Marcus & Millichap
NATIONAL OFFICE AND INDUSTRIAL PROPERTIES GROUP

MARKET UPDATE

Fall 2005

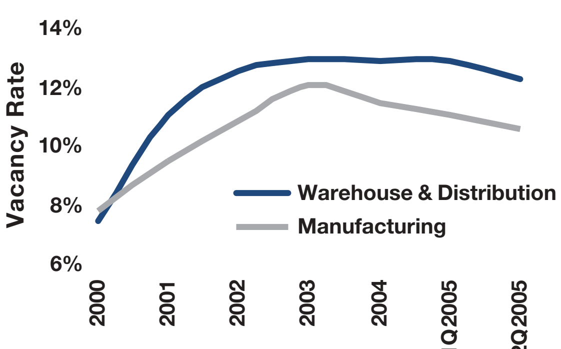
# Manufacturing: The Understated Opportunity

After a three-year downturn, the industrial market began to rebound in 2004 and is showing significant improvement this year. The vacancy rate dropped to 9.7 percent at the end of the first quarter of 2005 and had dropped an additional 30 basis points by midyear. While many investors have focused on the success of the warehouse/distribution sector, especially in port cities, the manufacturing sector has actually outperformed warehouse/distribution properties over the last year and offers tremendous near-term investment opportunities.

The economic boom of the 1990s led to a dramatic increase in imported goods, and the need for warehousing and distribution of these goods became the focal point of the industrial market. Consequently, completions in the warehouse/distribution sector reached a historical high in the 1990s. Through 2005, however, developers of warehouse/distribution space are on track to exceed the previous peak by 12 percent. In contrast, only 139 million square feet of manufacturing space was delivered to the market during the 1990s, representing the lowest decade total since the 1950s.

Both the manufacturing and warehouse/distribution sectors recorded significant increases in vacancy during the most recent economic downturn as illustrated below. Vacancy rates in the warehouse/distribution and manufacturing sectors peaked at 13.5 percent and 12.5 percent, respectively, during the first half

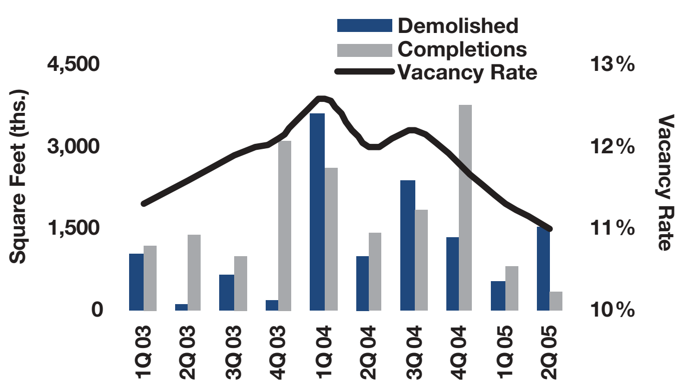
**Industrial Sector Vacancy Rates**




of 2004. Strong demand for manufactured products both at home and internationally has pushed demand beyond capacity, forcing manufacturers to expand their operations and increase their space needs. This has pushed occupancies higher with manufacturing vacancy falling 180 basis points off its peak, compared to a 120 basis point drop in the warehouse/ distribution sector.

In addition to an increase in overall demand, the manufacturing sector has also benefited by only a small net increase in total space. Manufacturing completions have exceeded demolitions by only 300,000 square feet since 2004, while completions in the warehouse/distribution sector have been more than 10 times greater than demolitions in the sector over the same period. Many aging manufacturing properties are being razed due to obsolescence. In general, these properties are being replaced with other types of developments, such as

**Manufacturing Properties**



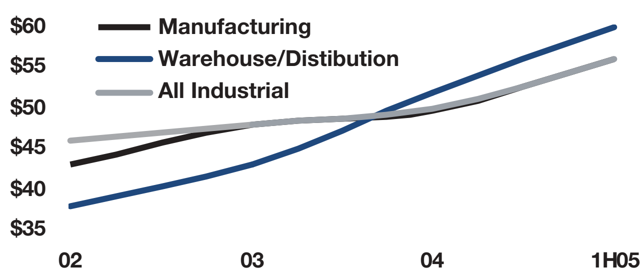

condominiums or shopping centers. This trend is likely to continue as nearly 68 percent of all manufacturing properties were built prior to 1980, with 30 percent of the total stock constructed prior to 1960.

In addition to limited new supply, leasing activity in the manufacturing sector has increased tremendously, especially for large spaces. Since the beginning of 2005, well over 2 million square feet of new leases (not renewals) have been signed for manufacturing space. While these numbers pale in comparison to warehouse/distribution leasing activity, they are substantial in relation to the size of the manufacturing sector and demonstrate growing strength within this product segment.

### Market Performance

Performances in the Midwest, the heart of American manufacturing, have been mixed. After a temporary rebound in 2004, vacancy in Chicago and Cleveland has gradually increased. Conversely, Indianapolis, Columbus and Detroit have registered strong rates of absorption over the last year. Manufacturing vacancy in Detroit declined 230 basis points to 17.8 percent from second quarter 2004 to second quarter 2005, while vacancy in Indianapolis and Columbus dipped 100 and 320 basis points to 11.2 percent and 14.6 percent, respectively, over the same period. The success of these Midwest markets has been eclipsed by news of improvement in tech-heavy markets such as Austin, San Francisco, Seattle and Denver, where increased demand for high-tech goods has fueled substantial gains in the manufacturing sector. Phoenix may soon join this group, as the recent announcement by Intel of a $2 billion overhaul and expansion of a chip plant may reinvigorate a market that has seen a sluggish recovery. Although small in scale, South Florida's manufacturing base is extremely strong and has recorded the strongest improvement in occupancy over the past 18 months. With the passage of CAFTA, more manufacturers may locate operations in South Florida, boosting already substantial demand for manufacturing facilities.

**Median Price per Square Foot**




### Investment Market

The disconnect between the manufacturing sector's success and investor attraction is most pronounced when reviewing sales statistics. Since 2003, the total industrial market recorded a 22 percent rise in the median price per square foot, reaching $59 as of midyear 2005. During the same period, the median sales price in the warehouse/distribution sector increased 39 percent, rising from $43 to $60 per square foot. Manufacturing properties managed a relatively scant 16 percent gain over the same period, from $48 to $56 per square foot.

Although prices for manufacturing facilities have registered limited growth, the number of transactions in the sector has increased significantly. Based on 1H2005 transactions, manufacturing velocity in 2005 will be 10 percent higher than 2004 and over 110 percent higher than velocity in 2003. Comparatively, the warehouse/distribution sector will see 13 percent growth over 2004 and 42 percent over 2003. Relatively limited price growth in the manufacturing sector cannot be attributed to limited demand, but rather the near absence of competition from institutions and foreign investors, often the most aggressive buyers. Of the 1,290 manufacturing transactions recorded over the past 18 months, only a handful of REITs and institutions purchased three or more manufacturing properties. Foreign buyers are choosing to act as passive joint venture partners in these transactions as opposed to direct purchasers. Even with the growing sale/leaseback market, the manufacturing investment market remains dominated by corporations, which account for almost 50 percent of all purchases. The remainder of the market is shared by local and national private buyers and a small, but growing segment belonging to opportunity and value-added funds. Higher margins have attracted add-value funds such as TA Associates, Rexford, Layton-Belling and Walton Street Capital to the manufacturing sector; all of which have made substantial purchases of manufacturing facilities over the last 18 months. Private owners, however, remain the driving force in the market and are beginning to realize the opportunity for profit with the increased attention in the market.

### Summary Points

- In several categories, manufacturing properties have outperformed warehouse/distribution properties and the overall industrial sector in the current recovery.
- While demand for manufacturing space is on the rise, limited construction and the demolition/conversion of outdated facilities have kept inventory levels virtually static.
- The most substantial annual absorption growth rates, over the next 12 to 18 months, will be experienced in tech-heavy markets, which will achieve growth of 5 percent and higher, while select manufacturing hubs in the Rust Belt will experience growth rates of 2 to 3 percent.
- Sale/leasebacks are a growing portion of the investment market, providing local and national manufacturers access to the capital necessary to expand operations. Sale/leasebacks often provide stable 8 percent to 10 percent yields on manufacturing properties.
- Institutions make up only a fraction of the manufacturing ownership. As a result of limited competition from this buyer pool, price growth of manufacturing properties has trailed the warehouse/distribution sector in spite of stronger fundamentals.
- Opportunistic buyers are expanding their holdings of manufacturing properties. This will continue to spur increased transactional activity in this product segment.



Alan L. Pontius, National Director / (650) 494-8900 / apontius@marcusmillichap.com • Yitzie Sommer, Research Manager / (201) 582-1000 / ysommer@marcusmillichap.com