

COMPASS

Navigating the Minneapolis-St. Paul Commercial Real Estate Market



HOTEL MARKET

Despite Construction Boom, Demand for Hotel Rooms in the Twin Cities Exceeds Expectations

Despite a flood of new hotel rooms delivered, the Twin Cities hotel market continues to boast record demand, which is absorbing most new supply. Supply growth increased an average of 3.9% in 2018, while demand increased an average of 5.0 percent.

It has been a long, healthy “up-cycle” with approximately 6,240 rooms delivered metro-wide plus 6,700 rooms in the construction pipeline. Demand has on average outpaced supply increases since 2009, although this trend did reverse in 2016 and 2017.

A strong economy is driving both leisure and corporate travel. Occupancy, average daily rates (ADR), and revenue per available room (RevPAR) increased throughout most of Minnesota in 2018.

Average occupancy in 2018 was steady at 67.6% for the Twin Cities and 70.8% in Minneapolis CBD, representing 1.0% and 3.5% increases over 2017, respectively. RevPAR for 2018 increased year-over-year 6.9% for the metro and 10.4% for Minneapolis CBD. Rates continue rising due to demand growth. Looking to 2019, if the economy remains healthy, there are no signs of a downturn.

CONSTRUCTION PIPELINE SLOWS BUT SOLID ACTIVITY CONTINUES

Development remains strong with approximately 6,700 rooms in some stage of planning/development, and developers continue to scout attractive sites, if they have the right flag for the right market. However, rising interest rates and construction costs, as well as the limited availability of flags, are barriers to new development. Amid overbuilding concerns and increasing costs, some developers have pulled plans. This will slow future supply growth.

BRANDS INTRODUCING LOWER-COST FLAGS TO KEEP EXPENSES IN CHECK, ATTRACT CONSUMERS

With rising construction costs and increased competition for guests, brands are bringing in lower-cost development options to make new developments and conversions feasible. These are limited-service and extended-stay brands in the upper midscale to upper upscale segments. Examples include InterContinental Hotels Group’s Avid, Home2 Suites and Tru by Hilton, and Marriott’s Moxy. The higher operating margins and lower development costs for these categories of hotels are appealing to developers. Dual-brand hotels are also attractive, as developers

HOTELS YTD DEC 18 vs. DEC 17

Source: MN Lodging Association

	OCCUPANCY %		ADR \$		REVPAR \$	
	2017	2018	2017	2018	2017	2018
United States	65.9	66.2	126.77	129.83	83.53	85.96
Minnesota	61.6	62.5	111.48	116.16	68.68	72.62
Mpls-St. Paul, MN-WI	66.9	67.6	115.97	122.66	77.63	82.96
Duluth, MSA	60.9	62.7	125.18	125.98	76.18	78.94
St. Cloud / I-94 Corridor	56.9	56.1	99.69	100.53	56.75	56.40
Rochester (MN)	62.9	66.2	111.40	114.15	70.07	75.59

HOTELS % CHANGE YTD DEC 18 vs. DEC 17

Source: MN Lodging Association

	OCCUPANCY	ADR	REVPAR	ROOM REV	ROOM AVAIL	ROOM SOLD
	United States	0.5	2.4	2.9	5.0	2.0
Minnesota	1.5	4.2	5.7	8.4	2.6	4.1
Mpls-St. Paul, MN-WI	1.0	5.8	6.9	11.1	3.9	5.0
Duluth, MSA	3.0	0.6	3.6	6.0	2.3	5.4
St. Cloud / I-94 Corridor	(1.4)	0.8	(0.6)	0.7	1.3	(0.2)
Rochester (MN)	5.3	2.5	7.9	8.2	0.3	5.6

look to streamline costs by combining multiple concepts under one roof. Home2Suites and Tru by Hilton is one example.

The **Minneapolis CBD** hotel market is thriving, with a construction pipeline of approximately 1,700 rooms. Upcoming major events such as the NCAA Men's Final Four and the X Games, as well as continued development and net migration in the CBD, are helping drive demand. **Projects include:**

- United Properties' plans are back on for a 180-room Four Seasons Hotel & Resorts in the Gateway Tower development at the north end of Nicollet Mall. It would be the metro's only five-star hotel.
- JR Hospitality and Hawkeye Hotels have about a dozen projects in the works including a 115-room Cambria Hotel and a 100-room Fairfield Inn at 41 10th Street North.
- The pair is also renovating the William McGee building at 317 Second Avenue South. into a 201-room, dual-branded Tru by Hilton and Home2 Suites hotel.

St. Paul CBD is seeing a flurry of activity, with roughly 1,150 new rooms in the pipeline. **Projects include:**

- Kaeding Management has opened a 109-room Residence Inn at Leech Street and Grand Avenue.
- Raymond Group has started construction on a 186-room SpringHill Suites at 472 Jackson Street.

Bloomington/Mall of America/Airport continues seeing robust developer interest, with approximately 1,300 new rooms in the pipeline. Occupancy has flattened somewhat. However, rates and demand have continued to increase. **Projects include:**

- Terratron broke ground on a 142-room Element by Westin at 24th Avenue South and 82nd Street East.
- Drury Hotels Co. is building a 214-room Drury Plaza Hotel at I-494 and France Avenue.
- Ceres Development has a 160-room Cambria Hotel under construction at 8001 28th Street South.

INVESTOR APPETITE IS HEALTHY ALTHOUGH DEAL VOLUME SLOWED

Strong investor demand continues for prime hotel properties in key submarkets. There is significant activity and deals are available. However, values may have peaked, and buyers are more cautious. Also, increasing interest rates and a widening bid-ask gap have slowed transaction activity. **Notable Sales:**

- Drury Hotels purchased the 208-room Embassy Suites by Hilton-St. Paul from Platinum Equity. It will be renovated and rebranded as a Drury Plaza Hotel.
- Magna Hospitality Group purchased the 140-room Grand Hotel Minneapolis from Pebblebrook Hotel Trust for \$30 million.

REVENUE IS UP WHILE PROFITS REMAIN STABLE

Although revenue continues rising, increasing operating expenses are impacting the hoteliers' bottom line, meaning their profit margins are not following the revenue at some properties. This is primarily due to labor shortages, expensive labor costs, and the increasing costs of supplies and materials

TECHNOLOGY, SOCIAL MEDIA IMPACT SECTOR

For millennials in particular, travel is about the "experience" and sharing it via social media. Hoteliers are paying attention. Social networking sites give hotel operators the opportunity to connect directly with a new generation of travelers. Millennial brands like Tru, Element, and Moxy play into that "millennial factor" as does Airbnb.

OUTLOOK

Demand should remain strong into 2019 and is expected to surpass upcoming new supply. The healthy economy should continue to fuel business/leisure travel. Supply growth will cool as development is slowing due to overbuilding concerns and increasing construction and financing costs.

Room rates will continue climbing with demand, and investor appetite should remain solid for attractive assets in prime markets.

ABOUT THE AUTHOR

THE COMPASS REPORT

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