VALUATION Viewpoint

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SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

State of the Real Estate Market Highlights

by Robert Strachota

For the past 10 years or so, the U.S. and Minnesota economies have experienced record-breaking expansion. At the same time, debt is up but the delinquency rate on debt is low. For Minnesota, unemployment is low, wages and income are strong, and the job market is diverse. These are all good signs, and there are other signs as well.

It's hard to drive any distance in this area without seeing construction cranes. Some people have speculated that we may be building too much, too fast, but so far, the market seems to be absorbing all the new construction and local architects report they are still busy with new projects.

What's different than ten years ago? There is less clueless lending and gross overbuilding than we saw in the past. Developers can't just wildly leap into the market now; they have to have financial backers with some skin in the game, some credibility. Lenders aren't throwing money around either; there is much stricter underwriting. Lenders aren't the only ones showing some restraint. People in the real estate industry also learned a lot from the economic crisis of ten years ago, and they are on guard not to make the same mistakes again. There is more self-discipline, more thoughtfulness.

> **"Instead, values will likely be somewhat static – not declining, but also not enjoying the steady increases of the past several years."**

I anticipate the real estate market will soften in the next two years for the Twin Cities and the region. Soften does not mean crash. This will not be like the great real estate recession of 10 years ago. Instead, values will likely be somewhat static – not declining, but also not

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Market Trends & Value Indicators:

	Value ∆ Over Past 12 Mo.
Office Buildings - Downtown	3%
Mall Retail	-15%
Strip Retail	1%
Industrial	13%
Apartment	6%

	YoY Change
New Housing Starts - Midwest	0.0%
Productivity	1.90%
U.S. Unemployment	-11%
Consumer Confidence Index	8%

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State of the Real Estate Markets Highlights

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enjoying the steady increases of the past several years.

The marketplace is experiencing a balanced discipline unlike what I have seen in the past 40 years. Yes, even in the apartment market, which seems to keep expanding at what some people see as a questionable pace.

So, my overall message today is: relax! Real estate values are not going to fall off a cliff like they did in 2009 or 2010. For most real estate executives, it is business as usual. We are just being careful not to "buy on the come." The cash flow numbers must make sense today, not three to five years from now.

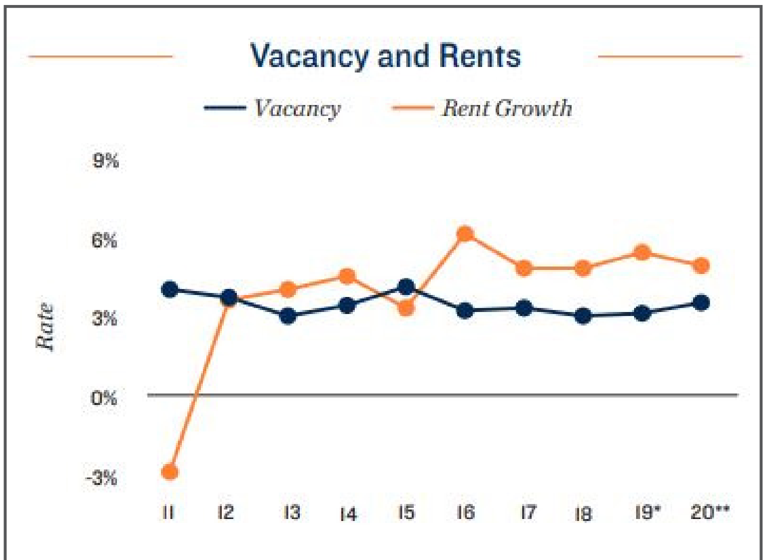
"We are just being careful not to 'buy on the come.' The cash flow numbers must make sense today, not three to five years from now."

Market Insights

Apartment Market

by H. Ellis Beck

Usually, holidays don't have much impact on the health of a market, but when analyzing the Twin Cities apartment market, my thoughts turn to Groundhog Day. Yet again, the local apartment market had an extremely solid year, adding inventory and successfully leasing up that new space while rental rates grew. However, as in recent years, signs suggest that this run of growth in the market may be nearing its end point, as local employment growth and rental rate growth slow. Once again, the local apartment market had an extremely solid year, adding inventory and successfully leasing up that new space while rental rates grew. However, as in recent years, signs suggest that this run of growth in the market may be nearing its end point, as local employment growth and rental rate growth slow.



**Estimate; **Forecast*
Sources: CoStar Group, Inc.; RealPage, Inc.; Real Capital Analytics

The Minneapolis-St. Paul apartment market has been consistently strong over the past decade, with vacancy rates remaining below 5% in the market over the past nine years. This has spurred a period of significant development that has continued through 2019. This should span into 2020, with more than 10,000 units expected to be delivered. This rise in apartment stock has not been spread throughout the metro, but has been concentrated in a few key areas, namely Downtown Minneapolis, in and around the University of Minnesota campus, and several clusters of suburban areas, primarily located near major highway intersections.

Through all this, capitalization rates have continued to compress, as out-of-state buyers look to get into an extremely tight market. At the same time, average prices have risen to over $130,000 per unit. With the large amount of inventory expected to come online in 2020, this is a trend we anticipate continuing.

Stop me if you have heard this, but it seems like we are headed for another year of a growing apartment market. Still, this can not and will not last forever, so keep an eye on key indicators such as local employment growth and rental rate growth to predict when this will finally end.

Market Insights

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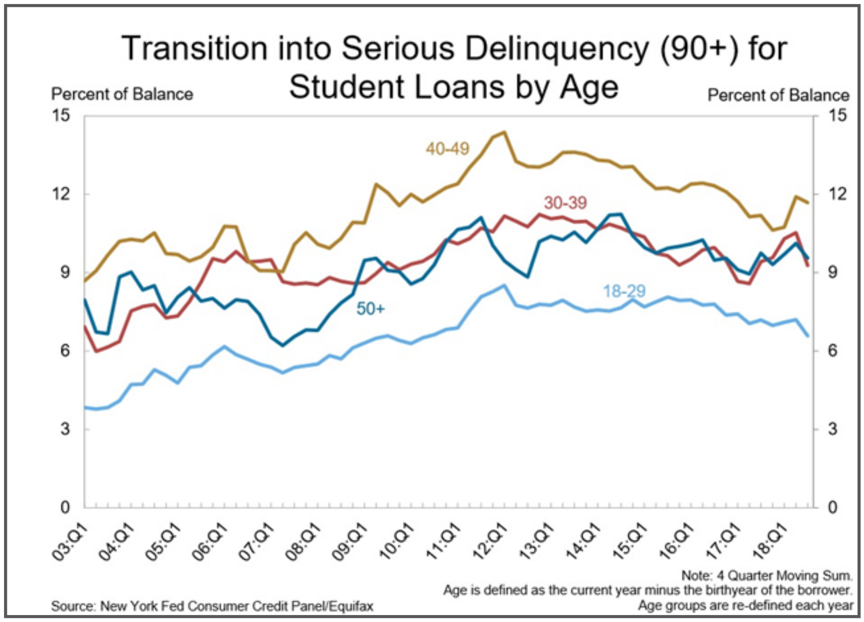
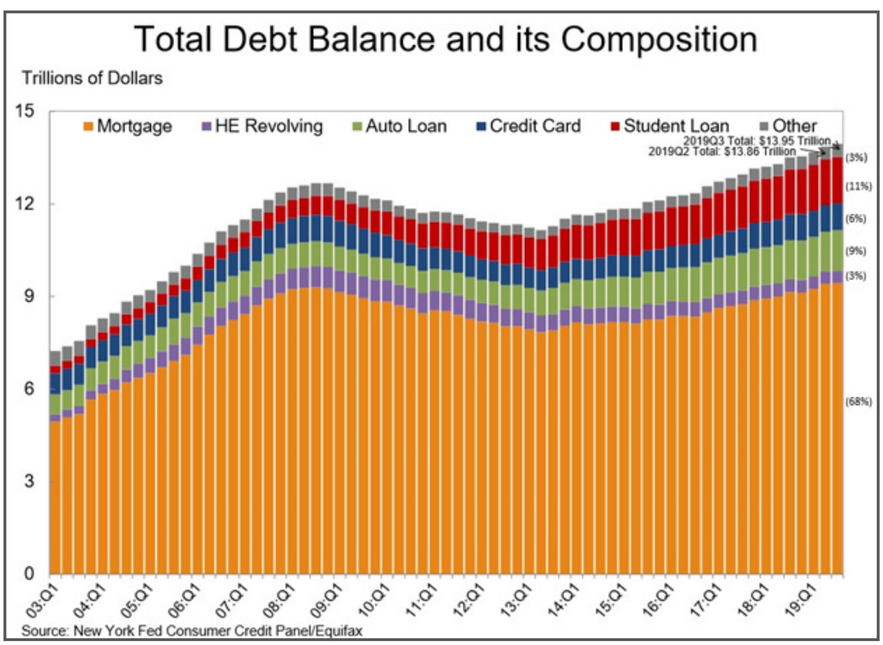
Household Debt

by Cody Lindman

Over the past year, all forms of U.S. household debt have increased, with aggregate U.S. household debt reaching $13.95 trillion for the third quarter of 2019, an increase of $440 billion compared to a year prior. However, delinquency rates have held relatively constant over the past year. People between the ages of 40 and 49 now hold 25.1% of the total debt outstanding, the most of any age group. However, people between the ages of 18 and 29 were the most likely to be 90+ days delinquent. Unsurprisingly, mortgage debt accounts for the lion's share of U.S. household debt, comprising approximately 67.6% of total debt outstanding. As of September 30, 2019, 4.8% of outstanding debt is in some stage of delinquency, a 0.1% increase compared to a year ago. Additionally, more than 63.5% of delinquent debt is considered 90+ days delinquent. However, on a per capita basis, household debt is still below the peak reached during the 2008 recession.





Student loan debt balances reached $1.50 trillion during the third quarter of 2019, up from $1.44 trillion a year prior. As of September 30, 2019, 10.9% of student debt balances were 90+ days delinquent or in default, a decrease of 0.6% compared to a year prior. People between the ages of 30 and 39 carry the most student debt at $490 billion or 32.8% of total student loan balances. Surprisingly, people between the ages of 40 and 49 were the most likely to be 90+ days delinquent on their student loans. One reason for this may be because this age group carries the largest amount of debt in aggregate and is prioritizing repaying mortgage debt and auto loan debt rather than student loan debt. This would be logical because there are more immediate negative consequences if one fails to repay mortgage debt (foreclosure) and auto loan debt (repossession) as compared to student loan debt.

Market Insights

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Opportunity Zones

by Brock Boatman

The Opportunity Zone program has not seemed to set the world on fire like some predicted. Yet. Most developers and investors appear to have the same sentiment – the tax break is nice, but really, it is just gravy; a deal still has to work on its own. But even with the release of a second round of guidance as to how the program is implemented as well as the December 31, 2019 deadline for receiving the maximum benefit, the program has not appeared to drive activity, just juicing deals that happen to qualify.

Condominiums

by Brock Boatman

They are kind of happening! So far in 2019 we have heard the announcements of some interesting and exciting new projects. TMBR, in the North Loop, would be the Twin Cities' first high-rise timber-construction residential building, following the T3 Building's innovative construction technique. Additionally, the top of the luxury market is being updated, with the Ryan Company's Eleven on the River and the Gateway project's Four Seasons-branded residences competing for the $1 million plus crowd. However, the on-again, off-again Alia project appears to have finally been shelved, showing that balancing costs, pricing, and timing with the depth of the market means that no project is a given success.

Economic Forecast 2020

by Madeline Strachota

A Bet on the Economy

Just like the outcome of the World Series, if a person could predict the future of the economy, they would be a very wealthy individual. In the same way that player statistics and game record narrow down the contenders for the World Series, especially as each season progresses, it isn't until several games into the Series, itself, that that the outcome is clear. The economy has different, albeit important, statistical indicators as to where its outcome will be in the years ahead. As with baseball, it becomes more challenging to predict outcomes many years out. And of course, in the same way that 86 years of data predicted the Red Sox would lose the World Series in 2004, there are upsets like the financial crisis in 2008 and 2009 that are difficult to predict.

However, trusted financial indicators deserve methodical analysis to narrow down the list of possible economic outcomes. One such indicator of the behavior of the U.S. Treasuries yield curve.

The Yield Curve

An inverted yield curve, when the yields on U.S. Treasuries with longer maturities are lower than the yields on U.S. Treasuries with shorter maturities, has preceded every recession since 1950. The spread between the yield on the 10-Year Treasury Note and the 2-Year Treasury Note is the most common threshold for determining an inversion. When the spread between the 10-Year Treasury and

The red line indicates an inversion. Data source: https://www.treasury.gov/resource-center/data-chart-center/

Economic Forecast

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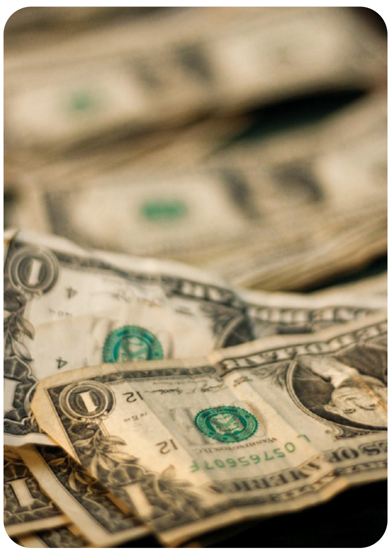
the 2-Year Treasury goes negative, the yield curve is considered inverted. In August 2019, the yield curve, according to the 10-Year less the 2-Year yields, inverted for the first time since the Great Recession.

"...it is important to consider that not every yield curve inversion has been immediately succeeded by a recession."



However, it is important to consider that not every yield curve inversion has been immediately succeeded by a recession. In fact, it is not accurate to expect, with certainty, a recession within the next two years, which is often the conclusion drawn after an inversion. For example, the spread went negative in June 1998 and a recession did not occur until January 2001. Moreover, when different measures of a yield curve inversion are considered, like the 10-year Treasury to 3-month Treasury spread or the 10-year Treasury to 1-year Treasury spread, it becomes even harder to determine the timing of recessions relative to an inversion. Since June 1976, there have been five recessions, which have followed yield curve inversions within 10 to 33 months. While economic cycles are an almost certainty, it is difficult to draw conclusions that the yield curve can predict these cycles with certainty. Analysis of the data also illustrates that the extent of an inversion is not strongly correlated to the size of the recession. Lastly, with the benefit of hindsight, the Federal Reserve is taking different actions to maintain economic stability. Compared to the Federal Reserve's response to the inversion that preceded the

"While economic cycles are an almost certainty, it is difficult to draw conclusions that the yield curve can predict these cycles with certainty."

Great Recession, the Federal Reserve has taken more preemptive action in lowering the Federal Funds rate in 2019. The Federal Reserve lowered rates several times in 2019, whereas the yield curve inverted in early 2006, and the Federal Reserve did not start cutting the Federal Funds Rate until August 2007.

A Recession of Our Own Making

The yield curve is a beneficial economic indicator, but it is important not to overstate its meaning. Many other indicators in the economy are strong right now: Unemployment in the U.S. is the lowest it has been since 1969. S&P 500 corporate earnings are strong. Trade negotiations between the U.S. and China are positively progressing. U.S. economic participants have control of our destiny: learn from the past and make disciplined investing, borrowing, and spending decisions, and perhaps we can avoid a recession of our own making.

Market Transaction
Real Estate

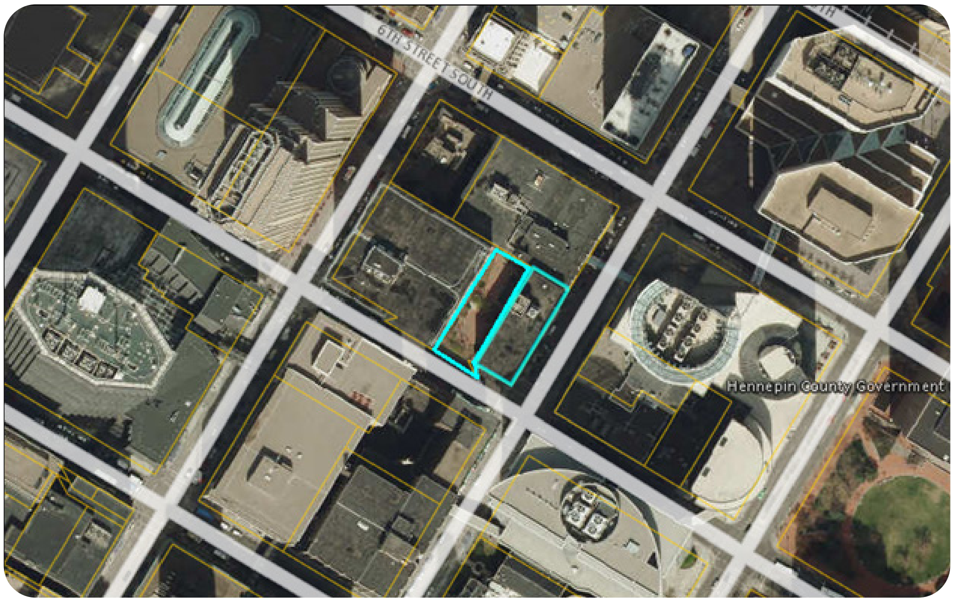
Buyer: Taconic Capital and Somera Road Inc.
Seller: PCCP
Property: Land Beneath Northstar Center
Sale Price: $20.9 million

Sale of Land Beneath Northstar Center

In November 2019, Taconic Capital and Somera Road Inc. purchased 23,725 square feet of land in downtown Minneapolis for $20,900,000. The property (the Northstar land) is located at 618½ Second Avenue South, Minneapolis, underneath the 17-story Northstar West building, 13-story Northstar East Building, and the 13-story Minneapolis Crowne Plaza hotel, along with a 955-space parking garage. The land sale can be calculated at $881 per square foot, which is considerably higher than typical land sales in the downtown central business district. Today, typical land sales per square foot in downtown Minneapolis are in the range of $250 to $350. Unlike many vacant land sales, this property was encumbered by a 100-year lease. However, it is important to note that the buyer of the land is also the owner of the leasehold in place.

The lease was initially negotiated between The 614 Company (landowner) and the original improvements developer in 1960. Later, Northstar Center West was built in 1962; Northstar East was built in 1918, and the Crowne Plaza Hotel was built in 1967. Based on our records, the ground lease was extended to then tenant BRE/TZ Properties LLC, by 100 years from January 1, 2007 through December 31, 2106, with no extension options. Rent started at $850,000 per year on January 1, 2007 and was to increase 2% per year for the first 25 years with revaluations in 2032, 2057, and 2082.

However, since then, the land and improvements have changed hands several times. The 614 Company transferred its interest in the Northstar land to Steven Greenberg in May 2017 for just over $15 million. The overlying improvements and leasehold have changed hands several times, with the most recent transaction occurring in March 2018 when Taconic Capital and Somera Road Inc. purchased the improvements for $62.78 million from PCCP, which had defaulted on its mortgage in late 2017. Upon purchasing the Northstar East and West buildings, and the Crowne Plaza, out of foreclosure, Taconic Capital and Somera Road Inc. announced plans to resell the buildings. However, Taconic Capital and Somera Road Inc.'s purchase of the Northstar land demonstrates a change in strategy as it consolidates ownership of the land and improvements, eliminating the need for a ground lease. This provides the New York City-based commercial real estate team with more flexibility in ensuring entitlements and financing to potentially redevelop the improvements, and it eliminates escalating land lease costs.

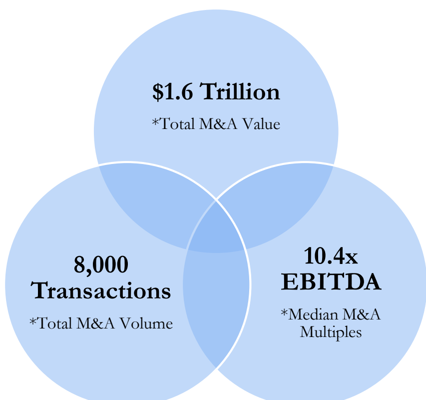


Market Transaction Business

by Gary O'Brien, Managing Director, Hennepin Partners

Continued Bull Market In North American M&A

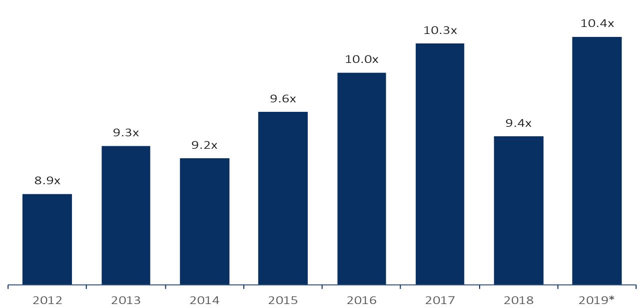
North American M&A activity continues to be strong. During the first three quarters of 2019, more than 8,000 deals were completed with an aggregate value approaching $1.6 trillion. Looking to year-end, the market was tracking toward the $2 trillion mark that was posted in 2018. Slowdowns in transportation and manufacturing have been offset by continued vibrancy in healthcare, technology, and other sectors.Valuations are being pushed higher by buyers competing over a limited supply of



Source: Pitchbook **Values as of September 30, 2019*

growing, profitable businesses. In the year-to-date period ending September 30, 2019, the median EBITDA multiple was 10.4x, up from 9.4x in 2018 and 10.3x in 2017.

Business Valuations

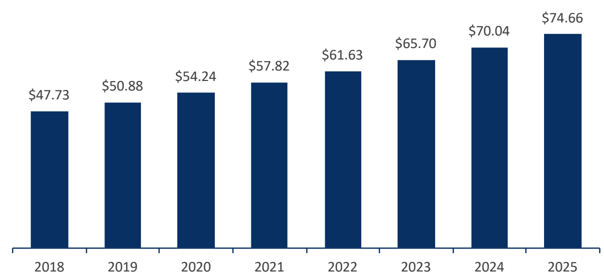


Source: Pitchbook

Industry Focus: Personal Protective Equipment

The Personal Protective Equipment (PPE) industry encompasses makers and distributors of protective clothing, respiratory protection, fall protection, hearing protection, head protection, and hand protection. Demand for PPE is largely non-discretionary because its use is mandated by government regulations, insurance providers, and corporate safety rules. Long-term industry growth is expected to come from technological innovations that make PPE more effective, comfortable, and user-friendly.

PPE Industry Growth Trends



Source: Grand View Research *$ in billions*

Hennepin Partners Transaction Spotlight: Recapitalization of Diversified Fall Protection

Diversified Fall Protection (DFP) is a provider of engineered systems that protect people working "at height" from falling to the surface below.

In the years leading up to the transaction, DFP posted strong revenue growth and profit margins. The owner wanted to keep working and driving growth, but he felt the need to de-risk his ownership position.

Hennepin recommended a "cash-out recapitalization" and was retained by DFP to arrange the transaction. At closing, the owner received significant cash proceeds that he later used to diversify his net worth. In addition, he retained a minority equity stake in the business alongside company managers who became shareholders in DFP for the first time. Funding for the deal came from North Branch Capital, a private equity firm that was identified by Hennepin Partners. North Branch was attracted by the strength of DFP's management team and the fundamentals of the safety industry.

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BUSINESS & REAL ESTATE VALUATIONS

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