Capitalization Rate a.k.a. Cap Rate

by Jon Dahlin, Itasca Funding Group, Inc. and Tim Hilger, Diversified Acquisitions Inc.

Capitalization (or “cap”) rates have been a hot discussion topic in the real estate business and overall investment lately. Cap rates on certain property types are at an all time low, while other property types continue to head upward. For those of us involved in the investment, lending or brokerage side of the business are reasonably familiar with the concept of a cap rate, this may be an appropriate time to review, the background of the capitalization process and the dichotomies in the current commercial real estate market for the more general MSCA membership.

The formal definition of capitalization rate is: “The rate of interest or discount rate used to convert a series of future payments into a single present value,” according to the Dictionary of Business Terms. In real estate this calculation includes annual return on investment (interest). The cap rate is

Capitalization Rate continued on page 2
CAPITALIZATION RATE continued from page 1

determined by dividing the initial or stabilized years annual net operating income by the purchase price. Algebraically it is expressed as:

\[
\text{OAR (Capitalization Rate)} = \frac{\text{NOI (Annual Net Operating Income)}}{\text{Value (or Purchase Price)}}
\]

The cap rate is usually expressed as a percentage (i.e. 9.5%). The price of the property moves in the exact opposite direction of the cap rate. If the cap rate rises, the price of the property decreases. The cap rate used by the professional appraiser is a composite of rates derived from recent comparable sales transactions in the marketplace. Misunderstandings, intentional or otherwise, often come about with the use of gross income rather than annual net operating income. Currently the NOI should be annual rental income after the deduction of all operating expenses (including management) but before replacement reserves, depreciation, debt service and ownership expenses.

There are many factors that influence an investor’s determination of the appropriate capitalization rate. Some factors are property specific, such as location, quality of construction, or the credit profile of the tenants; other factors may be external, such as current interest rates, overall vacancy, or the attractiveness and yields of alternative investments, such as stocks or bonds. For two identical office buildings in a new suburban business park, one occupied by a few large investment grade tenants on long-term leases will sell for a cap rate around 9.0%, while its sister building, occupied by many smaller local tenants and subject to current very high vacancy rates and flat rents, will likely sell at a cap rate of about 10.5%. This potentially represents a huge difference in value at a cap rate of about 10.5%. This potential difference has a huge difference in value for two buildings that cost about the same amount to build.

We are currently experiencing a definite bifurcation in cap rates. Historically, properties from the four major groups (multi-family, office, industrial and retail) traded in a fairly narrow band of 9.0% to 10.0%. Now we are seeing single tenant retail properties selling in the 10.0% range. Again, many owners are holding their properties off of the market because their “cost-to-carry” is low with the current interest rates.

In the general real estate market we are experiencing an unprecedented wide range in capitalization rates from 7.0% to 12.5%. There will be no relief for the stress on industrial, office, hotel/motel and newer apartment properties until there are some strong signs of recovery in the overall U.S. economy. Meanwhile, the downward pressure will continue on cap rates for net leased or well leased retail properties. Many owners would love to sell at today’s prices but there are few suitable alternative investments with the understandable disenchantment with the stock market and very low bond yields. Sooner or later our economy and real estate market will stabilize and we can get back to projecting cap rates in the 9.0% -10.0% range without thinking too hard about all the intricacies that come into play today.

There are simply not enough net leased properties to satisfy the tremendous pent-up demand.

With mortgage interest rates continuing to drop to historical lows, the price investors can pay inversely rises. There are simply not enough net leased properties to satisfy the tremendous pent-up demand, and this tight market condition is now benefiting the retail sector in general. There are some recent sales of well-leased but unanchored small strip centers at cap rates around 8.0% whereas this property type has heretofore experienced cap rates in excess of 10.0%.

On the other hand, the cap rates for industrial and office properties are holding steady or rising above the 10.0% level. The low interest rates available to owners and developers have prevented the cap rate for these property types from going even higher. Most owners are able to simply hold onto their properties and weather the storm of high vacancy and declining rental rates. With floating rate debt in the 3.75% - 5.0% range, their breakeven occupancy is more nearly 60%.

Upcoming Events

MSCA programs will be held at 8 a.m. (registration at 7:30 a.m.) at the Radisson South Hotel unless otherwise indicated with an asterisk. Pre-registration ends at noon the day prior. Any registrations received after that will not be guaranteed pre-registration. Program topics are subject to change.

Monday, June 16th
Annual Golf Event

Wednesday, July 9
Personal Development

Wednesday, August 6
Development

Wednesday, September 10th (Afternoon)
Mail Program/15th Anniversary

Wednesday, October 2nd (Afternoon)
Retailer Panel
Holiday Inn Mpls Metrodome

Wednesday, November 5th (Afternoon)
Retail Report
Holiday Inn Mpls Metrodome

Tuesday, December 9th (Evening)
STARR Awards/Year End Ceremonies
May Meeting Recap

Restaurant Easy Street?

by Bob Barton, Property Manager
Kraus-Anderson Realty Company

I’m sure at one time or another many of us have entertained the thought that we would be on “Easy Street” if only we owned a McDonald’s or a Dairy Queen. John Hamburger, President of Franchise Times Corporation, challenged that belief in today’s market at the May 7 MSCA breakfast program “Retail Development: A Restaurant Model for Deal Making.”

The Market

Hamburger began the presentation by outlining the various market segments; Quick Serve (ex: McDonald’s, Wendy’s), Family Dining (ex: Perkins, Denny’s) Casual Dining (ex: Olive Garden, TGIFriday’s), Fine Dining (ex: Pazaluna) and what he termed Fast Casual (ex: Chipotle, Baja Tortilla Grill) as well as the realities and challenges of today’s market.

According to Hamburger, the challenges facing the Quick Serve segment are numerous. Overall sales weakness has caused price discounting to become the norm, as shown by the proliferation of “$1 menus.” Demographic shifts are contributing to sales weakness as consumers are shifting to the casual sectors in order to satisfy their interest in “real food” rather than what is perceived as overly processed food products.

The Family Dining sector achieved lackluster results in the 90s but according to Hamburger, some analysts believe that this sector could be a growth area over the next decade as baby boomers age.

Casual Dining has experienced flat sales, due to declining liquor sales and rising investment cost.

The Fine Dining sector was hit particularly hard by the events of 9/11 and the following recession as business travel ground to a halt. Operators have been forced to offer less expensive products and overall check averages have fallen.

The good news is that the Fast Casual sector has benefited where the other sectors have suffered. This sector has a perceived freshness that appeals to consumers, especially women and youth, and is being delivered through modern decors and “reality based dining needs.”

The Bottom Line

The biggest challenge to restaurant owners, according to Hamburger’s analysis, is the erosion of margins due to competition and increasing operating expenses. Brands are being consolidated under one roof, large companies are controlling multiple brands and the growth of the multi-unit restaurant owner are all contributing to the increasingly competitive nature of the market. Pricing has failed to keep pace with inflation while the cost of investment (land and construction costs, fixtureing, etc.) is outpacing a restaurant’s ability to generate sufficient revenues to justify the capital investment. Successful operators in the future will be the ones who increase market share by appealing to changing consumer tastes, control development costs through re-evaluating site selection criteria and tightly controlling operating expenses.

Easy Street? I think I’ll just stick to the drive-thru lane.

Win a $100 Gift Certificate!

Refer in writing the names of fellow retailers, brokers, developers, architects, contractors, or any other colleagues who may be a potential new MSCA member. For each qualified referral received by June 30th, your name will be entered in a drawing to win a $100 gift certificate at the July 9th program!
ICSC Las Vegas 2003 - A Review

Terry R. Smith, President, TRS Commercial Real Estate Inc.

The 46th Annual International Council of Shopping Centers (ICSC) Spring Convention was held May 18 – 21, 2003 at the Las Vegas Convention Center adjacent to the Las Vegas Hilton Hotel. ICSC’s 41,000 members in the US, Canada and 75 other countries include shopping center owners, developers, managers, marketing specialists, investors, lenders, retailers, public officials and other professionals. This is the largest gathering of real estate and retail professionals in the world with over 30,000 members attending the four-day event, including a leasing mall, trade exposition and educational seminars in 3.2 million square feet of space. With 45,721 shopping centers in the United States, the convention is a must for those associated with the shopping center industry.

ICSC Factoids

30,800 registered this year, up from 30,638 in 2002. 850 vendors compared with 820 last year.
40 Cities were represented at ICSC this year. 800 municipal officials attended.

On Sunday, May 18 the convention began with the opening of the Trade Exposition, which offers services to the shopping center industry including advertising, marketing, public relations, architecture, design, engineering, building equipment/materials, computer hardware/software, construction, financial services, furnishings/equipment and suppliers, insurance, landscaping, maintenance, parking and traffic, personal services, publications/publishers, real estate services, security and services including ATM machines and gift certificate programs.

A review of Design Trends located in the Grand Lobby this year indicated how times and ambitions have changed. In decades past, shopping center design didn’t aspire to much more than showcasing the stores, but as entertainment elements were introduced into retail centers in the 1990s, architects began to diversify their skills to include more theatrical designs. Today’s centers are more complex, often integrating office, residential and other uses to such a degree that shopping centers design becomes urban planning in miniature. Among the large projects that have fully embraced this challenge are Bella Terra, Huntington Beach, CA (retail and entertainment, including an amphitheater), Denton Town Centre (retail, office, residential and civic space) in the Dallas Fort Worth area, North Hills (retail, office and residential) Raleigh, NC and Citrus Plaza (lifestyle and power center retail) Redlands, CA.

On Monday, the leasing mall opened and the biggest lines were in the food retailers corner. From Einstein’s Bagels to Cold Stone Creamery, vendors were dishing up everything from Quizno’s Subs to Auntie Anne’s fresh baked pretzels. The luncheon presentation “Mike Wallace Remembers” highlighted his journalistic career and a glimpse of the man.

A blockbuster general session “Caliente” with Daisy Fuentes on Tuesday took ICSC on a multimedia tour of the hottest retail concepts that are driving consumers into shopping centers. The luncheon presentation by Steve A Burd, Chairman, President and CEO of Safeway, Inc. conveyed “The Safeway Success Story.”

Wednesday offered a full day at the leasing mall with developers offering a wide range of retail developments from large to small and retailers chasing locations to service providers, wearing out their feet and shoes walking the convention floor. Buzz topics this year included lifestyle centers across the county, e-commerce, bankruptcy and security.

In general this year, the convention was very upbeat. Limo counts and crowds at meetings, negotiations, presentations and cocktail parties indicated a healthy shopping center industry and individuals eager to complete transactions.

Technology Committee

Have you checked out the MSCA website? If not, get on board and log on to www.msca-online.com to see all of the great updates.

The technology committee has been working hard to accomplish the following items:
- Online registration for monthly programs
- Golf tournament page and event registration
- STARR Awards Call for Nomination Form and Judging Criteria
- COMING SOON members only section

Don’t miss out on the great opportunity to inexpensively advertise your company on the MSCA website! Advertising on the MSCA web site will give your company a direct hyperlink to your website, extensive logo/brand exposure on the MSCA homepage and access to thousands of people every month. For more information contact MSCA at 952/888-3491.

Technology Committee: Co-Chair Adam Davies - Urban Retail Properties Company; Peter Austin – Welsh Companies, LLC; Charlie Casserly – Casserly Media; Larry Calhoun – Kraus-Anderson Companies; Paul Sevenich – Kraus-Anderson Companies
Gander Mountain

by Lisa Diehl, McDonald’s Corporation

In 1996, Gander was a public company with about 20 stores and a catalog operation. The company found that running the retail and catalog outlets was too much of a financial burden. Cabela’s purchased the catalog operation, and Holiday Companies in Bloomington, a privately held Minnesota based company, purchased five of the Gander stores and the balance of their stores the following year when Gander filed for bankruptcy protection.

Today, Gander operates 57 stores throughout the Great Lakes and is looking to expand to other parts of the country. The chain sells a wide range of hunting, fishing, hiking, and water sports equipment.

The typical shopper is male and between 25 and 55. Income levels and occupation vary. Their 2003 expansion plans include 10 new store openings throughout the Midwest. Gander Mountain will add two new super stores this fall in the Twin Cities. The stores, located in Lakeville and Forest Lake, will be more than double the size of a traditional Gander store.

As it expands, Gander Mountain plans to increase the size of its typical store. New stores will be between 55,000 and 100,000 square feet, versus the 31,000 square feet of the current average store. As Todd Rymer, Director of Real Estate for Gander notes, we have opened stores in markets as small as Bemidji or as large as Chicago. Gander sets itself apart from its competition through its emphasis on products and by taking existing locations vacated by previous retailers. Several new items to the stores include testing ponds for kayaks, a cabin décor department and an ATV sales and service department. In addition, having the right product. Employees at each of the stores assist by selecting merchandise for local tastes. It allows them to open stores more quickly in new markets.

The leasing contact at Gander Mountain is Todd Rymer, Director of Real Estate. For more information, visit www.Gandermountain.com.

The Caring Tree Program

Think back to your childhood when having school supplies, such as folders, pens, pencils, and crayons was as easy as asking Mom and Dad. Those days were simple. But for many children today, it is not that easy. The State of Minnesota reports that there are over 110,000 school-aged children per year who live at or below the poverty level. Their families are unable to provide the necessary supplies. That is why The Caring Tree is so important. Not only does it provide students with the tools they need to succeed, it boosts their self-esteem and gives them a better chance to successfully complete their education.

When The Caring Tree program was started in 1993 by MSCA, the goal was to help Minnesota communities in a unique and meaningful way. Over the past ten years, nearly 100,000 students from grades K-12 have received supplies from The Caring Tree allowing them to have a better start to their school year. The 2003 goal is to help more than 13,000 children statewide.

There are many ways to help. MSCA’s annual Golf Tournament on June 16th offer many chances to win great prizes through a key raffle, putting contest and silent/live auctions. All proceeds will go to the Caring Tree Foundation to help the 2003 campaign. Last year the golf event raised $8,931, which helped 255 low-income students! If you are not able to attend the golf event, please consider sending a donation to help less-fortunate students.

The school supply drive beginning July 30th provides opportunities to “adopt” a specific child at local participating shopping centers and Herberger’s stores or purchase pre-packaged basic school supplies at participating retail partners Cub Foods and Office Depot. More information on how to participate will be available in the July and August newsletters or visit www.caringtree.org.
Industry Tidbits

by Tim Hilger, Diversified Acquisitions, Inc. and Lisa Diehl, McDonald’s Corporation

- Lowe’s appears to have finally decided to make its long awaited entrance into the Minnesota market joining Home Depot and Menard’s. The first store location is expected to open in 2004 in the hot Coons Rapids market on a corner across from Riverdale Village at Highway 10 and Main Street.
- The April U.S. Customer Confidence Survey revealed a surprisingly strong jump to 81 from March’s 61.4. This is the largest jump since March 1991.
- Wal-Mart appears to be the replacement for the closed Kmart store in St. Paul’s Midway area.
- McDonald’s Corporation posted a 29% increase in company profits in its first quarter. This is in contrast to the loss in its prior quarter.
- Red Wing Shoe Company has teamed up with Sears to produce a shoe exclusively for Sears. The work boot will be named Craftsman By Red Wing. This is the first co-branding for the two companies.
- Quiznos Sub announced that the will remodel more than 2,000 of its restaurants. The remodeling at each store will be done overnight and reopen the next day. The changes include: a new beverage station, a lower counter for a better view of subs preparation, and a full service pepper bar featuring where customers can add their own selection of jalapenos, pepperoni, banana peppers, pickles and three sauces.
- The Cheesecake Factory reaffirmed that they will open 14 new restaurants in 2003.
- California Pizza Kitchen, with the opening of 4 new restaurants in the first quarter, said it is on track to open 22 new restaurants in 2003.
- Starbucks retail revenues increased 22% for the quarter and comparable store sales increased 7%.
- Brinkers International announced that revenues increased 11% for the quarter and blended store comps of .9%. The comparable store sales breakdown by restaurant brand were: Chili’s up 2.3%, 3% at Maggiano’s, Macaroni Grill down 1.1% and On The Border down 1.8%.
- Kohl’s opened 75 stores in 2002 and plans on opening 95 – 100 stores in 2003. They opened 28 stores on a single day, with all the stores located in Southern California.
- Outback Steakhouse announced the comparable sales in April increased 2.9% for its U.S. operations. However, comparable sales at its Carrabba’s Italian Grill were flat.
- The 30-story U.S. Bankcorp Center in downtown Minneapolis, home to the bank and its Piper Jaffery unit, was sold for $174 million to Wells Real Estate Fund based in Atlanta. The building has 929,694 square feet and is 77% occupied.
- Wilson Leather announced plans to close between 40 and 45 stores this year. Wilson’s has 614 stores in the U.S.
- Regis Corporation has purchased a chain of hair salons from Opal Concepts for $10.4 million. Regis will buy a total of 286 salons, both company and franchised primarily located in the western and southwestern United States. Opal operates or franchises more than 1,650 salons in North America and Asia, operating under the names including Fantastic Sams and Pro-Cuts.
- Wal-Mart’s Sam’s Club division turned 20 last month. Wal-Mart reported first quarter net income of $1.86 billion and total sales were $56.72 billion, which was slightly less than the $60.36 billion analysis were predicting. Wal-Mart stores sales increased 9%, Sam’s Club increased 7.2%, but same store overall sales increased a modest 2.2%.
- Denver-based Qdoba, Inc. will open three Twin City restaurants this summer in St. Louis Park, Maple Grove and Eden Prairie. Today, the company has over 84 stores from coast to coast. They plan on opening 15 locations in five years.
- According to Restaurant Business, restaurant sales dropped by 20%-30% last month after the World Health Organization warned travelers to avoid Toronto because of the danger of SARS. Restauranters say they are particularly nervous about Toronto’s impending summer tourist season, which usually brings some 20 million into the city and its restaurants.
- IKEA was given the green light by the City of Bloomington to proceed with construction on a 33,000 square foot store adjacent to the Mall of America, slated for completion the summer of 2004.
- AFC Enterprises has agreed to sell the Seattle’s Best Coffee chain to Starbucks. This also includes the pricier 21-store Torrefazione Italia group. Starbucks intends to develop both brands.
- Spiegel, Inc., owner of the Spiegel catalog and Eddie Bauer chain, has filed for Chapter 11 bankruptcy protection. The company has been under increasing pressure due to the inability of its credit-card operation, to meet established financial criteria.
- Land’s End merchandise has been well-received by Sears shoppers and is now in nearly half of the chain’s 870 full-line stores and will be rolled out to the rest of the stores for fall.
- Walgreen’s hit the 4,000th store mark with the opening of its store in Van Nuys, California.
- Gart Sports and The Sports Authority received the green light from federal regulators to go ahead with their proposed merger.
- Budgets for home improvement projects are expected to rise 31% to $3,796 this year, compared with $2,888 in 2000, according to American Express Home Improvement Index survey. Most will draw from their savings while others will use tax refunds, home improvement loans, a company bonus, gift money or mortgage refinancing.
- 27% of Web users trust their primary Internet activities are safe, according to the Consumer Internet Barometer. It was also found that 64% of users go on line at least monthly compared with 61% a year ago. 38% now go on daily, up from 36% in 2002.
- Chico’s FAS is showing a younger and edgier side with the launching of its new retail concept, Paz. The format as seen in its three debut locations, Atlanta, Memphis and Scottsdale, has a hip, contemporary look. The merchandise, trendy and fashion-forward for the most part, is hung around the perimeter and also displayed on chrome, glass and wood fixtures.
- Target Corporation announced it will close its first Minnesota location in Minneapolis on West Broadway in August.
- Kmart emerged from bankruptcy in May. It has 600 fewer stores than when it first filed

continued on page 7
original shop drawings and decorative painting reflecting the Beaux-Arts style used by B. Marcus Priteca, the original architect.

**Gae Veit Honored**

Gae Veit, CEO of Shingobee Builders, Inc., recently received the U.S. Small Business Administration’s (SBA) 2003 Entrepreneurial Success Award for both the Minnesota District and the Midwest Region. The Award honors companies that began as a small business, and with SBA assistance, have grown into a large business by SBA size standards.

Veit founded Shingobee Builders in 1980, after working for 20 years in the office of another construction company. The company was assisted in its early years by the Small Business Administration’s Section 8(a) program and by organizations that assist minority business owners.

**Jim Peters Joins Adolfson & Peterson**

Adolfson & Peterson Construction (A&P) announced that Jim Peters has joined its staff as Manager of its Facilities Solutions Group. Peters brings over 20 years experience in managing all aspects of facilities solutions in both the public and private sector.

**Landform Welcomes New Staff**

Landform announced the addition of E. Steven Wright, PLS, as a registered land surveyor and Pam Atkins as a senior survey technician to its Survey Department.

**Land Secured for Legacy Village**

Hartford Group, Inc. has closed on the land for the first phase of the proposed mixed-use development, Legacy Village at Apple Valley. The total development encompasses 52 acres and is located between Galaxie and Foliage Avenues, spanning north and south of 153rd Street, in downtown Apple Valley.

Legacy Village at Apple Valley is a mixed-use, planned development bringing together intergenerational housing with retail, offices, restaurants, and public amenities all within a pedestrian-friendly environment. Public amenities include an interior lake, outdoor plaza area, walking paths and outdoor seating areas. Projected development costs for all components will exceed $125 million.

The Master Developer of Legacy Village at Apple Valley is Hartford Group, Inc.

**KKE Working in Rochester**

KKE Architects, Inc. is finalizing the design and construction documents for a new multi-tenant retail building at Rochester Crossing. Located at the southeast entry to the site, the 21,000 sf structure includes tenants such as restaurants and service retailers. The strip configuration features a stepped, undulating facade with highlighted architectural features at key entries. Paster Enterprises is the developer and owner, with Weis Builders as the General Contractor. Construction is underway with a fall opening anticipated.

**New Minneapolis Chipotle**

Landform has teamed up with Wilkus Architects on a new Chipotle Mexican Grill at the corner of Hennepin Avenue and 26th Street in Minneapolis. Construction began in mid-May and a grand opening is planned for late July.

Landform provided civil engineering and landscape architecture services. Along with the architectural services and project management, Wilkus coordinated the approval process and the mechanical/electrical work.

According to Matt Swenson at Landform, “One challenge we tackled was to maximize greenspace on the existing site. Our landscape design created a ten-fold increase in turf, plantings and decorative buffer areas. Our innovative design promotes rainfall infiltration, which helps handle storm water runoff without using an on-site storm sewer.” Input from the local neighborhood group helped define the aesthetic goals for this urban redevelopment.

**New Look by Specialty Systems**

A new storefront design that reflects the state-of-art quality of today’s home and garden products will replace an aging rustic Western look for Blaine Ace Hardware in Blaine. Specialty Systems provided the design and construction of the new architectural exterior, featuring a dramatic entry that focuses on the Ace trademark, framed by tall columns and a cornice that rises above the main roof line.

**Upland Real Estate News**

Upland recently sold an Arby’s net-leased investment property, located in Buffalo, MN for $1.2 million. Upland also sold a 7,028 sf Blockbuster Video net-leased investment property, located in Eagan for $1.4 million. Upland has recently expanded with a mortgage brokerage division, Upland Capital Advisors, Inc.

**Giertsen Promoted**

Laura Ramme Giertsen was recently promoted to Manager of Real Estate Development. Giertsen joined Opus in 2000 and has since worked on several major projects. She has handled site acquisition and development for the 1,600,000 sf Best Buy Campus in Richfield and leasing and development for the multi-phase Arbor Lakes mixed-use development in Maple Grove, among others.

**Opus Awarded**

Opus Northwest, L.L.C. recently won in two categories at the Best In Real Estate awards competition sponsored by The Business Journal. The Shoppes at Arbor Lakes won in the category of Best New Retail Development and Grant Park won in two categories: Best Overall New Development, and co-winner for Best New Multi-Family Residential Development.
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**NEW JULY PROGRAM TOPIC:**  
**Personal Development**  
*WATCH FOR FLYER*