Mitchell Simonson, MAI was interviewed for the feature story in the Frandsen Bank & Trust February 2016 newsletter discussing the 2016 Commercial Real Estate Outlook. The newsletter was distributed via email to their clients.

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2016 Commercial Real Estate Outlook

This past year, the upper Midwest commercial real estate (CRE) market showed steady, stable growth. What's in store for 2016? **READ MORE »**

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February 2016 Newsletter

Commercial Real Estate Update

2016 Commercial Real Estate Outlook

This past year, the upper Midwest commercial real estate (CRE) market showed steady, stable growth—but what will 2016 bring? Mitchell Simonson, co-owner of Chadwick Appraisals—which provides licensed commercial realty and appraisal services throughout Minnesota and the surrounding area—and real estate specialist Paul Smith, of Frandsen's Montgomery (Minn.) office, share their insights about the coming year.

2015: a year of relative market stability

"By and large, the 2015 real estate market performed quite well," Simonson says. "Most market participants reported slight rent increases … and a lot of the bank-owned properties that had been on the market for some time started to disappear," adds Smith.

In his appraisal work, Simonson has seen the absorption rate of new units remain strong, though occasionally construction has marginally outpaced demand. "In some of the larger communities, such as St. Cloud and Fargo, there's been a lot of new apartment development, so some owners have reported that with all the new units being added to the market, vacancies have increased slightly," he says. In outstate Minnesota, the market for office property has been tough recently because there hasn't been much activity in terms of tenants relocating or taking on additional space.

In fact, office and retail vacancies are still common. "We all see it every day as we're driving around: empty storefronts, empty strip mall fronts," Smith says. "But it depends so much on market area. Your metropolitan markets seem to do a little bit better than outstate; outstate is still struggling a little bit to fill these properties." In part, this difference can be attributed to residents and businesses moving to the Twin Cities area, where job opportunities have been growing more rapidly.

"If you have a very active, vibrant market, it's fairly easy to start filling up these properties," Smith says. "I think the biggest trend we've seen in commercial real estate is that rental income—or how much one can pay to occupy a space—has declined." He explains that as these numbers decline, and as taxes and operating expenses start to go back up, the revenue stream for CRE is squeezed, which tends to reduce selling prices for property. "That's a big change in CRE: lesser returns."

2016: a mostly optimistic outlook

Simonson expects that capitalization rates for multi-family housing and retail properties will remain stable throughout 2016. “On the multi-family side, I anticipate rental rates to start leveling off slightly,” he says. “I’m not sure how much more rent growth we have in the smaller communities. As I’ve talked with owners of particularly multi-family, in smaller cities like the county seats across the state, they’re still projecting or planning for rent growth. I haven’t really seen an uptick in vacancies in these smaller communities, so I would anticipate vacancies to remain pretty flat.” The industrial market across Minnesota has been strong over the past couple of years, although rising construction costs may limit development and expansion of industrial properties outside the Twin Cities.

Financing for CRE has been readily available, however, and conditions are favorable for owners, developers, and lenders. If interest rates were to increase substantially over the next year or two, that potentially could negatively affect refinancing for some types of commercial properties, but Simonson doesn’t expect the recent Federal Reserve interest rate increase from this past December to have much impact on property values. “With interest rates where they are, that provides one layer of favorability for existing business owners, if they can lock in a longer-term rate,” he says.

“We’ve had record low interest rates, banks have money to lend, and they want to take on these opportunities, but they also want safe investments in this process,” Smith says. While it’s an excellent time to buy commercial property, he cautions investors that they still need to be in a position to fund it and have a good balance sheet to make it happen.

Over all, the economic picture for the region is quite positive. Even though the stock market has been erratic recently, economic indicators are still positive, and Simonson expects that CRE is unlikely to be significantly affected in 2016.

“Minnesota is still a very strong market,” Smith says. “We’re a strong economic area. I think there’s still a lot of entrepreneurial spirit in Minnesota, and that will keep our commercial market stable.”