VALUATION Viewpoint

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Minneapolis Mulls Renter Protections

by Brock Boatman

Housing is one of the largest challenges facing communities across the country, particularly providing housing for those in lower- and middle-income brackets. One of the ways in which these groups are being affected is by the common purchase and repositioning of Naturally Occurring Affordable Housing ("NOAH"). In an effort to preserve NOAH, communities are considering various vehicles for preservation, including variations of Washington, D.C.'s Tenant Opportunity to Purchase Act ("TOPA" or the "Act"). TOPA was enacted in 1980 to address the housing crisis at the time, and remains in place today. States and cities across the country are now considering some variation of the TOPA framework, including Minneapolis. In this article, we explore the process by which property owners would comply with these new proposed laws based on TOPA, and how the Act affects the multifamily real estate market in D.C.

The Act classifies D.C. rental housing into three tiers: single-family housing, 2- to 4-unit housing, and 5+ unit housing. Until recently, all three tiers were treated relatively equally. This proved onerous for several important reasons, including discouraging rentals of Accessory Dwelling Units ("ADUs") on single-family properties. ADUs are quite common in D.C., taking the form of English basements, carriage houses, and "Granny Flats," allowing single-unit rentals on existing single-family properties. However, the renters of single-family homes yielded extraordinary power to delay sales. As a result, landlords would commonly either keep potential rentals off the market, find ways to terminate leases, or refuse to renew rents at reasonable rates to avoid the often costly alternative, which would be to buy-out the tenant lease. These results ran counter to many of TOPA's goals. Under the revised D.C. rules, the only single-family tenant protection that remains is the right to occupy a unit for 12 months after sale under the current terms. TOPA now applies to D.C.'s second and third classifications, the 2 to 4 unit and 5+ unit properties, with the primary difference being the timeframes in which the tenants have to act.

For purposes of our discussion, we focus on the 5+ unit properties as they typify multifamily properties as we generally think of them. This discussion assumes typical market rate rentals and tenants; additional legislation in

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Market Trends & Value Indicators:

Indicator	Trend	Value
Office Buildings - Downtown	↑	2.0%
Office Buildings - Suburban	→	0.0%
Retail Centers	→	2.0%
Industrial Buildings	↑	2.0%
Apartments	→	2.0%
New Housing Starts - Midwest	↓	1.6%
Productivity	↑	1.8%
U.S. Unemployment	↓	3.3%
Consumer Confidence Index	↓	125.1

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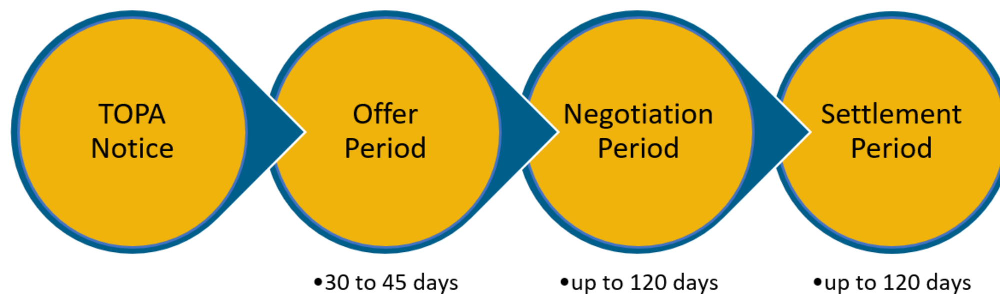
D.C. applies to special situations, particularly involving seniors and persons with disabilities, but those minutiae are beyond the scope of this discussion.

The key factor affecting a seller is the timing of all the required notices and the tenants' response periods. When the owner of a multifamily property enters into a sale agreement, they must notify the tenants. The following chart visualizes the various steps required to complete a sale.



After receiving notification of the sale, the tenants may request information regarding the property: floor plans, rent rolls, and income statements – the same information any buyer or investor would typically request. After review, the tenants may form an association (comprised of 50% or more of the tenants of the occupied units) to exercise their tenants' rights. At this stage, they have four options. The tenants' association may:

Attempt to purchase the property with terms roughly equivalent to the proposed third-party deal. In these cases the ownership has a responsibility to negotiate in good faith with the tenants' association, and not attempt to re-trade the deal with terms different than with the third-party buyer. If the purchase goes through, ownership is then typically controlled by the tenants as a cooperative or limited equity cooperative, with tenants holding the right to purchase their units.

Transfer their rights to purchase to a new investor/developer, in which case the tenants have the right to negotiate how the property will be managed by the new owner. This option can also stipulate renovations and rental increases for existing and future tenants, keeping the property cost-controlled, and may involve public assistance, non-profit involvement, or the creation of a public-private partnership.

Offer to release their rights to purchase the property to the existing owner for some consideration, effectively being bought out in exchange for not slowing the sale process. A key component in this arrangement is that some form of consideration must be given by the current ownership, which can become costly for the seller or new buyer when cash consideration is involved.

Opt to do nothing, and the sale proceeds just as we would see today. This option is most often seen with high-end and luxury developments in which new ownership intends to keep the property "as-is," with no significant plans to renovate or reposition the property.

	Washington, D.C.	Alexandria and Arlington
Population (2017 5-year estimate)	672,391	384,244
Occupied Housing Units	277,985	170,973
Renter Occupied Units	162,190	95,872
% Renter Occupied	58%	56%
Transactions (50+ units)	96	80
Transactions per 1,000 Renter-Occ. Units	0.592	0.834
Listing to Close	7.3 months	4.7 months

Under the D.C. law, a tenants' association can easily tie up a deal for 285 days, or longer. The owner has 360 days in order to enter a sale contract; if not, the TOPA process starts over. This protracted period is necessary for the tenants' association: they need time for research, analysis, and organization in order to decide what their course of action will be. However, this also creates major challenges for the seller. First, there is the financing issue; most lenders will not commit to a term sheet that they might have to hold for over nine months. Changes in market rates can cause a deal to fall apart while a property owner is negotiating with the tenants' association. Second, it makes using a multifamily property as the upleg of a 1031 exchange nearly impossible, given that there needs to be compliance with the 180-day rule. As a result, tenants can leverage extraordinary power and money over property owners looking to sell.

So what effects do these laws have on the apartment market? Anecdotally, market participants will say that these laws drive down values. However, we found the two largest outcomes were that 1) deal volume reduced dramatically and 2) properties remained on the market for an extended period of time.

In order to isolate the effects of TOPA legislation, we aggregated the last five years of apartment sales in D.C. and compared that activity to the nearby Alexandria and Arlington, Virginia markets, which are not affected by TOPA laws. After controlling for market size, we found that transactions of apartment buildings and complexes (50+ units) were 25% to 30% lower in D.C. than in the Virginia markets, and properties in D.C. typically spent 50% to 55% more time on the market. Both of these factors lead to downward pressure on values. This makes multifamily buildings a less attractive investment type in a TOPA market, and lowers the real property tax base for municipalities.

TOPA rules exempt new construction as properties under construction do not have tenants. This creates a strange quirk in the market as new construction properties often sell 100% vacant before tenants are able to occupy units and trigger the TOPA process. These laws affect both pure merchant developers as well as groups that intend to retain ownership positions in their projects.

TOPA rules also prompt the question of what constitutes a sale. Up until the mid-2000s, owners could sell 95% - and some argued up to 99.99% - of their ownership and still avoid triggering the TOPA process based on the courts' interpretations of what constituted a sale. Clearly, this went against the spirit of the Act, and has since been nixed by subsequent court decisions. However, the definition of a sale continues to be debated. A court case this summer asked whether a reallocation of ownership interests constituted a sale. The court ruled that a third party was necessary to define a sale and trigger the TOPA process. More importantly, the case demonstrates that TOPA legislation still provokes questions and challenges almost 40 years after its passage.

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Advocates for renter protections gathered outside Minneaplis City Hall this summer.
Source: www.thealliancetc.org/renter-rights-mpls/

So why pursue such legislation? Again, the goal of the legislation is to give renters, particularly those that occupy NOAH, seniors, and disabled people, tools to maintain rents and remain in their homes. Generally, these populations are renters "by circumstance" as opposed to those who rent in the newer luxury developments "by choice." People renting at top of the luxury market, say $3,000 for a two-bedroom unit in newer projects here in the Twin Cities, are generally not at risk of being displaced by new ownership. Additionally, TOPA legislation creates opportunities for those with more moderate means to purchase their apartment through the creation of a co-op. However, as much as the legislation can help empower renters, it can create substantial challenges in capital markets. As the data shows in the closest "apples to apples" comparison, available deal velocity and timing will be affected, particularly for larger investors. If TOPA legislation passes in Minneapolis, it will take years to fully measure its effects on housing and the real estate market.

Real Estate Transaction

Buyer: St. Armands Circle Investments LLC
Seller: Entity related to Rush family
Property: 9s on Nicollet
Sale Price: $10.1 million

Sale of 9s on Nicollet

The City of Minneapolis requires 60% of a building's street frontage on Nicollet Mall be retail. Many building owners question whether this zoning requirement is still a good idea as downtown retail has declined over the past several years. Some owners are optimistic about downtown retail and others are pessimistic. With the retail landscaping changing, many hoped the Nicollet Mall renovation would help fill the empty spaces. Many also hope the residential construction bringing an influx of downtown residents will make Nicollet Mall retail more lucrative.

Several recent transactions along Nicollet Mall demonstrate both interest and opportunities. The owners of The Andrus, formerly known as Renaissance Square, has asked the City of Minneapolis for a variance to lease street level space to an office tenant. Walgreens moved from 8th Street to a new store in Gaviidae Common; the store's previous building remains for sale. The Minneapolis Downtown Improvement District (DID) opened a pop-up satellite office in street level space at 6th Street and Nicollet Mall in Gaviidae Common. The façade of City Center is being renovated to improve the building's corner on Nicollet Mall and 7th Street. Brit's Pub sold this summer as did the connected buildings called the 9s on Nicollet Mall.

The 9s on Nicollet, which encompasses 915 and 927 Nicollet Mall, is valued at $4 million for property tax purposes by the City of Minneapolis. Over the summer, St. Armands Circle Investments LLC, a private, family-run commercial real estate entity based in Naples, Florida, purchased the buildings for $10.1 million. The entity's portfolio includes properties throughout western Europe and the southeastern United States; it purchased the 9s to diversify the geography of its holdings. Standard Commercial, a Minneapolis-based boutique commercial real estate investment service, represented the buyer.

The seller was an entity related to the Rush family of the former Rush Bridal store, which was located in the 9s until the store closed in 2016. Upland Real Estate's Deb Vannelli and North Central Commercial Real Estate's Russ McGinty represented the seller.

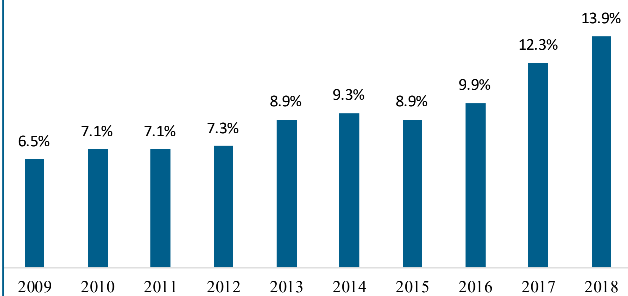
The 9s has 31,440 square feet of leasable area. Originally built in 1912, the Rush family invested approximately $4 million in building upgrades several years ago, including a skyway, an elevator, and tenant improvements. The building is home to Barrio, Rojo, the Stable, the Wilko Group, and Escape the Room. Barrio just extended its lease for 10 years and restaurants along Nicollet Mall have reported increased patronage since the completion of the Nicollet Mall renovations.

Business Valuation

by Jim Clancy, Managing Director, Hennepin Partners

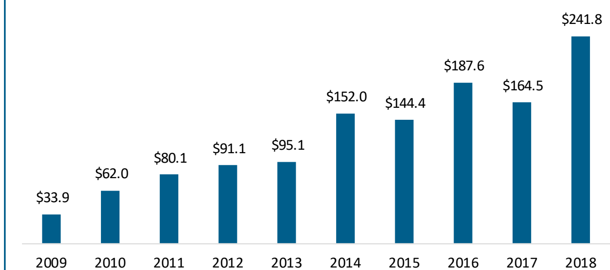
Private Equity Firms are Pushing Software Valuations Higher

Private equity firms have historically been attracted to established businesses with consistent cash flows that can be used to pay down acquisition debt. Meanwhile, start-up technology companies have been the domain of venture capital investors. In recent years, owing to new business models with stable cash flows, PE firms have become active bidders for software companies.



Growing competition in the M&A market for software businesses has led to higher valuations and expanded deal volumes. In large part, this competition is coming from PE buyers. According to Pitchbook, PE buyers now account for nearly 40% of software acquisitions.

In the bulge bracket, PE groups are competing head-on with Silicon Valley's elite. PE buyers outspent strategic acquirers on software deals larger than $1 billion in 2019 Q2.



PE Demand is Particularly Strong for Subscription-based Software Companies

Software-as-a-service or "SaaS" businesses have seen PE investments grow five-fold between 2015 and 2018. This exploding PE interest is driven by subscription-based business models that produce recurring monthly revenues and highly predictable cash flows. Adding to their allure, SaaS businesses often grow in excess of 30% per year.

Hennepin Partners Advises IndustrySafe on Its Sale to Vector Solutions

The rising trend of SaaS M&A activity is displayed in a recent transaction arranged by Hennepin Partners. IndustrySafe, a Philadelphia-based developer of environmental, health and safety ("EHS") management software, was acquired by Florida-based Vector Solutions.

Vector Solutions delivers award-winning online education, safety, compliance and performance-optimization solutions to customers in a variety of industries including architecture, engineering, construction, industrial, facilities management, public safety, IT, and education. With its acquisition of IndustrySafe, Vector has added highly sought-after EHS capabilities to its product portfolio. Vector can now give its clients a more complete array of solutions to increase compliance and improve safety.

Hennepin Partners LLC is a boutique investment bank that provides M&A advisory services and strategic advice to entrepreneurs, private equity firms, and corporations. Member FINRA/SIPC. For more information, visit www.hennepinpartners.com

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