University of St. Thomas
Minnesota Commercial Real Estate Survey
November 2013
Welcome to the latest edition of the UST Minnesota Commercial Real Estate Survey. The Minnesota Commercial Real Estate Survey has been developed by the University of St. Thomas Shenehon Center for Real Estate, and is designed to be a forecasting tool for the commercial real estate market in the Twin Cities. The semi-annual survey poses questions to local real estate market experts on their expectations for future vacancy rates and rental rate growth, on development costs and on new project financing structure. The questions are chosen to explore the various aspects of commercial real estate development and predict impact on new investment.

November Results

The semi-annual Minnesota Commercial Real Estate Survey conducted in November 2013 is showing mixed results. Overall, the survey continues to indicate a slightly less than neutral expectation looking ahead two years to fall 2015 for commercial real estate. This is a continuation of a trend that started with the May 2012 survey. As was done with all seven of the previous surveys, the same group of 50 commercial real estate industry leaders involved in development, finance, and investment were polled regarding their expectations of near-term, future commercial real estate activity. One thing we have observed in the current survey is there is less variation in the responses and that has caused a more uniform response rate reflecting the panel’s increased certainty in their views. The survey participants’ overall, composite outlook has remained at the same slightly pessimistic level as the survey recorded last spring; however, there are a few key differences in their outlook.

The November 2013 survey composite index remains at a slightly less than optimistic 47 for the third consecutive survey. Index values greater than 50 represent a more optimistic view of the market over the next two years, with values of less than 50 indicating a more pessimistic view. This fall’s results reflect a mixed bag of optimism in some areas and pessimism in others. This is similar to the pattern that was observed last spring. The difference is as you will see below, the degree of optimism and pessimism, have become slightly more moderate.

Market conditions expected in the fall 2015 are best described by the price for space (rental rates) and the supply of space (occupancy levels). The index for rental rates decreased from 69 to 66. This is an indication of a slightly less optimistic outlook for rent growth for the next two years. The index for occupancy levels also decreased, moving from 66 to 62. Despite the decrease, the panelists remain optimistic that rents and occupancy levels will continue to improve, albeit at slower rates.
This is the fifth consecutive survey with the results remaining above 60 for these two categories. This sentiment seems to indicate continued optimism that the economy is going to continue to improve and that there will be a greater demand for space.

The panel’s outlook for land prices reveals a strong expectation that land prices will continue to increase. The land price index decreased for the third consecutive survey moving from 33 last spring to 31 this fall. The 31 recorded this fall is the lowest level recorded for this indicator since the survey began in May 2010. This strong negative sentiment recorded by the panel, indicates their strong expectation that land prices will continue to increase in the next two years. Increasing land prices increase total project costs and are a hindrance to new development, making it more difficult to obtain financing and adequate returns for investors. One difference seen in this fall’s results is that our panel was slightly less pessimistic about the rate of increase in price of building materials. The building material index moved from a strongly negative 22 to a slightly less negative 24, reflecting the panel’s opinion that building material price increases are expected to moderate. Since building materials are a major cost component of any development project any improvement in prices will be favorable for future development.

The index for investor’s return expectations remained unchanged for the fourth consecutive survey at 48. Although this index value is slightly pessimistic, it is essentially neutral. The consensus among survey respondents continues to indicate that investors expected returns will not change significantly in the next two years. Investors will continue to seek out quality investments but they are being much more diligent about how they price risk and evaluate return when considering their investment options. The index for the amount of equity required by lenders decreased significantly, falling from 64 in to 57. This indicates the panel’s belief that credit will be available for good projects but lenders will increase their equity requirements in the coming two years. The good news is that more equity should result in better rates and terms; however, the bad news is that in many cases equity is harder to find and more expensive than debt.
Then and Now

The fall 2013 survey marks the eighth time we have conducted the Minnesota Commercial Real Estate Survey. We now have sufficient survey data to go back and examine the predictive qualities of previous Surveys. Looking back at the results of the November 2011 survey, we can examine the panel’s expectations of what the market would be like in two years (which would be fall 2013) and compare those survey results with actual market conditions in fall 2013. As we have found in our previous survey the actual market conditions today are very close to what our panel predicted they would be in November 2011. Here are a few examples from the November 2011 survey:

**Question: What do you think that rental rates will be in 2013?**

Result: Index at 67 – A strong expectation of higher rents

*What actually happened two years later (in 2013)?*

Rents on most asset classes have increased. The average net rent for class A office property in the Minneapolis / St. Paul Market increased from $14.88 in 2011 to $15.74* in 2013.

**Question: What do you think that occupancy will be in 2013?**

Result: Index at 67 – A strong expectation of higher occupancy

*What actually happened two years later (in 2013)?*

The average retail vacancy in the Twin Cities in 2011 was 8.4% and in 2013 it decreased to 7.8%* in 2013.

*Source Northmarq Compass

**Question: What do you think that the price of building materials will be in 2013?**

Result: Index at 28 – A very strong expectation of higher building material prices

*What actually happened two years later (in 2013)?*

The price of lumber increased from $252 per 1000 board feet in November 2011 to $396 in November 2013.**

**Source National Association of Home Builders

Summary

To summarize, it appears that land cost and building materials are driving the composite index to its slightly below neutral level. These two factors, along with a slow-to-react positive rent/price adjustment might be hampering the composite. In earlier surveys, it was less “certain” for each category as they had a larger variation in responses. Today, responses are more stable/certain and that has caused a more uniform response rate – all leading toward a *cautious* future. Things are improving, compared to two years ago, but that trend is tempered by a response of not overly proactive development activity. Compared to two years ago the respondents are less optimistic about continued, moderate growth in the commercial real estate marketplace. In November 2011, the respondents were optimistic about a positive change in development activity and growth. With that said, things are better today (as we saw with the panel’s expectations from two years ago), but the panelists don’t see any drastic changes in the next two years. It can be interpreted that things will continue to progress forward, but at a slightly slower pace due to higher development costs in land and materials. We can’t expect debt costs to fall lower, so accelerated growth due to increased leverage opportunities will not be there. Overall, our panelists do not foresee a commercial real estate recession coming in this market, but we will likely see two years of relatively slow growth and gradually improving conditions in the commercial real estate market in the Twin Cities.
About the Survey

The Minnesota Commercial Real Estate Survey has been developed by the University of St. Thomas Shenehon Center for Real Estate, and is designed to be a forecasting tool for the commercial real estate market in the Twin Cities. The semi-annual survey poses questions to local real estate market experts on their expectations for future vacancy rates and rental rate growth, on development costs and on new project financing structure. The questions are chosen to explore the various aspects of commercial real estate development and predict impact on new investment.

This survey is general in nature in that it takes into account office, retail and industrial properties in the Twin Cities market as a whole. The survey focuses on the supply side of commercial real estate, meaning people that develop, invest in and finance commercial real estate. Our participant panel consists of 50 individuals who are industry leaders in their respective fields. These people are actively engaged in studying both the demand and supply side of the commercial real estate market in order to analyze and evaluate potential investments. Since they are involved in leasing space and adjusting supply to demand conditions, these individuals are close to the actual changes taking place in the market. They have informed opinions on changes in supply and demand conditions looking forward two to three years into the future and they will be making investment decisions based on their opinions. These actions will, in turn, affect the demand for new construction and, consequently, the stock of commercial space in the market. Understanding the current and future views of the participants will help us better understand the evolution of the commercial real estate market.

The UST Minnesota Commercial Real Estate Survey is a forward looking survey. This type of survey seeks to elicit information about decisions being made today which will affect economic events in the future. The survey is conducted twice a year, in the spring and fall, and is patterned after the UCLA Anderson California Commercial Real Estate Survey initiated in 2006. As the years pass and more surveys are completed, the survey becomes a useful forecasting tool.

The survey consists of six questions around future markets and participants’ expectations. The participants give their views of market conditions between now and two years from now. Each question has a value from 0 to 100, with higher values corresponding to answers consistent with a more favorable outlook for commercial real estate. Lower values indicate a more pessimistic view of what will happen in the market over the next two years. The midpoint of 50 is neutral, indicating that no change is expected. Survey responses are summarized in the next section and provide some interesting insights into the market.

About the Authors

Herb Tousley, CCIM, M.B.A.  hwto1@stthomas.edu
Herb is the director of the Shenehon Center for Real Estate and Master of Science degree in Real Estate at the University of St. Thomas Opus College of Business. His research specialties include housing studies, affordable housing and commercial market analysis. Herb received a Bachelor of Science degree in business from Colorado State University and an M.B.A. from the University of St. Thomas.

Tom Hamilton, Ph.D.  twhamilton@stthomas.edu
Tom is an associate professor of Real Estate with the Department of Finance at the University of St. Thomas Opus College of Business. His research specialties include public utility valuation and real estate feasibility studies and investment analysis. He received a Bachelor of Science degree in natural resources from the University of Wisconsin and a Master of Science degree in Finance from the University of Wyoming. He received an M.B.A. and Ph.D in Urban Land Economics from the University of Wisconsin.

November 2013
Survey

The UST Minnesota Commercial Real Estate Survey consists of six questions. Each question asks participants to give their expectations of real estate conditions in 2015.

Compared to today, what do you think that rental rates will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Compared to today, what do you think that occupancy will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Compared to today, what do you think that land prices will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Compared to today, what do you think that the price of building materials will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Compared to today, what do you think that the threshold rate of return on equity will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Compared to today, what do you think that the amount of equity required by lenders will be in 2015?
- Significantly Lower
- Somewhat Lower
- The Same
- Somewhat Higher
- Significantly Higher

Real Estate at the Opus College of Business

Shenehon Center for Real Estate  www.StThomas.edu/Shenehon

The Shenehon Center for Real Estate serves as a resource to the commercial, industrial, residential and corporate segments of the real estate industry and the community to advance the public interest in real estate issues. For more than 15 years, the center has supported improvement in real estate leadership and management by creating and developing real estate leadership and management programs for undergraduate and graduate degree programs and professional development, providing a neutral forum to convene real estate professionals to share best practices, supporting and working with local real estate industry organizations, conducting real estate research, and developing mechanisms to transfer leading edge business practices to the real estate industry.

Master of Science Degree in Real Estate  www.StThomas.edu/RealEstate

The Master of Science Degree in Real Estate is one of seven graduate business degree programs offered through the Opus College of Business. This part-time, evening program provides students with a comprehensive understanding of real estate financial and quantitative decision making processes, and advanced issues in valuation and land economics, knowledge of critical legal issues, and techniques for market and feasibility studies and real estate investment analysis. Students in the UST MSRE program come from a variety of different backgrounds including appraisal, brokerage, property management, finance, development, engineering, design, facilities management and corporate real estate. The program produces alumni with strong leadership abilities, aptitude for sound decision making, focus on ethics and social responsibility, and a solid network of real estate professionals.

Bachelor of Science Degree in Real Estate  www.StThomas.edu/business/BSRealEstate

The Bachelor of Science Degree in Real Estate is one of 13 undergraduate concentration areas in the Opus College of Business. This four-year degree program provides students with a background in general business and real estate theory and practice. Students study the many factors involved in property assessment and sales, how they change and how these changes affect real estate and individuals. Recent graduates hold positions in the government, nonprofit, construction and private business sectors, including leadership positions in real estate brokerage, investment management, property management, appraisal, construction management, land-use planning and land development.