January 27, 2023

MEMORANDUM (EXECUTIVE SUMMARY)

TO: **Rockport, LLC**

FROM: Ms. Mary C. Bujold
Maxfield Research and Consulting, LLC

RE: Update of Market Conditions for Office and Industrial Space and Land Use Allocations for Mixed-Use/Business Campus Property in Apple Valley, MN

Introduction

This Executive Summary presents an overview and update of current and long-term market conditions for development and acceptance and absorption of various uses, including those articulated in the City of Apple Valley's proposed Mixed Use-Business Campus (MU-BC) ordinance for Apple Valley and a broader review of the surrounding communities in the Market Area including Burnsville, Eagan, Lakeville and Rosemount. Based on current and projected market conditions in the Market Area submarket, we comment on the proposed land uses for the Mixed-Use/Business Campus zoning on the Rockport property immediately south of County Road 42 and the proposed land use allocation.

Maxfield's review of the City's proposed MU-BC Ordinance concludes that the proposed allocations do not coincide with current and/or projected market conditions for office, industrial and commercial uses in Apple Valley or the surrounding northern Dakota County area. Further, based on current and projected future market conditions, the proposed allocations contained in the MU-BC Ordinance for office and industrial uses are not realistic over the next ten years on Rockport's Property or even the broader Market Study area. In sum, Maxfield concludes that the MU-BC Ordinance as drafted will have a negative development impact on Rockport's Property, including reducing market interest in the Property, decreasing potential development on the Property, and ultimately reduce Rockport's expected development opportunities and income.

Overall, the MU-BC's proposed use percentages do not reflect market conditions for development in the area and should be rejected in favor of market uses and trends that are present in Apple Valley and surrounding Market Study Area. Based upon Maxfield's review of the Market Study Area, the proposed MU-BC Ordinance percentage allocations should be rejected entirely or revised significantly to reflect current and projected market trends.

Office Market

Metro Area Summary

In 4th Quarter 2022, the direct office vacancy rate rose by 8.7%, accounting for most of the newly vacant space. Sublet space however, rose by a dramatic 33%.

Almost all office tenants with leases coming up in 2023 will elect to downsize their footprint.

The 4th Quarter 2022 posted a negative absorption of just over 1.5M square feet of space.

In 4th Quarter 2022, despite a decline in asking rents, there was still year-over-year rent growth. Class A office vacancy however, particularly in suburban locations rose above Class B and C space. The overall Class A vacancy rate was 15.8% as compared to 12.4% for Class B space and 7.5% for Class C space.

There is a concern that declining office building values may lead to a drop in property taxes which loss may then be transferred onto homeowners in Minnesota.

Vacancies have spiked upward in response to large users downsizing. Many have chosen to vacate and sublease. No new buildings were delivered and office construction continues to decline.

More buildings are up for sale or are having loans debt restructured considering current market conditions.

Class A office proposals are down significantly, companies have vacated or not even occupied new space and notices have been placed that some corporate campuses will be downsized and/or redeveloped.

Lease transactions in 2022 were down 50% from 2021's transaction activity which was about 1,200 transactions Metro-wide.

The Twin Cities medical office market however, has remained strong throughout the pandemic. The overall market remains very stable with an on-campus vacancy rate of 8.6% and an off-campus rate of 10.6%. There is strong demand for off-campus locations for non-acute care for location access and cost savings. Rents have increased due to continued demand and higher costs for new construction. Providers are focused on expanding close to their customer base, providing full-service medical hubs offering outpatient surgery and specialty services to communities while offering low-cost care away from a hospital campus.

According to a recent medical office report, outpatient volumes in Minneapolis are expected to grow by nearly 33% in Minneapolis making it one of the most promising medical office markets in the US.

According to conversations with commercial office brokers, some tenants are taking an opportunity to “move-up” in the market to obtain higher quality space at a concession price. While this creates turnover in the market, it is not expected to lead to an increase in new construction of office space for some time. Office users are continuing to sort out their space needs considering the “new workplace.”

Although owners are hopeful that the recession will be shallow and that rising unemployment rates will draw works and subsequently, demand back to office buildings, the current return-to-work landscape has not occurred as rapidly as was expected. Tenants are likely to continue to downsize when given the opportunity.

Dakota Co Submarket Summary

Office vacancy increased substantially in 2022 as more companies downsized or vacated space in the submarket. Class A office vacancy rose to 40% as several large spaces became available and new deliveries went unleased or unoccupied. Companies are placing vacant space on the market to sublet, but with a greater number of smaller users than larger ones, it will take a longer time to absorb vacant space.

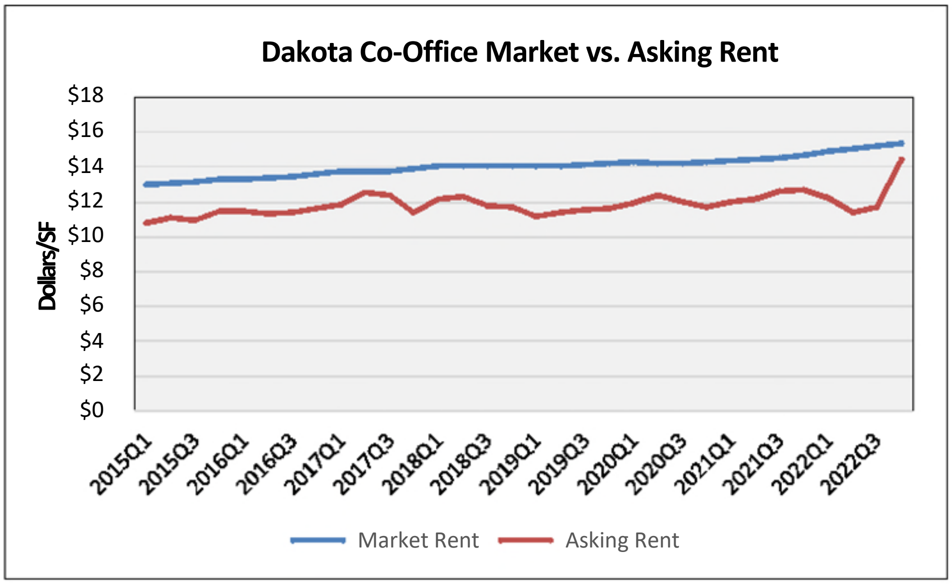
As mentioned previously, vacancy increased in 2022 in the submarket and negative absorption ranked third among the Twin Cities submarkets behind Minneapolis CBD and the I-494 Corridor.

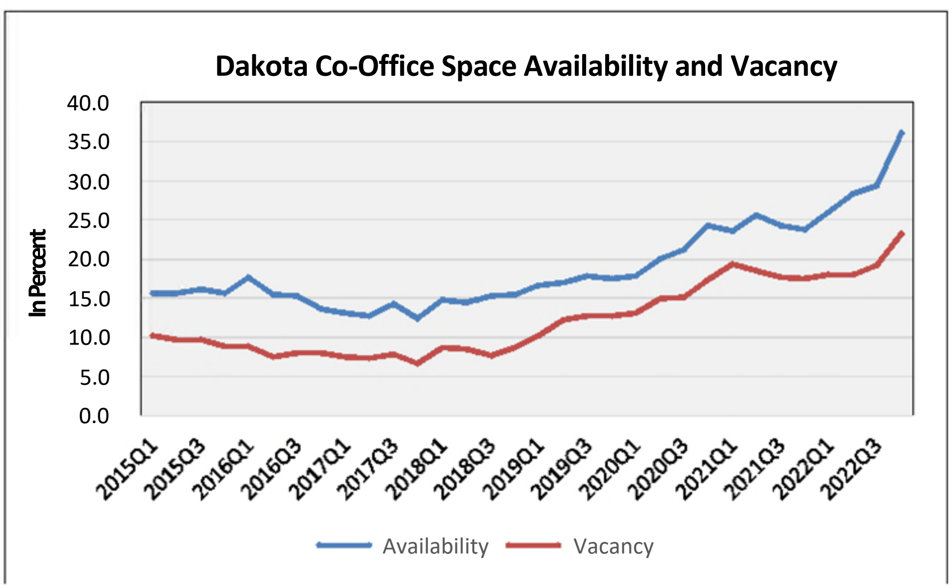
In terms of leasing activity and overall vacancy rates, suburban submarkets are faring better than the central business districts. Some owners are renovating Class C and Class B spaces trying to attract tenants to better quality. This is a difficult balance to achieve given the costs of upgrading and higher interest rates. Between 2021 and now, absorption has consisted primarily of smaller spaces in smaller buildings (less than 60,000 square feet). Many larger buildings remain substantially vacant or entirely vacant.

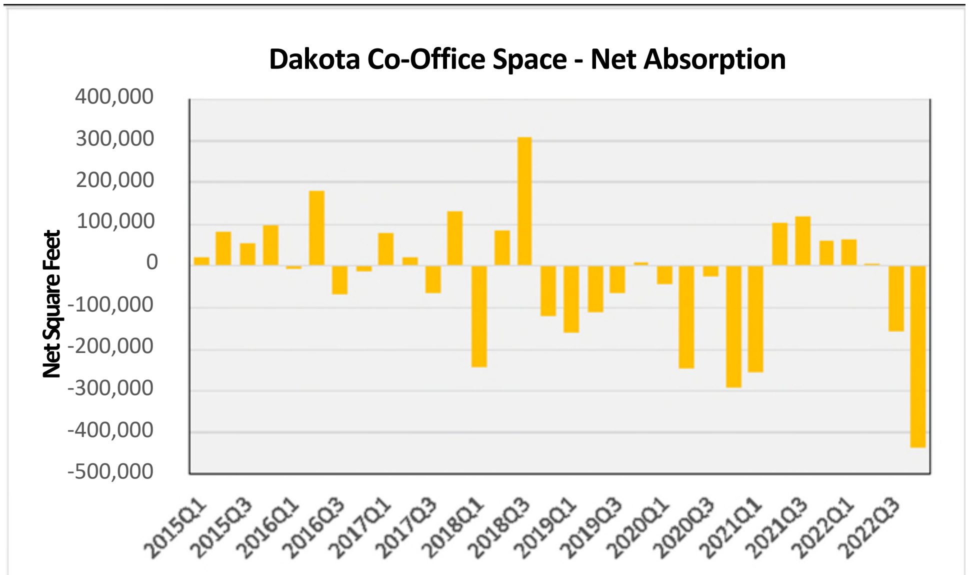
Health care vacancies are much lower than for traditional office space and there has been continued leasing activity in the medical space sector. New medical space is under construction and it is anticipated that new clinics are likely to attract smaller health care tenants that will tap into the traffic generated by the larger clinic. Small health care tenants however are likely to occupancy in-line spaces in retail commercial rather than office space in traditional format buildings.

Prime Therapeutics, a health care benefits company, which was to have moved into its two new buildings in Eagan, decided it no longer needed the new headquarters considering employees working remote and have decided to place the buildings on the market for sublease.

Thompson-Reuters, the largest employer in Eagan, recently announced it is downsizing its corporate office space and will carve up its existing campus to make way for incorporating other uses on the site including residential, industrial and retail space. This will enhance the ability of Eagan to accommodate more space in the city.







Industrial

Twin Cities Metro

The Industrial real estate market in the Twin Cities is moving toward a buyer's and tenant's market. Tenant demand for small to mid-size warehouse-distribution spaces continues to exceed supply, but other market challenges such as labor stagnation, rising interest rates and reduced demand from larger users are placing pressure on the constant growth over the last two years. This is placing tenants in a stronger position to negotiate lease terms.

Office-showroom space is bearing the brunt of these forces. Vacancies in this segment of the market are struggling to fill as owners and users of flex space experience a wide gap in expectations regarding acceptable lease terms. Much of the office-showroom inventory in the metro was built over 40 years ago. These older properties need improvement to attract tenants away from the competition, but with increased challenges in lending, the proportion of office and warehouse space in these buildings determine their potential upside in the market.

Much of the office showroom space in the market has more office finish than what tenants want, therefore placing landlords in a tough position to reduce office space and increase warehouse space while maintaining operational viability. Without improvements, flex space cannot command market rents and rental rates on office showroom space have fallen from the previous quarter. The ongoing demands of more warehouse, less office space and tenant improvements are making economics difficult on both the landlord and tenant sides.

Construction of new industrial space continues to push forward in the Metro Area, as opposed to little to no new construction of office space. Seven million square feet of warehouse distribution space is scheduled to deliver in 2023. As a potential recession nears, vacancy rates are expected to rise across the board, and new developments are likely to have competition in vacated older warehouses.

Although the Twin Cities Metro Area currently has one of the lowest unemployment rates in the US and the lowest of other larger Midwestern cities such as Chicago, Milwaukee and Des Moines, concern is increasing about the long-term growth of Minnesota's labor pool.

Land prices are falling and, in some cases, by as much as half the value. Despite the drop, land deals are stopping across the market because of the inability to make the economics work. Outdoor storage is still a tight market with high demand, but this use faces significant zoning challenges outside of locations along Highway 13.

Rental rate expectations are changing as the market dips and asking rents are increasingly negotiable for landlords to lease up space. Asking rates in office-showroom buildings have dropped by one dollar in the last three quarters of 2022. Office-showroom space was asking for more than $10 per square foot, which rate has now dropped to $9 per square foot. By contrast, Manufacturing and Warehouse/Distribution rental rates rose. The bulk of new construction is warehouse/distribution space still demands a premium as the market for small and mid-sized warehouses continues to tighten.

Absorption for warehouse and distribution buildings in 2022 was down 58% and there are fewer larger users looking for space of more than 100,000 square feet. There is concern about the demand for larger warehouse spaces over the next two to three years.

Financing new construction is increasingly difficult as supply chain shortages have created extended delays in obtaining the necessary materials and equipment. Although there has been some let up in these shortages, it is not enough to push additional supply into the market.

South Central Submarket

A survey of market conditions as of the 4th Quarter 2022 for the South Central submarket identified that the industrial/flex space segment of the market remains relatively strong with generally low vacancy rates, although the vacancy rate for office/showroom space has increased to 6.4% from 5.7% back in late 2021. In addition, this segment experienced negative absorption year-to-date.

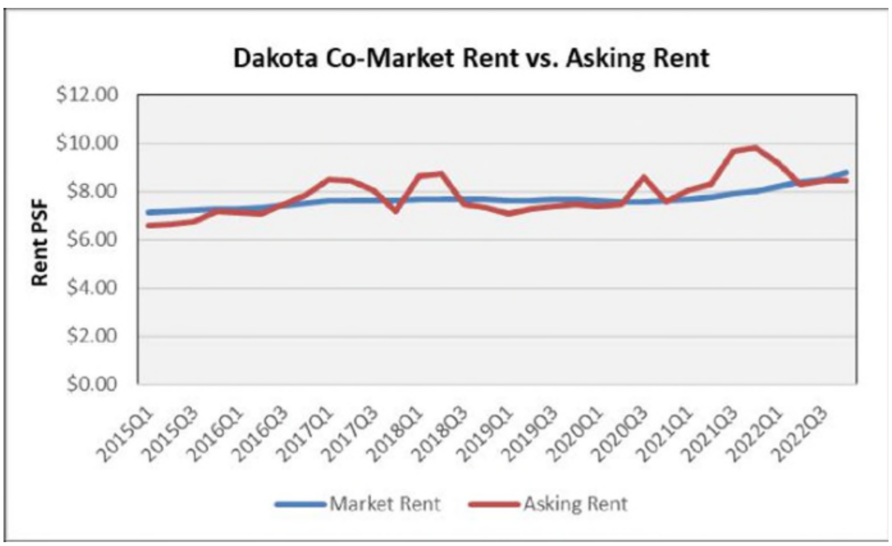
The only industrial space segment to have experienced deliveries in 2022 was the warehouse/distribution segment, which had 462,500 square feet of space open during the period. There is an additional 1,255,416 square feet of warehouse/distribution space under construction. There is no pending development of office/showroom or manufacturing space in the submarket and no deliveries in either of these two segments in 2022.

Lease rates by industrial segment as of 4th Quarter 2022 were as follows:

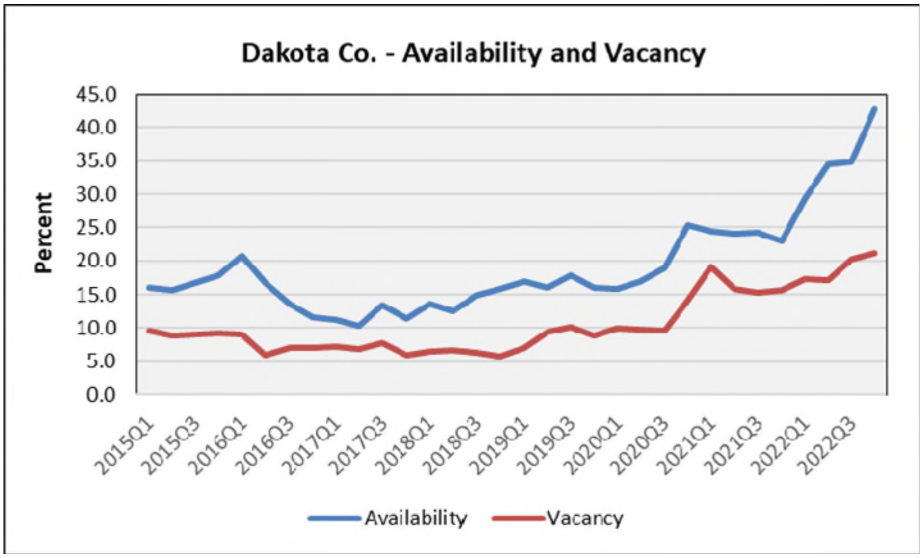
$9.63 psf – Manufacturing
$7.47 psf – Office Showroom
$7.44 psf – Warehouse/Distribution

Market Rent vs. Asking Rent

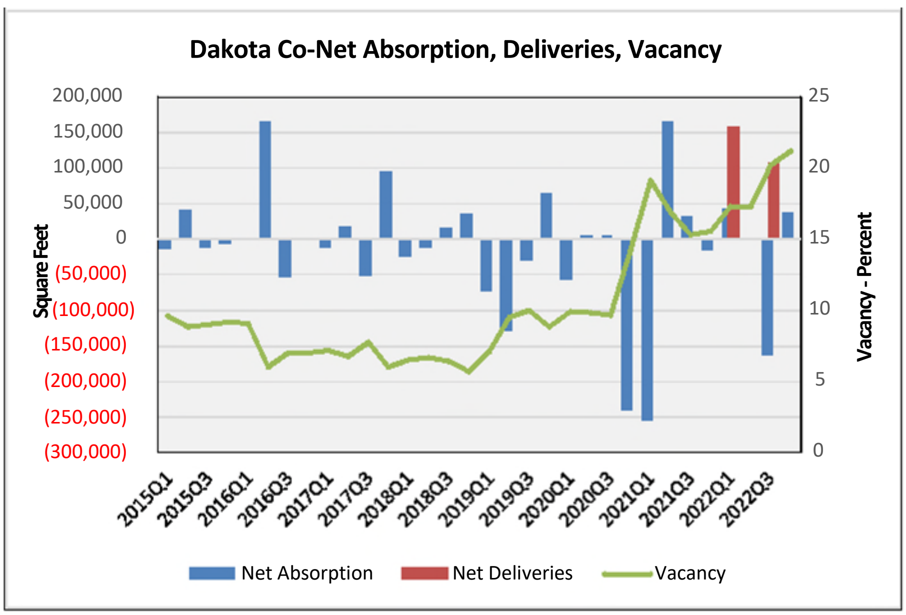
Asking rents increased over market rents in mid to late 2021 as demand increased. Asking rents dropped off in 2022 as demand slacked off, primarily in the office showroom category, although demand in all segments have dropped.



As shown below, availability and vacancy climbed in 2022 with availability surging above vacancy.



Net Absorption has been mixed but as new deliveries came on board in 2021 and 2022 and economic conditions have faltered, rents have dropped and vacancies have increased.



Proposed Land Uses and Allocations in the City's Proposed Ordinance

Based on Maxfield's review of the City's proposed uses contained in the Mixed Use-Business Campus (MU-BC) Ordinance, the proposed allocations do not coincide with current and/or projected market conditions for office, industrial and commercial uses in Apple Valley or the surrounding northern Dakota County area. Further, based on current and projected future market conditions, the proposed allocations for office and industrial uses are not realistic for the foreseeable future at the designated location and will detrimentally impact development on Rockport's Property for the foreseeable future.

Maxfield specifically reviews the following proposed uses within the context of acceptance and absorption in the Market Study Area:

- Corporate offices or headquarters
- Research or testing laboratories conducted in a building
- Professional offices and offices of a general nature where the operations do not include over-the counter retail sales or warehousing
- Marketing and research buildings
- Clinics for human care
- Hospital
- Comprehensive, intensive or full care facility
- Hotel
- Restaurants, Class I and Class III only
- On-sale Wine and/or 3.2% liquor in conjunction with a restaurant facility;
- Fitness centers, gyms or athletic clubs when contained within a hotel or office building
- Banks and savings and loan
- Day care centers
- Municipal buildings

- Institutional uses such as a library, swimming pool, church, public school, religious center and community building

Regarding current market conditions for these types of uses, many of these uses should be allocated to other commercial districts such as restaurants, banks, day care centers, hotel and health care facilities. Although medical office is expanding in Apple Valley, as reflected by recent development activity, including HealthPartner's proposed building on a portion of Rockport's property, these uses are locating in areas adjacent to other commercial retail areas. Generally, these medical office uses prefer areas with high commercial traffic. Clusters are likely, but a large-scale hospital is unlikely to be attracted to Apple Valley as other health care facilities are already in place or will be in place soon. Also, area hospitals are expanding, renovating, and remodeling existing area facilities, which makes it even less likely that a hospital user would be attracted to the area for development of a new hospital building.

Based on our recent discussions with real estate professionals in the market, and specific to the Market Study Area, many corporate campuses are downsizing and corporate offices will have a different style and design moving forward. All the market indicator numbers are consistent, with high vacancy rates and negative net absorption, and that is even more acute in the Market Study Area. A number of markets are seeing existing corporate office buildings being converted to or proposed plans to construct corporate office buildings that are shifting to residential, hospitality or commercial uses. Further, the cost to support new corporate headquarters buildings in today's market is precipitously high, generally requiring significant tax incentives, abatement, or other public money tools to entice developers to consider development in particular areas. Without this public/private partnership, it is extremely unlikely that development of corporate campuses will locate within the Market Study Area, including Apple Valley. Making it even less likely for development of corporate campuses, is the continuing infrastructure considerations, difficulty with access to highways/interstates and traffic concerns in and around the Apple Valley area.

Markets fluctuate regularly and City land use considerations should be compatible with adjacent and surrounding land uses and reflect current market trends, market absorption, and development expectations. Specifically in Apple Valley, buildings are anticipated to be filled with small to mid-size users with smaller footprints with compatible and complimentary uses such as commercial, retail, and service type uses that attract people to the area. This is also true of warehouse/distribution space which is seeing an increase in the number of small to midsize users, while office/showroom space (flex) is exhibiting lower demand, unless specific users are identified and the buildings are built to user specifications.

Compatible land use planning should be considered in conjunction with current uses rather than relying on arbitrary proportional allocation by percentage with no consideration for market trends, demands, or development potential. Using arbitrary percentages will likely be rejected by the market and dissuade developers or users from considering Rockport's Property because of the prospect of increased costs to change zoning or guidance to better reflect expected or anticipated uses on the Rockport Property. Further, market trends and development potential demonstrate that flexible zoning and land use designations will enable the property owner and developers to work together to provide compatible development with surrounding land uses, including on Rockport's Property. In conclusion, the MU-BC Ordinance must be rejected as drafted and likely revised significantly to properly track with market trends and development potential in Apple Valley, including removing percent allocations and expanding potential permitted uses, and more broadly the Market Study Area. If not, the MU-BC Ordinance will have a detrimental impact on development in Apple Valley and, more specifically, on Rockport's Property.

Maxfield recommends that the City remove from MU-BC Ordinance the percent use allocations entirely and focus on expanding permitted uses to reflect current market trends, absorption, and development expectations. Expanding permitted uses will provide the necessary market flexibility to capture market trends and development Rockport's Property at the highest and best use for Apple Valley and the Market Study Area.