

Steady Midpoint Sets Stage for Major Change in Second Half of 2018

VACANCY AND ABSORPTION TRENDS

The first half of 2018 has been relatively stable in terms of net absorption in the Minneapolis-St. Paul multi-tenant retail market. The market total saw negative 6,800 square feet of absorption in the first two quarters combined, which sets the multi-tenant direct vacancy rate at 6.21%.

Looking beyond the physical absorption and vacancy numbers, the retail market has seen several major changes and expectations are that the second half of the year will see a dramatic shift in these figures. From a vacancy perspective, Big Box and Junior Box vacancies dominate our statistics. These also happen to be product types that have been hit hard by retailer closures. In the first half of the year, Gander Mountain, Herberger's, Toys R Us and Babies R Us, as well as several Sears, Kmart and JCPenney locations have announced closures locally. However, there has been positive activity with backfilling new larger box vacancies, especially in well-located areas.

While vacancy rates are expected to rise in the second half of 2018 as these spaces are fully vacated, 2019 should see rates drop back to near-current levels. Outparcels, quick-service restaurants, fitness and furniture users have all been active product types filling vacancies in the first half of the year.

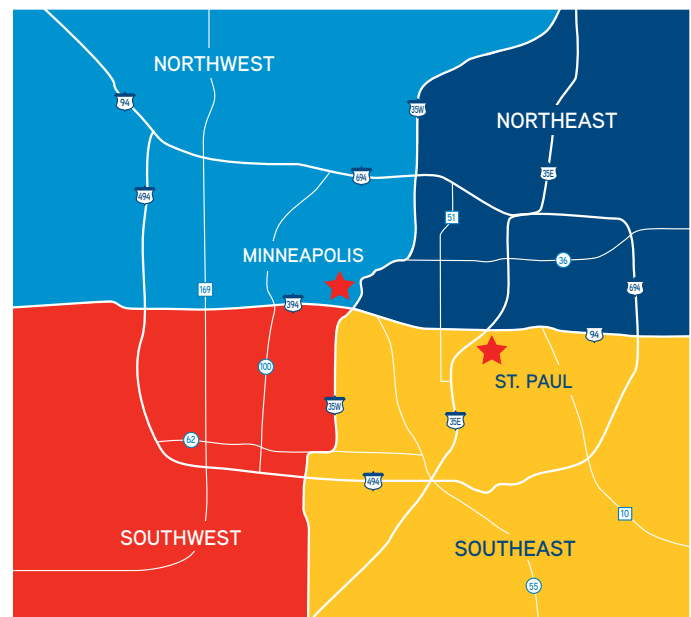
Retail construction has been slightly below average, with 325,000 square feet completed year to date, headlined by a new 165,000-square-foot Costco in Woodbury. There is currently another 350,000 square feet of retail space under construction that should be completed by the end of 2018. Last year, there was 1.15 million square feet completed, so 2018 is expected to end below those figures. These construction numbers count both multi-tenant and single-tenant buildings—not all of these buildings will enter our tracked universe due to size and tenancy.

Q2 Market Indicators



Relative to prior period

MSP RETAIL SUBMARKETS



MARKET TRENDS

New Tax Regulations May be the Great Retail Equalizer

Landlords of brick-and-mortar retail can breathe a sigh of relief, because in this case, e-commerce wasn't necessarily the victor. A Supreme Court ruling sided with the State of South Dakota in a lawsuit against Wayfair, Inc. on the state's desire to collect sales tax from out-of-state e-commerce companies who had been skirting the tax on a technicality. Retailers with a physical presence are thrilled about the ruling because they believe it equalizes competition by eliminating the advantage of online tax-free shopping. Minnesota's large local retailers such as Target and Best Buy supported the court's decision, believing the law creates a more level playing field. Some experts believe that as e-commerce continues to grow, this Supreme Court decision could be the start of more favorable rulings and policies for brick-and-mortar stores. The ruling may also alleviate concerns from retail investors who may be more apt to value retail property as a safer investment. However, the law leaves room for individual states to make their own decisions and the ruling could have damaging effects on smaller e-commerce businesses, who will have to follow differing state-by-state tax mandates, which could create an irreconcilable burden to handle different laws for each state. It's too soon to understand the end result of this ruling and what effect these new laws and regulations will have on either online or storefront retailers, but watch out online consumers—you may soon start to see your purchase totals rise slightly at checkout, based on your shipping address.

Repurposing Underutilized Property Driving New Retail Development

As with the housing market, retail property owners and developers are seeking to densify uses on well-located properties in urban core areas, at a higher rate than they are perusing new suburban greenfield developments. However, unlike housing, retail can't densify by simply going vertical with multiple stories—instead, property owners, tenants and city staff are getting creative to find new alternatives to spur retail development. For example, in many major retail trade areas, the addition of outparcels—also called pad sites or carve-outs—have been popping up all over the Twin Cities metro area. This trend has been inspired by property owners looking to increase portfolio value from repurposing the underutilized land areas found on its properties.

Historically, when many retail centers were constructed, the city parking requirement mandated a minimum of five parking stalls per 1,000 square feet of retail space. Owners and cities alike have

realized that for most of the year, this amount of parking far exceeds what is truly needed for the normal course of business. Multi-modal transportation alternatives have also lessened the need for traditional huge seas of parking. So today, many cities are now relaxing parking standards and are working with owners to lower parking ratios, sometimes to 4.5 stalls or below per 1,000 square feet of retail space. While this may seem like a slight difference, in a 300,000-square-foot retail center, this half a stall decrease in parking ratio over the entire property could amount to an acre or more, which provides sufficient land area for a new multi-tenant retail building, restaurant or drive-thru facility. Shopping centers adding structured parking can create even more areas in outlying parts of a property for new development.

Due to these factors, outparcels are underway in nearly every large retail area in the Twin Cities metro. Examples can be found along France Avenue in Edina and at the Southdale Mall, where portions of the parking lot were sold for new multifamily and hotel developments. In addition, Restoration Hardware and Shake Shack are both constructing at Southdale on outparcels. Starbucks recently opened further south on a new pad site at Centennial Lakes. Other examples can be found at shopping centers across the metro, including: Ridgedale, Knollwood, Rosedale and Burnsville Center, which are exploring carve-outs for uses such as banks, multifamily residential, quick service restaurants and other retail uses. Community shopping centers, including properties in Eagan, Woodbury and Maple Grove, are actively pursuing this as well and are finding ways to maximize the value of excess land—for example, the addition of Portillo's on a pad site at Arbor Lakes in Maple Grove. Even freestanding retailers like Cub Foods, Target and The Home Depot are actively selling or ground leasing pad sites in front of its stores.

Increasing density for a property is a trend that is impacting all areas of real estate as owners are incentivized to reevaluate and optimize the best use of their land. Retail will continue to follow housing and transit trends and is continually changing to meet the demands of its customers. The trend of densification and reimagining land use across retail product types is one that will continue and likely increase in frequency in the coming years.

EXPERT INSIGHT

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Lease Activity – First Half of 2018

TENANT	PROPERTY	ADDRESS	CITY	LEASED SF	SUBMARKET
Gander Outdoors	Former Gander Mountain	12160 Technology Drive	Eden Prairie	55,611	Southwest
Cub Foods	The Capp	46th Street and Hiawatha Avenue	Minneapolis	46,000	Southeast
TJ Maxx/Homegoods/Planet Fitness	Grove Plaza	7210 E Point Douglas Road	Cottage Grove	38,000	Southeast
Fun Lab	Former Gander Mountain	10650 Baltimore Street	Blaine	22,500	Northeast
Goodwill	Southview Square	1857-1917 S Robert Street	West St. Paul	20,712	Southeast
Top Ten Liquors	Rosedale Square	1601-1677 W County Road C	Roseville	11,400	Northeast
Allina Health System	Calhoun Village	3220 Lake Street W	Minneapolis	11,201	Southwest

RETAIL ACTIVITY

Vacancy



Absorption



INVESTMENT INSIGHT



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Fundamentals in the retail investment market have remained positive through the middle of 2018 as occupancy and rent growth both continue to rise, while interest rates remain at historic lows,

despite the Federal Reserve raising rates multiple times in the beginning of the year. Driven by these positive fundamentals, many landlords are taking advantage of the high liquidity in the market today by exchanging different assets to better fit their investment goals.

Strip centers and single tenant properties continue to be the preferred product type for investors, as the flood of private

capital pushes up demand for low maintenance properties. However, larger properties have seen a drop in demand over the past 12 months. The speculation of online retail and closing announcements for large box retailers have hurt retail real estate investment trust (REIT) valuations—one of the key demand drivers for larger retail real estate. Within this category, there is still plenty of capital chasing core investments, which almost always require a stable grocer and infill location.

In Minnesota, the grocery landscape continues to change as SuperValu announced a buyout of its distribution sector, while the retail arm (Cub Foods and Hornbachers) will split off from the acquisition. What this means for grocer market share in Minnesota is yet to be seen, but nonetheless, these changes will have a major impact on everyone touching this sector.

Retail Market Statistics



YTD NET ABSORPTION



325K
Square Feet

YTD COMPLETIONS



6.21
Percent

VACANCY RATE



350K
Square Feet

UNDER CONSTRUCTION

Sales Activity – First Half of 2018

PROPERTY	ADDRESS	CITY	BUYER	SELLER	PRICE	SF	\$/SF
Walgreens	2099 Ford Parkway	St. Paul	WB Capital Partners IV LLC	AXA Real Estate Investment Managers US LLC	\$15,968,000	15,316	\$1,043
4405 Pheasant Ridge Drive NE	4405 Pheasant Ridge Drive NE	Blaine	VEREIT Real Estate LP	4405 Pheasant Ridge Dr LLC	\$14,122,022	140,685	\$100
The Shops at Wedgwood	13290 Bass Lake Road	Maple Grove	CH Retail Fund II and Minneapolis Wedgwood, LLC	Wedgwood Equities II LLC c/o EXCOM Properties Inc	\$12,800,000	33,661	\$380
5600 LaCentre Avenue	5600 LaCentre Avenue	Albertville	Phillips Edison & Co	Hempel	\$12,800,000	96,002	\$133
Northtown Village Shopping Center	10-50 Coon Rapids Blvd NW	Coon Rapids	L & K Capitals LLC	World Class Capital	\$11,000,000	180,763	\$61
Plaza 66	1601 66th Street E	Richfield	Flag Builders of Minnesota, Inc	Interstate Development	\$5,870,238	10,448	\$562



SPOTLIGHT TREND: Big Box Vacancies Lead to Exciting Backfills

The first half of 2018 saw very little change in the Twin Cities retail market. Vacancy and absorption rates have changed very little and there has only been a negative 7,000-square-foot change in absorption, meaning that the vacancy rate has remained around 6.2% in the Twin Cities market.

However, in the second half of 2018 and into early 2019, several large box spaces* will become vacant, adding a significant amount of new space to the market and pushing vacancy rates metro-wide significantly higher. Some of the most notable retailers who will be vacating dozens of metro area big boxes include: Herberger's, Sears and Toys R Us.

While the vacancy rate will be significantly affected by these big box spaces becoming vacant, there is confidence that 2019 will bring in a number of new tenants backfilling these spaces and vacancy rates will drop back to near-current levels after the late 2018 and early 2019 hike.

Doubtless this spike in vacancy will have many weary sceptics questioning the staying power of brick-and-mortar retail in the e-commerce age. However, these large fluctuations in vacancy have happened in the past and every time this surge has brought with it new, exciting users to fill these vacancies.

For example, one year ago there were a number of large blocks that came available in the Twin Cities market due to the closing of Gordman's, Kmart and Gander Mountain, to name a few. The premier, Class A locations, those with high visibility or in well-traveled commerce centers, were quickly backfilled by other large retailers. Locally, examples of this Class A retail backfill include SCHEELS taking occupancy of the entire Sears in Eden Prairie Center, Lifetime Fitness taking the entire JCPenney space in Southdale mall and Burlington Coat Factory taking up the Sports Authority space at The Shoppes at Lyndale.

Class B locations were also backfilled, though at a slower rate, and unlike Class A space, were occupied by nontraditional users, specifically furniture stores, new-to-market fitness centers, gaming, fun or experiential users, or even in some cases faith-based organizations. Local Class B examples include: Xperience Fitness taking a number of vacated big box spaces, including the Gordman's in Rosedale, At Home filling Kmart vacancies in both Blaine and Burnsville and Fun Lab taking the former Gander Mountain in Blaine.

It is forecasted that a similar amount of activity for newly vacated big box space will positively impact vacancy statistics this year, until at least the mid-point of 2019. Currently, 1.7 million square feet of vacant space in the Twin Cities metro is available and in the next year there will be another 1 million square feet of vacancy. 760,000 square feet has already been spoken for and will be absorbed by new users.

This vacancy and absorption trend is an age-old story that speaks to evolving consumer preferences, habits and expectations, not to the end of the box, but just a change to what's inside it.

** For the purposes of this article, a big box vacancy is counted as 35,000 square feet contiguous or larger and all spaces are referred to as such that fit that criteria, regardless if the space is in a power center, regional mall or is a free-standing building.*

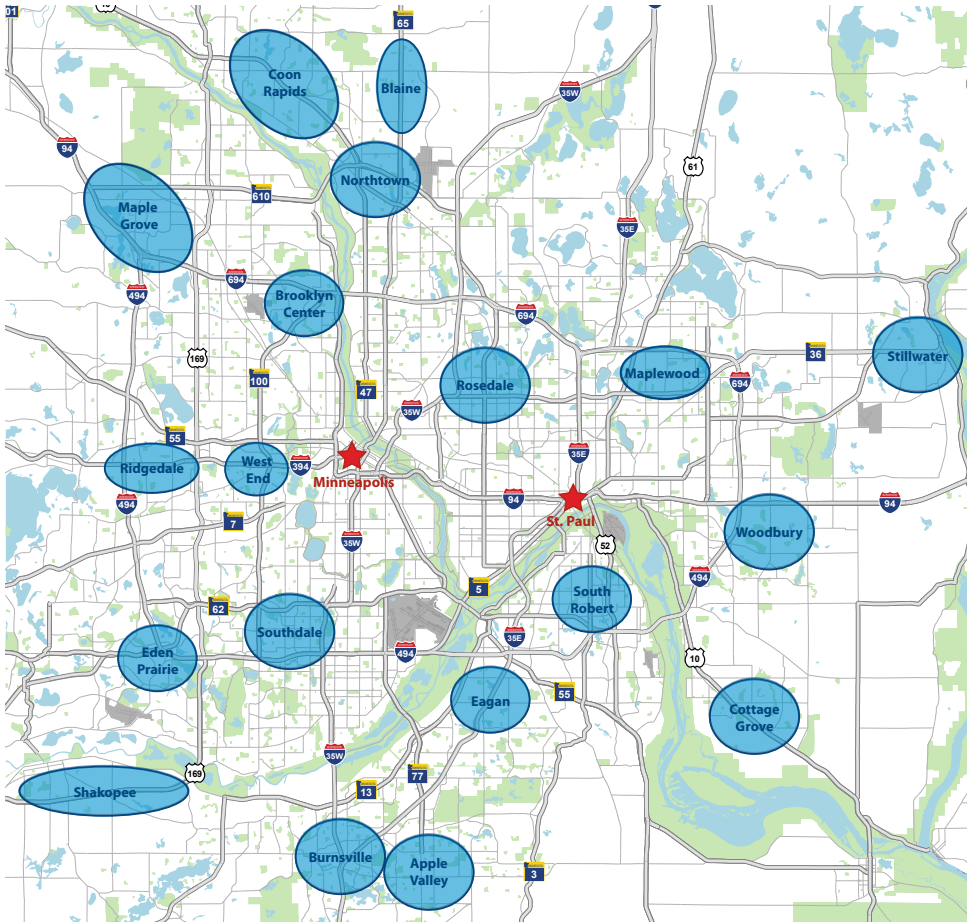
EXPERT INSIGHT

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MSP RETAIL TRADE AREAS



YTD ABSORPTION 5 LARGEST RETAIL TRADE AREAS

SOUTHDALE
3,757 SF

ARBOR LAKES
0 SF

WOODBURY
20,000 SF

ROSEDALE
15,613 SF

BURNSVILLE
-32,452 SF

Retail Trade Area Summary

TRADE AREA	# OF BUILDINGS	SF	AVAILABLE SF	VACANT SF	% VACANT	AVERAGE RATE	YTD ABSORPTION
Apple Valley	50	2,054,496	88,112	65,148	3.20%	\$15.33	40,286
Maple Grove - Arbor Lakes	81	5,037,849	116,227	70,667	1.40%	\$20.80	0
Blaine	49	1,746,553	175,128	135,245	7.70%	\$15.00	1,091
Brooklyn Center	19	1,061,525	8,071	85,678	8.10%	\$20.00	1,833
Burnsville	22	3,020,067	129,874	120,560	4.00%	\$15.67	-32,452
Coon Rapids	47	3,074,541	411,593	388,293	12.60%	\$10.00	-132,700
Cottage Grove	26	1,198,091	160,197	159,112	13.30%	\$14.50	1,663
Eagan	35	1,578,281	51,153	34,288	2.20%	\$17.88	0
Eden Prairie	28	2,472,321	137,988	344,255	13.90%	\$19.00	3,868
Maplewood	45	1,875,383	123,315	121,417	6.50%	\$18.00	11,285
Northtown	37	2,049,446	286,659	260,282	12.70%	\$16.00	-10,843
Plymouth	37	1,976,620	11,220	7,722	0.40%	N/A	-7,722
Ridgedale	15	1,399,376	56,530	53,530	3.80%	N/A	0
Rosedale	18	3,216,932	169,762	118,740	3.70%	\$13.00	15,613
Shakopee	43	2,480,645	77,968	73,121	2.90%	\$15.00	37,742
South Robert	59	2,204,097	217,959	223,455	10.10%	\$17.00	19,524
Southdale	32	5,239,323	236,137	173,405	3.30%	\$22.00	3,757
Stillwater	57	2,549,847	96,414	83,946	3.30%	\$14.16	-7,918
West End	14	1,248,008	78,475	75,658	6.10%	N/A	2,817
Woodbury	35	3,371,769	252,420	184,798	5.50%	\$21.00	20,000

TENANT TRACKER

Expanding



New or Looking



MARKET STATISTICS

SUBMARKET	# BLDGS	BUILDING SF	DIRECT AVAILABLE SF	DIRECT VACANT SF	% DIRECT VACANT	W/ SUBLEASE VACANT SF	% VACANT W/ SUB*	ASKING RENTAL RATES LOW	ASKING RENTAL RATES HIGH	AVERAGE OPERATING	ABSORPTION	YTD ABSORPTION
Minneapolis CBD												
Minneapolis CBD	10	960,984	112,614	103,259	10.75%	103,259	10.75%	N/A	N/A	\$13.31	-22,253	-7,206
Totals:	10	960,984	112,614	103,259	10.75%	103,259	10.75%	N/A	N/A	\$13.31	-22,253	-7,206
Northeast												
Community Center	19	4,187,322	127,225	115,250	2.75%	115,250	2.75%	\$9.75	\$9.75	\$8.10	18,552	50,052
Neighborhood Center	78	5,142,265	420,500	364,332	7.09%	364,332	7.09%	\$12.85	\$14.39	\$7.04	7,769	-4,049
Regional Center	5	2,914,077	115,247	115,247	3.95%	115,247	3.95%	N/A	N/A	N/A	-6,939	-6,939
Totals:	102	12,243,664	662,972	594,829	4.86%	594,829	4.86%	\$12.63	\$14.06	\$7.26	19,382	39,064
Northwest												
Community Center	46	5,350,901	350,473	324,801	6.07%	324,801	6.07%	\$23.50	\$25.50	\$7.31	-10,843	-18,565
Neighborhood Center	127	9,050,666	803,220	810,924	8.96%	815,891	9.01%	\$15.91	\$17.27	\$7.40	1,449	16,755
Outlet Mall	1	430,000	0	0	0.00%	0	0.00%	N/A	N/A	N/A	0	0
Regional Center	20	3,827,114	306,729	287,424	7.51%	287,424	7.51%	\$23.65	\$24.32	\$10.15	0	-132,700
Totals:	194	18,658,681	1,460,422	1,423,149	7.63%	1,428,116	7.65%	\$17.69	\$19.07	\$7.50	-9,394	-134,510
Southeast												
Community Center	33	4,810,163	306,276	253,266	5.27%	253,266	5.27%	\$17.08	\$22.00	\$7.75	-44,000	4,159
Neighborhood Center	112	7,422,994	796,712	651,635	8.78%	651,635	8.78%	\$13.98	\$15.36	\$7.14	6,130	29,023
Outlet Mall	1	114,701	4,968	4,968	4.33%	4,968	4.33%	N/A	N/A	N/A	0	0
Regional Center	11	6,015,202	88,931	132,057	2.20%	132,057	2.20%	N/A	N/A	\$11.58	20,000	20,000
Totals:	157	18,363,060	1,196,887	1,041,926	5.67%	1,041,926	5.67%	\$14.34	\$16.10	\$7.46	-17,870	53,182
Southwest												
Community Center	21	3,550,912	148,846	138,235	3.89%	138,235	3.89%	\$18.00	\$18.00	\$10.59	2,887	42,122
Neighborhood Center	94	6,836,669	430,848	388,745	5.69%	392,654	5.74%	\$18.59	\$20.06	\$9.99	22,449	559
Regional Center	7	5,237,679	198,967	400,663	7.65%	400,663	7.65%	N/A	N/A	\$12.62	0	0
Totals:	122	15,625,260	778,661	927,643	5.94%	931,552	5.96%	\$18.56	\$19.96	\$10.19	25,336	42,681
Total All Markets												
Minneapolis CBD	10	960,984	112,614	103,259	10.75%	103,259	10.75%	N/A	N/A	\$13.31	-22,253	-7,206
Community Center	119	17,899,298	932,820	831,552	4.65%	831,552	4.65%	\$19.22	\$21.75	\$8.08	-33,404	77,768
Neighborhood Center	411	28,452,594	2,451,280	2,215,636	7.79%	2,224,512	7.82%	\$15.45	\$16.93	\$7.90	37,797	42,288
Outlet Mall	2	544,701	4,968	4,968	0.91%	4,968	0.91%	N/A	N/A	N/A	0	0
Regional Center	43	17,994,072	709,874	935,391	5.20%	935,391	5.20%	\$23.65	\$24.32	\$11.30	13,061	-119,639
Totals:	585	65,851,649	4,211,556	4,090,806	6.21%	4,099,682	6.23%	\$16.10	\$17.64	\$8.22	-4,799	-6,789

The above table is summarized data on multi-tenant office buildings greater than 20,000 square feet. Not included are single-tenant, owner-occupied, medical or government buildings.

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