NORTHMARQ

Twin Cities Office Market Delivers Solid First-Half Performance

First-half results in the Twin Cities office market showed improvement, particularly in increased activity levels in most submarkets. The first six months of the year have set the stage for what appears to be a long, slow recovery as the market begins to respond to tepid gains in employment.

The market is showing early signs of recovery, as evidenced by a slight decline in the market-wide vacancy rate to 19.2%, down from 19.9% at year-end 2010.

The first half's 324,000 sq. ft. of positive absorption plus the projected 950,000 sq. ft. of positive absorption in the next six months (due mostly to leases that have already been signed and will commence later this year) is certainly a welcome sight for the office market.

While this amount of absorption is notable against a backdrop of negative absorption over the past three years, it is important to understand that this will only decrease the vacancy rate to 18.1%.

Landlords in Class A buildings are seeing the most benefit in the current market. Class A properties posted 508,895 sq. ft. of positive absorption in the first half, while there was 173,000 sq. ft. of negative absorption in Class C properties and 12,000 sq. ft. of negative absorption in the Class B market.

CLASS A PROPERTIES INCREASING OCCUPANCY

Occupancy levels are running at 90-95% in Class A buildings along the Nicollet Mall corridor in the Minneapolis Central Business District (CBD). Only a handful of larger blocks of space remain in the corridor's towers. The CBD's overall vacancy rate is 18.9%, but the table is set for a strong second-half performance, including a projected 500,000 sq. ft. of positive absorption due to several leases that have already been signed. The CBD could see a sub-10% vacancy rate for all of its Class A space by year end.

Class A space is also in tight supply in the West submarket's two central business hubs, the West End and the I-394/I-494 quadrant. Occupancy levels are near 93% in the Class A hub buildings. The West submarket could also see a sub-10% overall Class A vacancy rate by year end, down from the current 11.4%.

It is important to note that neither the Minneapolis CBD nor the West submarket had any speculative new development in the last real estate cycle and, therefore, didn't experience the high vacancy levels of some other markets. Both submarkets have experienced absorption levels similar to the other submarkets.

SOUTHWEST ALSO ON UPSWING

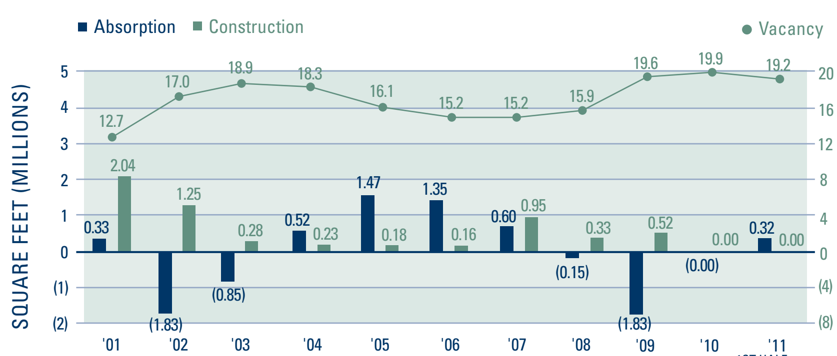
The Southwest submarket recorded 242,000 sq. ft. of positive first-half absorption and could see another 250,000 sq. ft. of positive absorption in the second half. Overall vacancy declined from the year-end mark of 20.8%, but still remains a hefty 18.5%. It's a deal-maker's market as space users look to take advantage of the soft leasing environment. Aggressive landlords are succeeding in closing deals, and concessions are still very much in the mix.

MORE ONLINE

Detailed information by submarket, including:

- Vacancy
- Absorption
- Rental rates
- Transaction activity
- Projections for the second half

OFFICE ABSORPTION, CONSTRUCTION AND VACANCY



Source: NorthMarq

OFFICE VACANCY AND ABSORPTION

SUBMARKET	TOTAL # OF BUILDINGS	NRA	VACANT SPACE	PERCENT VACANT	PERCENT VACANT W/ SUBLEASE	2ND HALF 2010 ABSORPTION	1ST HALF 2011 ABSORPTION	LAST 12 MONTHS ABSORPTION
Minneapolis CBD	109	26,855,459	5,071,408	18.9%	22.0%	201,760	(80,141)	121,619
Northeast	120	7,683,586	1,595,656	20.8%	21.7%	20,119	78,631	98,750
Northwest	36	2,364,711	714,634	30.2%	31.8%	(132,942)	6,762	(126,180)
South/Airport	79	5,580,573	1,050,765	18.8%	19.8%	158,403	(4,904)	153,499
Southwest	146	14,281,085	2,635,896	18.5%	21.7%	(21,750)	264,316	242,566
St. Paul CBD	44	6,895,206	1,641,638	23.8%	25.1%	(72,217)	(54,764)	(126,981)
West	97	8,794,422	1,227,772	14.0%	17.7%	48,888	114,117	163,005
TOTAL MARKET	**631**	**72,455,042**	**13,937,769**	**19.2%**	**21.8%**	**202,261**	**324,017**	**526,278**

Source: NorthMarq

NORTHEAST SUBMARKET BURSTING WITH BIG BLOCKS OF SPACE

Multi-tenant office landlords in the Northeast are besieged with competition from both the single-user office market and the office showroom segment of the industrial market. Several of the submarket's larger blocks of space—14 in all that are 50,000 sq. ft. or larger—are in single-user office buildings. Despite an increase in activity, the submarket's overall vacancy rate remained flat at 20.8%. The hyper-competitive environment is keeping net effective rental rates under continued downward pressure.

SMALLER DEALS DRIVING ACTIVITY IN EAST METRO

The St. Paul CBD posted negative absorption of 55,000 sq. ft. in the first half, but activity levels are on the upswing, especially among smaller space users in the market for 2,000-8,000 sq. ft. of space. Most of the submarket's larger space users have settled into new space or renewed at existing locations.

Landlords in the Northeast submarket have welcomed the increase in activity that lead to 79,000 sq. ft. of positive absorption. However, with the vacancy rate still above 20%, rental rates remain soft. Stiff competition from the single-story office showroom segment of the industrial market is also squeezing rates.

Corporate relocations are taking a toll on the landlords in the South / Airport submarket. Activity among smaller space users wasn't enough to push down the vacancy rate—it's stagnant at 18.8%.

ON THE HORIZON

Rental rates remain under downward pressure in much of the market. The average quoted rental rate for multi-tenant office space market-wide is $12.28 per square foot. Space users are readily able to secure large concession packages from landlords, such as free rent and generous tenant improvement allowances. The market for Class B and C properties is still hyper-competitive, with aggressive deal-making expected to be the norm for some time to come.

No new multi-tenant product is under construction, nor is any new product scheduled to be delivered this year—or even next year. The market still has an abundance of existing space to absorb, and demand—while improving—is still spotty and uneven.

Second-half projections are for 950,000 sq. ft. of positive absorption and a reduction in overall vacancy. The Minneapolis CBD is expected to lead the way, with 500,000 sq. ft. of positive absorption, followed by a 250,000-sq.-ft. contribution from the Southwest submarket. Each of the remaining five submarkets projects positive absorption in the range of 50,000-100,000 sq. ft.

The absorption projections include a significant number of situations where tenants have already committed to leases, and the absorption will register when they take occupancy.

Forward momentum may slacken again in the first half of 2012, especially if the pace of recovery in the job market remains tepid. Also on the horizon is the looming question over government cutbacks at all levels—municipal, state and federal—and their ultimate impact on the multi-tenant space market. The St. Paul CBD in particular is vulnerable to a reduction in government space demand, since government space users account for about one-third of the total occupied space in the submarket. ■