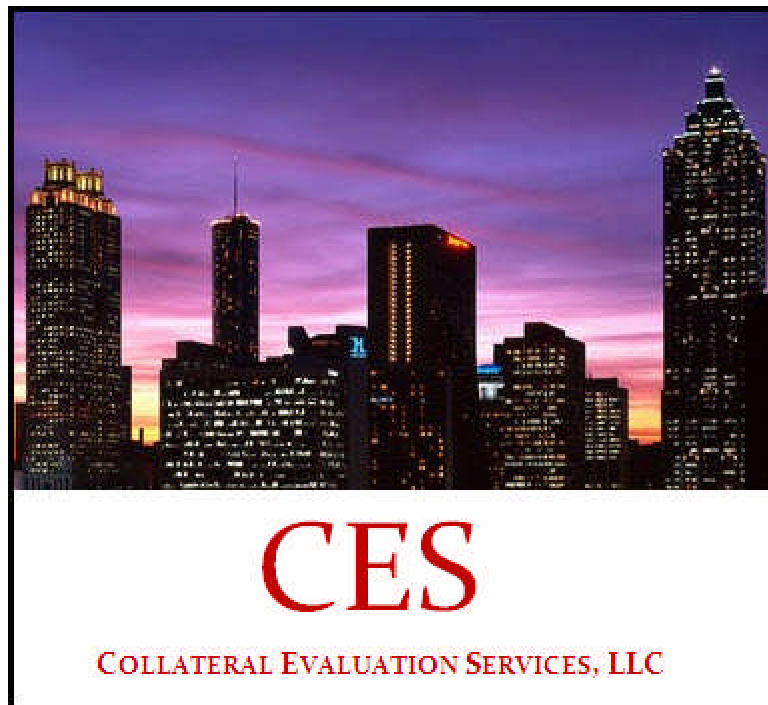
CES

Real Estate Market Report – July 2009



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

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INTRODUCTION

By Collateral Evaluation Services, LLC

If the trend continues, 2049 should be a very interesting year. 1929 gave us 'The Crash'. 1969 gave us the moon landing (and for any Mets fans out there yes the Amazing Mets, too). 2009 will probably go down as giving us The Great Recession. Albeit, the government won't term it as I did 4 years ago in June/July 2005 when I forecast 'The Great Depression II' was beginning. It's doubtful the government, or even the press, will use that 'D' word ever again. At any rate, the 40 year cycle has proven interesting once again.

Current highlights include a report this week by Grubb & Ellis giving us nationwide vacancy rates. As shown below the picture continues to worsen and now more and more market participants are forecasting vacancy rates will rise above those seen in the early 1990's.

VACANCY RATES - NATIONWIDE

	APARTMENTS	INDUSTRIAL	OFFICE	RETAIL
2ND Quarter 2009 Vacancy Rates	7.6%	10.7%	16.6%	10.0%
12 Month Change	+ 80bp	+ 120bp	+ 100bp	+ 80bp

Source: Reis, Inc., Grubb & Ellis

Vacancies are now being forecast to top out in late 2010 or possibly even early 2011. Of the four major property types, industrial has the best fundamentals to recover first.

A more detailed analysis of each property is contained in the National Overview section of this report.

Remember this is a free publication that we aim to publish monthly. If you know of anyone who might be interested in receiving our market report, please feel free to pass this copy along to them – they just need to send us their email address and we will add them to our distribution list.

As always, 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. Note that we do not share our mail list with anyone outside CES.

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NATIONAL OVERVIEW

By Collateral Evaluation Services, LLC

NOTE: Following is a summary of market conditions for major property types with a focus on the past 18 months and the upcoming 18 months. 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 (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 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.*

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

> *"The pace of decline in residential real estate slowed in April," said David Blitzer, chairman of Standard & Poor's Index Committee. "In addition to the 10-city and 20-city composites, 13 of the 20 metro areas also saw improvement in their annual return compared to that of March. Furthermore, every metro area, except for Charlotte, recorded an improvement in monthly returns over March."*
>
> *The strongest performing cities continue to be Denver, Dallas and Boston with annual declines of 4.9 percent, 5.0 percent and 7.7 percent, respectively, as of April. The weakest performing cities as of April continue to be from the Sunbelt, with Phoenix reporting a decline of 35.3 percent during the last 12 months, Las Vegas falling 32.2 percent and San Francisco decreasing 28.0 percent.*
>
> *From the housing market peak in the second quarter of 2006 through April 2009, the 10-city composite has fallen 33.6 percent and the 20-city composite has dropped 32.6 percent. Dallas has fared the best, falling only 9.6 percent from its peak in June 2007, while Phoenix has been hit the hardest, dropping 54.1 percent from its peak in June 2006.*

As noted, national prices have declined about 33% from their peaks in 2006, with 'bubble' markets experiencing declines over 50%. In 'bubble' markets, CES has seen 2009 appraisals 40% to 60% lower than appraisals in 2005-2006.

CES has projected declining house prices throughout 2009 with the rate of decline slowing in the Fall. Per Case-Shiller, home prices have declined about 7.5% this year. Housing futures traded on the Chicago Mercantile Exchange (CME) are projecting a further 2% decline thru yearend.

Some studies indicate that prices will need to decline another 10%-20% nationwide to get average prices back in line with long-term appreciation rates. We believe that to be a reasonable assumption. As of early July, housing futures traded on the CME 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, but unchanged from last month.

Our projection for housing in 2010 is complicated by a significant number of negative 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.

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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. Likewise it is too early to make speculative investments as you would have to pay carrying costs over the next 15 months, while values are projected to decline by about another 4%. Some market participants use 1% of value per month as a carrying cost estimate – thus over the next 15 months a home investment made today might lose 20% in value.

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.

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.

CES has reviewed over 100 appraisals of residential subdivision and condominium projects this year and the majority are estimating market value at 65% to 70% below either total project cost or gross retail prices at the market top. **Internal Rates of Returns are approaching 35% (inclusive of entrepreneurial profit) in some of the weakest markets.** Bulk condo sales are becoming more common and we hope to report on what our research finds in that regard in future issues of this market report.

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.

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COMMERCIAL PROPERTIES – Income Producing

Almost two years after the credit crisis began (August 2007), market participants have finally come to the realization that commercial property values are generally down 30%-35%+ from their peaks. The decline continues to pick up speed (unlike the housing market which is slowing down as it nears a bottom) and more and more markets are reporting 50%+ value declines in commercial properties.

Many property owners continue to be in denial about the price declines or simply refuse to sell at a loss. An axiom we learned long ago is that you don't have to buy, but often you have to sell. As such, the number of property owners having to sell their properties is increasing and the prices they are receiving are in line with the value declines reported above. Although market participants complain about a lack of data, we are seeing several 2009 sales in almost every appraisal we review.

APARTMENTS – Market participants originally thought this market segment would benefit from the current recession because families that lost their homes to foreclosure would move to apartments. Also, fewer young families could buy their first home due to stringent financing requirements and they would have to stay or move to apartments. However, the supply side has exceeded their expectations and the large number of failed condo conversions and the increasing number of houses being rented has been greater than demand – the result is a general increase in vacancy rates nationwide. **Lower rents and higher vacancy rates are forecast thru 2010, also.** According to the most recent Korpacz Survey, cap rates have increased 174bp in the past 12 months. In addition, appraisals we have reviewed show cap rates for 'fractured condo' projects are 150bp higher than cap rates for normal apartment projects.

OFFICE – As projected earlier this year, the Office market has seen significant weakness – Grubb & Ellis is now showing national vacancy at 16.6%. According to the Korpacz Survey, cap rates have increased 96 to 126bp in the past 12 months. **The Korpacz Survey also states that market participants are projecting an average value decline of 11%-12% over the next 12 months – some participants are forecasting a 30% value decline.** This is on top of the 30%-35% value decline that has already occurred in many markets.

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.**

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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.

According to the CoStar Group, 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. The latest Korpacz Survey shows cap rates for institutional-grade warehouse properties at 7.93% (up 137bp from a year ago) with a 230bp premium for non-institutional grade warehouse properties. **This indicates cap rates have already exceeded 10% (7.93% + 2.30% = 10.23%).**

RETAIL – As we forecast a year ago, **banks needed to review their retail center loan portfolio in great detail as the number of store closings will continue to increase rapidly.** Market participants claim the most common activity this year is for tenants to ask owners to reduce their rent. 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. **Reis, Inc. has forecast the national vacancy rate won't top out until 2011** and over half the properties they survey have declining average rents. 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. Early indications are the industrial segment (warehouse and distribution, not office/flex) will be the first to show signs of improvement.

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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 in the second half of 2009 with the retail property market being affected the most.

Banks need to stay on top of their business loan portfolio to determine how many loans are to companies in industries that will be adversely affected over the next 2 years. Real estate collateral may move from a secondary source of repayment to primary source. We have worked with loan review teams that say they have seen quarterly sales for some companies drop over 80%, thus leading to a classified loan without much warning. The normal slow decline in a company's performance may not occur in this cycle – rapid declines may be more common this time around.

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.

The one exception being locations where market participants paid premiums for 'entitled' properties. These areas are finding that these 'entitlements' are being valued at $0 today and thus significant value declines are occurring. This is more attributable to the 'bubble' mentality that paid outrageous prices for an entitlement that might have cost a few thousand dollars to obtain. We have seen several properties that were sold at 1500%+ price increases between 2003 and 2006 only to experience 90%+ value declines as the entire entitlement premium vanishes.

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 – Distressed Prices? Not!

By George R. Mann, MAI, SRA, MRICS

For the past year or two as news writers and reporters learned about the real estate market crash, it has become the norm to see the words 'distressed prices,' 'bargain prices,' and 'below market' tossed around with abandon. Reports abound, and factually so, that investors (hedge funds, etc.) are buying properties 'at 20 to 40 cents on the dollar.'

That makes for great headlines, but does not tell the whole story. As more people are starting to ask – 20 to 40 cents of what dollar? Today's dollar? The 2005-2007 bubble dollar?

The following tables attempt to put into perspective some of what we have seen in appraisals over the past 4-5 years. For simplicity sake, we'll assume our subject property is a 100-unit condominium project with $1,050,000 priced units (name your location – Florida, Phoenix, Vegas, Inland Empire, etc).

At the market top, it was common to have such projects sellout in one day. Also, it was not unusual to see appraisers use discount rates (inclusive of entrepreneurial profit) as low as 15% and minor expenses. This property likely would have been valued as follows:

	1 DAY	
Gross Retail Sales	$105,000,000	
Expenses (5%)	($5,250,000)	
Cash Flow	$99,750,000	
Discounted at 15% annual rate	None - 1 Day sellout	
$99,750,000	← Value	

In reality, this wasn't as much an estimate of market value as it was an indication of a bubble price market participants were paying. At the top, as will occur at the upcoming bottom, most market participants, including appraisers, forget that price does not always equate with value.

A more appropriate indication of market value at the top would have reflected a 'normal' 2-3 year sellout, normal expenses of 8%-12% of gross sales, and an IRR of 18%+. This would have resulted in a value estimate of $74,000,000 as shown below:

	YEAR 1	YEAR 2	(YEAR 3)
Gross Retail Sales	$52,500,000	$52,500,000	
Expenses (10%)	($5,250,000)	($5,250,000)	
Cash Flow	$47,250,000	$47,250,000	
Discounted at 18% annual rate	0.8475	0.7182	0.6086
$74,000,000 (RD)	← Value		

Obviously this is an overly simplistic DCF for this property type – but the end result is probably close to what a more detailed DCF would conclude. If a 3-year absorption was more typical for the above market, the value would have been $68,500,000 (Rounded).

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The above two tables show that the market had already stretched prices 35% to 45% above market value. Loans made on inflated value estimates were certainly destined for significant trouble.

Fast forward to today and in many cases it is tough to support even one unit per month absorption. Property owners are lowering prices significantly to create sales. Our recent review of appraisals of this property type in the bubble markets showed a 50%-60% reduction in prices was able to create sales rates of 4 to 10 units per month in some markets – obviously the property had to be well located in its particular market to generate such sales. Those property owners who had refused to lower prices or maybe lowered them 20% or such were seeing almost no sales.

The following table assumes a 50% price reduction ($525,000 average price), a 2-year sellout (somewhat aggressive due to the high prices), and a IRR of 25% to 35% (inclusive of profit):

	YEAR 1	YEAR 2
Gross Retail Sales	$26,250,000	$26,250,000
Expenses (10%)	($2,625,000)	($2,625,000)
Cash Flow	$23,625,000	$23,625,000
Discounted at 25% annual rate	0.8000	0.6400
$34,000,000 (RD)	← Value @ 25%	
$30,500,000 (RD)	← Value @ 35%	

The current value estimate is $34,000,000 (for now, we'll ignore the 35% IRR that is becoming more common in these markets), which is 68% below gross retail sellout at the top and 66% below the likely appraised value at the top. But, it is only 54% below what I would have considered to be true market value at the top ($74 Million in this example) – and 54% is in line with the 50% decline in housing values we used above and has actually occurred in most bubble markets.

So, we have a property that may be bought by some hedge fund (doubtful as noted below) at what appears to be 32 to 34 cents on the dollar. The reporters and many market participants would call that a 'distressed' purchase price. I would say it is far from distressed and might actually still be above market – I'm not sure how many of us would be willing to put $34 Million of our money on the line in this market to sell 100 condominiums priced at $525,000, and truly believe it will all be accomplished in the next two years.

Twenty cents on that 'dollar' sounds a lot more inviting and maybe more indicative of what market value (not distressed value) is today for this property type. A hedge fund requires 'excess profits' for its investors and as such this would explain their desire to pay 20 cents. They pay around $20 Million for the above property so they can make an extra $14 Million versus the developer or local investor who pays $34 Million and is satisfied with the 'normal' profit built into the 25% IRR. Of course for either party to get the property at the required price, they first need a seller willing to recognize the likely value of future cash flows as outlined above – so far most sellers have been holding off on accepting the above prices.

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METRO AREAS OVERVIEW - Tampa

By Collateral Evaluation Services, LLC

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.

((Note: Due to time constraints on publishing this issue we did not change metro areas from the last issue. The August issue will provide a different Metro area.))

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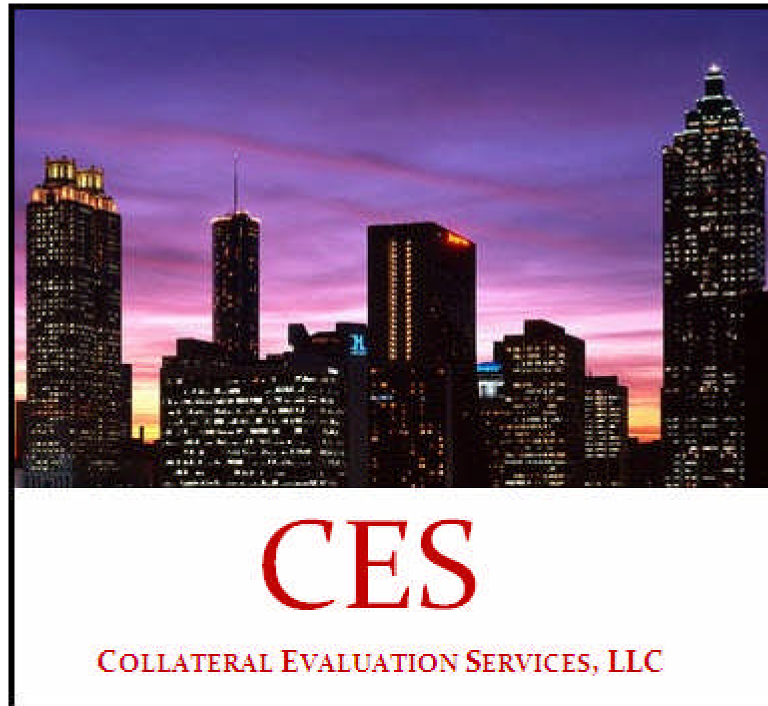

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