar data for asking rents, TWR tracks and reports at the submarket level historical asking rents, availability, and absorption for three subtypes: manufacturing, warehouse, and R&D. They also provide a historical and current breakdown of the property types by age and size. Industrial rents are forecasted as a blend of all three property subtypes. Reis surveys owners/managers to collect data. Market coverage also varies.

	TWR	Reis
primary markets	62	79
submarkets	612	no
secondary/tertiary markets	56	93

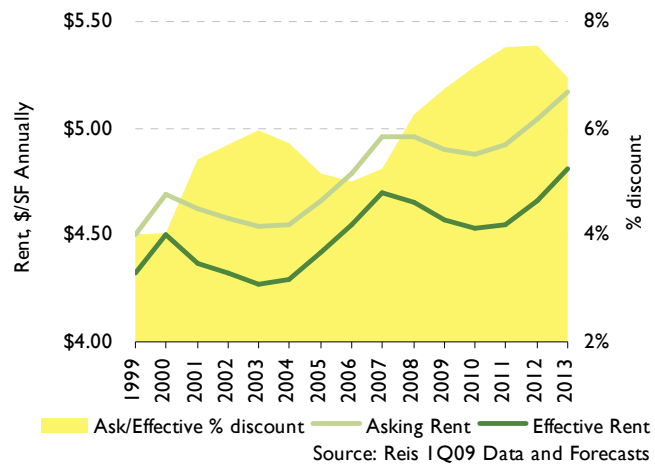
REIS data is collected and forecasted at the metro level, and is used in Deal Zones by CPA as a reality check on the TWR data. Reports from brokerage houses are also reviewed as appropriate.

Fig. Five: Annual Industrial Rent Growth



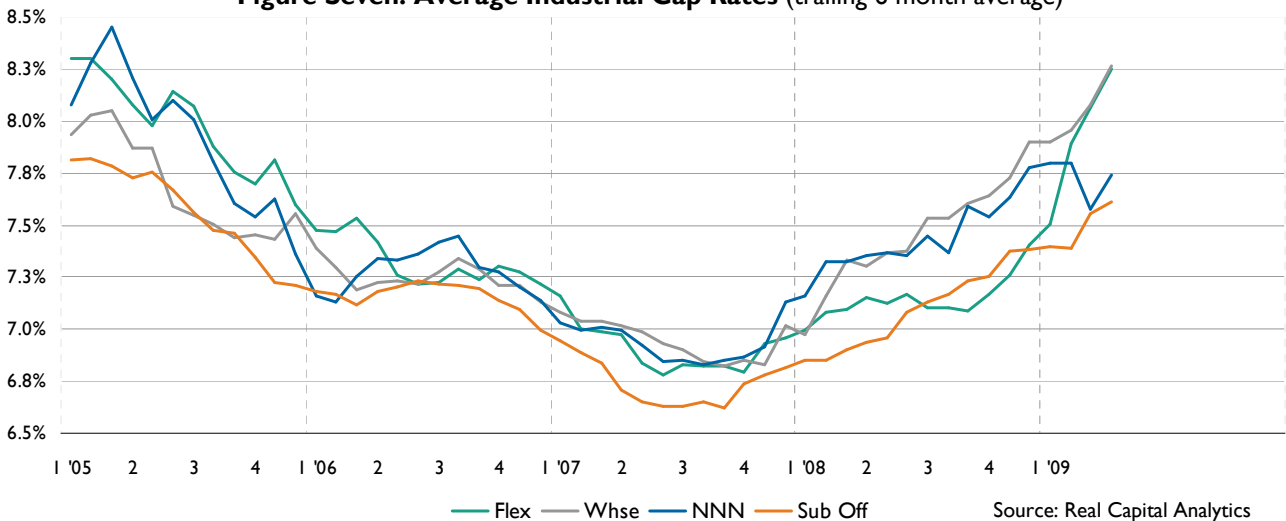
Source: TWR and Reis IQ09 Data and Forecasts

Fig. Six: National Industrial Asking – Effective Rent Discount



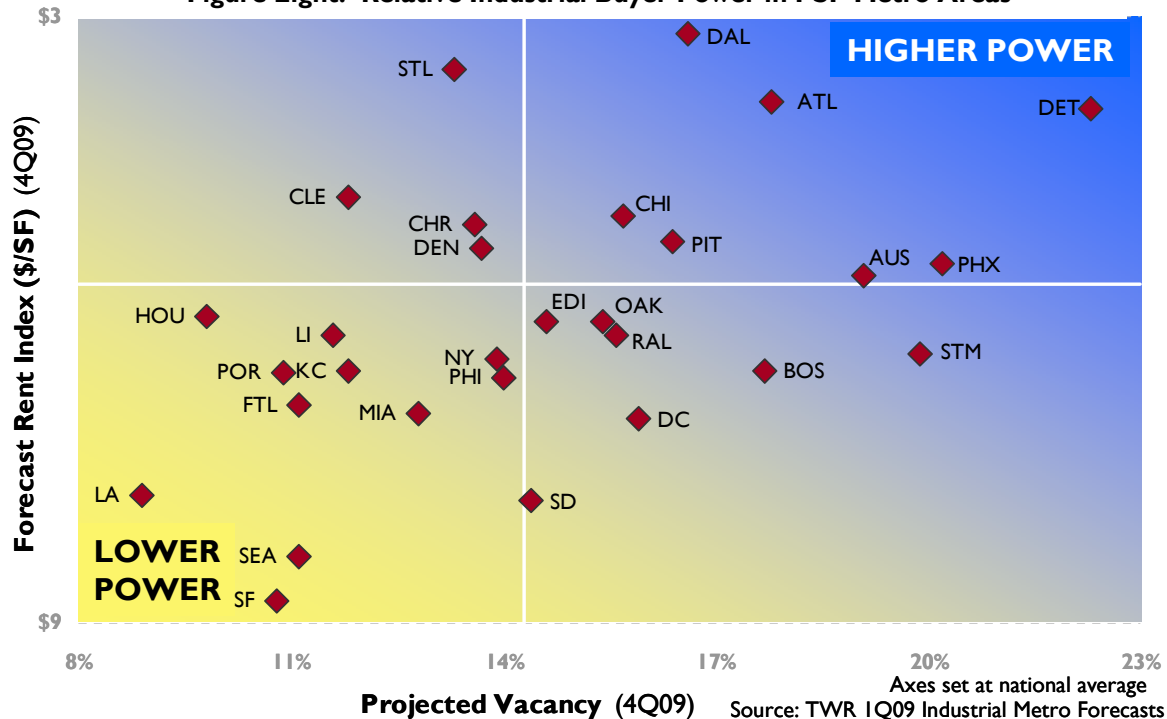
Source: Reis IQ09 Data and Forecasts

Figure Seven: Average Industrial Cap Rates (trailing 6 month average)



Source: Real Capital Analytics

Figure Eight: Relative Industrial Buyer Power in PSP Metro Areas



Opportunities for Corporate Real Estate Occupiers

In contrast to the office market, where decreasing rents are offering substantial opportunities to lower operating costs for corporations, it is more difficult to translate weakness in the industrial sector to short-term operating cost savings. Given that many industrial locations have been heavily improved by their tenants, and that rent differentials are less in a real dollar basis, even in a declining market, the threat of relocation is harder to enforce. Tenants who have built out office spaces in industrial properties are at the greatest disadvantage. Since the spread between asking and effective rents have never been greater, as shown in Figure Six, **aggressive bargaining is still appropriate.**

It is a great time to buy, and a terrible time to sell. Essentially, the entire ProLogis portfolio, often state-of-the-art properties, is on the market. Cap rate and sales data from Real Capital Analytics show that warehouse and flex space pricing are back to more sustainable 2005 levels (see Figure Seven). Although fewer industrial properties are expected to become distressed compared to other sectors, selected purchases of long-term core locations may prove attractive to corporate occupiers. Buyer Power is high across many markets (Figure Eight). Further, the industrial sector is expected to recover more robustly than the office sector, due to constraints on new supply.

The hunt for operating cost savings is driving some **diversified manufacturing companies to look for real estate synergies across lines of business** that may have been politically difficult to achieve previously. As manufacturing and distribution companies rethink their logistics and value chain activities, and more heavily weigh transportation costs, carbon impact and other sustainability measures, the greater availability of recently built industrial space will give occupiers **the opportunity to upgrade to more efficiently designed and better located facilities.**

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For further information please contact:

Martha A O'Mara PhD, CRE martha@cpanalytics.com

Glenn L. Burdick glenn@cpanalytics.com

C O R P O R A T E ■ P O R T F O L I O ■ A N A L Y T I C S

**100 Franklin Street
Boston, Massachusetts 02110**

**617.938.6460
www.cpanalytics.com**