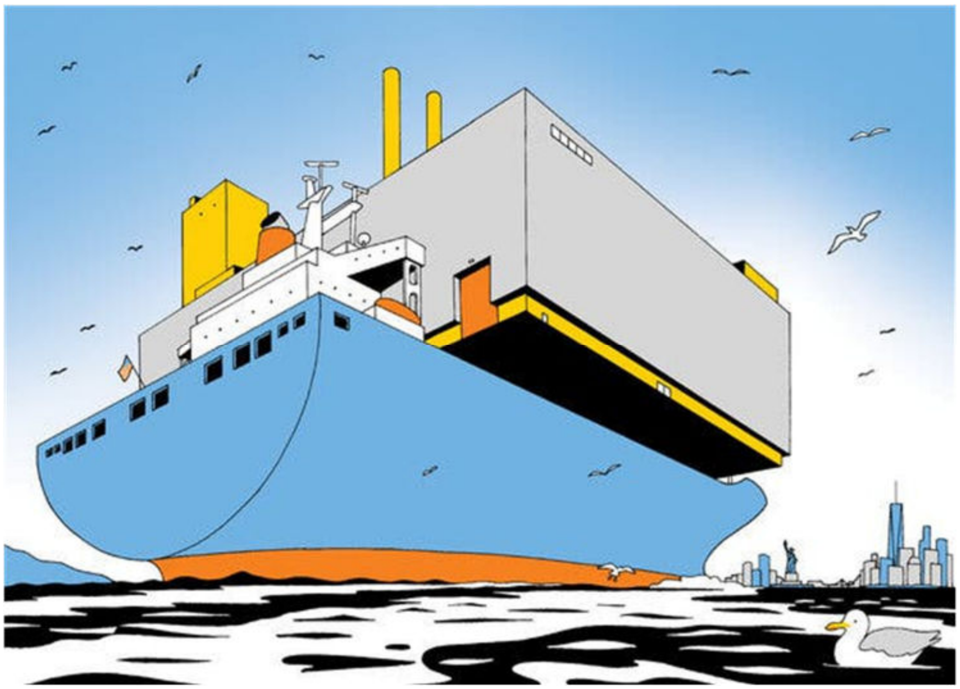
Macro Outlook for Advanced Manufacturing and R&D Industrial Real Estate in Urban Locations



Urban industrial demand returns to the US.

Todd Gooding
President and Principal
ScanlanKemperBard Companies

Dr. Randall Zisler
Chairman
Outsourced Research by Zisler Capital Associates, LLC

Prepared for ScanlanKemperBard Companies

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What is manufacturing and R&D industrial property? Manufacturing and R&D industrial property includes mixed use industrial space with a small portion of creative office and a larger "high bay" area to test, research, assemble, produce, distribute and manufacture tenants' goods and products. Their tenants produce advanced robotics, electronics, programming, artificial intelligence, craft manufacturing, media productions, metal or woodworking, light manufacturing, production design, agriculture and food tech and life science. ScanlanKemperBard Companies focuses on **these** manufacturing and R&D properties that are located near a highly trained labor force.

The workers for these tenants are well-educated, highly skilled, and generally are provided with efficiency-enhancing tools that include artificial intelligence, automation, and digitalization, all of which are transforming the nature of work, the traditional role of manufacturing, and the quality human capital. If efficiency-enhanced labor is one input in the production process, the right kind of industrial property is another critical input. The combination of these factors means that firms can maximize profits by finding the right proportions of labor, machines, and industrial space. This increases the effectiveness of the workforce and more efficient use of the capital and manufacturing space per worker. These new efficiencies reduce the need for manufacturing outside the U.S., and increase the competitiveness of the domestic industrial sector. Other drivers include the avoidance of supply chain disruptions and complexity, which affect directly or indirectly all forms of manufacturing. As domestic manufacturing progresses, the sector will reassert the importance of close proximity of manufacturers and their employees. Accordingly, most tenants prefer locations within proximity to large, well trained labor pools, supported by institutions of higher learning, and we expect this preference to strengthen.

Why will manufacturing and R&D properties prosper? Employment growth is strong, and this strength is correlated with increasing excess demand for manufacturing labor and manufacturing space. The growth rate of total industrial demand for industrial space currently outstrips the growth of inventory, as shown in Exhibit 1. Consequently, rents and values continue to strengthen. The pricing pressure on all types of industrial space, real estate will benefit net operating income and prices of urban industrial real estate. Total returns are rising accordingly, as noted in Exhibit 2.

Supply chain issues. COVID is not the cause of supply chain problems; it exposed long-festering structural weaknesses and accelerated in-process changes. The recovery has exposed vulnerabilities. The supply chain is under pressure due to global and domestic pressures, which is good news for the domestic manufacturing and R&D industrial market. Existing supply chains are efficient, but brittle, lacking resiliency: A failure in one part of the link can reverberate globally. The chain lacks shock absorbers, so when the global economy hits speed bumps, the shocks hurt the growth engine. Many firms over the last two decades outsourced major pieces of their business. The rate of this outsourcing will slow and possibly reverse. This trend should benefit US manufacturing and industrial real estate. Supply chains need buffers, redundancy, and more built-in optionality, a role which urban industrial real estate can successfully address. Firms are reasserting greater control of their supply chain. We observe a movement from "just-in-time" to "just-in-case". The "just-in-time" model depends upon the smooth and predictable flow of goods. Firms have recently discovered that this flow can be volatile and unpredictable. Domestic manufacturing and supply can reduce this volatility and the new evolving efficiencies should control the additional costs associated with manufacturing in the U.S.

The right kind of manufacturing facilities will help offset rising costs due to reshoring. Sufficient capital investment, higher labor productivity, scale economies and well-located property, will likely moderate product price increases. Reshoring, an option or insurance policy, will fortify urban industrial real estate against rising supply chain pressures. (See Exhibit 3.)

Why manufacture and supply domestically? Here are some reasons: (1) Reduce supply chain disruption; (2) Address intellectual property concerns; (3) Respond to the "Made in USA" ethos: It's good politics; (4) Better manage quality concerns; (5) Reduce communication barriers; and (6) Better manage rising costs due to bad public policy that includes tariffs, shipping costs, taxes, regulation, and immigration restrictions.

Exhibit 1. Demand exceeds supply and is growing much faster than the industrial supply

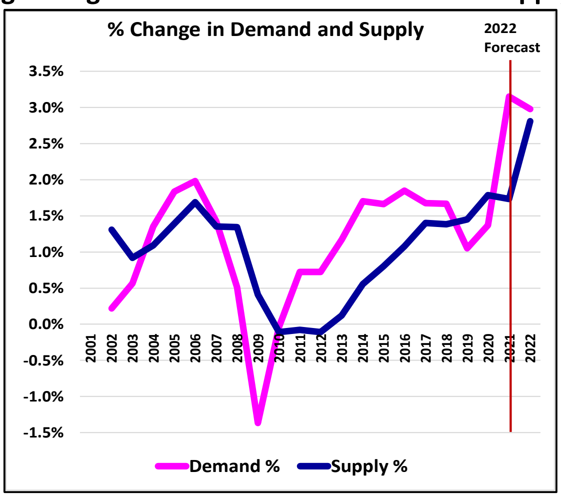
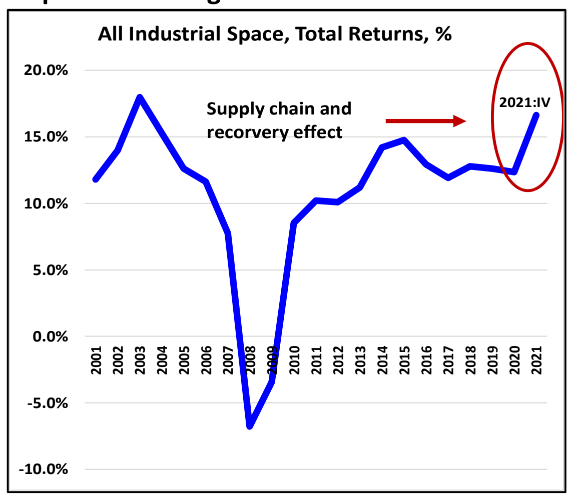
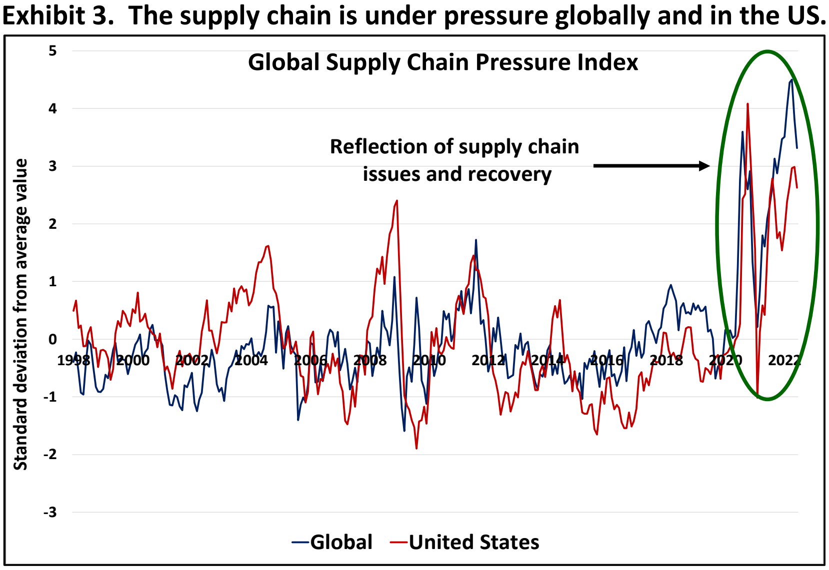


Exhibit 2. Total industrial returns are rising in response to rising excess demand.



Source: COSTAR; NCREIF

Exhibit 3. The supply chain is under pressure globally and in the US.



Source: Federal Reserve Bank of New York

Implications for urban industrial space and returns. The recent heady performance of industrial property is not a bubble. The underlying fundamentals are strong, the outlook is encouraging, and total returns will likely continue rising.

It's returning!

Todd Gooding
President and Principal
ScanlanKemperBard Companies
503-552-3562
tgooding@skbcos.com

Dr. Randall Zisler
Chairman
Zisler Capital Associates, LLC
310-560-1192
rzisler@zislercapital.com