



- Twin Cities market stressed; severity likely to deepen in next 6-12 months
- Landlords need to intensify risk management efforts
- Retail vacancies rising on heels of brand name bankruptcies
- Investors, lenders looking for market bottom

Recession Dampens Demand, Puts Landlords on the Defensive in Twin Cities Commercial Real Estate Market

As expected, the aftershocks of the late-2008 financial meltdown reverberated through the Twin Cities commercial real estate market. The effects of the recession—rising unemployment, manufacturing cutbacks, corporate contractions, slowing consumer spending—are now being experienced in all product types of commercial real estate.

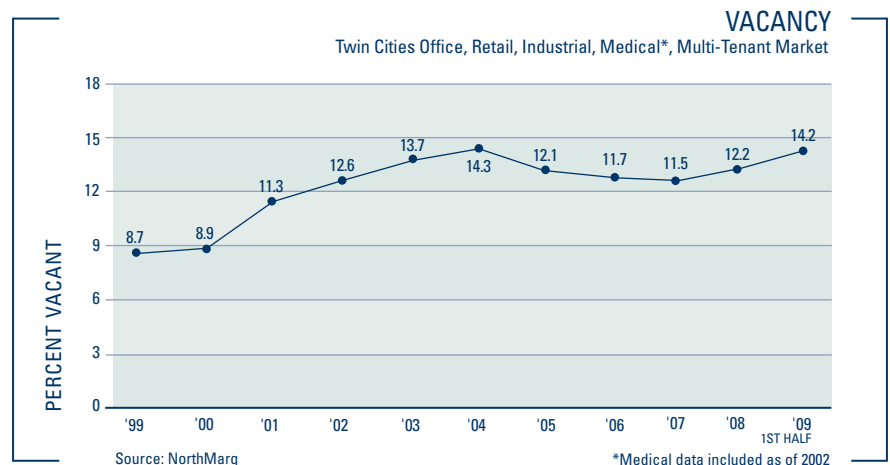
The Twin Cities market is generally experiencing stress. Every market sector—retail, office, industrial, medical office, multi-family, land and investment—softened considerably. However, many property owners remain well-capitalized—a benefit of the more conservative approach to financing that characterizes the Twin Cities market, according to some observers.

VACANCY RISING ACROSS ALL PROPERTY TYPES

First-half numbers for all property types were not particularly encouraging. Overall vacancy among all property types increased to 14.2% (16.3% including sublease space)—figures last seen in 2004. Office vacancy saw the largest increase, rising to an overall rate of 17.9% / 20.7%. That was followed by industrial, rising to 15.1% / 17.2%. Medical office moved up to 12.7% / 13.2%. Retail vacancy increased substantially, reporting 9% (10.3% with sublease)—the highest level in more than 10 years.

LACK OF DEMAND TRIGGERS DROP IN ABSORPTION, CONSTRUCTION

Less business growth also translated into 3.7 million square feet of overall



negative absorption. The battered industrial market accounted for more than 2 million square feet of the negative absorption. Office recorded 963,000 sq. ft. of negative absorption while retail showed 681,000 sq. ft. of negative absorption. Medical office was the bright spot, posting 65,000 sq. ft. of positive absorption.

New users are scarce in all submarkets. Most activity is driven by tenants with expiring leases. The trend is toward shorter-term leases, which has made sublease space much more competitive with the direct-space market.

New construction is tapering off. The market saw 1 million square feet of new product delivered during the first half, including some substantial new office buildings in the Southwest submarket. In the second half, 750,000 sq. ft. of new retail product is set for delivery, along with a 120,000-sq.-ft. office property in the West submarket that is 100% leased.

LANDLORDS NEED TO STAY AGGRESSIVE, MANAGE RISK

Landlords will have to manage their relationships with individual tenants and may need to be creative when

negotiating leases to maintain existing occupancy levels in the midst of further decline in demand for new space.

Managing risk is becoming more of a priority for landlords, as they are asked to do more to help struggling tenants survive. Landlords are in essence becoming the lender of last resort for some tenants, and they will need to clearly understand the financial situation of each individual tenant in today's market. Their survival may depend on it.

Tenants are expecting landlords to present their best offer early in negotiations, especially in the retail market where the presence of co-tenancy agreements can potentially trigger a domino effect of tenants either substantially reducing rents or leaving a struggling retail center.

DOWNWARD MOMENTUM LIKELY TO CONTINUE

Some observers believe the market has not yet hit bottom, which could spell more problems for landlords in the months ahead.

It's clear that the market will see an increase in distressed ownership

situations during the second half of 2009 and into 2010 as more landlords face cash flow problems due to limited financing options. Lenders are waiting for the market to reach the bottom and for a clearer understanding of market fundamentals and the effect of new government regulations on the industry.

Absent a real motivation to liquidate in today's market, sellers are generally unwilling to bridge the pricing gap caused by buyers' limited financing options, more onerous terms and increasingly fragile property income streams. This has caused gridlock in the sale market, a trend expected to continue through year end.

Speculative land owners who have survived this long may wish to take a look at how much more staying power they have to tap. It's likely that speculative land prices will dip even further, as there is very limited development pressure on the near-term horizon for any kind of commercial real estate projects. ■

MORE ONLINE

Find more information by submarket and/or product type for office, medical office, industrial and retail, including:

- Vacancy
- Absorption
- Rental rates
- Transaction activity
- Construction activity
- Investment sale activity
- Projections for the next 6-12 months

