

# Minneapolis, Minnesota



Multifamily Housing Update

August 2010

## EXECUTIVE SUMMARY

**A**fter spinning wheels for over three years, the Minnesota and Twin Cities labor markets found traction in summer, producing some of the strongest job growth in the nation. State private sector employers created 19,000 payroll jobs in July, according to a government report, and added 29,000 net jobs over the previous 12 months, representing the strongest job growth in four years. Year-to-date, metro payrolls expanded by more than 26,900 jobs, including a 10,100-job add in July, the largest one-month payroll advance recorded since 2005.

Not seasonally-adjusted year-over-year comparisons remained in the red through June, falling at a 16,000-job, -0.9% rate in 2Q10, comparing unfavorably to the -0.5% national average. But July's robust performance changed the dynamic, pushing the annual payroll comparison above parity by 9,000 (0.5%) jobs, representing the first 12-month employment growth posted since December 2007.

The July surge was fueled largely by faster hiring in the business service, health care, education and hospitality sectors. Together, payrolls in the foregoing industries increased 28,700 jobs from July 2009 levels, a 4.3% advance, paced by surging employment at food and drink establishments and administrative service companies.

**RED Research** expect employment growth to continue to accelerate through 2011. Our econometric payroll model indicates that the annual pace of metro growth will exceed 20,000 (1.2%) jobs by 4Q10, and is likely to reach or exceed a 30,000-job, 1.8% rate by next summer. By way of forecast, the model projects net increases of 30,100 (1.8%) jobs in 2011, and 47,300 (2.7%) jobs in 2012.

Second quarter apartment absorption grew accordingly, as improved job

prospects unleashed pent-up housing demand. Tenants net leased 474 units during the second quarter, up from 210 in 1Q10 and 72 in the year-earlier period. Accounting for the delivery of 171 new units to the St. Paul submarket, occupancy increased 20 basis points to 94.9%, the sixth highest rate among the **RED 50** markets.

Rent trends were mixed. Metro average asking rent was unchanged sequentially but a small (\$1) increase in the typical concessions package sent effective rents down -0.1% to an average of \$892. Effective rents were unchanged or higher in five of Minneapolis's eight submarkets, but decreases of more than 1% in the large Minneapolis City and Dakota County submarkets pulled the average lower.

Reis expect balanced absorption and supply trends through 2014 to keep average occupancy in a tight band between 94.9% and 95.1%. But the outlook for rent growth is constructive. The service projects that average effective rents will rise 0.7% by YE10, followed by annual compound growth at a 3.2% rate through 2014, 50 bps faster than the **RED 50** mean.

Trade in metro apartment assets was slow in the first half. Real Capital Analytics identified only two completed institutional quality trades totaling \$48 million of proceeds. Prices averaged \$151,079 and \$229,630/unit.

While there was little empirical evidence to substantiate it, market clearing cap rates appeared to move lower during the summer, reflecting the growing appetite among large investors for apartment properties in markets that appeal to skilled Gen Y workers. Although closed trades of stabilized class-A assets were most recently consummated at cap rates in the mid-6% area, CBRE estimated in August that clearing rates were in the 5.5% to 6.25% range.

## SNAP SHOT

	Y-o-y change	Projected YE 2010
Vacancy (5.1% - 2Q10)	↑ 40 bps	↑ bps
Effective Rents (\$892 - 2Q10)	↓ 0.1%	↑ 0.8%
Cap Rate (NA - 2Q10)	↔	↔
Employment (1,701.0m - 2Q10)	↓ 16.0m	↓ 10.6m

## KEY POINTS

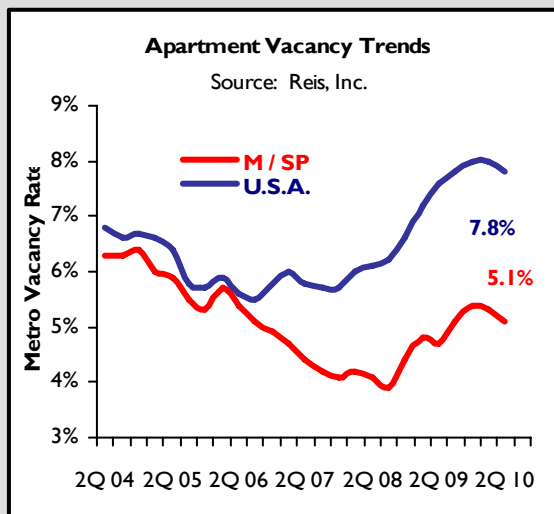
- After slumping for nearly three years, the Minneapolis-St. Paul economy sprang back to life in the spring. Seasonally-adjusted payroll aggregates increased 24,500 jobs during the five months ended in July, easily the strongest results posted in five years.
- **RED Research** expect strong employment growth to continue through 2012. Our model forecasts 30,100- and 47,300-net job gains in 2011 and 2012, respectively.
- Improved job prospects unleashed a portion of the pent-up demand for apartments amassed since 2007. Tenants net leased 474 units during 2Q, trimming 20 basis points from the metro average vacancy rate.
- Owners seemed content to build occupancy and consolidate rent increases implemented last year. In spite of solid gains recorded in Washington County and Saint Paul neighborhoods, average effective rents fell -0.1% quarter-to-quarter, principally due to weakness in Minneapolis city submarket.
- Based on thin trading, **RCR** conclude that 6.5% is an appropriate metro generic cap rate. At that level, we estimate expected total returns for metro assets of about 7.9%.

## 2Q10 VACANCY TRENDS

- Apartment demand continued to recover after weak 2009 results. Tenants leased a net of 474 units in 2Q10, raising the first half total to 684 units. This compares to -515 net unit move-outs during 2H09. Average occupancy increased 20 basis points from 1Q10 to 94.9%.
- Properties in submarkets appealing to Gen Y tenants encountered mostly robust demand: tenants absorbed a net of about 130 units in the Minneapolis city and Washington County submarkets. Saint Paul was an exception; moderate tenant losses and the addition of 177 units to inventory caused average occupancy to plummet 110 bps to 93.9%.
- Reis project balanced supply and demand over the next several years, holding average metro occupancy near the 95% equilibrium level.

**RANK:** 6<sup>th</sup> out of 50

**RCR** believe pent-up demand could yield tighter markets than the Reis baseline.

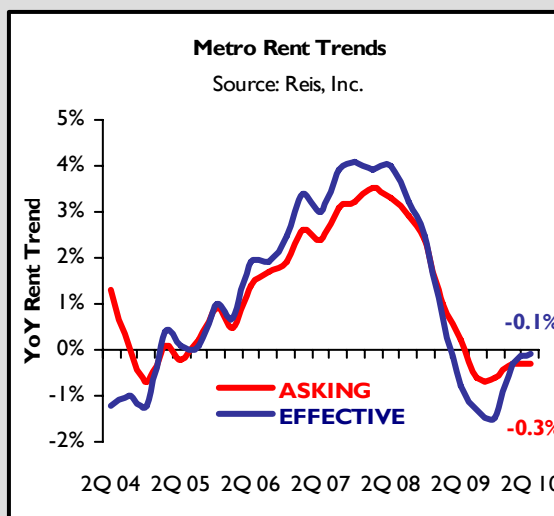


## 2Q10 RENT TRENDS

- Rent trends were mixed in the second quarter as softness in the infill Minneapolis submarket and higher concessions levels in the suburban Dakota County submarket offset moderate gains elsewhere. The average metro asking rent metric was unchanged sequentially at \$950, but a \$1 increase in concession costs yielded an effective rent decrease of the same degree (\$1/-0.1%), reducing the metro average to \$892.
- Owners in the tech-flavored Washington County submarket exhibited the greatest degree of pricing power in the metro area. Average effective rents increased \$12 (1.3%) sequentially to \$947.
- Reis expect metro effective rents to increase \$6 (0.7%) by year end, followed by compound growth averaging 3.2% per year through 2014.

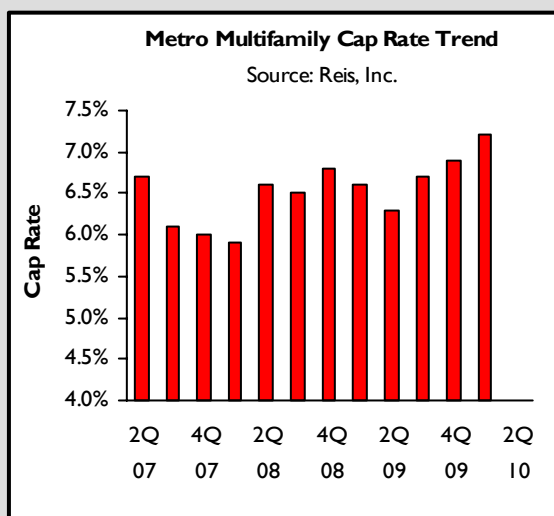
**RANK:** 33<sup>rd</sup> out of 50

Projected rent growth through 2014 is the 12th fastest among the RED 50 markets.



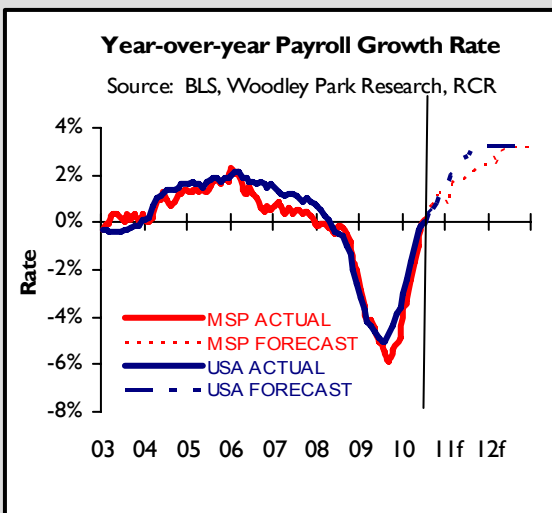
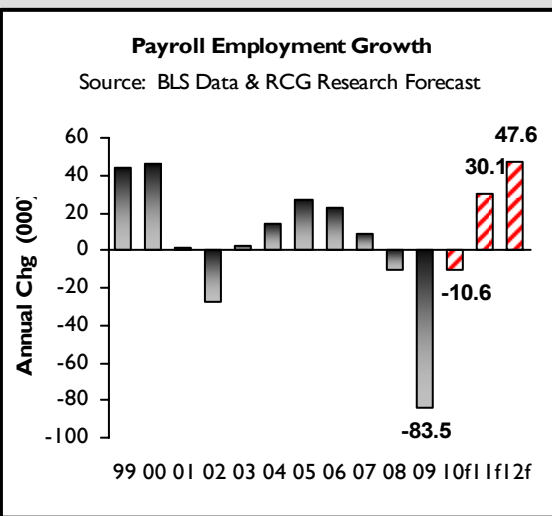
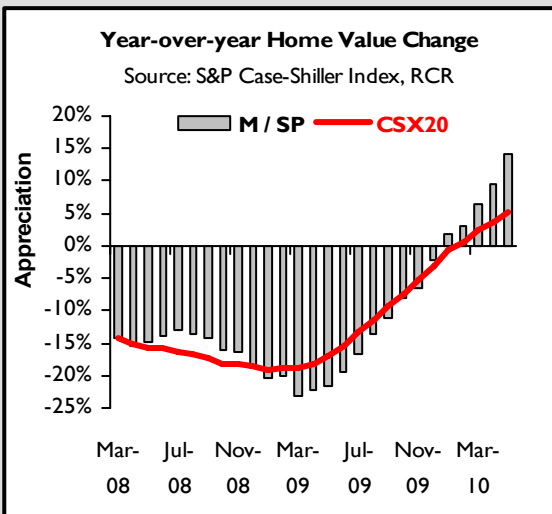
## PROPERTY MARKET & CAP RATE TRENDS

- Never among the more actively-traded markets, Minneapolis liquidity was thin in the first half 2010. Real Capital Analytics identified only two transactions closed during the period for total proceeds of \$48 million. Last year, two trades valued at \$65 million were consummated in the comparable six-month period.
- A new construction 97% occupied property located adjacent to the University of Minnesota campus in “Dinkytown” was marketed for sale in August. The price of the property, where rents averaged \$1,597 (\$2.08/sf), will be determined by the market.
- Based on a 6.5% generic cap rate assumption, **RCR** estimate that typical M / SP assets will generate total returns averaging 7.7% per year over a 5-year holding period, 18th highest among the R50. Cap rates have tightened recently, however, so currently yields are likely to be lower.



## NOTABLE TRANSACTIONS

Property Name	Property Class	Date of Transaction	Total Price (in millions)	Price per unit	Estimated Cap Rate



## DEMOGRAPHICS & HOUSING MARKET

- Unlike a host of metro areas where population growth stalled in 2009, Minneapolis enjoyed steady demographic expansion. The area added 32,202 residents over the year ended July 1, 2009, an increase of 0.99%, down from 33,416 (1.04%) in 2008.
- Home price trends were weaker than average. The median price of a metro home sold during 2Q10 was \$176,200, according to the NAR, representing a year-on-year decline of -4.5%. By contrast, the median prices of Midwest Region and U.S. homes increased 1.5% and 1.4%, respectively.
- The S&P Case-Shiller repeat sales index told a different story. The Minneapolis price index in May was 14.2% above the year earlier comparison, ranking as the second strongest year-on-year gain among the 20 markets in the CSX20 index.
- Home sales plunged in July, contributing to weaker pricing and increased sales inventories. HousingTracker.net report that the median asking price of M/SP homes slid 4.4% from July to August while for-sale inventory rose 0.9%.

## EMPLOYMENT TRENDS

### Non-Seasonally Adjusted

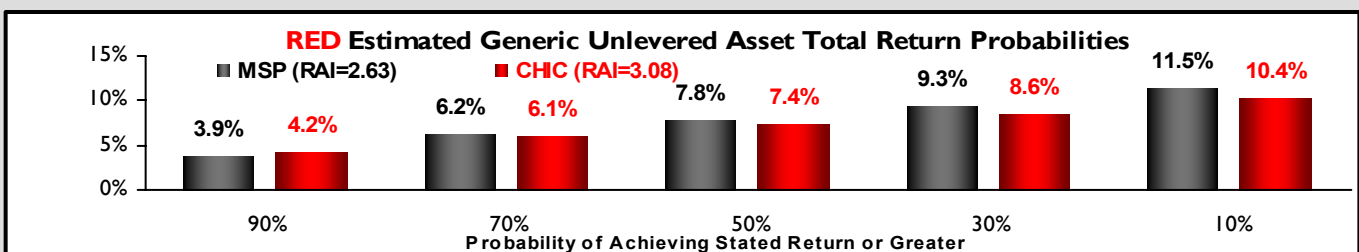
- Minneapolis payrolls declined at a 16,000-job, -0.9% year-over-year rate in 2Q10, up from losses at a 53,200-job, -3.1% pace in 1Q.
- The gain was spurred principally by expansion among business, health care, education and hospitality service employers, as well as slower attrition in the manufacturing and retail sales sectors.
- Payrolls in July pierced the year-on-year parity threshold for the first month since December 2007. The 9,000-job, 0.5% advance outperformed the -0.0% national average, representing the first monthly comparison since May 2009 in which metro growth trends were superior to those recorded for the nation as a whole.
- Unemployment in June averaged 6.3% of the work force, the lowest rate registered since December 2008.

### Seasonally-Adjusted

- Preliminary data indicate that metro payrolls increased by 10,100 jobs in July, the largest one-month advance in more than five years.
- Minneapolis establishments hired a net of 26,900 workers during the first seven months of 2010.
- In July, Minnesota enjoyed the 8th lowest unemployment rate (6.8%) and the largest year-on-year unemployment rate decline (-1.5%) among the 50 states and District of Columbia.

### Forecast

- After suffering through a long dry spell the Minneapolis economy developed strong momentum in the spring and early summer. The RCR econometric payroll model interprets the trend positively, forecasting the onset of year-on-year payroll growth at rates exceeding 30,000 jobs per year by 1Q11. Consequently, M / SP is positioned to add 30,100 jobs in 2011, followed by more than 40,000 in 2012.

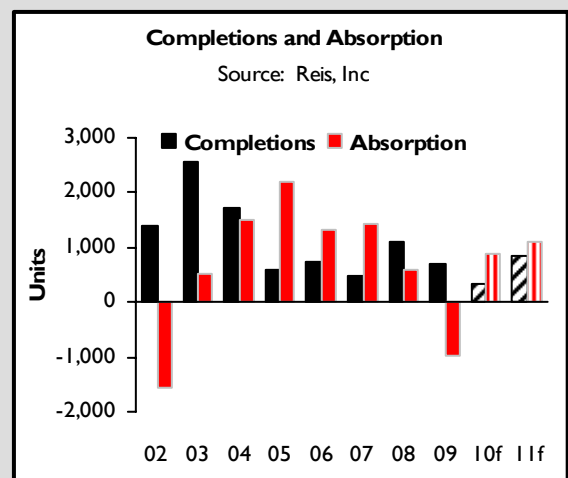


## SUBMARKET TRENDS

Submarket	Effective Rent			Physical Vacancy		
	2Q09	2Q10	Change	2Q09	2Q10	Change
Dakota County	\$869	\$864	-0.6%	4.9%	5.7%	80 bps
Minneapolis	\$1,048	\$1,034	-1.4%	4.8%	4.5%	-30 bps
Northeast	\$808	\$799	-1.1%	4.6%	4.6%	Unchd
Northwest / Anoka County	\$761	\$759	-0.3%	4.3%	4.7%	40 bps
Southwest	\$899	\$914	1.6%	4.9%	4.8%	-10 bps
Saint Paul	\$858	\$870	1.4%	4.4%	6.1%	170 bps
Washington County	\$939	\$947	0.9%	5.9%	5.8%	-10 bps
West	\$940	\$944	0.4%	4.7%	5.2%	50 bps
<b>Metro</b>	<b>\$893</b>	<b>\$892</b>	<b>-0.1%</b>	<b>4.7%</b>	<b>5.1%</b>	<b>40 bps</b>

## SUPPLY TRENDS

- Developers completed only one major project in the metro area during the first half 2010, a 177-unit mid-rise in Downtown Saint Paul. Quoted asking rents at the property ranged from \$1,020 to \$2,125 in late August, equating to about \$1.40 to \$1.60 per square foot.
- Reis identify three major apartment projects currently underway. One is nearly complete: a 132-unit modernist mid-rise located in the city of Saint Louis Park near the Minikahda Golf Course. A few units at the property were available to lease in mid-August. Face rents ranged from \$995 to \$2,299 or \$1.50 to \$1.75 per square foot.
- The other two projects under construction (encompassing 416 units between them) are projected for 2011 completion. Both are targeted at upscale young professionals. Construction on a 242-unit mid-rise in Woodbury, Washington County began in March. A December 2011 completion date is projected. The other project is an infill four-story courtyard design on Portland Avenue. The project broke ground last fall and media reports suggest that some units may be available as early as the fall. Pre-leasing rents range from \$990 to \$2,540, equating to \$1.50 to \$2.00 per square foot.
- A 133-unit loft property in Saint Paul, completed in the summer 2009, was already 97% occupied in June. Rents averaged \$1,435.



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