VALUATION VIEWPOINT

Winter 2021/22
Vol 27 No 2

State of the Real Estate Market

by Bob Strachota and Ellis Beck

Over the past year, we have seen continued growth in real estate. Here is a breakdown by market type.

Single Family Residential - Determining what is normal in these abnormal times is a challenging proposition. Pending sales contracts of single-family homes were up 0.8% from November 2020 and up 15.9% from November 2019. Over the last decade, home prices might have increased in the range of 3% to 5% per year. Year over year increases over the past 12 months show an increase of 8% to 9%. The median sale price of a home that sold in the 16-county Twin Cities region from November 2020 through November 2021 was $340,000. The average home sat on the market for just 27 days, and there is no indication that the spring 2022 market will bring relief for buyers.

Apartments - The apartment market seems to be returning to its pre-pandemic trend of growth at a slower pace. Rent increases this past summer were flat but now are edging up again. However, suburban rent hikes largely exceeded those of the urban submarkets. At the end of 2021, trailing 12-month net deliveries are near an all-time high, with approximately 12,000 units currently under construction. Metro-wide occupancy is near 95%, which for most of us reflects a balanced rate for a long-term investor. The slowdown in renter demand in the Minneapolis city core, and St. Paul, will most likely continue moderate rent growth for the foreseeable future. Concessions and other incentives should remain common through early spring 2022. Twin Cities rental growth is currently 3.6%, exceeding the area's five-year average yet trailing national markets.

Hotels - Unfortunately, business travelers are not back; the leisure traveler has the travel bug. Explore Minnesota has found that people are ready and willing to engage in leisure travel this winter. Roughly 82% of surveyed Minnesota travelers planned domestic U.S. trips this winter. Approximately 50% plan to visit destinations more than 500 miles from home, and approximately 48% of those surveyed are planning trips that include time in Minnesota. Generally, travelers expect pre-pandemic levels of customer service, product quality, and pricing. For those who will not be traveling, COVID-19 is the top reason for not planning to travel in the next six months. Obviously, new variants of COVID-19 and restrictions surrounding them are the wild card in any projection of the future of the local hospitality market. The downtown hotel market is struggling as reflected by recent sales of the Marquette and Westin hotels. The Marquette traded at a loss of $14 million from the 2016 acquisition price of $74.5 million, a 19% loss. And the Westin, which sold for $66.4 million in 2015, sold for just $47.2 million in October, a 29% loss.

Manufacturing - Minnesota has over 8,300 manufacturers making a wide range of products. Manufacturing is growing in Minnesota with employment in this sector rising over 11% since 2020. Real estate used for manufacturing is not constructed on a speculative basis. Usually, a manufacturing facility is built for a specific user. When that user grows and needs a new building, they leave behind a second-generation manufacturing building that is available for a startup. The opportunities to build new manufacturing space and the availability of second-generation space are balanced in terms of supply and demand. Numerous government incentives supplement all manufacturing startups. In summary, Minnesota manufacturing has strength in a broad range of industries. It has momentum to grow, but there is an acute shortage of workers that will keep the lid on expansion for the near term.

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National Market Trends & Value Indicators

High Qual. Institut'l Grade	Value ∆ Over Past 12 Mo.
Office	6%
Mall	27%
Strip Retail	30%
Industrial	41%
Apartment	29%
Health Care	10%
Lodging	32%
Manufactured Home Park	24%
Self-Storage	66%
Student Housing	16%
	YoY Change
New Housing Starts - Midwest*	10.6%
Productivity**	-.6%
U.S. Unemployment***	-41.8%
Consumer Confidence Index****	27.4%

Real Estate Indicators from Green Street Advisors CPPI Report, *Source: St. Louis FRED, ** 3Q 2020/3Q 2021 – Source: Bureau of LaborStatistics, *** 2020/2021 – Source: Bureau of Labor Statistics, **** Jan 2021/Jan 2022 – Source: The Conference Board

Market Insights

Rising Inflation in America by Thomas Blomgren

One of the major talking points over the past year has been rising inflation in the United States economy. Whether it be at the gas pump, grocery store, or in workplace wages, rising prices have touched just about every part of life. According to the Bureau of Labor Statistics, U.S. inflation increased at a greater annual rate in 2021 than any other 12-month period since 1982, creating a 39-year high. The consumer price-index rose 7% in December from the same month a year ago. This rise in prices can be attributed mostly to strong consumer demand paired with supply chain constraints and shortages. Rises in inflation affect consumers and companies in a multitude of ways. Large inflation gains erode the purchasing power of consumers in the marketplace. However, this rise in prices encourages people to spend and invest more in the short term, due to the lower value of holding cash. Then again, this spend-and-invest cycle will only accelerate inflation due to increased demand, creating a vicious cycle of rising prices. The rise in prices has not been felt equally across different industries. For instance, used auto prices have skyrocketed due to a semiconductor shortage that greatly limits the supply of new cars. Meanwhile, prices for services centered around education and medical care have risen just slightly. Also, rising inflation has led to higher wages in the workplace. Having said that, the gains in wages are dulled by the effects of inflation. According to a CNBC article dated November 10, 2021, the average wage growth year over year through October 2021 was 4.9%. However, when accounting for inflation, real hourly wages have decreased by 1.2% in that same time period. Currently, the Federal Reserve is discussing multiple interest rate increases in the next year aimed at slowing inflation, although it is unclear how these increases will affect the economy and the spending power of workers over the year to come.

Reuse of Existing Structures by Brock Boatman

Adaptive reuse of existing properties continues to be an interesting development opportunity in the Twin Cities, particularly in downtown Minneapolis. However, the data suggests that not all opportunities are equal. The simple example is the continued conversion of aged warehouses and offices in the North Loop, where conversion to residential uses has been well established for years. A recent example of a new project that is underway is Solhem's Security Warehouse conversion to apartments. Including new construction and properties still in lease-up, downtown Minneapolis apartment vacancy is still near 5%, with starting rent near $1,700. Reuse in this market sector is still well received, although new opportunities are diminishing as supply dries up.

In another adaptive reuse market, owner-users are still being drawn to the Downtown Minneapolis market. A recent example is the purchase by the Red Lake Nation to create a new student campus near US Bank Stadium. The Nation recently purchased the former Tiger Oak Media building and the adjacent properties for use as a new campus for their college. Previously, the buildings here had been a combination of offices, retail, industrial, among other uses in their 100 years of existence. Conversion to a classroom and administrative offices was a natural fit for an owner-user willing to invest the dollars to make these well-located structures beneficial to their cause.

The Rand Tower conversion to a hotel at the end of 2020 was unfortunately poorly timed yet helps demonstrate that existing structures that may no longer be viable as an office use can still find a purpose for reuse. While all hotels have experienced challenges over the last two years, the historic structure located in the heart of Downtown Minneapolis is currently experiencing above average occupancy rates as of the beginning of 2022 and reaching more than 80% occupancy on weekends and event nights – particularly Vikings games and other US Bank events. The Rand Tower conversion took obsolete office space off the market and created a new use that the market is utilizing. The largest reuse space is the Dayton's project. Finally opening in early 2021, this million square foot project has only secured one major tenant, Ernst and Young. This project, with an extensive amenities package

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Reuse of Existing Structures

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that not all developments can provide, does present a unique challenge; the large floor plans cannot easily accommodate a user smaller than around 5,000 square feet. This requires the project to find more home run type tenants in order to stabilize, a challenging prospect given space that has become available in City Center and the relocation of RBC. The Dayton's project was always going to be a risky venture as a speculative development, and the unforeseen challenges of the last two years only added to the risk undertaken by investors and lenders.

Adaptive reuse of existing properties is always going to be a challenging undertaking, and the market's reception can be mixed; however, we would expect to see continued development of this type with investors with the right creative mind and opportunities to keep these projects moving forward.

State of the Real Estate Market

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Warehouses - There appears to be no end in sight for the industrial warehouse boom. Despite clogged supply, demand for major distribution facilities and warehouses seems to be "off the charts" in the Twin Cities. Other regional hubs like Dallas, Atlanta, Chicago, and Denver are experiencing the same shortages of space.

The pandemic has accelerated the already growing trend of e-commerce. Some call this the Amazon Effect. To manage growth, businesses of all types are leasing space to store more inventory and reduce reliance on material supply flows. Despite rampant new development, record-setting demand has kept the Twin Cities vacancy rate below 4% for 22 consecutive quarters. The strongest performing industrial market in the Twin Cities is the Northwest submarket.

Retail Malls - Considering the economic damage brought on by the one-two punch of the pandemic and civil unrest, the Twin Cities retail market has been somewhat resilient in the past two quarters. The retail sector is made up of several submarkets, such as malls and big box stores. In the Twin Cities, these markets make up 29,700,000 square feet. There is virtually no new construction, and there won't be for many years. These sectors are plagued by big box store closures and bankruptcies of numerous tenants. Most landlords have sued dozens of tenants for overdue rent in 2021. All malls continue to see foot traffic down compared to pre-pandemic levels. Even the metro's "best in class" malls are suffering from the pandemic's impact. Older malls and areas with below-average demographics are having the most difficulties backfilling large scale vacancies. Reported vacancy rates for market power centers are in the 11% to 12% range. It is likely that the vacancy rates reflect the occupancy level but not the amount of rent being paid; we at Shenehon believe that landlords may only be collecting 80% of all rent due. Rental rates in these sectors have been flat at $20 to $30 per square foot plus operating expenses, and they will not show any meaningful increase for the next one to two years. For malls in particular, creativity is the theme as landlords and developers will reconfigure and redevelop obsolete or underperforming retail spaces. The goal of the creativity is to explore unique venues that will draw traffic and again engage the consumer's interest. Despite the e-commerce expansion, most retailers are confirming their commitment to brick-and-mortar retail.

Community Strip Centers - Community Strip Centers have not received the same amount of negative pressure from COVID-19. While the pandemic nearly gave the malls and power centers the "knock-out punch," certain retail segments (i.e. grocers, pet supplies, coffee, sporting goods, alcohol, discount clothing, and home improvement supplies) were propelled by the pandemic. How many of you wait in drive-through lines for your Starbucks or Caribou coffee? Most of us, even at the height of the pandemic, were visiting our community/neighborhood strip centers with more regularity than in pre-pandemic times because we were not traveling out of town. As with anything, there are exceptions to this rule, with restaurants being the biggest example. It is anticipated that restaurants will likely be the area of this sector to recover.

TC Office Market - The Metropolitan Twin Cities downtown office market, which is composed of 46,100,000 square feet, reached an all-time high vacancy rate in the third quarter of 2021. This 46.1 million square foot market includes all Class A, B, and C buildings. Think of the total office space as the equivalent of 30 IDS buildings in a row. The current vacancy rate as of January 1, 2022, is 14.3% of all space, or 6,700,000 square feet. This is as if we had four and a half empty IDS buildings. While we have not returned to pre-pandemic levels of downtown office vacancy, we are seeing improvement.

Market Insights (continued)

COVID Impact on Valuations by Madeline Strachota

Since March of 2020, clients have asked us about the impact of COVID on the value of their business or real estate. We believe that there is no one-size-fits-all, uniform "COVID discount" nor "COVID premium." Sectors of the economy have encountered different positive and negative microeconomic impacts from COVID. In fact, sub-sectors of the economy have been impacted differently by COVID. Even within those sectors, the underlying fundamentals of businesses have led to various outcomes. In the hardest hit sectors of the economy, companies with strong fundamentals have been able to weather the storm better than similar companies without strong fundamentals. In sectors where there has been growth opportunities from COVID, companies that have quickly scaled their online, curbside, or delivery sales, have faired better than their competitors who were not as nimble. For example, we appraised a business that saw a 75% increase in annual sales during the global pandemic because they were prepared to serve customers through online sales.

Given this variety in outcomes, the impact of COVID on business and real estate valuations poses a unique challenge to appraisers. It requires forecasting cashflows and determining discount rates when the future of COVID is opaque. It also requires particular attention to detail when analyzing comparable sales. We have noticed a trend among business and real estate owners during this time. For sectors of the economy that have benefited from the COVID impact, business owners are eager to sell. Oftentimes, owners in these sectors want to sell when their cashflow is up, hoping to convince buyers that what may be a short-term uptick in cashflows is a sustainable increase to the bottom line. Alternatively, we have observed many businesses and real estate owners delay sales of their businesses or real estate in the most negatively impacted sectors to avoid a perception problem. So, many of the business and real estate transactions in negatively impacted sectors have been sales where the operator did not have strong fundamentals underlying their business. For example, highly leveraged real estate in badly hit sectors, such as central business district hotels, may have undergone financial distress, causing the owners no option but to sell at a discount to intrinsic value.

Therefore, the sales comparison approach to value presents unique challenges right now—are the sales of like-kind property really comparable to the assets being appraised? Although the real estate may be the same property type, in a similar location, the sale must be analyzed to determine if it was a sale under distress that caused a depression in price beyond the intrinsic value of the asset. Furthermore, sales of real estate or businesses in booming sectors of the economy must be analyzed to determine if the forecasts assumed overly optimistic long-term performance. For example, in the business where we observed a 75% increase in sales, we determined that some of the change in consumer preferences for this brand's products will be sustainable, although the sales will largely return to pre-COVID levels and growth rates in the future.

In summary, a thorough financial analysis on a case-by-case basis is necessary to determine if a "COVID discount" or "COVID premium" is applicable to a business or real estate. So, be cautionary when receiving a cursory answer to the question—what is the COVID impact on value?

Trends in Price to Earnings Ratios for Public and Private Companies by Cody Lindman

The price to earnings ratio (P/E) is one of the most widely used metrics in the valuation of companies. As the name suggests, the P/E ratio is calculated by dividing the price of one share of a company's stock by the company's earnings per share. Although commonly used as a relative measure of valuation between companies in the same industry, it can also be beneficial to compare P/E ratios for a specific company or index over time.

In particular, the Standard and Poor's 500 (S&P 500) P/E ratio is closely followed by investors and analysts because it is believed to provide a reading on the temperature of the overall stock market. As of December 31, 2021, the P/E ratio of the S&P 500 was 30.0, a level significantly above the long-term average of 16.0 since 1871,

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Trends in Price to Earnings Ratios for Public and Private Companies

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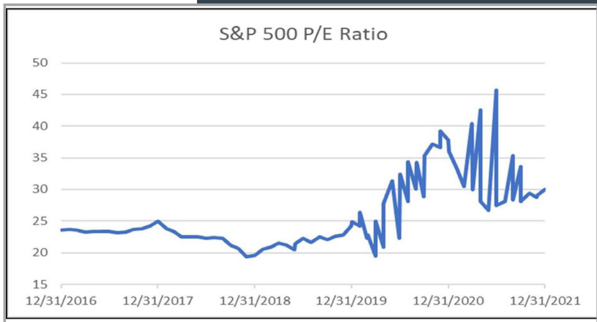
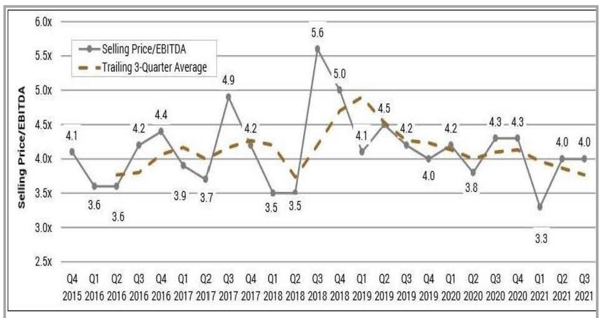
yet below the levels experienced during the dot-com bubble and the 2007-2008 financial crisis. Additionally, the S&P 500's P/E ratio of 30.0 as of December 31, 2021 was above the five-year historical average of 26.7, yet below the 2021 average of 32.2. Due to lower interest rates in response to the COVID-19 global pandemic, P/E ratios have increased significantly since December 2019. In the near term, we expect P/E ratios to decrease as a result of both higher interest rates and inflation. However, the decrease may be muted as a projected increase in interest rates and inflation is likely already priced into the market.



Source: Shenehon Company, data provided by Nasdaq.com

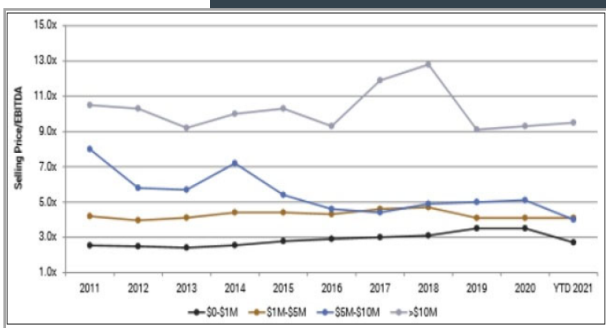
Unfortunately, one is not able to readily calculate the P/E ratio of a privately held company. Instead, investors and analysts look at transactions involving privately held companies and then calculate a variant of the P/E ratio called the selling price to earnings before interest and taxes ratio (Price/EBITDA). The Price/EBITDA ratio is calculated by dividing the selling price of a business by its EBITDA. Although the formula is slightly different, the P/E ratio and the Price/EBITDA ratio should follow the same trends, although they are not directly comparable. One of the best resources for data on Price/EBITDA ratios for privately held companies is the DealStats Value Index, which is published by Business Valuation Resources. According to the fourth quarter DealStats Value Index, the Q3 2021 median Price/EBITDA multiple for private company transactions was 4.0, a level slightly above the three-quarter average of 3.8, yet below the five-year average of 4.4. Since peaking at 5.6 in Q3 2018, the Price/EBITDA ratio has generally declined, hitting a low of 3.3 in Q1 2021. The chart below showcases the DealStats average Price/EBITDA ratio since Q4 2015.

The data suggests that the valuations of publicly and privately held companies have taken divergent paths over the past five years. As of December 31, 2021, the S&P 500 P/E ratio was 27.3% greater than the December 31, 2016 P/E ratio. In contrast, the average Price/EBITDA ratio for privately held companies as of Q3 2021 was 2.4% lower than the average Price/EBITDA ratio as of Q4 2015. One possible explanation for the declining median Price/EBITDA ratio for private companies is an increase in the "size premium." The "size premium" is the tendency for larger companies to typically trade at higher multiples than smaller companies; due to being perceived as less risky and having greater access to capital. Further analysis of the data supports our hypothesis; as shown in the chart below, median Price/EBITDA ratios for privately held companies with less than $10 million in revenue declined between 2016 and Q3 2021. In contrast, median Price/EBITDA ratios increased slightly for private companies with more than $10 million in revenue.



Source: 4Q DealStats Value Index

Another possible reason is that the types of businesses that are typically publicly held or privately held differ. For example, although they are privately held during their early stages, technology firms typically go public eventually. Additionally, as the world economy has become more dependent on technology, the valuation of technology firms has risen steeply over the past five years, with the S&P 500 Information Sector index returning an annualized 28.93% over the past five years.



Source: 4Q DealStats Value Index

Regardless of the reason for the divergence in the valuation trends of public and private companies, the data clearly shows that small privately held companies have underperformed both larger privately held companies and public companies in general over the past five years. In the near term, we expect small privately held companies to continue to underperform both larger privately held companies and public companies due to small private companies typically experiencing greater negative effects from higher interest rates and inflation.

MARKET TRANSACTION
Real Estate

Sale of Bloomington Building

Schmitt Music recently celebrated their 125th anniversary. Shortly after, the five-generation Schmitt Music company purchased a 92,000 square foot building on 9.25 acres in Bloomington. The current Schmitt Headquarters located at 240 Freeway Boulevard, Brooklyn Park will move to 7800 Picture Drive, Bloomington once renovations are complete. The Bloomington location will host the corporate headquarters, an auditorium, teaching space, and a retail store. The 20,000 square foot second floor of the building will be leased out.

The 50-year-old building was appraised considerably higher than the purchase price of $6.3 million, which included a $280,000 environmental escrow to deal with an environmental issue on the property. Depending on the cost of this issue, the money or a portion thereof, may be refunded. Since Schmitt will be keeping the existing building, the signage from 494 will be grandfathered in. This will add immense value for Schmitt considering 142,000 cars drive the interchange at Interstate 494 and Highway 100 every day. The sale needed the approval of the City of Bloomington since Schmitt will be using some of the space for a retail store, which was not a use permitted by existing zoning. The property also includes excess land that Schmitt may elect to parcel off for sale in the future.

Buyer: Schmitt HQ125 LLC

Seller: Shutterfly Lifetouch LLC

Property: Office Building on 9.25 acres, 7800 Picture Drive, Bloomington, Minnesota

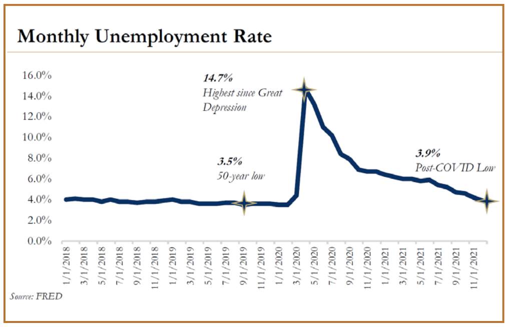
PID: 16-116-21-22-0003

Sale Price: $6,300,000

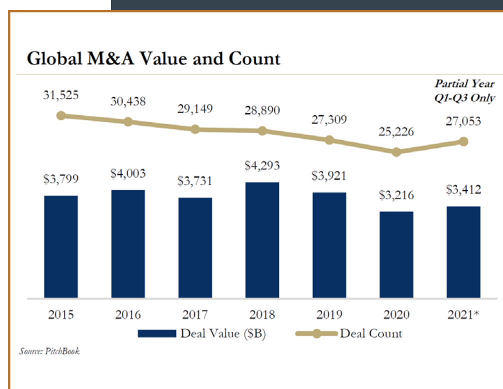
MARKET TRANSACTION
Business

by Chad Starman, Managing Director, Hennepin Partners

Steady and Increasing Activity in Current M&A Landscape



Global M&A activity witnessed a record year in 2021 in many aspects and appears to have little signs of slowing down. Despite continued concern regarding the spread of COVID-19 and its variants, robust activity is continuing. The M&A frenzy is being driven by numerous factors. For private equity firms, it is driven by their desire to capitalize on attractive economic growth and low interest rates. Private equity firms continue to have record levels of dry powder that they are looking to put to work.



On the strategic buyer side, companies are continuing to see strong earnings, increasing cash reserves and pressure from shareholders to create growth organically and through acquisition. Sellers are continuing to monitor a variety of factors when evaluating a potential sale. Potential tax changes, attractive end-market trends and strong valuation multiples are all contributing to an increased volume of deals coming to market.

The US economy continues its boom following the economic recovery from COVID-19. There are still challenges to face, including inflation and the spread of COVID-19 variants, but the U.S. economy continues to grow and remain resilient. This is evident by the most recent unemployment rate of 3.9%, just 40 basis points off of the 50-year low.

Activity in the global M&A market continues to be robust, with both deal value and number in 2021 eclipsing 2020 values only through Q3 2021 (PitchBook). The global M&A market has shown no signs of slowing down with strong activity heading into 2022.

Hennepin Partners Advises Modern Athereter Technologies on its Sale to VitalPath, a Portfolio Company of Inverness Graham

MODERN CATHETER TECHNOLOGIES
HAS BEEN ACQUIRED BY
VITALPATH
A PORTFOLIO COMPANY OF
INVERNESS GRAHAM

In a recent transaction, Hennepin Partners served as the sell-side advisor to Modern Catheter Technologies ("MCT") to VitalPath, a portfolio company of Inverness Graham. Based in Maplewood, MN, MCT provides complex catheter- based delivery systems for a range of endosurgical and interventional applications, with a primary focus on the neurovascular and electrophysiology markets. MCT is known for its high-quality product offering, easily customizable configurations, quick lead times and superior service to enhance customers' time to market and profitability.

MCT's expertise in microcatheters strengthens VitalPath's service to fast-moving customers in the neurovascular, coronary and peripheral market segments. These include nine of the top ten Tier I OEMs and dozens of innovative early-stage medical device companies. The acquisition will also expand VitalPath's ability to scale, increasing its total footprint to more than 80,000 square feet of manufacturing space, including 35,000 square feet of ISO 7 and 8 cleanroom space.

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BUSINESS & REAL ESTATE VALUATIONS

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VALUATION VIEWPOINT NEWSLETTER INSIDE

SHENEHON COMPANY IS A REAL ESTATE AND BUSINESS VALUATION FIRM, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services to offer innovative solutions to difficult valuation issues. Shenehon Company is commited to equipping its clients with the tools necessary to make informed and knowledgable decisions regarding their capital investments.

- Allocation of purchase price
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- Charitable donations
- Commercial properties
- Condemnation
- Contamination impact studies
- ESOP/ESOT
- Estate planning
- Feasibility analyses
- General limited partnership interests
- Gift tax evaluations
- Going public or private
- Highest and best use studies
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- Land development cost studies
- Lease and rental analyses
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- Marriage dissolution
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- Municipal redevlopment studies
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- Special assessment appeals
- Special purpose real estate
- Tax abatement proceedings
- Tax increment financing
- Utility and communication easements

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BUSINESS & REAL ESTATE VALUATIONS

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