

## SNAPSHOT



- Lean times for landlords as demand slows
- More downward pressure on speculative land values
- Retail vacancy reaching 10-year high, but some retailers still looking to expand
- Investment market at a standstill, but deals can be made if the price is right
- Turnaround in job market is the key to recovery

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## Credit Crunch, Struggling Economy Stunt Growth of Twin Cities Commercial Real Estate Market

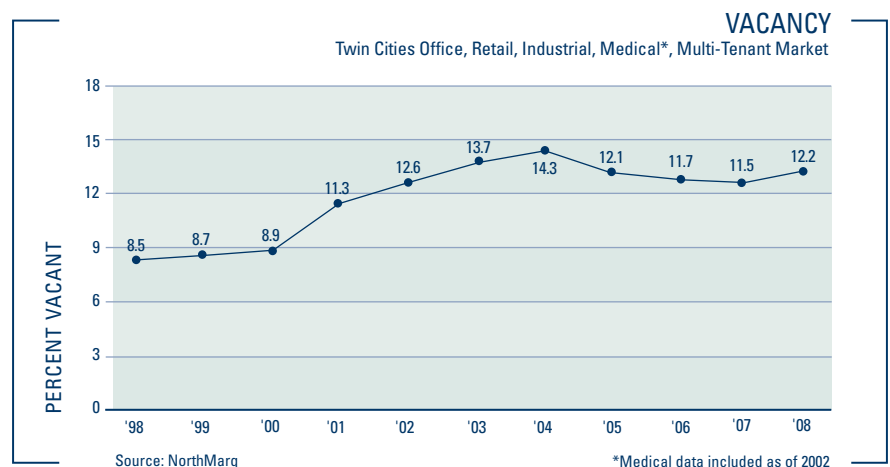
Bad news in the economy and financial markets took its toll on the Twin Cities commercial real estate market during the second half, resulting in a significant slowdown in leasing, investing and new development activity. The Twin Cities region saw a net loss of 22,000 jobs through the first 11 months of 2008. That pushed the unemployment rate to 6.4%, and projections are that the state will see unemployment of 8% or more in 2009<sup>1</sup>.

Land prices continued their downward spiral in the second half of the year. Speculative land in outer-ring suburbs was discounted by as much as two-thirds compared with the peak period of 2005-2006. In-fill sites, especially those suited for industrial uses, were more stable

but still declining in value. Pricing instability is likely to continue, and values will continue to decline in 2009 as the regional economy sheds jobs and the new housing market continues to stagnate.

### A FEW BRIGHT SPOTS IN THE MARKET

Sales activity in the multi-family apartment market remained brisk, due in large part to the continuing ability of Fannie Mae and Freddie Mac to underwrite deals. Despite the slowdown in consumer spending, some national and regional retailers such as Sonic, Aldi, Smashburger and Leeann Chin continued to explore the market for new locations. Also, the medical office, industrial and retail markets all posted positive absorption totals, albeit at reduced levels compared with 2007.



That said, the impact of the financial crisis and recessionary environment was severe and growing more threatening at year end. This led to a near shutdown in investment activity in the office, industrial and retail markets in the second half. Buyers and sellers were often at marked odds over what constituted market value for a property; pricing in general declined significantly across all property types, reflecting growing concerns over weakening fundamentals like rental rate structures and occupancy levels going forward.

### WEAKENING DEMAND SETTING OFF ALARM SIGNALS

Office leasing activity slowed throughout the market, resulting in the first full year of negative absorption since 2003. Overall vacancy edged up to 15.9%. Average rental rates were relatively steady during the year, but concessions were increasing.

The medical office market was not immune to the current economic environment. Several large hospital expansion projects were postponed due primarily to the increased cost of capital, and new construction activity overall delivered just 99,000 sq. ft. of new product to the market in 2008. The slowdown in new construction is allowing the market to absorb excess space, evidenced by 35,000 sq. ft. of positive absorption in 2008.

Demand for industrial space softened in the second half, pushing overall vacancy up to 12.3%—the highest level since 2006. The market recorded positive absorption of 882,000 sq. ft. in 2008, while adding almost 1.1 million square feet of new product. Sublease space on the market more than doubled, a likely indication of

increased downsizing by tenants. The number of user buildings on the market has increased significantly—up 58% from one year ago<sup>2</sup>. Despite increased supply, buyers are difficult to find in light of the credit crunch and limited access to debt.

### RETAIL MAKEOVER IN PROCESS

Retailers were struggling in the second half, dampening demand for new space and sending vacancies up in all product types. At 7.9%, overall vacancy increased to its highest level in a decade. Side-shop vacancy stands at 18%. The year's 365,000 sq. ft. of positive absorption was a mere shadow of that of recent years. New construction activity slowed but still managed to bring 928,000 sq. ft. of new space to the market in 2008. New construction activity will likely decline significantly in 2009.

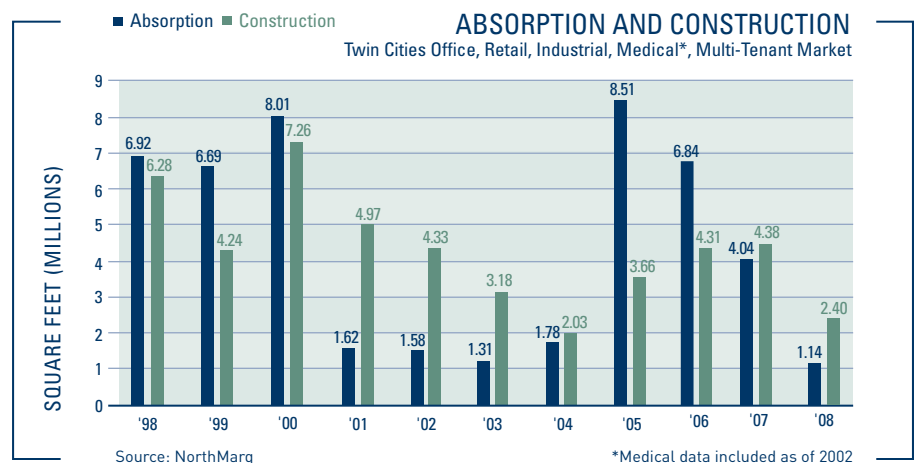
### 2009: A YEAR OF CHALLENGES

Looking into 2009, it's obvious the commercial real estate markets will continue to struggle. Many of the markets—office, industrial, retail—will see rising vacancy rates and much less competition. Landlords need to be prepared for a protracted downturn in demand. Short-term strategies to save

assets will likely be a higher priority than building longer-term value for many landlords, which will in turn lead to lower overall rents and more use of concessions and other creative marketing tactics.

Owners of all property types will be under increased pressure. On the positive side, there is abundant capital on the sidelines, waiting for the opportune time to invest in commercial real estate. Sellers will need to reset their prices in accordance with present-day realities, which are much different from the boom years of 2005-2007.

Tenants generally fall into one of two groups. Many are waiting for an apparent improvement in the economy before making long-term real estate decisions. They are staying in their current space, renewing with short-term leases and asking for flexibility from their landlord. Other companies are taking advantage of current market conditions and working to secure more favorable terms than their present obligations. Both trends are likely to continue into 2009 as tenants' businesses work through the challenges of the current economy. ■



<sup>2</sup> According to the Minnesota Commercial Association of Realtors