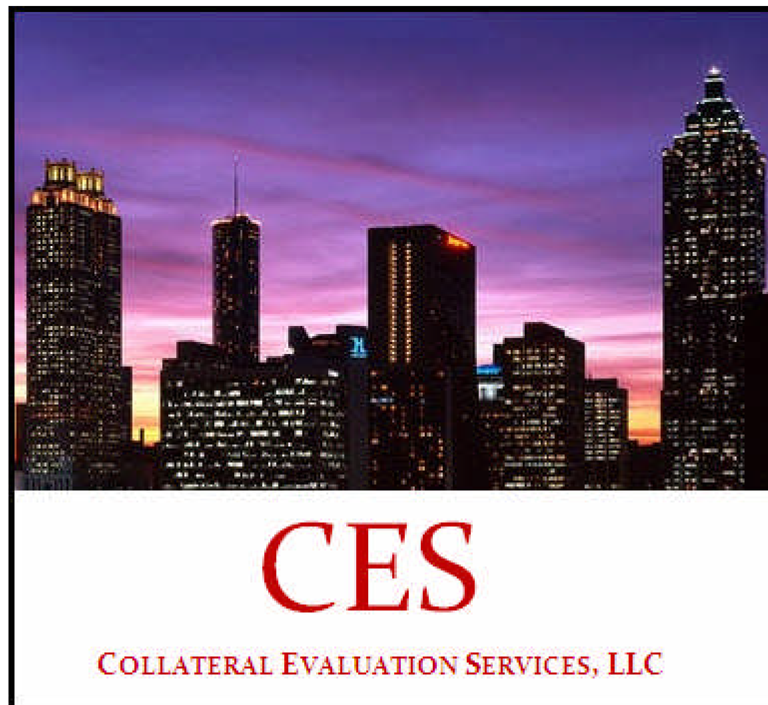
CES

Real Estate Market Report – June 2009



Collateral Evaluation Services, LLC **June 2009 Edition**

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If this is your first issue of our Real Estate Market Report, Collateral Evaluation Services, LLC welcomes you to our current view on the national real estate market and where we think it is headed over the next few years. For those who have seen prior issues, we hope you are enjoying our analysis and thank you for your input to date.

This is a free publication that we aim to publish monthly. Past issues will soon be available on our web site – www.CES-WM.com.

Each issue contains three parts:

1. National Overview – As real estate markets do not move rapidly (typically!), this section does not change significantly from issue to issue. However, as we find information of significance we update our analysis accordingly.

2. Monthly Topic – Each month we will try to provide you an unique perspective on real estate markets or share interesting market information that is (hopefully) difficult to come by. As we are introducing our report to a wider audience that is seeing everything for the very first time, this topic has not changed from the prior issue. In the next issue we will show why the current purchase prices at '20 to 40 cents on the dollar' are not distressed prices and may even be above market!

3. Metro Areas Overview – One metro area will be included in each market report as a sample of what we normally produce when working on due diligence projects for our clients. Our custom market reports for a client will typically address all metro areas of concern to them.

We hope you find this report interesting, and optimally somehow of use in your everyday job. The contents will be dictated by our readers, so your comments are appreciated and needed. Please email them to George Mann at GMann@CES-WM.Com.

Any item sent via email would be remiss if it did not contain information on how to 'unsubscribe' and stop receiving this report – simply email George Mann (GMann@CES-WM.Com) that you no longer wish to receive this report.

Best of luck to everyone during this difficult cycle – until next month, Happy July 4th and enjoy the Summer weather!

Managing Directors
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NATIONAL OVERVIEW

NOTE: Following is a summary of market conditions for major types with a focus on the past 18 months and the upcoming year. The information within this section provides generalizations on a nationwide basis. Exceptions may exist and they will be detailed in the subsequent Metro Areas Overview.

SINGLE UNIT DWELLINGS

The following is from S&P/Case-Shiller (March 2009):

> *Existing single-family home prices across the United States continued to fall in January according to the March Standard & Poor's/Case-Shiller Home Price Indices. Both the 10-city and 20-city composites set new record annually declines in January of 19.4 percent and 19.0 percent, respectively. From the housing market's peak in 2006, the 10-city composite is down 30.2 percent and the 20-city composite is down 29.1 percent.*
>
> *According to David Blitzer, chairman of Standard & Poor's Index Committee, all 20 of the metro areas reported annual declines, and nine of the MSAs fell more than 20 percent in the last year. Phoenix, Las Vegas and San Francisco reported the largest annual declines in January, with drops of 35.0 percent, 32.5 percent and 32.4 percent, respectively. The best performing cities included Dallas, Denver and Cleveland with annual declines of only 4.9 percent, 5.1 percent and 5.2 percent, respectively. Looking at the data from peak-through-January 2009, Phoenix has suffered the most, declining 48.5 percent from its peak in June 2006. Dallas, however, has fared the best with only a 10.8 percent drop from its peak in June 2007.*

The following is from S&P/Case-Shiller (May 2009):

> *The National Home Price Index continues to set record declines, according to March 2009 data recently released by Standard & Poor's in its S&P/Case-Shiller National Home Price Index. The index, which covers all nine U.S. census divisions, recorded a 19.1 percent decline in the first quarter of 2009 since the same period a year ago, the sharpest decline in the index's 21-year history. The 20-city composite fell by 18.7 percent in March from the same period a year ago while the 10-city fell 18.6 percent. As of March 2009, home prices across the country are similar to fourth quarter 2002 figures. Overall, home prices are down 32.2 percent from the housing market peak in 2006.*
>
> *"Declines in residential real estate continued at a steady pace into March," said David Blitzer, chairman of Standard & Poor's Index Committee. "All 20 metro areas are still showing negative annual rates of change in average home prices with nine of the metro areas having record annual declines. Seventeen metro areas recorded a monthly decline in March, with Minneapolis, Detroit and New York posting record monthly declines. On a positive note, nine MSAs are reporting a relative improvement in year-over-year returns and nine of the 20 metro areas saw an improvement in their monthly*

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> *returns compared to February… Based on the March data, however, we see no evidence that that a recovery in home prices has begun."*
>
> *Minneapolis, Detroit and New York reported the largest monthly declines in March, falling 6.1 percent, 4.9 percent and 2.5 percent, respectively. Phoenix, Las Vegas and San Francisco reported the steepest annual drop, declining 36.0 percent, 31.2 percent and 30.1 percent, respectively. Boston, Dallas and Denver continue to be the top performing markets with annual declines of 8.0 percent, 5.6 percent and 5.5 percent, respectively. In terms of peak-through-March 2009 data, Dallas has fared the best with only an 11.1 percent decline from its June 2007 peak while Phoenix has been hit the hardest with a decline of 53.0 percent from its peak in June 2006.*

As noted, national prices have declined about 30% from their peaks in 2006, with 'bubble' markets experiencing declines over 40%. In 'bubble' markets, CES has seen 2008/2009 appraisals 30% to 60% lower than appraisals in 2005-2006.

CES projects declining house prices throughout 2009, although the rate of decline should start to slow in the Fall. Some studies indicate that prices will need to decline another 15%-25% nationwide to get average prices back in line with long-term appreciation rates. We believe that to be a reasonable assumption. As of early June, housing futures traded on the Chicago Mercantile Exchange are projecting a 3.7% decline for home prices nationwide through the end of 2010. This is down from an 8.5% decline projected in early April.

Our projection for housing in 2010 is complicated by a significant number of reverse amortization mortgages coming due in the Spring and Summer of that year. It is projected that most of these will go into foreclosure as the LTVs are likely to be in the 150%-200%+ range. It is difficult to project how many of these mortgages will be 'fixed' by the government. Regardless, lenders are finding out that adjusting mortgage terms is not providing much relief as over 50% of mortgages adjusted in 2008 are already in default. **For 2010, we believe prices will likely decline nationwide by 5% to 10%**, with some markets bottoming out and having no further declines.

The earliest CES sees a true market bottom in housing is 2011. Even then we will probably have a mixture of markets still declining along with others seeing some appreciation. Overall, the nationwide average price should begin to finally turn up. Price appreciations in some markets may be double digits as they will be bouncing up from severely oversold conditions.

In general, due to holding costs and further uncertainties in all financial markets, it is probably better to sell today than hold thru the remaining housing market decline.

VACANT LAND, RESIDENTIAL SUBDIVISIONS, & CONDOMINIUM PROJECTS

These property types are lumped together as they are encountering the same market conditions – extreme weakness. CES has found a large average decline in property values for these projects nationwide, with 'bubble' markets experiencing the largest decreases.

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To address 'bubble' markets first, as they are causing the most problems to the financial industry and the national economy. CES has seen a typical decline of 60% to 80% in value (from peak levels in 2005-2006) for residential subdivisions (i.e. finished lots) and condominium projects in Florida, Gulf of Mexico and Atlantic Ocean beachfront projects, Phoenix, Las Vegas, and many areas of California.

Bank Workout Groups have been able to sell individual projects for 40 cents on the dollar in markets from Florida to Detroit to California. However, this is taking time and effort and is on a property by property basis. Hedge and vulture funds continue to offer 20 cents on the dollar – if banks want to sell a portfolio, this is probably the price they will have to take.

We have seen value declines up to 80% for raw land in those markets, also. Banks are having trouble getting any bids when auctioning OREO land. Market participants seem to have no desire to buy raw land when there are so many finished lots available at distressed prices. Finished lots will be purchased before vacant land as builders can get their product to market faster when the inevitable up cycle occurs. We hear buyers say that maybe at 5 or 10 cents on the dollar they may buy vacant land – but at many auctions no one even bids those prices.

In non-bubble markets (e.g. the Midwest), subdivisions and condo projects have probably declined 20%-40% in value. The decline is less as these markets did not experience rapid appreciation or absorption rates. However, the slowdown in the housing market coupled with increase risk for all real estate has still adversely affected the value of these properties.

COMMERCIAL PROPERTIES – Income Producing

In August 2007 when the credit crisis began, cap rates for income properties increased about 100bp across the board. The increase was mostly due to a higher cost of capital (LIBOR spreads increased 200-300bp).

During the first two quarters of 2008, market participants indicated that Class B and C properties had adjusted to the new cap rates and sales were occurring – albeit at a much slower pace than pre-August 2007. The resulting 100bp increase in cap rates resulted in a 10% to 15% decline in market values.

For the most part, owners of Class A properties refused to lower their prices and very few sales occurred during the first three quarters of 2008. However, after the Lehman Brothers debacle in September 2008, the entire marketplace experienced a major shock with values declining rapidly thru the end of the year.

Our Wall Street sources inform us that Class A properties are down about 30% to 35% in value from their peaks – 20% to 25% of this is due to increased cap rates and 10% due to revenue decreases. Apartments are the exception as revenues have held steady, so they are only down 20% in value due to the cap rate increase. The same sources say it is very difficult to move Class B and C properties now.

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APARTMENTS - Although revenue has held steady for Apartments, some weakness is expected in 2009 and 2010. Also, a significant increase in cap rates from extreme lows, is expected to **drop Apartment values over 30% by 2010 (from their peaks in 2006-2007)**. Cap rates for 'fractured condo' projects are reportedly 150bp higher than cap rates for normal apartment projects.

OFFICE - The Office market should see significant weakness – one study projects 1.5 million job losses nationwide in 2009. About 1.2 million of those jobs will be white collar. At 150 to 200sf per employee that indicates 200 million square feet of office space will be vacated. As it will take time for leases to expire and companies to downsize, the vacated space is projected to hit the market in 2009 and 2010. It is difficult to see much absorption for this space in the current down cycle.

INDUSTRIAL - Employment sectors that drive Industrial demand are projected to lose about 1.3 million jobs in 2009, with additional losses forecast for 2010. These employment sectors turned negative (i.e. net job losses) in the 4th Quarter of 2007. Employment growth generally leads absorption by six months – in fact, industrial absorption turned negative in the 2nd Quarter of 2008. We will watch the industrial employment sectors closely in 2009 and 2010 to see if they bottom and start to turn up. Six months after that occurs the industrial market should start to see signs of life. The table below shows **the last four quarters have seen an average loss of 633,000 jobs in industrial sectors.**

INDUSTRIAL SECTOR EMPLOYMENT - NATIONWIDE

	2008			**2009**		
	2nd QTR	3rd QTR	4TH QTR	1ST QTR	2nd QTR	3rd QTR
Quarter Change *	-287.2	-371	-843.1	-1030		
4-Quarter Average *				**-633**		

* - In Thousands

The CoStar Group forecasts **the national vacancy rate will increase from 8.9% at Yearend 2008 to 11% by Yearend 2010.** Weakness has already been seen with average concessions increasing from 2.5% of asking rent in early 2007 to 5% of asking rent at the end of 2008. Also, **the average time to re-lease a vacated space has increased from 75 days in 2006 to 425 days currently.** A recent study revealed that average space leased by a tenant was 50% less in 2008 than in 2000. Companies are being very careful not to lease more space than they need today or in the near future. **Cap rates are forecast to increase to 10%, which is 300-400bp from their lows. As a result, a 50% value decline is expected for this property type.**

RETAIL - Due to the number of store closings, **banks should continue to review their retail center loan portfolio in great detail.** Centers that have had an excellent operating history can quickly become distressed properties. Larger tenants have lease clauses that allow them to end a lease if another large tenant vacates their center. Such clauses have a domino affect and a stabilized property can encounter significant vacancy in a short period of time. Also, many property owners are reportedly reducing rents (without reporting such on rent rolls) or not collecting rent at all. Their logic is it is better to have tenants and foot traffic than a vacant center. Banks may want to take a closer look at Balance Sheets to

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see if rents past due or similar accounts are increasing rapidly. In general, retail centers should see the greatest value decline of all commercial property types.

For commercial real estate overall, 2011 is the earliest we should expect to see any upturn in values.

COMMERCIAL PROPERTIES – Owner Occupied

It is likely the increase in cap rates has negatively affected owner occupied properties also. However, our data does not show the decline to be as extreme. We believe this is due to a lag effect – companies are just now starting to accelerate their closings and layoffs and loan renewals are encountering an extreme credit crunch.

The housing bubble was responsible for significant increases in employment and demand for industrial, office, and retail properties. However, the same factors that played a major role on the way up are now playing a major role on the way down.

As businesses close down or downsize, the demand for industrial, office, and retail properties will decline. This decline is expected to accelerate throughout 2009 with the retail property market being affected the most.

Banks need to review their business loan portfolio to determine how many loans are to companies in industries that will be adversely affected over the next 2-3 years. Real estate collateral may move from a secondary source of repayment to primary source. In some areas like the Inland Empire in California, over 40% of the real estate demand before the top occurred came from businesses related to the housing boom. As a result, these same businesses are likely to close up or downsize and vacate a large amount of space.

COMMERCIAL PROPERTIES – Vacant Land

Commercial land did not have the bubble that the residential land market experienced. As such, we have not seen a significant change in commercial land values.

Land owners will often hold their land until the next up cycle. It is not unusual for land owners to wait 5 or 10 years or longer to sell their property at the price they originally paid for it. Holding costs are minimal so they wait to get their price. As a result, the number of land sales has been declining significantly.

However, for market participants that want to buy and sell land so they can develop a project or build an owner-occupied building, we expect they will see a decline in land values over the next few years. If improved properties are declining in value, it is logical to assume land values will have to decline accordingly. Market participants are discounting commercial land 10%-12% annually for the holding period until development is feasible.

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MONTHLY TOPIC - LONG WAIT UNTIL 2025-2040

When a bubble bursts it is not unusual for a market to take 25+ years to get back to the prices seen at the top. The Dow Jones Industrial Average did not exceed its 1929 top until 1954. The NASDAQ is nine years out from the 2000 Dot-Com top and is still 70% below that peak. Japan's Nikkei Index is 18 years removed from its top and 75% lower. The list goes on and on throughout history. In fact, some markets never recovered to see their grandiose tops again.

In our review of appraisals nationwide, we have seen property declines of 50% to 80% for houses, land, and even some improved commercial properties. The following table puts into perspective how long an owner or investor will likely wait to once again see their purchase price of 2005/2006.

Annual growth rates of 3%, 4%, and 5% are shown as these represent 'normal' appreciation rates for real estate in the past – these should be reasonable considering an average of two economic recessions/downturns can be expected once we get out of The Great Depression II.

YEARS THE BUBBLE PRICES WILL BE SEEN AGAIN

Annual Appreciation →	**3%**	**4%**	**5%**	**10%**
Value Decline from Bubble Top ↓				
-50%	2033	2027	**2024**	2017
-60%	2040	2033	2028	2019
-70%	2050	2040	2034	2022
-80%	2064	2051	2042	2026

Source: George R. Mann, MAI, SRA, MRICS; Collateral Evaluation Services, LLC

As an example, say a home was purchased for $1,000,000 in 2005. The value has declined 50% to $500,000. If this home appreciates at a 5% annual rate going forward, the $1,000,000 value will be seen again in the Year 2024 (bolded cell in table).

An extremely optimistic column is added at the far right to show what might happen if these properties appreciated at a 10% annual rate. It will still be 2017-2026 before prices get back to levels seen in 2005/2006.

This supports the stock market axiom that says to cut your losses quickly. It takes a lot of appreciation to make up for significant losses. 2025-2040 will be back to the future.

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METRO AREAS OVERVIEW

The follow metro area overview primarily addresses recent and future trends of effective revenue (net of concessions and vacancies). In order to translate to value trends, consideration must be given to recent increases in cap rates. Cap rates have reportedly resulted in value declines around 30%-35% since the Summer of 2007.

TAMPA – Effective Revenue								
YEAREND	APARTMENTS		INDUSTRIAL		OFFICE		RETAIL	
	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE
2006	$736	---	$4.26	---	$15.56	---	$12.83	---
2007	$729	-1%	$4.36	+2%	$16.68	+7%	$13.22	+3%
2008	$726	-0%	$4.22	-3%	$15.71	-6%	$12.46	-6%
2009	$707	-3%	$4.14	-2%	$14.51	-8%	$11.82	-5%

Source: REIS, Inc.; EGI – Effective Gross Income, CES estimate using REIS data. Average monthly EGI for apartments and average annual EGI per square foot for industrial, office, and retail segments.

TAMPA – Vacancy Rates				
YEAREND	APARTMENTS	INDUSTRIAL	OFFICE	RETAIL
2006	5.4%	6.4%	11.7%	6.5%
2007	6.9%	6.7%	12.0%	6.7%
2008	8.6%	7.6%	15.9%	9.0%
2009	9.3%	8.4%	18.6%	10.5%
2010	8.9%	8.1%	19.4%	11.6%

Source: REIS, Inc.; Vacancy rates are average for all classes of properties in apartment, industrial, and office categories; Retail vacancy reflects neighborhood and community centers.

Revenue for Apartment properties peaked in 2006 and have experienced a slow decline since then – projected to continue thru 2009. Industrial, Office, and Retail properties all experienced revenue peaks in 2007. Office and Retail properties are projected to have significant declines in revenue in 2009.

Over the next two years, vacancies are projected to increase slightly for the Apartment and Industrial markets and significantly for the Office and Retail properties.

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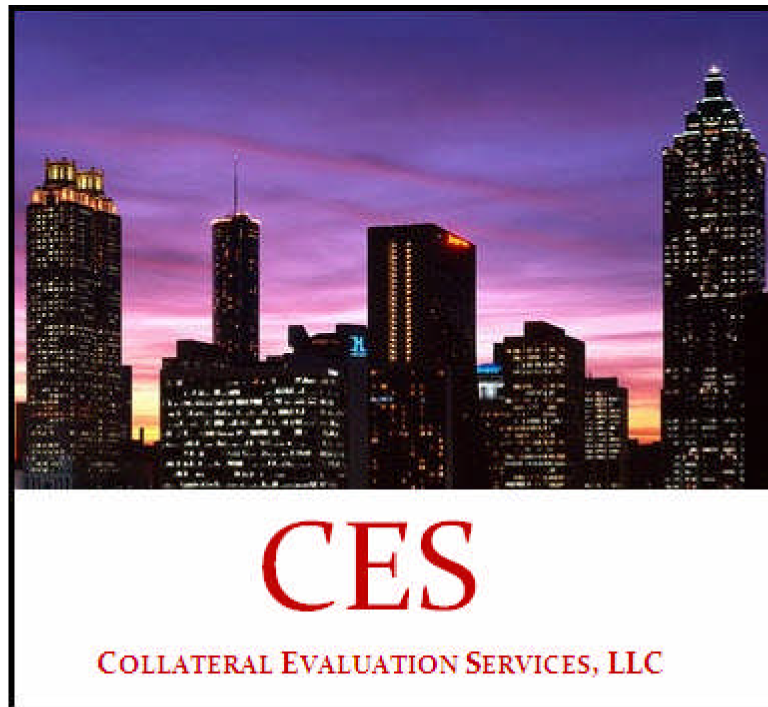

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