

Minneapolis, Minnesota

Multifamily Housing Update

October 2007

EXECUTIVE SUMMARY

Momentum in the Minneapolis / Saint Paul job market evaporated in the six months ended in March, falling below a 1.0% year-over-year pace for the first time in three years. But the regional job engine sparked back to life in 2Q07, producing a seasonally-adjusted total of 9,100 jobs, the equivalent of an 18-month high 26,000-job (1.5%) annual growth rate.

No credit is due to the goods producing industries. Indeed, the construction and manufacturing sectors saw payrolls decline at a combined -4,700- job annual pace. Rather, the skilled services were primarily responsible, especially private and higher education, which expanded at a surprising 3,600 (9.6%) y-o-y rate, and health care services, which registered growth at a 6,600-job (3.3%) pace. Legal and architectural firms reported strong billings, leading to hiring at a brisk 3.5% y-o-y clip, while logistics and employment service payrolls grew with considerable speed.

Only durable goods manufacturing and information services exhibited materially weaker market conditions. The former was affected by job losses in the metals and transportation equipment components, and the latter saw substantial cuts in the publishing and periodicals industry. But even in these super-sectors negative trends were by no means universal. Net hiring was reported in the electronics and navigation and medical device manufacturing industries, while in information services telecom and internet headcounts held steady.

The M/SP economy is positioned to prosper in the current environment by virtue of its strengths in high-skill services and exportable durable goods. The metro's inherent strengths are supported by the state's fiscal discipline and competitive tax structure. Consequently, metro job growth is likely to outperform peers and exhibit more

stable trends than the U.S. through 2008. RED's econometric model foresees a slowdown in 2H07, leading to creation 18m to 20m FY07 net jobs. Hiring will decelerate in 2008, slowing to the 7m to 20m range, with a most probably outcome of 13,000 (0.7%).

Conditions in the apartment market improved in 2Q07, reflecting healthy tenant demand and moderate supply trends. Households absorbed 527 units, according to Reis, versus no supply, giving rise to a 30 basis point sequential occupancy rate increase to 95.6%, a 5-year high. Occupancy advanced 100 bps y-o-y, a performance surpassed by only three members of the RED 50. With only about 1,000 units currently under construction, owners are positioned to make further gains.

The tight market notwithstanding, owners did not move aggressively to hike rents. Effective rent increased an average \$8 (0.9%) sequentially, yielding a \$25 (3.0%) y-o-y advance, ranked 39th in the RED 50. This compares to a 4.6% rise in Chicago. The conservative pricing approach may reflect owner concern over soft demand for condos among target households and the implications of failed condo projects for prospective supply.

Whatever the reason, Reis expect soft conditions to prevail through 2008. The service forecast 3.6% effective rent growth in 2008 (near the U.S. average), preceded by a cautious \$8 (2.9% y-o-y) hike in the second half of 2007. Reis's demand outlook is similarly dour, as the firm anticipates negative net absorption in 2H07 against supply of 375 units, yielding a 30 bps occupancy setback to 95.3%.

Reis's cautious outlook and the low cap rates applicable to M/SP assets produce mediocre total returns. RED are positively disposed anyway, ranking metro assets solid buys and Minneapolis an "Accumulate" market.

SNAP SHOT

	Y-o-y change	Projected 2007
Vacancy (4.4% - 2Q07)	↓ 100 bps	↓ 20 bps
Effective Rents (\$865 - 2Q07)	↑ 3.0%	↑ 2.9%
Cap Rate (6.2% - 2Q07)	↔ Unch	↑
Employment (1,819m - 2Q07)	↑ 26.0k	↑ 13k

KEY POINTS

- The Minneapolis economy rebounded after a six-month soft patch. Metro payrolls increased at a 26,000-job (1.5%) annual pace, the fastest in 18 months. RED forecast positive but slower growth in 2008.
- Median M / SP home prices fell -2.5% over the 12 months ended in June, according to the NAR, and sales velocity was down 14.9% January through August. Downtown condo sales slowed to a snail's pace, leading to foreclosures of three downtown projects.
- The buoyant economy and weak for-sale market ignited apartment performance. Tenants net leased 527 units, reducing overall vacancy 0.3% to 4.4%. Average vacancy plummeted 100 bps y-o-y, the 4th largest down move among the RED 50.
- Owners raised rents cautiously, opting to build occupancy. Average effective rent increased \$8 in 2Q07, a 0.9% sequential and 3.0% over-the-year advance ranking 32nd and 39th, respectively, in the RED 50.
- Projected total returns are mediocre, but RED are more bullish than Reis with regard to occupancy and rent trends. We consider Minneapolis an "Accumulate" market.



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