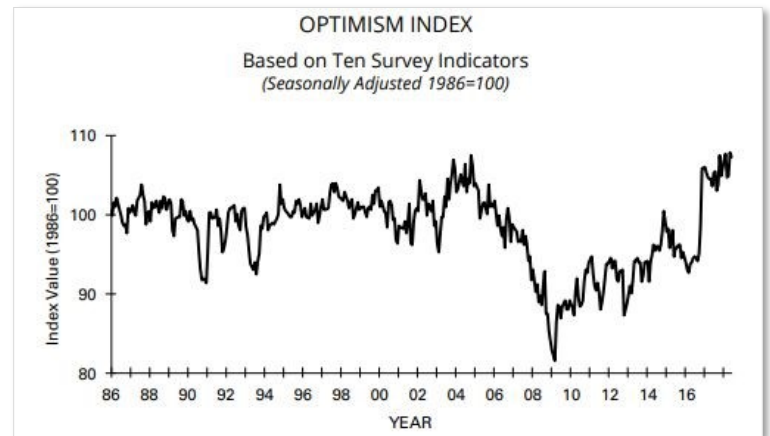


## US MACRO TREND

The first half of 2018 has been a confusing time for business owners and investors. Euphoria from the late 2017 federal tax reform has clashed with incendiary global tariff threats and currency manipulation. Record corporate earnings wrestle with headlines that a foreign government interfered in the 2016 presidential election. Eye popping GDP growth of 4.1% competes with ominous yield curves and rising 10 year Treasury Yields. Record low unemployment numbers are shrugged off with work force participation graphs. Veteran financial market commentators and billionaires appear on financial networks and in print routinely trashing the bull market. Equities and bond markets reflect these inputs as this year's volatility has substantially increased over 2017.

The truth is somewhere in the middle of extreme headlines. The US Economy is doing well, but there are several things to worry about. In these unsettling times American businesses and investors are doing well as a whole and the resulting optimism is reflected in the accompanying graph.



Source: National Federation of Independent Business, "Small Business with Economic Trends"

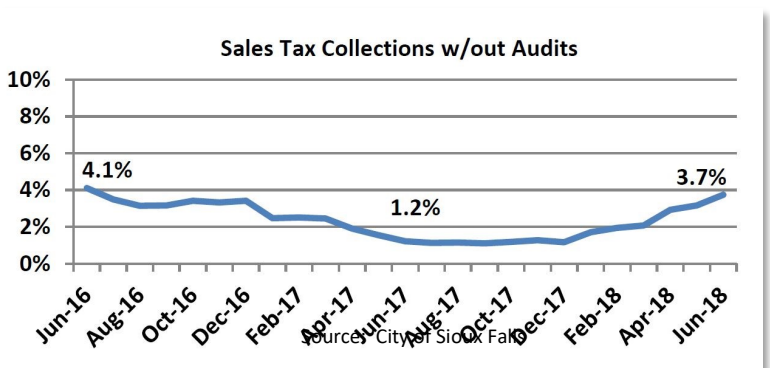
## SIOUX FALLS MARKET

Over the last 21 years our firm has been committed to understanding the Sioux Falls commercial real estate market in both raw data and trends. We have made our continuing research available to our clients and the Sioux Falls Community at large through our Annual Market Outlook held in February and in our mid-year report.

This year's mid-year report contains some notable new trends in the retail sector with rising vacancies over the last 18 months and the transition of old big box retailers.

Investment transactions remain steady, if not higher, than last year in several sectors. Multifamily developers have taken a big step back from new construction of new units compared to the previous years. Positive trends continue in the industrial market with rental rate growth and positive net absorption.

Sioux Falls continues to grow with positive population growth, strong construction trends and increasing sales tax collection reflecting a healthy and dynamic business. At mid-year, sales tax collection has increased by 4.8%, a healthy sign for our growing community. In all, Sioux Falls continues to grow and build on previous years' success.

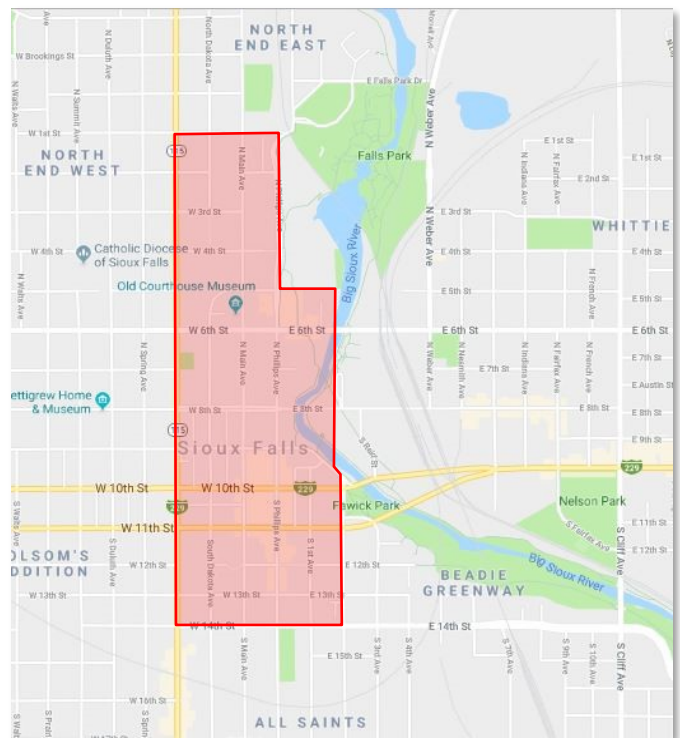


By midyear of 2018, Sioux Falls entire office market consisted of approximately 14,751,345 square feet of space. This figure includes both owner and non-owner-occupied buildings. However, buildings that are entirely leased by an owner do not truly affect the market’s rental rates, hence it is removed in this report when examining the market. This criteria left 7,938,274 square feet of tenant-occupied space, an increase of over 43,000 square feet in the past six months. The overall vacancy of the Sioux Falls office market increased slightly from 10.4% at the end of 2017 to 10.6% by mid-2018.

## CENTRAL BUSINESS DISTRICT SUMMARY

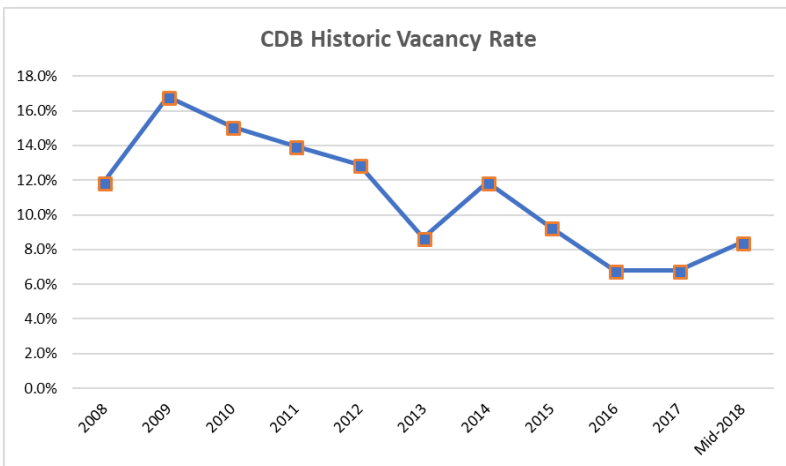
The Central Business District, or CBD, can be defined as the area east of Minnesota Avenue to the Big Sioux River with 2nd Street marking the northern boundary and 14th Street as the its southernmost edge. The CBD’s inventory remained at 2,327,255 square feet with no new space being introduced in the first half of the year. This sector, however did see a significant increase in vacancy from 6.8% at year end to 8.4%. A large office space on the fourth floor of The Plaza at 9th and Phillips entering the sublease market accounted for more than half of this increase in vacancy.

As the CBD is still considered a relatively small market with little change in the inventory from year to year, any change in vacancy can have a significant effect of the absorption factor. Due to the increase in vacancy in the first part of this year, this sector saw a negative absorption of 38,130 square feet. The CBD had also had a negative absorption at the end of 2017, however this has no effect on the rental rates. Rates have remained steady at \$12.75 per square foot NNN overall with a slight increase of \$0.10 per square foot for the Class A properties.



### Central Business District Market Key Facts

|   | CBD        | Class A CBD | Class B/C  |
|---|------------|-------------|------------|
| <b>Inventory (SF)</b>                   | 2,327,255  | 733,529     | 1,593,726  |
| <b>Vacant Space (SF)</b>                | 196,239    | 43,137      | 153,102    |
| <b>Vacancy Rate</b>                     | 8.4%       | 5.9%        | 9.6%       |
| <b>Net Absorption (SF)</b>              | (38,130)   | (26,352)    | (11,778)   |
| <b>Asking Average Rental Rate (NNN)</b> | \$12.75/SF | \$17.00/SF  | \$11.75/SF |



## SUBURBAN SECTOR SUMMARY

The remaining office space outside of the defined Central Business District comprises the Suburban Market. This segment is made up of several types of property from Class A office/technology space with high-end finishes to older buildings located in the northern part of the city. This sector had a 1.1% increase in inventory, equating to 5,611,019 square feet. This increase was due to a couple of conversions, notably the former Joe Foss School redevelopment, and a new construction near 77th Street and Minnesota Avenue. In addition to the increase in inventory, the vacancy rate for the Suburban Market decreased slightly from 11.9% at the end of 2017 to 11.5%. The availability of the CitiBank campus office space introduced to the market in late 2017 continues to affect the suburban market as it is expected to be vacant for the remainder of the year. Like the CBD, rental rates in this sector held steady at \$15.50 per square foot triple net for Class A space and \$11.00 for Class B/C space. Rebounding from a negative net absorption at the end of 2017, the first half of the year had a positive absorption of slightly less than 75,000 square feet.



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**“The Sioux Falls market has excellent options available from 100 to 150,000 square feet which provides opportunities for tenants and owners alike.”**

|                                  | Suburban   | Class A Suburban | Class B/C Suburban |
|----------------------------------|------------|------------------|--------------------|
| Inventory (SF)                   | 5,611,019  | 1,674,268        | 3,936,751          |
| Vacant Space (SF)                | 648,042    | 141,218          | 506,824            |
| Vacancy Rate                     | 11.5%      | 8.4%             | 12.9%              |
| Net Absorption (SF)              | 74,841     | 18,943           | 55,898             |
| Asking Average Rental Rate (NNN) | \$12.00/SF | \$15.50/SF       | \$11.00/SF         |

## NOTABLE OFFICE TRANSACTIONS

| Address                | Building Size | Price       | Sale Date    |
|------------------------|---------------|-------------|--------------|
| 612 E. Tan Tara Circle | 5,625 SF      | \$1,100,000 | January 2018 |
| 3800 W. 53rd Street    | 7,084 SF      | \$776,000   | January 2018 |
| 512 N. Main Avenue     | 4,500 SF      | \$1,200,000 | April 2018   |
| 300 N. Main Avenue     | 9,240 SF      | \$1,050,000 | June 2018    |

| Address             | Tenant                        | Space Size | Lease Type |
|---------------------|-------------------------------|------------|------------|
| 4205 W. 53rd Street | Fidelity Information Services | 7,188 SF   | NNN        |
| 1000 E. 41st Street | Avera McKennan                | 10,794 SF  | NNN        |
| 4900 E. 57th St.    | Digi-Key                      | 3,145 SF   | NNN        |

# Sioux Falls Mid-Year 2018 Retail Market Report



At Market Outlook in February, we predicted that the retail sector was in the beginning stages of hypersupply in the real estate cycle (we compared it to the bottom of the 7<sup>th</sup> inning) but not to be alarmed as it could be a long 8<sup>th</sup> and 9<sup>th</sup> inning. At mid-year, we've likely moved in to the 8<sup>th</sup> inning as we have not seen much rental rate growth, vacancy held steady, and new construction has remained strong.

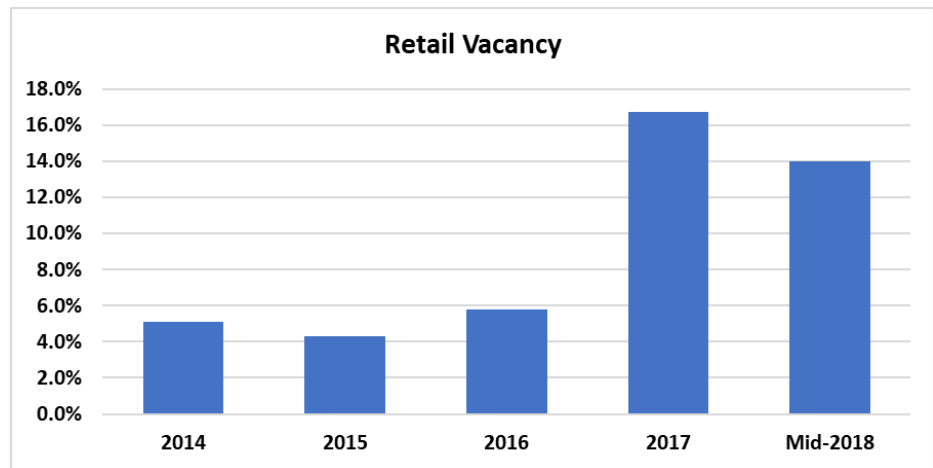
## RETAIL VACANCY

At year end, we saw the vacancy rate spike somewhat substantially up to 16.7%. By the mid-year, the vacancy rate has dropped to 14.0%. Two big stories:

1. **57<sup>th</sup> & Western absorption:** vacancy went from 21.4% to 5.3%. Historically, 57<sup>th</sup> & Western has had the benefit of minimal vacancy. The primary drivers of lowering the vacancy came when both the Bracco and Starz buildings were recently leased.

2. **West 12<sup>th</sup> Kmart:** 75,000 SF building that was purchased by owner occupant and removed from the vacancy report.

If we added the Kmart back in to the market survey, our vacancy would remain unchanged from year end 2017.



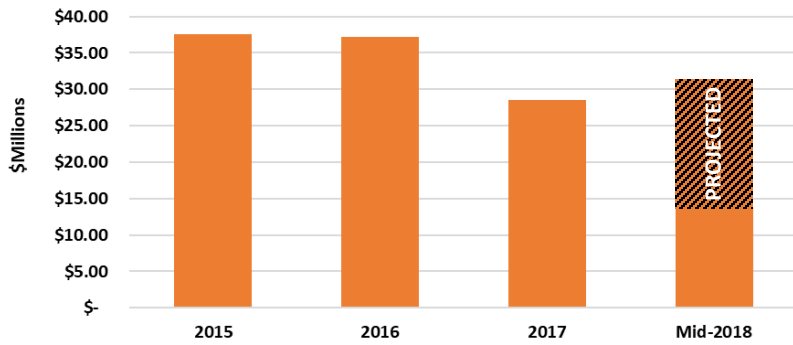
| RETAIL MARKET SURVEY RESULTS            |          |              |                      |
|---|----------|--------------|----------------------|
| SECTOR                                  | TOTAL SF | VACANCY RATE | ASKING PRICES (NNN)  |
| Mall Area                               | 456,832  | 8.2%         | \$12.00 - \$30.00/SF |
| 57th Street & Louise Avenue             | 189,328  | 13.7%        | \$17.00 - \$25.00/SF |
| 57th Street & Western Avenue            | 92,774   | 5.3%         | \$16.00 - \$25.00/SF |
| Dawley Farm / East Sioux Falls          | 579,416  | 21.6%        | \$14.00 - \$24.00/SF |
| Minnesota Avenue (North)                | 239,495  | 13.4%        | \$7.00 - \$18.00/SF  |
| Minnesota Avenue (South)                | 76,962   | 5.9%         | \$14.00 - \$24.00/SF |
| 41st Street                             | 760,229  | 15.6%        | \$12.00 - \$25.00/SF |
| 26th Street & Marion Road/Lake Lorraine | 112,471  | 10.2%        | \$11.00 - \$20.00/SF |
| <b>Vacancy</b>                          |          | <b>14.0%</b> |                      |

### RETAIL CONSTRUCTION

The Sioux Falls retail market continues to add new and exciting shopping and dining options to its residents. At mid-year, retail permits are on course to match the 2017 figures. A few projects in that figure include:

- Aldi at 85th Street and Minnesota Avenue
- Perkins on Arrowhead Parkway
- Roosevelt Marketplace on Sertoma Avenue near 41st Street
- Fleet Farm near the Sanford Sports Complex

**New Retail Construction**



### ZOMBIE RETAIL AFTERLIFE

Nationally, the backfilling of zombie retail has primarily been with the following uses: entertainment, food, churches, climate-controlled storage, dense office space, and last mile distribution. These empty boxes have the benefits of good locations and plentiful parking, which is unique for infill developments. This is allowing for an entrepreneurial mindset from investors who purchase because of the large parking lots, excess land, and the price per square foot on the building is often similar to that of an industrial building but in a retail location. This will only continue in the coming years as several more retailers are limping along and delaying the inevitable. Let's take a look at few local examples:

- Stan Houston → West 12th Street Kmart
- Party America → Portion of 41st Street Hobby Lobby
- Scandinavian Designs → Toys R Us



### RETAIL 2018 PREDICTIONS

#### New Developments-69<sup>th</sup> Street

Watch for several announcements along 69<sup>th</sup> Street in the next 6-12 months. There are new developments planned on Western, Minnesota, and Cliff.

#### Predictions:

- Vacancy: should hold steady throughout the next 6 months
- Construction: With Fleet Farm's recent \$15.6M building permit, we should show a strong retail construction number (above \$30M) again at year end 2018
- Rental Rates: high street retail will hold steady while class B retail will decrease as those Landlords try to fill vacancy.
- Harrisburg: watch for more announcements from Harrisburg in the next 6 months.



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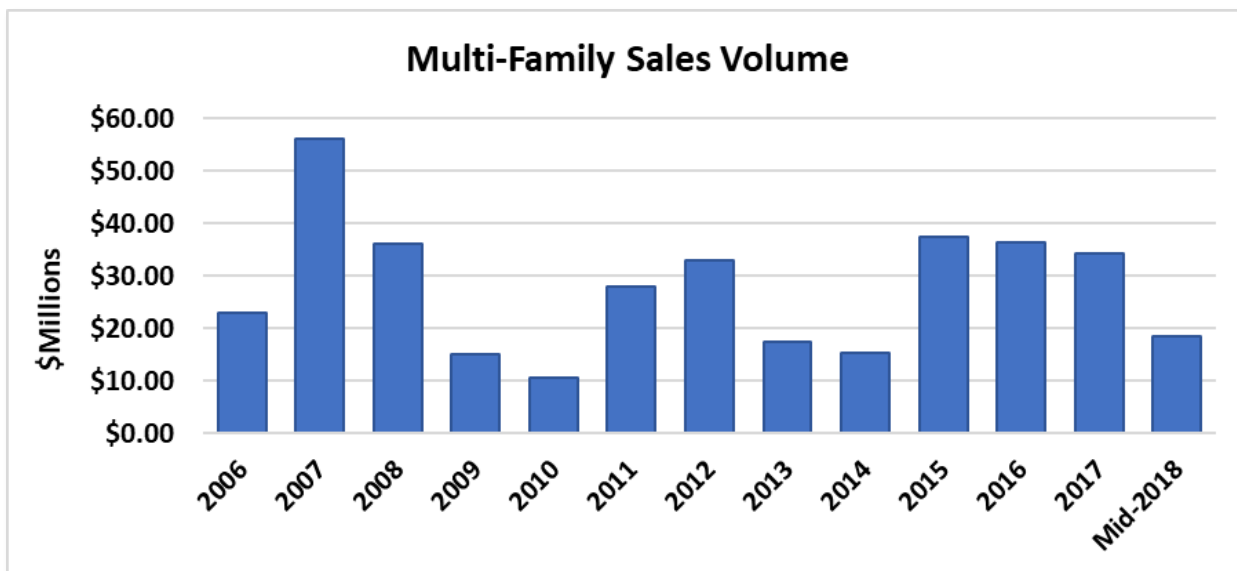
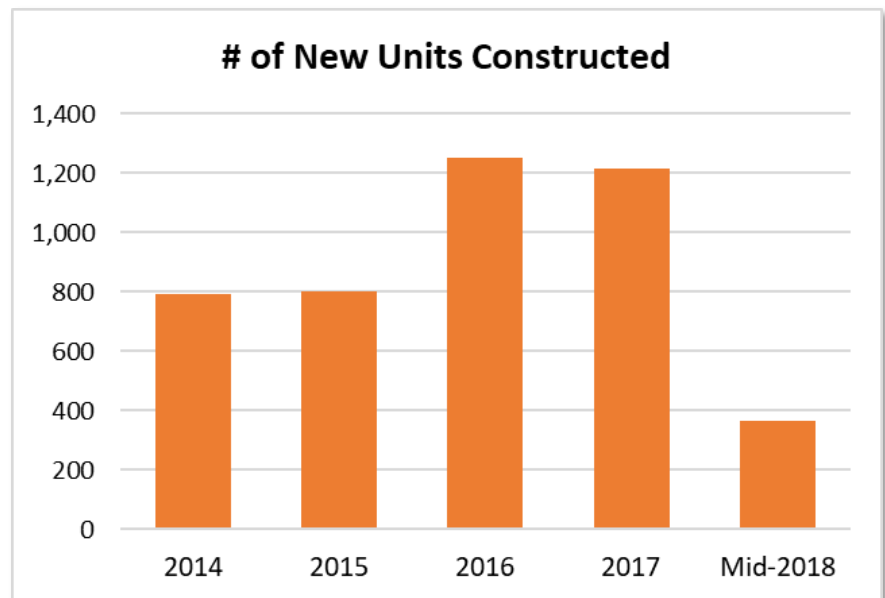
**“After several years of a robust retail market that saw dozens of new strip malls and new tenants, the expansion period appears to be taking a breather”.**

## INTRODUCTION TO THE INVESTMENT MARKET

It's been an interesting first six months of the year for real estate investors as tariffs, rising interest rates, geopolitical posturing, and volatile equity markets compete for headline space. If I can sum up the general mood among local real estate investors it would be one of tentative optimism. Eight years of robust transactions, low interest rates and solid fundamentals (rising rents, low vacancy) have driven seller expectations to new highs. Buyers have noted rising interest rates and are exercising increasing caution as the bull market enters yet another year. In spite of these trends, reasonably priced investment property in Sioux Falls continues to move quickly. Sellers with excessive expectations are experiencing disappointment.

## MULTI-FAMILY MARKET

Sales volume measured in dollars has remained steady and in line with last year. Developers have pulled back on new development as only 365 new units have had building permits pulled through mid-year contrasting with last year's 1,200 unit total. New listings in this sector are on the rise. Informal conversations with large property managers lead me to believe that MF vacancy rates are improving over 2017 year end's 11.50% for conventional units. Softness continues for newer units with high construction costs and higher rental rates.



### RETAIL INVESTMENT MARKET

Several large transactions have taken place in the first half of the year. Westside Plaza sold \$3,600,000 on 26<sup>th</sup> & Marion, Shopko on 41<sup>st</sup> Street sold for \$11,701,199 and the strip mall at 1602 South Sycamore sold for \$3,050,000 all traded in the first half of the year. With several other notable transactions retail is on pace to surpass 2017 sales.



### OFFICE INVESTMENT MARKET



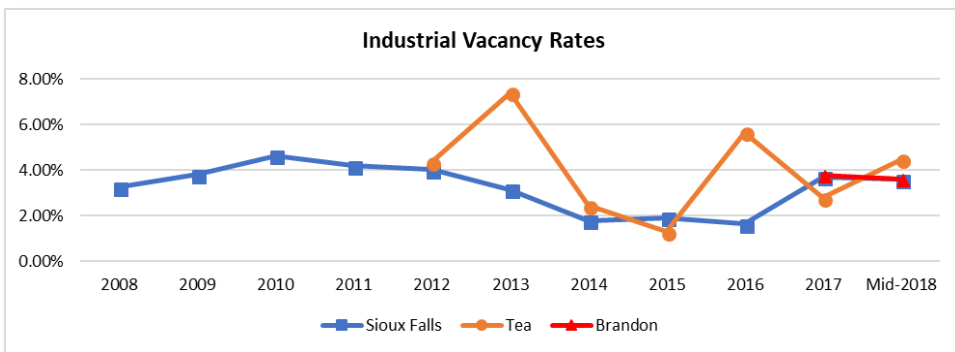
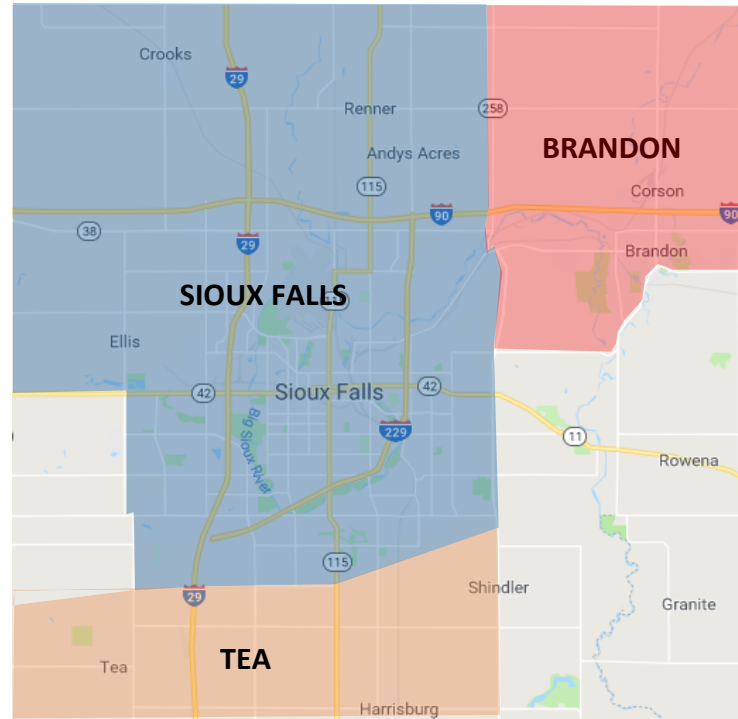
Downtown office buildings with historic elements continue to attract investment interest. A family owner-occupant purchased the renovated Standard Oil Building on 512 North Main for a record breaking \$400.00 per square foot (\$1,200,000.00) for personal use. The Randolph Building which houses Senator Mike Round's office and other tenants also sold for \$1,050,000 or \$113.64 per square foot. Overall sales volume outside downtown remains steady but largely confined to owner-occupant transactions.



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**“The next three years of Sioux Falls investment market activity will be driven by expectations on national macro economic events and local market fundamentals.”**

By definition, the industrial market is made up of those properties used for manufacturing, warehousing, distribution, transportation, and a large part in this area, contractor shops. Currently, the industrial market encompasses a total of 1,314 buildings, equating to 22.9 million square feet of space. Of these, the Sioux Falls market makes up approximately 17.8 million square feet (829 buildings), with the Tea market at 3.4 million square feet (382 buildings) and Brandon at 1.7 million square feet (103 buildings). In contrast to the office market, both owner and tenant-occupied space are included in our survey. Of the nearly 17.8 million square feet in Sioux Falls, 66.5% is owner-occupied - the remaining being either tenant-occupied or vacant. In Tea and Brandon, owners occupy approximately 70% and 83% respectively. The economics of the Tea and Brandon markets make it easier to own your own building.



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**“The overall market continues to teeter-totter between expansion and hypersupply.”**

## Sioux Falls Industrial Market

The well deserved focal point in the industrial market has been on the completion of WinChill and Gage Brothers new state-of-the-art facilities. These two products have added a combined 435,000 square feet to the industrial market with WinChill starting construction on phase 2 of their project, which will include a 126,000 square foot freezer addition with nine loading docks and 18,900 pallet positions. These are great additions for the Sioux Falls market and we look to see similar projects continue with the availability of land - including but not limited to Foundation Park, Delbridge Family North Farm, Development Foundation Park 8, the Jansmick Industrial Park, and other industrial parks in surrounding markets.

For years, the lack of speculative construction - and high demand - has kept vacancy rates at record lows. However, over the past two years the market has seen an uptick of speculative construction throughout the area, ranging from 1,500 square foot contractor shops to a 60,000 square foot warehouse/distribution facility. As the supply for larger spaces (10,000 + square foot) continue to get absorbed, developers will be looking to add additional product to the market.

At the beginning of 2018, the Sioux Falls industrial market had 650,195 square feet of vacant space. At midyear, the Sioux Falls vacancy rate was 3.6% (635,819 square feet), down slightly from 3.7% at year-end.



**NOTABLE SIOUX FALLS TRANSACTIONS**

| BUYER              | PROPERTY              | ADDRESS              | Market                   | SIZE (sq. ft.) | Transaction Amount |
|--------------------|-----------------------|----------------------|--------------------------|----------------|--------------------|
| Dakota Allied      | Old Republic National | 1710 N M Ave         | Airport Industrial Park  | 54,728         | \$2,400,000        |
| Brauer Development | Sherwin Williams      | 4600 N Northview Ave | Jansmick Industrial Park | 18,000         | \$2,195,475        |
| AV Pro             | Ferguson Distribution | 2222 E 52nd St N     | Development Park IV      | 17,472         | \$1,600,000        |

**Tea Industrial Report**

Some exciting things are taking place in Tea. The Soukup Industrial Park is filling up with both tenant and owner-occupied space. The Bakker Farm is underway and the development of this 360-acre tract will provide additional opportunities for industrial development. Most of the buildings added to the Tea industrial market have been - what we refer to as – contractor shops. We hate to say it, this market is a bedroom community that houses the construction industry for the Sioux Falls Metro Area. If you drive down through the industrial parks they are full of contractor shops. Typically, part of a building will be owner-occupied with the remaining space being leased to subcontractors. This is a great model if Sioux Falls continues to grow and break construction records. The tale of worry is if projects start to slow over the next year, Tea property owners may struggle to fill buildings. If they rely on the rent to pay the mortgage, they may be forced to sell or significantly drop their lease rate.



The tale of worry is if projects start to slow over the next year, Tea property owners may struggle to fill buildings. If they rely on the rent to pay the mortgage, they may be forced to sell or significantly drop their lease rate.

**Brandon Industrial Market**

Perception is everything. Measure the distance on Google Earth from downtown Sioux Falls to Foundation Park and do the same to the Brandon/Corson Industrial Park and you discover they are within a mile of being the same distance. As such, Brandon/Corson has become an economic alternative to Sioux Falls’ industrial parks. Anyone entering South Dakota from the east can’t help but notice all the ‘stuff’ going on. There are plans to redo the I-90 Brandon interchange which will improve accessibility.

Brandon, another “bedroom community” for Sioux Falls is more than a place to sleep. Brandon/Corson has quietly built an impressive industrial park that straddles I-90. From building fire trucks, wind turbine towers, road oil, plate steel and lumber distribution there are a lot of 'Big Things' going on in this market. Local leadership in Brandon has decided to turn up the heat with the purchase of eighty acres on the north side of the Brandon/Corson Industrial Park, scrambling to get it build-ready. Rail (Burlington Northern) will be added in this new park. The completion of Highway 100 to I-90 will only add to the momentum.

By mid-year, Brandon had 62,233 square feet available for lease, leading to a slight down-tick, from 3.8% to 3.6% vacancy.



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**“Local leadership in Brandon has decided to turn up the heat with the purchase of 80 acres on the north side of the Brandon/Corson Industrial Park.”**

# Casualties of Change

## E-COMMERCE DOESN'T JUST EFFECT RETAIL

When we think about E-Commerce's effect on real estate we typically think about the Big Box Retailers vacating and malls closing, but what about the effects on the Sioux Falls industrial market. Drive along North Cliff and you will notice a number of older style industrial buildings that are now on the market and sitting vacant. These buildings typically have a retail front with low ceiling height in the warehouse. Last Mile Logistics (AKA, the Amazon Model) has changed the way industrial retailers are looking at real estate by occupying spaces with higher sidewalls, multiple dock doors and wide-open warehouse. They are switching to the last mile model, in which easy-to-access locations for warehousing and transportation are most important. A recent example is when we worked with Lennox Parts Plus to find a Sioux Falls location. They chose a new clear span 10,000 square foot building, located along West Madison Street. This building provided multiple dock doors with 18' sidewalls. We look to see more of these small last mile warehouses as E-Commerce continues to strive and gain market share.



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**“We are starting to see both the negative and positive effects of E-Commerce in the Sioux Falls Industrial Market”**



Another trend that is picking up momentum is the shift of companies from functionally obsolete buildings to new state-of-the-art facilities, leaving behind a graveyard of old facilities with the intent of repurposing or redeveloping. High Roller Conveyors, among others, started this trend in 2016. The Bimbo Bakery Facility has been vacated and is no longer in operation. Gage Brothers is moving out of their facility as completion of their new facility draws near in the Sweetman Industrial Park. Look for this trend to continue as the availability of land in industrial parks become more readily available.

Lastly, another aspect of the casualties of change are small “mom and pop mechanic shops”. As several business owners look to retire they are running into the challenge of not being able to sell their business - the pool of buyers is few and far between. These businesses are not struggling to stay busy, rather they struggle to find good help or someone to pass the reigns, forcing these business owners to pack up, close the door and sell their real estate. A few examples include Dave's small Engine Repair and Siouxland Forklift. As this trend continue, the market will continue to see an offering of these services shops throughout the market.

