Institutional Real Estate Investors Zeroing in on Twin Cities Commercial Real Estate Market

Buyers are taking a more optimistic approach to the Twin Cities commercial real estate market with more capital currently available than at any time since the market last peaked in 2006-2007.

There is more interest from investors outside the market as investor attention shifts from major coastal markets to second-tier markets such as the Twin Cities in search of both yield and deals. The Twin Cities is also receiving favorable notice from third-party investment advisors who see the local market as undervalued, based on projected growth in demand and rental rates for multi-tenant space.

Steady economic growth is driving a modest rebound in space demand in the Twin Cities retail, office and industrial markets, while the underappreciated multi-family market is experiencing a sharp spike in demand from renters and investors alike.

Underwriting is as aggressive for quality retail properties today as it was during the peak years, and buyers are also closing the expectation gap with sellers of quality assets in the office, industrial and multi-family markets.

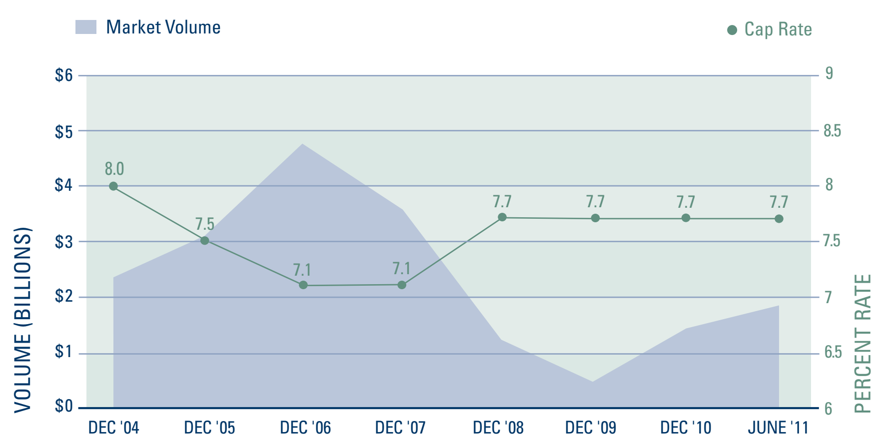
Large national buyers and regional players are mostly interested in the highest-quality assets in each property class—grocery-anchored retail, high-end apartment projects, bulk warehouse industrial and stabilized Class A office buildings.

Caution continues to prevail in the capital markets. Lenders remain highly selective in terms of what types of properties they will finance—higher-quality only, for the most part—although there are some signs that they are starting to expand their "strike zone." The shortage of available properties is putting downward pressure on investors' equity returns. Valuations on lesser-quality properties are still in flux. Liquidity is trickling back into the capital markets.

OFFICE SECTOR GAINING SOME BELIEVERS

Sales activity in the Minneapolis CBD is picking up steam, with buyers anticipating a near-term recovery in demand that will enable landlords to regain their ability to raise rates in the next few years. The same thing can be said for the major suburban submarkets, such as the Southwest and West, both of which are in the beginning stages of a recovery in the space markets. Buyers are generally pricing in a 100-basis-point premium on quality assets in the Minneapolis CBD over comparable suburban office properties. The good-quality product in the Minneapolis CBD is being priced on a 7-8% cap rate basis, while similar suburban properties are trading with an 8-9% cap rate. With strong term and credit, the best assets may trade at lower cap rates.

SALES VOLUME AND CAPITALIZATION RATES
Twin Cities Office, Retail, Industrial and Multi-Family Properties



Source: Real Capital Analytics, Inc.

MORE ONLINE

- Investor interest heating up for all types of properties
- Buy or build? Institutional investors may do both in tight multi-family market
- Office building sales may total 10% of Minneapolis CBD this year

NEW LEASE ON LIFE FOR MULTI-FAMILY MARKET

Rental rates are now on par with those of mortgages in the Twin Cities, causing home ownership rates to slip and the apartment vacancy rate to decline to just 3.1%. The market now finds itself facing a shortage of for-rent multi-family housing, and investors are paying attention. Interest in the Twin Cities multi-family market is accelerating. Institutional investors such as pension fund advisors and REITs with deep pockets are driving up demand for the better-quality Class A and B product. But local and regional private investors, sometimes in a joint-venture partnership with institutional players, are also stepping back into the picture. Sellers of institutional multi-family product are meeting market demand, as evidenced by the increased velocity of transactions in the past six months. A new development cycle is underway, with developers planning to add 800 new apartment units to the market this year.

INDUSTRIAL MARKET HEATING UP

Investor demand for core and core-plus industrial product is heating up, in tandem with the renewed emphasis by national investors on Twin Cities commercial real estate. Bulk warehouse properties remain the top choice for investors, while distressed assets are also attracting buyer attention.

INVESTOR INTEREST IN RETAIL STILL TOP-HEAVY

On the retail side, grocery-anchored centers are still at the top of the food chain for buyers. A handful of such properties hit the market in the first half. Pricing is back to pre-recession levels for the highest-quality, grocery-anchored properties, the supply of which is limited to about 12-15 centers in the Twin Cities.

ON THE HORIZON

Aggressive demand for high-quality assets will likely spur an increase in commercial real estate activity in the second half, with much of the focus on multi-family and office properties—property types that appear to have the most active base of sellers.

Large national investors will drive much of the demand. All indications are that they have additional need for quality real estate in their portfolios.

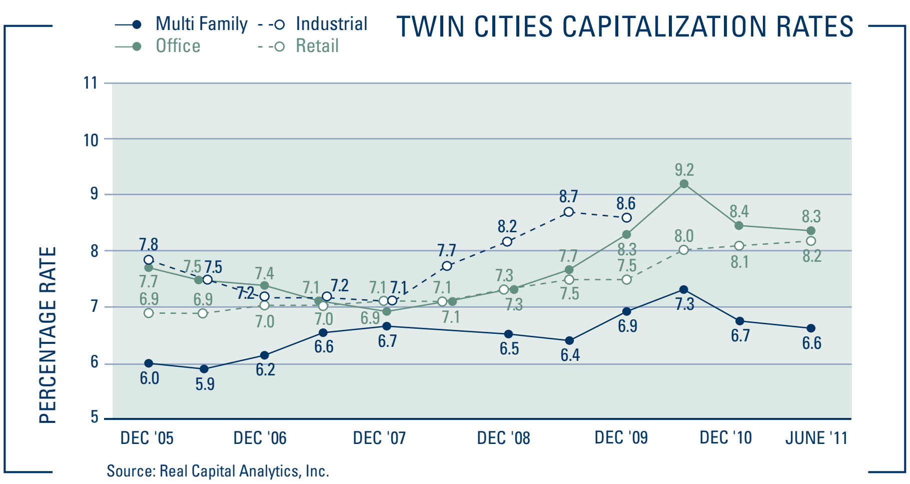
These investors will be banking on continuing improvement in the fundamentals of the space markets in the Twin Cities.

Private investors are available for assets in distress, as indicated by the strong buyer response to the sale of the 100%-vacant Minnetonka Corporate Campus—a Class B suburban office property—in the first half. The market is expected to broaden to include more moderately distressed assets—properties with significant vacancies or other near-term issues, for example, but not in default—in the office, industrial and retail sectors. Buyers will look closely at the cost-benefit ratio of buying an existing property with issues, versus the theoretical cost of replacing those properties with new construction.

It's worth noting that the only sector with a significant amount of planned new construction at this time is the multi-family apartment market.

Institutional investors, large national investors or any investor with access to pooled capital resources should be in a strong position to win new deals in the second half. These types of buyers have indicated a willingness to accept a somewhat smaller yield than the more entrepreneurial private investors, making it difficult for entrepreneurs to compete in this market.

Liquidity is returning to the capital markets, as indicated by the rebound in the CMBS market. This will help fuel a more active investment market going forward as well. ■



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