SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

Valuation Viewpoint

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Bubblewatch: A Glimpse into the Minneapolis-St. Paul Metropolitan Apartment Market

The Minneapolis-St. Paul apartment market is currently in a period of rapid expansion, with 2017 anticipated to bring more of the same. Deliveries are expected to easily exceed 2016 figures, while rents will continue to expand, with growth rates rarely seen in the local market. At the same time, vacancy levels are near local historic lows. This has been going on for several years, with vacancy rates declining sharply in 2010 and 2011, followed by a steady decline through 2016. Responding to tightening vacancy rates, rental rates have trended steadily upwards since 2011, as seen in the chart (on page 5) provided by Colliers.

Three major factors in the local market have pushed this expansion of the apartment market in recent years, both on the local and national level. Demographic trends, student loan debt, and the changing makeup of families have all helped steer possible homebuyers into the apartment market, strengthening demand, pushing rental rates upward, and dictating the need for a building surge. What follows is a closer examination of those three factors:

An Aging Population

The generation known as "Baby Boomers", which until recently made up the largest portion of population in the United States, has now advanced in age to between 53 and 71 years old. For many people in this age bracket, this means a time for downsizing, as children are now entering or fully at adulthood. Beyond the lack of a need for the physical space often sought to raise a family, houses often come with a set of chores and responsibilities that become

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Market Trends and Indicators

Office Buildings–Downtown	→	3.0%
Office Buildings–Suburban	→	1.0%
Retail Centers	→	2.0%
Industrial Buildings	→	2.0%
Apartments	→	3.0%
New Housing Starts–Midwest*	↑	16.0%
Productivity*	↑	3.1%
US Unemployment*	↓	4.6%
Consumer Confidence Index*	↑	107.1%

Statistics reflect year-over-year change from 1Q 2016 through 1Q 2017

In This Issue ...

Net Lease Rental Agreements: Investment Potential and Risk Factors

By Alec D. Gooley

One of the most common lease agreements in the commercial real estate industry is a net lease. Net leases are rental contracts between landlords and tenants that require the tenants to contribute payments toward operating expenses in addition to an annual base rental rate. Although many office and industrial leasing contracts are net lease agreements, net leases are also popular in retail properties such as drug stores or fast food chains. Investors are attracted to these properties because they often represent safe investments that boast steady returns over a long period of time. When investing, it is important to consider the risk factors that can influence the overall return of a net lease investment such as landlord responsibilities, tenant retention, and capitalization rates.

Higher-credit tenants, such as international fast food chains, typically attract more demand from investors, which result in higher purchase prices. Ideally, a good credit tenant will remain in a property over a longer period of time and exercise options to extend their lease after the duration of the original lease term expires.

Landlord Responsibilities

Investors place a considerable amount of weight on the extent of landlord responsibilities outlined in a lease when negotiating with a tenant. The lease type impacts the annual income produced from any investment property. The three primary net lease types are listed below:

- Double Net (NN) – Tenant is responsible for base rent plus property taxes and insurance
- Triple Net (NNN) – Tenant is responsible for base rent plus property taxes, insurance, common area maintenance, utilities, and operating expenses
- Absolute NNN – Tenant is responsible for base rent plus all other operational and real estate expenses

The Absolute NNN lease provides the landlord with the least amount of risk, and is therefore the most attractive lease type for investors.

Retail Tenant Retention

Retail tenants with certified credit ratings above BBB- are in the highest demand for both private and institutional net lease investors. The credit of the tenant leasing an investment property is directly related to the amount of risk associated with that investment. Higher-credit tenants, such as international fast food chains, typically attract more demand from investors, which result in higher purchase prices. Ideally, a good credit tenant will remain in a property over a longer period of time and exercise options to extend their lease after the duration of the original lease term expires.

Good credit retail tenants seek out prime real estate locations in order to maximize annual sales revenues. Having an excellent location and visibility will help ensure tenant retention over the long-term investment period. Locations with decreasing economic stability or low traffic counts may dissuade the tenant from extending their original lease term at the end of the original term's life. If the tenant continues to produce high sales revenues at a specific location, the chance of lease renewal substantially increases.

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Net Lease Rental Agreements *continued from page 2*

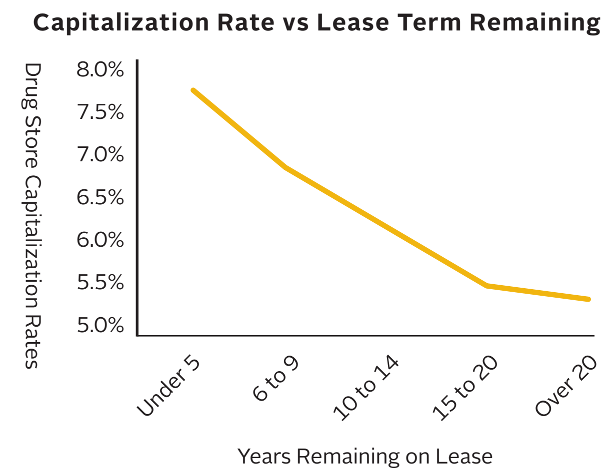
Capitalization Rates

Investors prefer net lease deals that provide adequate returns along with somewhat minimal risk. The capitalization rate is a reliable indicator of investment security. The capitalization rate is calculated by dividing the annual net operating income of a property into the market value of a property.

$$\textit{Capitalization Rate} = \frac{\textit{Annual Net Operating Income}}{\textit{Market Value (or Purchase Price)}}$$

As the market value of a property increases due to demand, capitalization rates tend to decrease. Tenants with high credit ratings, popular name brands, long-term lease agreements, and prime locations reflect the lowest capitalization rates and the highest demand. Tenants with low risk of abandoning the property and a high probability of renewal are considered safer investments. A high-credit tenant with 25 years remaining on their original lease term carries much less risk than a tenant with only two years remaining on their original lease term. If tenant renewal is uncertain, the demand for that property will decrease due to the risk of vacancy. This results in a lower market value of the property and a higher capitalization rate. The following graphic illustrates this principle:

As the market value of a property increases due to demand, capitalization rates tend to decrease. Tenants with high credit ratings, popular name brands, long-term lease agreements, and prime locations reflect the lowest capitalization rates and the highest demand.



*Median asking capitalization rates as of Quarter 3 of 2016, The Boulder Group Net Lease Drug Store Report

Investment Security

Net-leased retail properties have the potential to provide a safe investment with attractive returns. Depending on the lease terms and escalation clauses, a net lease investment property could provide stable cash flow over the course of 50 to 75 years. Net lease investments are generally considered low risk, although the risks that do exist must be examined carefully. The demand for net-leased properties remains high, and capitalization rates remain generally low. High-credit tenants with over 20 years remaining on their original lease terms currently serve as the safest investments. Tenants with lower credit or less than five years remaining on their original lease terms have increased risk and higher capitalization rates. The net leased retail sector remains a strong market and is expected to continue growing in years to come. VV

Market Trends and Indicators

Economic Indicator

	2010	2011	2012	2013	2014	2015	2016	MAR 2017
New Housing Starts—Midwest Yearly Totals	97,900	100,900	127,900	149,600	165,200	152,600	165,500	38,500

P/E Ratios in Select Industries

Industry (by year)	2010	2011	2012	2013	2014	2015	2016	2017
Basic Materials	15.0	16.0	10.7	10.4	11.8	*	*	8.13*
Construction	5.3	5.8	6.5	7.1	6.0	5.2	3.7	3.8
Manufacturing	8.5	10.4	10.2	9.4	9.8	16.4	7.1	15.04
Wholesale Trade	6.6	8.3	7.4	9.6	8.5	7.1	6.1	7.93
Retail Trade	5.1	4.9	5.1	6.2	6.3	5.0	4.0	15.51
Transportation & Warehousing	6.7	5.9	5.6	5.6	5.8	5.2	3.4	4.33
Information	10.2	11.5	11.3	6.8	15.2	6.1	7.1	7.04
Finance & Insurance	9.3	7.2	6.4	7.1	8.1	5.2	16.5	5.24
Professional Services	7.8	10.2	7.3	7.9	9.9	5.9	5.2	5.31
Healthcare	5.8	9.3	5.2	6.9	6.6	7.1	6.9	6.86

*As of March 15, 2017 **Based on One Transaction

Economic Indicators

Indicator	2010	2011	2012	2013	2014	2015	2016	2017
Inflation	1.6%	3.1%	2.1%	1.5%	1.6%	1.4%	1.3%	2.4%
Productivity	1.5%	0.8%	0.9%	0.0%	0.7%	2.1%	0.2%	1.3%
GDP	3.0%	1.7%	2.2%	1.9%	2.4%	2.4%	1.6%*	1.9%
Consumer Confidence	62.0	70.8	72.2	78.1	92.6	115.3	113.7	125.6

*YoY 2016

Unemployment

	2005	2010	2011	2012	2013	2014	2015	2016	MAR 2017
US	**5.3%**	**9.4%**	**8.5%**	**7.8%**	**6.7%**	**5.6%**	**5.0%**	**4.6%**	**4.5%**
Northeast	4.9%	8.4%	8.0%	8.1%	7.3%	5.6%	4.9%	4.2%	4.5%
Midwest	5.7%	8.7%	7.9%	7.2%	6.9%	5.6%	4.7%	4.1%	4.4%
South	5.2%	9.3%	8.4%	7.3%	6.7%	5.2%	5.2%	4.6%	4.6%
West	5.5%	11.0%	8.5%	8.6%	7.6%	6.3%	5.4%	4.7%	4.7%
Minnesota	**4.5%**	**7.0%**	**5.7%**	**5.4%**	**4.6%**	**3.6%**	**3.5%**	**3.2%**	**4.4%**

Rates of Return and Risk Hierarchy

Investment	
30 Year Treasury	3.14%
Aaa Bond	3.74%
Bbb Bond	3.80%
Commercial Mortgage	4.0–5.25%
Institutional Real Estate	5.75–7.0%
Non-Institutional Real Estate	8.0–10.0%

Investment	
S & P Equity (Duff & Phelps)	9.87%
Equipment Finance Rates	10.0–12.0%
Speculative Real Estate	11.0–16.0%
NYSE/OTC Equity (Duff & Phelps)	13.45%
Land Development	12.0–25.0%
NYSE Sm Cap. Equity (Duff & Phelps)	25.08%

Sources: Appraisal Institute, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census, Bureau of Labor Statistics, Duff & Phelps, PwC Real Estate Investor Survey, The Conference Board, Pratt's Stats®.

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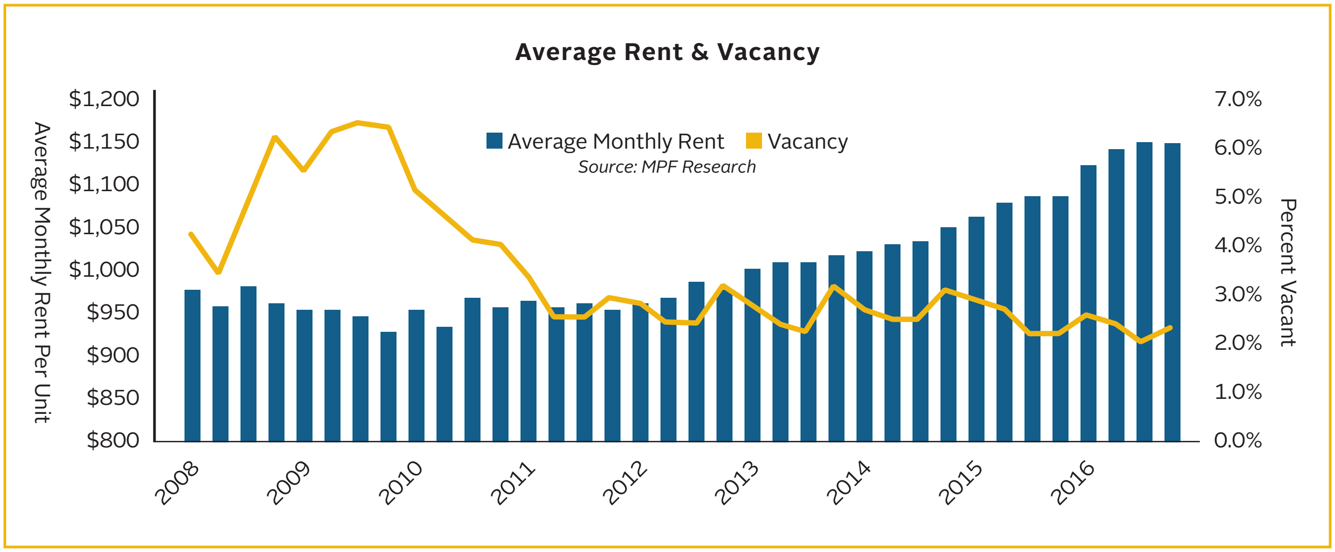
Bubblewatch *continued from page 1*



less desirable as people age, pushing people toward apartment living. New apartments are now being built that look to capitalize on this trend, offering amenities such as a rentable guest suite for family visits, common spaces for hobbies or activities, and connectivity to walking trails and parks.

Student Debt Levels

Normally, the Baby Boomer generation aging into the empty nest phase of life would not have that large of an impact. After all, we just mentioned above that Baby Boomers are no longer the largest segment of the population, that distinction now belongs to the Millennial generation, generally defined to be comprised of people between ages of 13 and 35 years old. As the Millennial generation ages into adulthood, it would be expected that it gradually moves into the housing market, as most generations previously have. However, this has not been the case thus far. Many theories have been floated for this generation being slow to buy homes, from a wholesale change in values to an unwillingness to settle down. At Shenehon, we believe that there are many factors that influence this trend, but the clearest to identify is the amount of student debt with which many college graduates are now saddled. Recent research done by the Wall Street Journal states that the average member of the Class of 2016 graduated with $37,172 in student debt. This means that the portion of the population (college graduates) that is best positioned for future income growth and potential home buying enters their working life in no position to save money. Even with a high-income job directly out of college, it could take years to dig out from under the financial hole of student debt and save for a down payment, while monthly rental payments (even high payments) may be far easier to make.

Recent research done by the Wall Street Journal states that the average member of the Class of 2016 graduated with $37,172 in student debt.

The Changing Family

According to a recent study done by John Burns Real Estate Consulting, the 2010 United States Census revealed that 32.1% of households with a child (or children) were single-parent households. This is a figure that has risen in every census taken since 1960, when the rate of single-parent homes with children

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Bubblewatch *continued from page 5*

As of right now, and perhaps as a result of hard lessons learned in the previous decade, the industry has shown considerable discipline.

was just 8.5%. Needless to say, high barriers into the housing market become more difficult to achieve with just one income, as opposed to two.

So, now that we have laid out some reasons we believe the apartment market will remain strong, let's take a step back. Given the boom-and-bust nature of the real estate market, it is reasonable to ask, are we on a bubble?

Here at Shenehon Company, we do not believe that we are, as of yet. Besides the three factors listed above that bode well for the future of the apartment market, we point to three more common-sense indicators of a bubble:

"House Flipping"

As seen in the correspoding chart, raw data from Google on searches for the phrase "how to flip a house" show that public interest in learning how to flip a house, while higher than in the depths of the most recent economic recession, still remain well below the peaks recorded during the housing bubble that preceeded that recession.

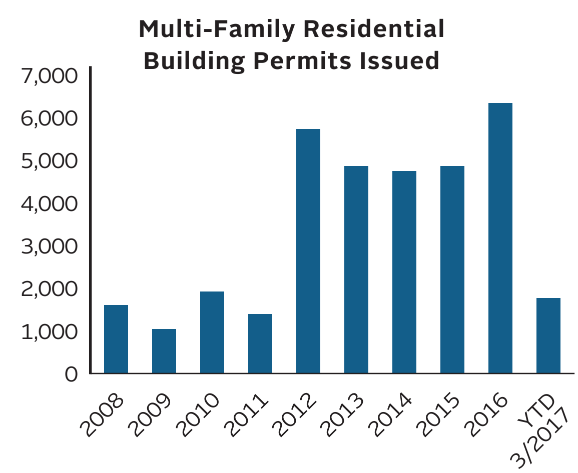
Homes for All

As of this point, we have not seen the widespread availability of lending dollars that was so noted during the subprime mortgage crisis. Barriers to entry remain high, keeping the for-sale housing market stable and pushing more potential home buyers into renting.

Excessive Investments

As of right now, and perhaps as a result of hard lessons learned in the previous decade, the industry has shown considerable discipline. Thus far, development has not occurred, at least locally, in a number of small, calculated short-term bets that rely on rapidly-escalating prices. This has kept vacancy low while allowing rapid expansion in rental rates, and has limited the amount of long-term risk absorbed by developers.

It would be easy to speculate that, based on the rapid growth seen in the apartment market in the Minneapolis-St. Paul area, we are currently on a bubble that is due to pop at any moment. However, at Shenehon we believe that when you take a close look at the factors pushing the market to expand, sustained growth is viable for at least the next few years. Additionally, we have not seen any of the warning signs that were apparent in the last housing bubble. Based on these factors, we do not expect the bubble to burst anytime soon in the local apartment market. VV



MARKETVIEW 1Q 2017

According to the January 9, 2017 Beige Book, the economy of the United States continued to expand through 2016, albeit at a modest pace. In the final quarter of 2016, labor markets in most districts tightened, and financial conditions were stable. Manufacturing and retail sales generally expanded throughout the nation, with several districts reporting a solid turnaround from conditions cited earlier in the year. Overall, most districts indicated a modest to moderate pace of economic growth, and the overall economic outlook for the U.S. economy through 2017 remains positive.

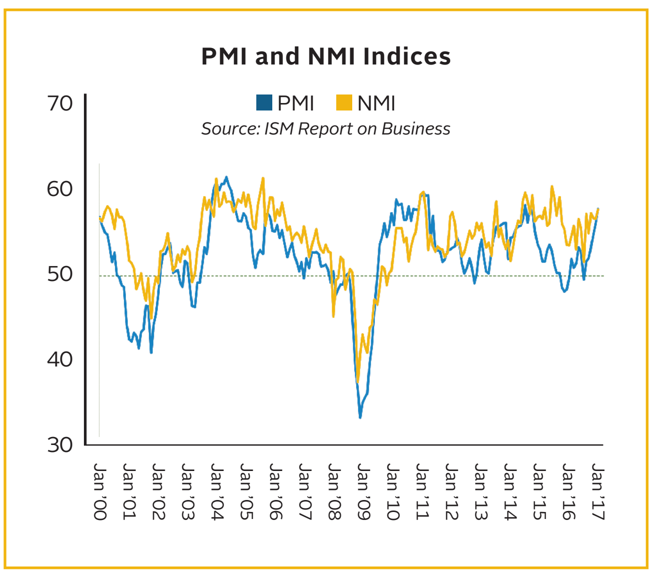
Nationally, employment continued to rise throughout 2016, with districts that reported major layoffs in certain sectors still adding total net employment during the year. The trend of high-skill jobs struggling to fill openings continued in some districts, with the problem of finding qualified labor extending into lower-skilled positions in some locations as well. This tightness in the labor market drove wage increases, a trend expected to continue through 2017.

Regional economic projections for 2017 are generally strong, with the hiring outlook positive, building off the momentum of a tightening employment market. That said, projections for the year lag behind the initial projections made early in 2016, as some area layoff events have effectively cooled expectations. Despite tempered hiring expectations, wage increases are anticipated to continue the moderate growth seen in the region in 2016.

Taking a deeper look into the regional economy, manufacturing prices remained steady in 2016, though they may increase slightly in 2017, with one-third of operators expecting to raise prices. Consumer spending struggled in the area throughout the holiday season, though tourism in the area was strong through the first half of winter. The construction sector has been strong with a number of notable projects underway in the metropolitan area, though several other large projects have been held up through finance or neighborhood concerns. The expected start of construction on the Southwest Light Rail line in 2017 will provide a large amount of construction jobs in the region.

Difficulties remain in making any 2017 national economic projections; as the impact of the economic policies sought by the incoming administration are not known. However, on March 15 the Federal Reserve voted to raise its interest rate by 0.25% , and it is speculated that several additional rate hikes will occur throughout 2017, acknowledging recent economic growth and signaling confidence that growth trends will continue.

At the start of 2017, the national manufacturing sector continued to grow, in spite of challenges from some industries within the sector. According to the ISM Report on Business®, the PMI® (Purchasing Managers' Index) was recorded at 57.7% in February 2017, up significantly from 56.0% recorded in January 2017 and 49.5% recorded in February 2016. In comparison, economic activity in the non-manufacturing sectors expanded for the 91st consecutive month in February 2017, rising to the highest rate since February of 2011. The following graph presents the five-year historical PMI® and NMI® index readings.



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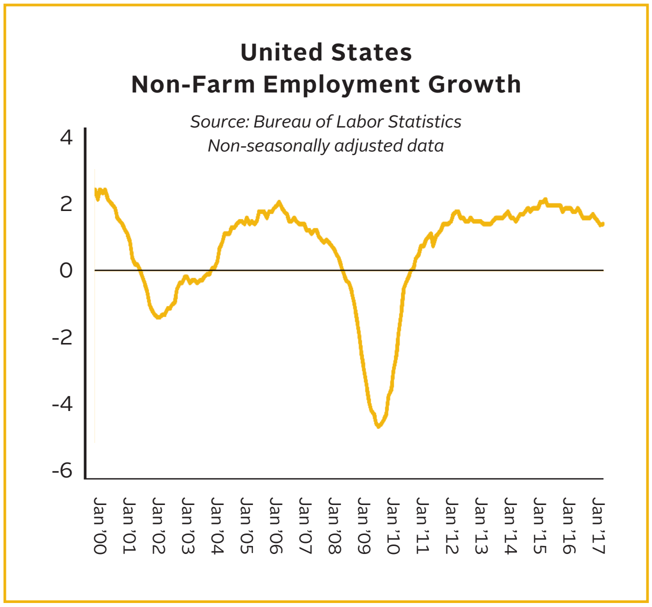
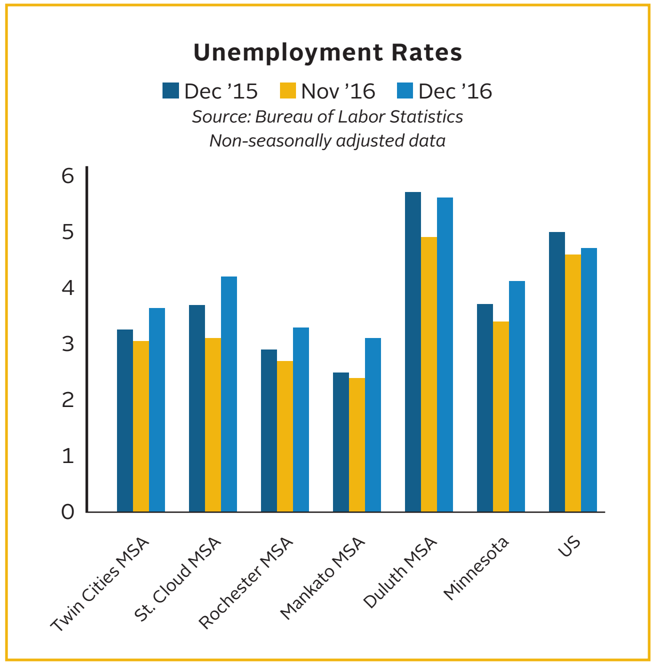
Non-farm employment at the national level increased by roughly 1.5% over the year ended January 2017 on the net addition of over 2.13 million jobs. Job growth was largest in the Professional and Business Services sector, which added 530,000 jobs, a year-over-year gain of 2.7%. While the Construction sector added fewer jobs overall (165,000), the sector still grew by 2.6% year-over-year. The following graph presents overall national non-farm employment growth.



Employment gains noted across nearly all major markets continue to put downward pressure on national unemployment rates, though local rates rose slightly year-over year. Nationally, the non-seasonally adjusted unemployment rate decreased to 4.7% in December 2016, down 30 basis points from 5.0% recorded 12 months prior. In comparison, the non-seasonally adjusted unemployment rate in the state of Minnesota stood at 4.1% in December 2016, up 40 basis points from the 3.7% rate recorded in December of 2015. Within the state, unemployment remains lowest in the Mankato market (3.1%), followed by the Rochester market (3.3%), then the Twin Cities (3.6%) and St. Cloud markets (4.2%). The Duluth market, which in recent history has had unemployment rates trending slightly higher than the other major Minnesota markets, had a December 2016 rate of 5.6%. All of the major metropolitan areas across the state saw year-over-year gains in their unemployment rates, with the exception of Duluth. The following graph presents non-seasonally adjusted unemployment rates at the national, regional, and local levels.



Retail sales and real estate markets remain healthy nationally, aiding economic growth. According to the U.S. Census Bureau, retail sales at the national level grew by 3.27% from 2015 to 2016. Consumer confidence over the last three months has been the highest recorded over a three month stretch since March 2004, though optimism falls strictly along partisan lines, with Democrat's low expectations and Republican's high expectations generally cancelling each other out, and the positive leaning coming from political independents who feel the economy is improving. However, with neither recession nor robust growth anticipated in 2017, it is expected that the observed partisanship in confidence will fade. The University of Michigan Consumer Sentiment Index stood at 96.3 in

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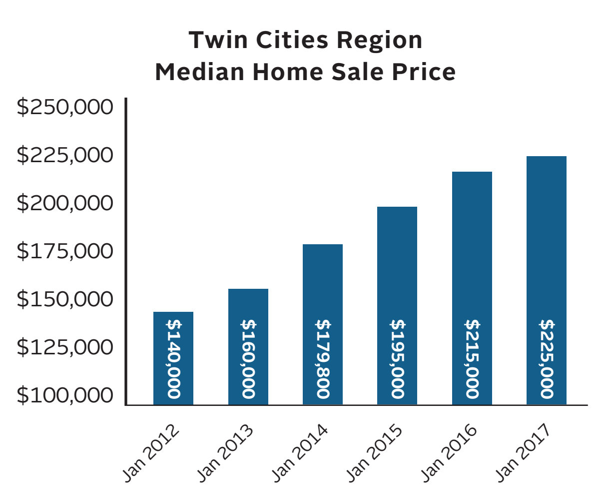
Marketview *continued from page 8*

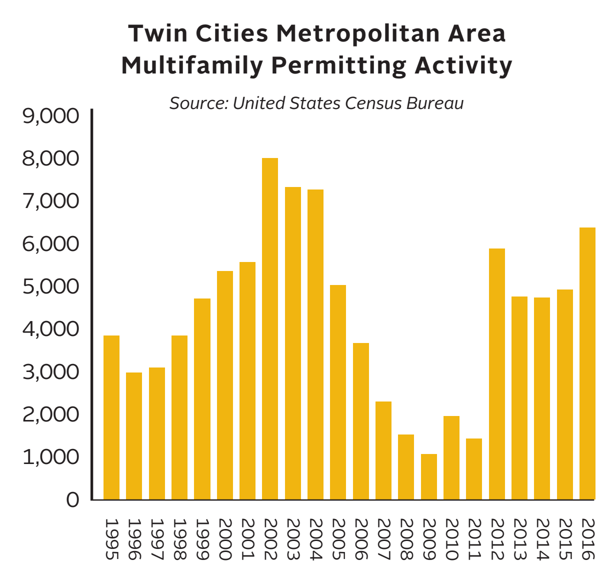
February 2017, down from 98.5 in the prior month, but up significantly from 91.7 in February of 2016.

Meanwhile, transaction volume in the real estate markets continues to drive further growth and underlying market fundamentals are generally encouraging. At the national level, the median home sale price throughout 2016 increased to $313,600, up 5.8% from $296,400 reported for 2015. In the commercial sector, fundamentals across all four major property types at the national level remain healthy to improving.

Conditions in the residential and commercial real estate markets within the Twin Cities market mirror national trends. According to data released by the Minneapolis Area Association of Realtors, in the Twin Cities for-sale residential market, the number of year-to-date closed home sales increased by 3.1% through January 2017, while the median home sale price increased by 4.7% during this same period, rising from $215,000 in January 2016 to $225,500 in January 2017. Further indicating healthy demand, the average days on market decreased by 7.1% and the percentage of original list price received increased by 0.9% during this same period to 95.9%, as available inventory remains limited. The following graph presents historical median home sale prices in the Twin Cities market.



The local apartment market is strong, with underlying fundamentals in the Twin Cities apartment market among the strongest in the nation. While new construction activity in the Twin Cities market remains above historical norms, demand continues to exceed the pace of new additions to the existing apartment inventory, keeping vacancy rates well-below the market equilibrium of 5.0% and putting upward pressure on rental rates. According to Marcus and Millichap, the vacancy rate for 2016 was 2.2% and is projected to fall to 1.9% in 2017. Demographic trends are in place to suggest demand for apartment units will remain healthy over the long term, and a decline in the pace of new construction will put upward pressure on occupancy levels and asking rents. Given these conditions, multifamily permitting activity in 2016 grew by roughly 29.3% compared to 2015. The following graph presents historical multifamily construction permitting activity in the Twin Cities market.



The region's broad-based economy and employment growth continue to facilitate healthy demand within both the local for-sale residential and apart-

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Market Transaction: Real Estate

601W Companies Purchases Macy's Building

Property: Former Macy's building in downtown Minneapolis. Building is located between South 7th Street and South 8th Street along the Nicollet Mall. 700 and 730 Nicollet Mall, 17 7th Street South, and 26 8th Street, Minneapolis, Minnesota, 55402

Approved: January 4, 2017

Closing: March 1, 2017

Zoning: B4-2 Downtown Business District

Sellers: Macy's, Inc.

Purchaser: 601W Companies Minnesota, LLC

Source: Macy's, Inc. Press Release, Public Record

Sale price: $59 million, or $59.43 per square foot of GBA (not including parking garage)

Terms: Cash

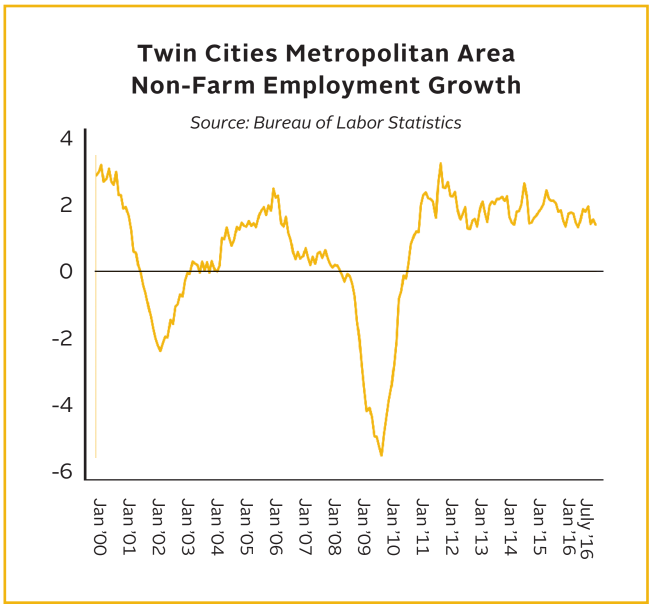
Remarks: Due to the age of the building, we at Shenehon Company believe that the transaction involves significant environmental concerns, most likely involving asbestos, which will need to be addressed in any renovation to the property that may occur in the future.

The sale included four parcels, three of which make up the retail portion of the property, plus one that contains the parking garage. However, there is a small tract of land, owned by the Hattie Knoblauch Estate, and leased by Macy's, that was not sold with the property. This tract includes roughly 6,594 square feet and includes 42 feet of frontage along 8th Street South. Currently, the tract is in the middle of a long-term lease.

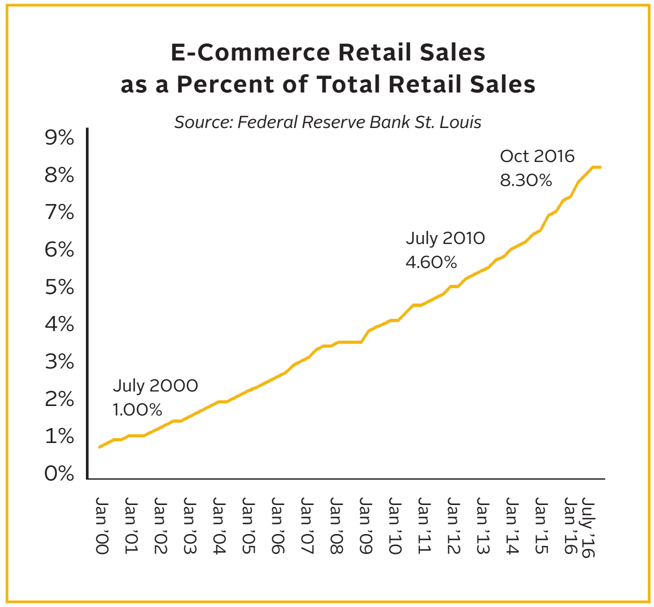
The ongoing rebuilding of the Nicollet Mall through downtown Minneapolis has prompted the levying of special tax assessments for each of the four parcels, which total $167,976.34. This is in additional to any standard property taxes levied against the property. This special assessment was not paid by the seller.

Marketview *continued from page 9*

ment markets. Non-farm employment in the Twin Cities metropolitan area increased by 1.4% over the year ended in December 2016 on the net addition of about 27,400 jobs. Growth in the Twin Cities market was strongest within the Professional and Business Services and Education and Health Services sectors, which registered year-over-year growth rates of 4.2% and 4.0%. Further employment growth in the Twin Cities market was held back by year-over-year job losses in the Leisure and Hospitality, Wholesale Trade, Information, and Manufacturing sectors. The following graph presents overall non-farm employment growth in the Twin Cities metropolitan area.



Secular trends, most notably including the rise of e-commerce, are driving much of the demand for warehouse and distribution space. Now accounting for over 8.3% of total retail sales (roughly double the market share posted in 2010), e-commerce is anticipated to continue rising at a steady pace, and will continue to foster strong demand for warehouse and distribution space in the local, regional, and national industrial markets into the long term, while possibly hurting brick-and-mortar retail locations. The following graph presents historical e-commerce retail sales as a percent of total retail sales. VV



Data referenced in this report was current as of March 15, 2017, and includes preliminary figures, which are subject to revision.

Shenehon is an industry leader located in Minneapolis, Minn.

SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

88 South Tenth Street, Suite 400
Minneapolis, Minnesota 55403
612.333.6533
Fax: 612.344.1635
www.shenehon.com

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Contributors:
Alec D. Gooley, Robert Strachota, Wendy Cell, Joshua Johnson, and Ellis Beck