Navigating the Minneapolis/St. Paul Commercial Real Estate Market

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INVESTMENT & CAPITAL MARKETS

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Investors Targeting Twin Cities as Pandemic Drives a Shift in Allocations

With healthy overall economic and market fundamentals heading into 2020, the Twin Cities' investment market continued to attract new equity and debt capital throughout the first half of the year. New investors challenged long-held pricing and sales assumptions and pushed through to set new high water-mark pricing and sales volumes in certain asset classes. Beginning in mid-March, necessary statewide and global responses to COVID-19 public health issues introduced levels of economic and business uncertainty into the Twin Cities' investment market not seen in previous downturns.

As debt markets and standard financing vehicles paused in March, not all property classes were impacted equally. Assets that support essential services such as eCommerce and logistics saw little to no pricing impact while assets heavily dependent upon travel and entertainment will have a longer runway to pricing discovery and financing. While the pause in debt access has started to thaw for select products, investors will require additional time to fully understand impacts to underwriting assumptions and pricing for some asset types.

TWIN CITIES INVESTMENT SALES (In Millions: Rolling 12 Month Total) Source: Real Capital Analytics

PROPERTY TYPE	2019 SALES VOLUME	2020 SALES VOLUME	PSF/UNIT
HOTELS	$252.85	$248.92	$103,517.13
MULTIFAMILY	$1,984.80	$1,552.67	$183,104.08
INDUSTRIAL	$1,401.83	$1,977.24	$83.07
OFFICE	$1,995.81	$1,205.83	$156.06
RETAIL	$1,065.31	$605.84	$187.53
TOTAL	**$6,447.74**	**$5,341.59**	**$113.83**

STEADY MULTIFAMILY MARKET EXPERIENCES RISING VACANCY RATE

The multifamily sales momentum of the last five years in the Twin Cities continued through the first quarter of 2020 before pausing due to the uncertainty brought on by the pandemic. Deals were still able to cross the finish line in the second quarter, albeit at a slower pace, and the general consensus in the market is near term flattening of rent growth with increased vacancy creating upward pressure on cap rates. Private capital began to lead the way on resumed deal activity at mid-year. Though market-wide vacancy is expected to continue increasing through the second half of 2020, suburban submarkets have proven to be more resistant to rising vacancy, as both physical occupancy and rent collections remained stable.

RECORD DEALS DRIVE INDUSTRIAL SALES

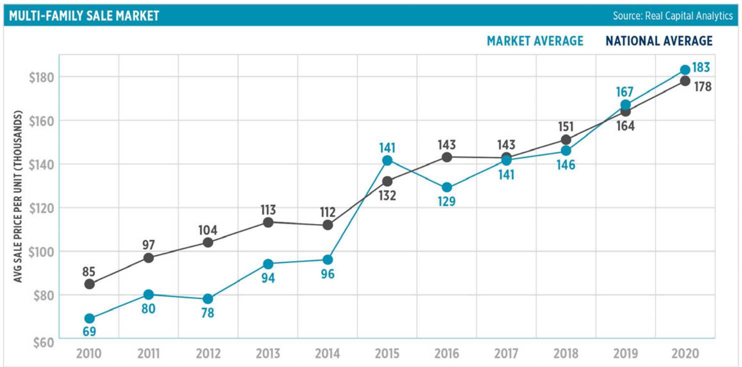
The industrial sector is coming off a historic first half as the largest real estate transaction in terms of square footage closed, and eCommerce continues to attract new capital to the market. Blackstone cemented their ranking as the area's largest industrial landlord with the acquisition of CSM's Twin Cities and Denver industrial and office-flex portfolio totaling 7 million square feet (msf), of which 5.7 msf is in the Twin Cities. In a separate transaction, new high-water marks on price per square foot were reached as the first sub-5% cap rate on an industrial deal was completed for a prominent distribution center. The industrial market experienced a very short-term slowdown in investment opportunities and access to financing due to the overall COVID-19 impacts on debt markets. The asset class has rebounded, however, and investor demand is now in line with pre-pandemic levels.

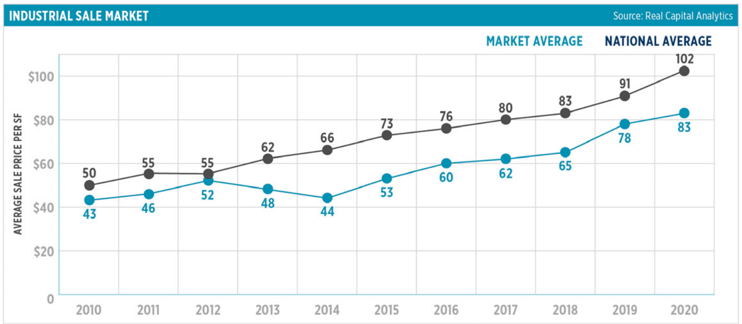
OFFICE SALES PAUSE AS PUBLIC HEALTH UNCERTAINTIES PERSIST

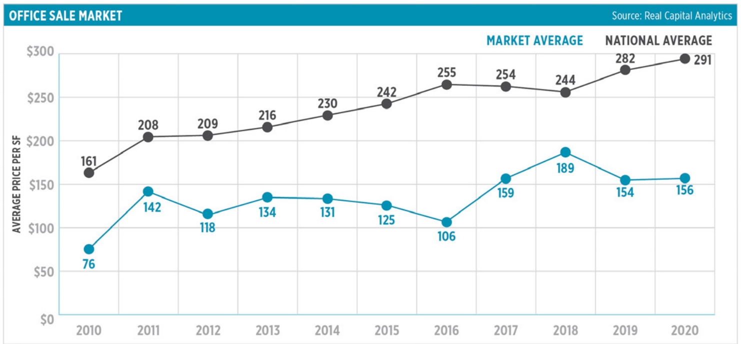
Office sales slowed in the first half as debt markets paused while governments and tenants implemented public health policies and work-from-home responses to the COVID-19 pandemic. Quality credit and term continue to be in demand for investors as the Twin Cities remains a highly liquid market despite limitations to traditional financing options in the current environment. Investors and lenders will require additional time and market data points to better understand if modifications are needed to pricing and underwriting assumptions amid public health uncertainty.

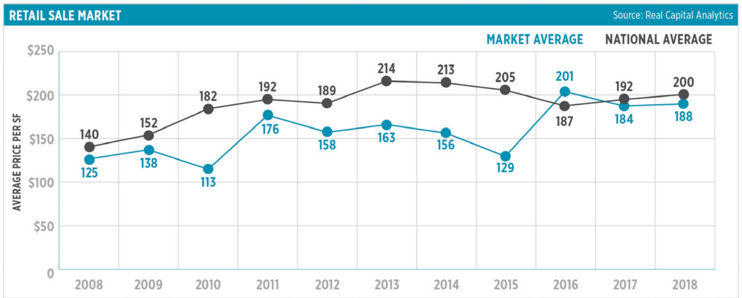
INCREASED ALLOCATIONS FOR MEDICAL OFFICE PRODUCT FUELING DEMAND

Although deal activity paused in the first half of 2020, capital is plentiful as buyers have increased allocations for medical office product. Quality credit with term will continue to command premium pricing, and little to no pricing adjustment is expected for projects that have long-term health system credit included in the rent roll. A dichotomy has been solidified, however, as value-









add properties are likely to see a modest pricing adjustment due to the ongoing disruption in the industry. Deal activity is expected to accelerate in the second half of 2020, though some underwriting assumptions have changed, particularly among on-campus product. Potential sellers of assets with long-term stability can expect pricing support when coming to market.

RETAIL SALES MARKET PAUSES TO EVALUATE ESSENTIAL VERSUS NON-ESSENTIAL

There remains a high level of uncertainty in the retail markets, the fallout of which is a general hesitancy from investors in acquiring or selling retail assets. As such, transaction volume in the Twin Cities during the second quarter declined significantly. The pandemic is challenging the market to better understand the distinction between essential and non-essential retail businesses. The fluidity of this environment has made underwriting particularly difficult among multi-tenant or NNN offerings with non-essential retail. As a result, in the near term, grocery anchored assets with 70% or more of NOI allocated to this category, and NNN assets with investment grade, “essential” credit, are likely to remain the focus for retail investors seeking new acquisitions. Total sales volume in the first half of the year equaled the first half of 2019; note, however, Sterling’s portfolio acquisition in March accounted for 53% of Twin Cities deal volume in the first half of 2020. Absent this outlier, first-half retail sales volume was down significantly compared to the same period in 2019, and trading at the mid-year point was minimal.

HOTEL PRICING DISCOVERY EXPECTED DURING SLOW BUT STEADY RECOVERY

Uncertainty persists in the hotel development pipeline going forward, as the Twin Cities market begins to reset following a years-long trend of new supply outpacing record demand growth. Extended stay, economy and midscale properties, which have been supported by essential workers continuing to work and travel during the pandemic, as well as select independent and resort properties have led the early bounce back in performance that the market recorded in May and June. There is more liquidity in the market today than during previous recessions, such as the Global Financial Crisis, which will support resumed deal activity and necessary pricing discovery in the second half of 2020.

OUTLOOK

Lending availability is generally expected to improve in the second half of 2020, but conditions will be dictated largely by the duration of COVID-19 restrictions and correlated economic uncertainties. Asset classes with lower risk profiles, or those that engage in essential services, will continue to see good access to financing and deep investor pools. Higher risk profile assets will likely generate good activity but require more pricing discovery due to limited transaction activity since the end of Q1 2020.

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