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.

Summer 2015 Results

The semiannual Minnesota Commercial Real Estate Survey conducted in May 2015 is showing mixed results. Overall, the survey continues to indicate a slightly less than neutral expectation looking ahead two years to summer 2017 for commercial real estate. This is a continuation of a trend that started with the May 2012 survey. As was done with all eight 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 that was recorded in our previous survey; however, there are a few key differences in their outlook.

The May 2015 survey composite index remains at a slightly less than neutral 46 for the fifth 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 survey’s composite results reflect a mixed bag of optimism in some areas and pessimism in others. This is similar to the pattern that was observed in our previous survey. The difference is as you will see below, the degree of optimism and pessimism, have become slightly more moderate.
Market conditions expected in the summer 2017 are best described by the price for space (rental rates) and the supply of space (occupancy levels). The index for rental rates remained at 66. This is an indication that our panel is still expecting strong rent growth for the next two years. The index for occupancy levels decreased, moving from 62 to 56. Despite the decrease, the panelists remain optimistic that rents and occupancy levels will continue to improve. This is the ninth consecutive survey with the results remaining above 50 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 continued demand for additional space.

The panel’s outlook for land prices reveals a strong expectation that land prices will continue to increase. The land price index increased slightly moving from 31 in the previous survey to 35. This continued strong negative sentiment recorded by the panel, indicates their 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 summer’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 24 to a slightly less pessimistic 29, reflecting the panel’s opinion that building material price increases are expected to moderate slightly. Since building materials are a major cost component of any development project any moderation in price increases will be favorable for future development.

The index for investor’s return expectations decreased from 48 to 41. The index has moved from essentially neutral to a more pessimistic level. The consensus among survey respondents seems to indicate that investors expected returns will be higher in two years. There was a concern that interest rates that have been at record low levels for the past seven years will be higher two years from now requiring higher rates of return on future investments. Higher interest rates will add to total project costs and higher project costs will squeeze project return on investment. 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, falling from 57 in to 53 this indicates the panel’s belief that credit will still be available for good projects but the panel expects that 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 May 2015 survey marks the ninth 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 May 2013 survey, we can examine the panel’s expectations of what the market would be like in two years (which would be May 2015) and compare those survey results with actual market conditions today in the summer of 2015. As we have found in our previous surveys the actual market conditions today are very close to what our panel predicted they would be in May 2013. Here are a few examples from the May 2013 survey:

Question: What do you think that rental rates will be in 2015?

Result: Index at 69 – A strong expectation of higher rents

What actually happened two years later (in 2015)?

Rents on most asset classes have increased. The average net rent for all types of industrial properties in the Minneapolis / St. Paul Market increased from $5.70* in spring 2013 to $6.15* in spring 2015. *Source – Colliers North American Research and Forecast Report.

The average net rent for class A, B, and C office space larger than 10,000 square feet increased from $12.05/ SF** in Q2 2013 to $13.16/SF** in Q2 2015 ** Source – Colliers Minneapolis St. Paul Office Report.

Question: What do you think that occupancy will be in 2015?

Result: Index at 66 – A strong expectation of higher occupancy (lower vacancy)

What actually happened two years later (in 2015)?


The average vacancy for class A, B, and C office space larger than 10,000 square feet decreased from 12.9%** in Q2 2013 to 11.6%** in Q2 2015 ** Source – Colliers Minneapolis St. Paul Office Report.

Question: What do you think that the price of building materials will be in 2015?

Result: Index at 22 – A very strong expectation of higher building material prices

What actually happened two years later (in 2015)?

Although the price of lumber decreased from $396 per 1000 board feet in spring 2013 to $315 in spring 2015, the Mortenson Construction Cost Index for the Twin Cities that includes most of the commodities used in most non-residential construction projects increases from 104**** to 114**** during the same period of time.

***Source - National Association of Home Builders

****Source - Mortenson Construction Cost Index

Question: What do you think that lenders Loan to Value (LTV) requirements will be in 2015?

Result: Index went from 57 to 53, an indication of the panel’s expectation that lenders will require more equity.

What actually happened two years later (in 2015)?

According to Trepp Commercial Real Estate Direct, the national average weighted LTV for Q2 2013 was 61.45%. In Q2 of 2015 the same average had climbed to 65.12%.
Summary

To summarize, it appears that our panel’s expectations of higher land costs and the higher cost of building materials are the primary culprits driving the composite index to its slightly below neutral level. Despite the headwinds created by higher project / acquisition costs the panel has strong expectations that general economic conditions in our area will continue to improve and there will be an increasing demand for space. The demand for more space will put upward pressure on rents. Higher revenues in the form of higher rent will offset most of the much of the expected increase in the price of land and building materials allowing owners and investors to achieve their required returns and development to move forward. 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. Conditions for development and acquisitions have definitely improved since the last survey. Based on the survey results our panel expects that even if interest rates increase modestly development and acquisition activity will continue at near present levels for the next two years.

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 Author

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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.

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May 2015
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.

UST Minnesota Commercial Real Estate Survey