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.

May Results
The semiannual Minnesota Commercial Real Estate Survey conducted in May 2013 is showing mixed results. Overall, the survey continues to indicate a slightly less than neutral expectation looking ahead two years from now for commercial real estate. This is a continuation of a trend that started with the fall 2011 survey. As was done with all six 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. The survey participants’ overall, composite outlook has remained at the same slightly pessimistic level as the survey recorded last fall; however, there are a few key differences.

The May 2013 survey composite index remains at a slightly less than optimistic 47 for the second 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 spring’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 fall. The difference is as you will see below, the degree of optimism and pessimism, have intensified recording higher highs and lower lows.

Market conditions in the spring 2013 are best described by the price for space (rental rates) and the supply of space (occupancy levels). The index for rental rates increased slightly from 67 to 69. This is a continued indication of an increasingly optimistic outlook for rent growth for the next two years. The index for occupancy levels decreased by one point, moving from 67 to 66. Despite the small decrease, the panelists remain strongly optimistic that occupancy levels will continue to improve. This is the fourth consecutive survey with the result being essentially unchanged in the upper 60s 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 from 37 last fall to 33 this spring. The 33 recorded this spring is the lowest level recorded for this indicator since the survey began in May 2010. This is the strongest negative sentiment ever recorded by the panel, indicating their strong expectation that land prices will continue to increase in the next two years. Increasing land prices are a hindrance to new development, making it more difficult to obtain financing and adequate returns for investors. We also continue to observe a very strong indication that the price of building materials will increase significantly over the next two years. The building material index moved from a strongly negative 26 to an even more negative 22, reflecting the panel's concerns about increasing commodities prices. Higher costs for building materials, much like higher land costs, are a hindrance to new development.

The index for investor's return expectations remained essentially unchanged for the fourth consecutive survey moving from 49 to 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 increased from 58 in fall 2012 to 64 in May 2013. This is a significant positive move that indicates the panel's continued belief that the credit markets are returning to more historically normal loan to value requirements. This is a good indication that lenders are considering more favorable underwriting criteria that will help to make financing more obtainable with better terms.

To summarize, our panel participants have not significantly changed their expectations of what market conditions will be two years from now. Overall they remain slightly pessimistic about the prospects for the commercial real estate market in 2015; however, they continue to be confident that rents and occupancy will continue to grow in the next two years. The May 2013 survey indicates an even stronger belief that land prices and the price of building materials will be significantly higher in two years. The expected increase in land prices and building materials will continue to have a negative impact on development activities. They expect that the terms and the availability of financing will continue to improve, returning to more historically normal levels and there should be increasing amounts of equity capital available. That being said, lenders and investors are going to continue to be very selective in their underwriting criteria.
and evaluation of potential deals. The bottom line for the spring 2013 survey finds our panel more confident regarding general economic conditions and the availability debt and equity capital; however, that optimism is being tempered by increasing concern about expected significant increases in the price of land and building materials.

A Look Back

The spring 2013 survey marks the seventh 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 Spring 2011 survey, we will examine the panel’s expectations of what the market would be like in two years (which would be spring of 2013) and compare those survey results with actual market conditions as they existed in the spring of 2013.

**Question: What do you think that rental rates will be in 2013?**
Result: Index at 71 – A very strong expectation of higher rents
What actually happened two years later (spring of 2013)?
*Rents on all asset classes have increased. The average office rent for all classes of property in the Minneapolis / St. Paul Market increased from $12.28 in 2011 to $13.13 in 2013, with higher increases being observed in the Minneapolis CBD, the southwest, and west submarkets. Similar increases were recorded in most other asset classes as well.*

**Question: What do you think that occupancy will be in 2013?**
Result: Index at 71 – A very strong expectation of higher occupancy
What actually happened two years later (spring of 2013)?
*Occupancies across all commercial real estate asset classes in most submarkets have increased significantly.*

**Question: What do you think that land prices will be in 2013?**
Result: Index at 38 – A strong expectation of higher land prices
What actually happened two years later (spring of 2013)?
*Land prices have increased considerably fueled by increased build to suit activity in the retail and industrial sectors and by increased competition by multi-family and single family builders looking for premium locations.*

**Question: What do you think that the price of building materials will be in 2013?**
Result: Index at 25 – A very strong expectation of higher building material prices
What actually happened two years later (spring of 2013)?
*Building material prices are up considerably since 2011. In 2012 the price of drywall and lumber increased 14% and 11%, respectively. Many other commonly used materials such as steel and concrete have increased as well.*

**Question: What do you think that the threshold rate of return on equity will be in 2013?**
Result: Index at 52 – An expectation of little change in expected returns
What actually happened two years later (spring of 2013)?
*The persistence of historically low interest rates has influenced investor’s expected returns. On core properties threshold returns have decreased slightly. In 2011 expected returns were in the 7% - 10% range compared with 5% to 8% in 2013.*

**Question: What do you think that the amount of equity required by lenders will be in 2013?**
Result: Index at 63 – A strong expectation of higher LTVs (less equity)
What actually happened two years later (spring of 2013)?
*Lending criteria for many categories of commercial real estate has loosened with the biggest changes being observed for core properties and high quality borrowers. LTVs are about 10 basis points higher in comparison to what was available in 2011.*
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

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May 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?

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<thead>
<tr>
<th>Option</th>
<th>Significantly Lower</th>
<th>Somewhat Lower</th>
<th>The Same</th>
<th>Somewhat Higher</th>
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Compared to today, what do you think that occupancy will be in 2015?

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<tr>
<th>Option</th>
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Compared to today, what do you think that land prices will be in 2015?

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Compared to today, what do you think that the price of building materials will be in 2015?

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Compared to today, what do you think that the threshold rate of return on equity will be in 2015?

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Compared to today, what do you think that the amount of equity required by lenders will be in 2015?

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**Real Estate at the Opus College of Business**

**Shenehon Center for Real Estate**  [www.StThomas.edu/Shenehon](http://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](http://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](http://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.