About the Survey

Herb Tousley, CCIM
Director of Real Estate Programs, University of St Thomas

Thomas Hamilton, PhD, CRE, FRICS
Associate Professor of Real Estate, University of St Thomas

The Minnesota Commercial Real Estate Survey has been developed by the University of St. Thomas Master of Science degree in Real Estate and Shenehon Center for Real Estate, and it is designed to be a forecasting tool for the commercial real estate market in the Twin Cities. The survey posed questions to the local real estate market experts on their expectations of future vacancy rates and rental rate growth, on development costs, and on new project financing structure. The questions were chosen to explore the various aspects of commercial real estate development and for their impact on how much new investment would be undertaken.

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 will be conducted twice a year, in the spring and fall. Our survey is patterned after the UCLA Anderson California Commercial Real Estate Survey initiated in 2006. As the years have passed and more surveys have been completed, it is becoming a useful forecasting tool.

The survey consists of six questions around future markets and the participants’ expectations. The participants give their views of market conditions between now and 2012. 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. Since this is the first survey, it will provide a benchmark for future surveys. The responses to these questions are summarized in the next section and they provide some interesting insights into the market.
Results

There is light at the end of the tunnel for commercial real estate in the Twin Cities market. According to a new survey taken by the UST Real Estate program, the market in the office, retail and industrial sectors of the Twin Cities is showing signs of recovery over the next two years. This survey, the first of a series to be conducted, polled real estate professionals in the commercial real estate development, finance and investment market regarding the near-term future of commercial real estate in the Twin Cities. The composite index for this survey was 53.5, indicating some optimism by the participants that general conditions are going to improve slightly over the next two years. This would be good news for an industry that has been badly battered for the last two years.

Market conditions are best described by the price (rental rates) and the excess supply (vacancy rate). The participants were strong in their belief that rental rates and, in particular, occupancy rates would increase over the next two years. The index for occupancy was at 69.4 and the index for rental rates was 60.2. Both of these numbers reflect a strong opinion by the participants that these two areas would show strong improvement over the next two years. Increased rents and occupancies would both contribute to higher net operating incomes. Since commercial property values are a function of income, this trend indicates an increase in property values over the next two years. As the existing vacant space is absorbed, developers will start to contemplate new development that would come on-line in two to three years to take advantage of the anticipated increase in demand and values.

It should also be noted, however, that any new development will be tempered by the participants’ opinions that land values and building costs will increase from current low levels. The indices for land prices and the cost of building materials were 42.9 and 33.7, respectively. These increases in expected development costs will moderate potential development returns and limit new supply. These increased costs would be of particular concern should rents not rise at least as fast as development costs. On a positive note, the participants were of the opinion that investors’ return on investment requirements would fall and that the degree of financial leverage would increase, as seen in the respondents’ expectation of lower equity requirements. The index for investors’ expected returns was 56.6 and for the amount of equity required was 59.2. Together, these indicate that financing should be easier to obtain, and that it is more likely projects will be undertaken.

In summary, the participants were optimistic about expected increasing rents, higher occupancies and better, more attainable financing. However, the expectation of increasing land prices and a strong opinion that the cost of building materials will increase over the next two years was a cause for concern, and that concern tempered the composite index. While the participant group was not predicting boom times ahead, there was an overall consensus that commercial real estate is starting to turn the corner toward better times in the Twin Cities.

This initial survey gives us a baseline to compare with future surveys. As we accumulate a number of surveys over the next few years, the results will start to show market trends that will be useful as a forecasting tool.
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 2010.

Question 1
Compared to today, what do you think that rental rates will be in 2012?

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<th>Somewhat Lower</th>
<th>The Same</th>
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Question 2
Compared to today, what do you think that occupancy will be in 2012?

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<th>Significantly Lower</th>
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Question 3
Compared to today, what do you think that land prices will be in 2012?

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<tr>
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Question 4
Compared to today, what do you think that the price of building materials will be in 2012?

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<th>Significantly Lower</th>
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Question 5
Compared to today, what do you think that the threshold rate of return on equity will be in 2012?

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<th>Significantly Lower</th>
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Question 6
Compared to today, what do you think that the amount of equity required by lenders will be in 2012?

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May 2010