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The future looks bright for manufacturing - by William Kane

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Having been a commercial real estate appraiser for over 40 years, I've experienced numerous market corrections and the impacts of various governmental agencies' changing fiscal and economic policies. For many years, I focused on the valuation of retail real estate, and I can recall delivering a speech to about 400 attendees of a UConn conference explaining the potential impact of the burgeoning online retail market on the existing supply of retail real estate. At the time, online sales were getting off the ground. However, it was clear that the combination of the average annual online sales and the forecast growth of online shopping would first have an adverse impact on the development of retail real estate by slowing the expansion in this market. But then, in the not-so-distant future, online sales would begin to displace existing retail real estate causing both closures, demolition, or repositioning of many open and enclosed shopping centers throughout the country. This early trend and the ominous impact on retail real estate has in fact, come to fruition.

Another more recent systemic trend is the impact of the work-from-home model. Whether it is full-time remote work or a hybrid of working in the office and at home, there has clearly been an adverse impact on office vacancies throughout the country. Even though, in some instances, companies are starting to bring employees back to the office, the trend of being able to work from home does make economic sense for some specific functions of most companies. Further, it is reasonable to expect that Artificial Intelligence (AI) will bolster the trend of reducing the need for large blocks of office space as computers can fulfill some of the job roles of office workers, much like robotics reduced the demand for manufacturing workers. Given the relatively long-term nature of office leases, especially for large blocks of space, the impacts on the market will be felt for years. Many institutions that formerly funded the acquisition of office real estate have either closed their doors to new office lending or they have made loan requirements so daunting that most borrowers will balk at the potential deals, until they have no other option but to accept them or give back the keys. The future for this market segment looks rather bleak, and it is reasonable to expect more demolitions and repurposing of those office buildings that provide for functional floor plates for alternative uses, such as apartments or hotels.

As with most markets, there are always winners and losers. Right now, the most challenging market segments are the retail and general-purpose office segments. However, on the bright side, there appears to be a resurgence in the industrial market. While improvement in the warehousing sector has been experienced over the past decade, given the explosion of online shopping, there also appears to be a resurgence (or at least a bump in demand) in the manufacturing sector. The catalyst for this uptick in domestic demand in the manufacturing sector was the Covid-19 pandemic. It became painfully clear that the impact of the pandemic, aside from the horrific human toll, was the cracks in the supply chain, especially with imports. With the potential for more global health concerns and the high-tension geopolitical environment, there appears to be a resurgence in the need for more domestic production in the United States.

According to the Federal Reserve Economic Data, manufacturing employment peaked in July 1979 at 19,531,000 persons. With pressure to continue to provide less expensive manufactured goods, governmental agencies opened up foreign trade in this sector as wages in many developing countries were a fraction of those in the United States. With the outsourcing of manufacturing and the establishment of robotics in manufacturing, there has been a continued trend of diminishing manufacturing employment in the country. By April 2020, manufacturing employment hit its nadar at 11,414,000 persons, a decline of over 41.5% and displacing over 8.1 million jobs. However, due to the pandemic, which froze imports, manufacturing employment increased. By November 2023, manufacturing employment increased to 12,985,000 persons, a growth of 13.7% since April 2020.

According to the Federal Reserve's Industrial Production Index, this index has grown from 100 in 2013 to 102.67 by November 2023. While this is a short-term trend with vacillation, the most recent trend since the pandemic has been very positive, increasing from a nadar of 85 in April 2020. While there have been higher and lower peaks and troughs over the past 30 years, the overall trend in industrial production has been positive, increasing from an index of 66 in November 1993 to the current rate of 102.67.

To convert the trends in manufacturing employment and industrial production to impacts on the real estate markets, we have used analytical data published by Costar. According to Costar, Connecticut has a total inventory of 8,572 industrial buildings of all classifications. This encompasses a total supply of 297 million s/f of industrial space. As of the fourth quarter of 2023, vacancy, following a clear trend of decline since 2014, stood at 4.45% or 13.2 million s/f of space. Vacancy, as of the first quarter of 2014, stood at 8.85%. However, the current vacancy rate represents a 12-month high over the average 12-month vacancy of 3.78%, which indicates a short-term increase in the vacancy rate overall.

The growth in market rents continues to accelerate but at a declining rate. In the fourth quarter of 2023, the annualized growth in rents was stated at 6%. Over the past four quarters, the rate of growth ranged between 6.0% and 9.4%, with an overall average annual growth rate of 8.1%. So clearly, there is significant demand to force rents to be higher. However, Costar forecasts the yearly average growth rate to decline over the next five years to a pace of between 3% and 4% annually.

The average annual market rent as of the fourth quarter of 2023 was reported at $9.40 per s/f. This is up considerably from a low of $5.58 recorded in the first quarter of 2013. Since the first quarter of 2013, rents have been increasing at an accelerated rate through the first quarter of 2023, after which the rate continued to increase but at a decreasing rate. It is anticipated that the average market rent will increase to just over $11.00 per s/f over the next five years.

In terms of sales volumes and pricing trends, despite a dip in the volume of transactions in the state in the past quarter (primarily due to the effect of rising interest rates), the trends have been very positive since 2013, with a surge in unit prices and volume of transactions since the second quarter of 2020. Costar reports that in the second quarter of 2020, the sales volume was $56.6 million, with an average unit price of $56 per s/f. By the third quarter of 2023, the sale volume had increased to $220.8 million, with an average unit price of $73 per s/f. Costar has forecast the average unit price to increase over the next five years to $95.00.

It is likely that the potential growth in the supply of industrial space will be hindered in the short term by high-interest rates. However, with recent indications that the Fed may ease up on rates in 2024, there may be a moderate increase in construction in the next few years.

So, while there may be difficulties in the office and retail sectors, the bright spot for commercial real estate may be in the industrial manufacturing sector.

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