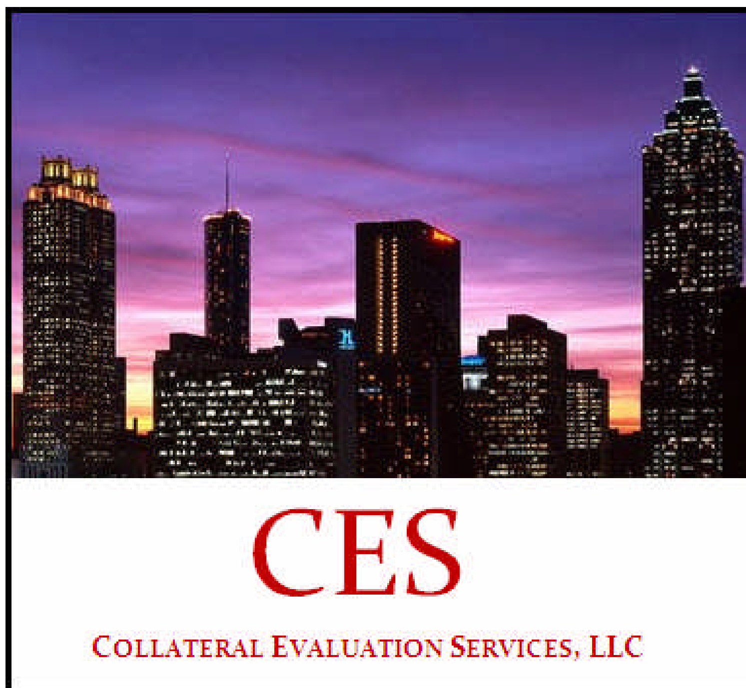
CES

Real Estate Market Report – November 2009



Collateral Evaluation Services, LLC **November 2009**

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INTRODUCTION

By Collateral Evaluation Services, LLC

"A Tale of Two Markets"

First off, as you may have noticed we have not put out a market report since August. Real estate markets simply do not change rapidly and we were finding about 80%+ of the content to be the same from issue to issue. Although, this may still occur going forward, seeing the information every two or three months makes more sense than monthly. We obviously do not want to bore you with this market report. Thus, expect a new issue every 2-3 months going forward.

Most everyone has heard by now that The Great Recession, as it is now being commonly referred to, is 'officially' over. Of course, we wonder why it takes 2 consecutive negative GDP figures to start a recession, but only one positive quarter to end it? Oh well, it's our Government that only declared the recession starting last year when former government economists with the original formulas say it actually started in Late 2005.

All of that aside, an important question to ask, and answer, is – can the general economy actually grow while the commercial real estate (CRE) market continues to decline? The simple answer is Yes. Based on all the data, there is absolutely no doubt in our mind CRE will decline throughout 2010 with 2011 being a bit far out to know if a bottom will occur then. So how can the economy and CRE have such a great divergence?

The reason we propose goes back to a few paragraphs above and the shocking concept that the government might manipulate the economic data. Charts have shown that over the last 30-40 years consumer confidence has bottomed about two years after the government said the recession ended. Could it be that we consumers better know when the recession is over? Probably. And since CRE is dependent on people spending money, it is quite likely that it will be two more years before the consumer rises again and CRE starts to improve.

It is a tale of two markets…..and our goal is to focus on CRE in our market report.
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Remember this is a free publication. 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. Thanks to those who did just that last issue – we welcome our new subscribers. Note that we do not share our mail list with anyone outside CES.

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. Happy Veteran's Day!

Managing Directors
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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 Moody's Economy.Com (October 2009):

> *"The national median home price is expected to drop an additional 11.3 percent before bottoming in June 2010, according to financial information and analysis firm Fiserv. After bottoming out, Fiserv predicts some stabilization and then a slight increase in value of 3.6 percent. Mark Zandi, chief economist with Moody's Economy.com, agrees with Fiserv. "I think more price declines are coming because the foreclosure crisis is not over," Zandi told CNN/Money.com.*
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> *Over the next year, Fiserv noted that prices will drop in 342 of the 381 markets. Miami is expected to take the heaviest hit, with prices falling 29.9 percent by next June in addition to the 48 percent drop in value the market had during the past three years. By June 2011, the median home price in Miami is expected to be $142,000.*
>
> *Other areas expected to have significant drops in value include Orlando, Fla., with a fall of 27 percent; Hanford, Calif., with a drop of 26.9 percent; Naples, Fla., with a decrease of 26.8 percent; Las Vegas, with a drop of 23.9 percent; and Phoenix, with a fall of 23.4 percent.*
>
> *Fiserv's outlook differs from the S&P/Case-Shiller Home Price Index, which suggests that the housing market already may be stabilizing after increasing 3.6 percent since May 2009. Brad Hunter, chief economist at Metrostudy, told CNN/Money that he agrees with Fiserv. "I'm afraid Case-Shiller may be just a temporary reprieve," Hunter said, pointing out that a wave of foreclosures will soon hit that will cause home values to decrease, and that the first-time home buyer tax credit has been skewing current housing data.*
>
> *Fiserv noted that 33 markets will actually post gains over the next year while six will remain flat. With an expected increase of 3.4 percent, the Kennewick, Wash., metro area is expected to fair the best. Following closely behind are Fairbanks and Anchorage, Alaska, which are expected to increase 2.5 percent and 2.1 percent, respectively, and Elmira, N.Y., which is expected to increase 1.8 percent.*
>
> *Prices in New York City are expected to fall an additional 17.4 percent by June 2011, while Chicago and Los Angeles are forecasted to fall an additional 25.2 percent and 20.2 percent, respectively, by June 2010. The Detroit metro area, which has the lowest home prices in the country, is expected to fall an additional 9.1 percent."*

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Per Case-Shiller, national prices declined about 33% from their peaks in 2006 through May 2009. This placed home prices at 2003 levels. A 3.6% rise has occurred since May – but we agree with Economy.Com above, a renewed decline in prices should occur in 2010.

Economy.Com's forecast of a further 11% decline would coincide with studies that indicate prices need to fall another 5%-15% nationwide to get average prices back in line with long-term appreciation rates. As of early November, housing futures traded on the CME are projecting a 2% decline for home prices nationwide through the end of 2010. This is down from 3.7% in August and 8.5% projected in early April. However, a further decline (4% from end of 2010) into the Summer of 2011 has developed recently.

Our projection for housing in 2010 is complicated by a significant number of negative amortization mortgages coming due in the Spring and Summer of next 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, but recent reports indicate very few have been fixed to date. Recent projects we have worked on already confirm that LTVs are near 150% for many borrowers in the bubble markets. **Our forecast for 2010 remains the same - we believe prices will likely decline nationwide by 5% to 10%**, with some markets bottoming out and seeing 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. Likewise it is too early to make speculative investments as you would have to pay carrying costs over the next 12-18 months, while values are projected to decline by about another 5%-10%. Some market participants use 1% of value per month as a carrying cost estimate – thus over the next 12-18 months a home investment made today might lose 15% to 30% 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

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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. Also, most transactions that have occurred are showing no value is being given to any infrastructure costs already spent.

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.**

We encourage readers to subscribe to **RealtyRates.Com** to get the most comprehensive survey of discount rates. For those using this survey (the only survey we know of nationwide that covers residential subdivisions and condo projects), note that the discount rates for residential lots include entrepreneurial profit. However, the discount rates for condo projects do not include profit – a 12% to 15% line item deduction must be made in addition to the discount rate in the survey.

Bulk condo sales are becoming more common. The entire Corus Bank portfolio (about $4 Billion) was purchased in October with a reported IRR of 25%. Theoretically, portfolios have a lower rate of return than single properties (due to diversity of location, property type, etc.) – thus, another indication of IRRs being above 25% for high-rise condo projects today.

FYI, the website CondoVultures.Com, which reports on bulk condo sales in South Florida, is worth checking out. They have a free email newsletter which will let you know when bulk sales occur.

We have seen value declines up to 90% for raw land in bubble 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 discount 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. It is important to remember that if housing prices have declined say 20%, finished lot prices have declined 40%-60%. Lot prices and raw land prices decline significantly more than improved home prices.

COMMERCIAL PROPERTIES – Income Producing

Two years after the credit crisis began (August 2007), market participants have finally come to the realization that commercial property values are generally down 35%-40%+ 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.

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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.

The following article that appeared on the Appraisal Institute web site sums up the CRE market fairly well:

> *Moody's Investors Services has found that with an additional 3 percent drop in August, commercial property prices have now fallen 40.6 percent from their peak in October 2007, according to MBA NewsLink. Commercial prices are now 32.8 percent lower than the same period a year ago and 40.3 percent below two years ago, Moody's found. Although prices have fallen consistently over the past year, the rate of decline has slowed in recent months, according to Moody's.*
>
> *Federal Deposit Insurance Crop. Chair Sheila Bair noted that 43 percent of community bank portfolios relate to construction and CRE loans while the average ratio of CRE loans to total capital is more than 280 percent. Her comments came during testimony last week at a Senate Banking subcommittee on Financial Institutions, according to NewsLink.*
>
> *"The most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters is in CRE lending," Bair said. "While financing vehicles such as (commercial mortgage-backed securities) have emerged as significant CRE funding sources in recent years, FDIC-insured institutions still hold the largest share of commercial mortgage debt outstanding, and their exposure to CRE loans stands at an historic high. As of June, CRE loans backed by nonfarm, nonresidential properties totaled almost $1.1 trillion, or 14.2 percent of total loans and leases."*
>
> *According to NewsLink, the Sept. 22-23 minutes from the Federal Open Market Committee noted that commercial real estate activity fell in most districts because of declining occupancy and rental rates, as well as tight credit. "Credit remained quite tight for many businesses and households dependent on banks, and many regional and small banks were vulnerable to the deteriorating performance of commercial real estate loans," according to the FOMC minutes.*
>
> *In a recent Realeconometrics' Core Report, Sam Chandan, president and chief economist at Realeconometrics, noted that a slow return to labor market stability could be sparked by adjusting October's consumer sentiment lower than September's level, but higher than levels seen in July and August. "An easing of the financial and credit markets' negative spillovers into the real economy is welcome news for commercial real estate," Chandan wrote. "Downward pressures on property fundamentals will abate as real economic activity normalizes."*

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Don Marron , chairman and CEO of Lightyear Capital, told Bloomberg Television, "Commercial real estate is the best telegraphed crash there has been." He added that keeping buildings occupied and managed properly will help the industry move forward.

Forecasts for mortgage delinquency rates indicated we might only be 30%-40% of the way through the commercial real estate bear market. According to Trepp, the overall delinquency rate for CMBS climbed to 4.8% in October. Some forecasts have this delinquency rate peaking above 12%. Our analysis of each property type follows.

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. **In fact, the national vacancy rate is now at a 23-year high.**

Lower rents and higher vacancy rates are forecast thru 2010, also. According to the most recent Korpacz Survey, cap rates have increased 198bp in the past 12 months to 7.84%. The latest Korpacz Survey also shows a 150bp premium for non-institutional grade apartment properties. **This indicates cap rates are over 9% (7.84% + 1.50% = 9.34%).**

In addition, appraisals we have reviewed show cap rates for 'fractured condo' projects are 150bp higher than cap rates for normal apartment projects. The CMBS delinquency rate of multi-family properties was 7.66% versus 4.8% for all properties (October 2009 – Trepp).

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 107 to 138bp in the past 12 months. For non-institutional grade office properties, cap rates are about 10%. **The Korpacz Survey also states that market participants are projecting an average value decline of 12% over the next 12 months – some participants are forecasting a 30% value decline.** This is on top of the 35%-40% value decline that has already occurred in many markets.

INDUSTRIAL - Employment sectors that drive Industrial demand have lost over 1.7 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 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 646,000 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	-371	-839	-1005	-403	-335
4-Quarter Average *				**-633**	**-655**	**-646**

* - 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 8.46% (up 183bp from a year ago) with a 233bp premium for non-institutional grade warehouse properties. **This indicates cap rates are approaching 11% (8.46% + 2.33% = 10.79%).**

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. According to the latest Korpacz Survey, cap rates for non-institutional grade strip centers are 10.60%.

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. However, 2010 should see a continued decline in values across all segments. Unlike 2009 where most of the value decline was due to an increase in cap rates versus a loss in income, we believe the opposite will be the case in 2010.

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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 into 2010 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 twelve months. 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. Although we have not seen a significant change in commercial land values to date, more and more appraisals that we review are showing declines up to 50% may be occurring in some markets. This looks to be attributable to market participants discounting values for a holding period of 2 to 5 years before development becomes feasible again. Market participants are discounting commercial land 10%-12% annually for the holding period until development is feasible.

The most significant price declines have been in 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.

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MONTHLY TOPIC – Fair Value

By George R. Mann, MAI, SRA, MRICS

A term not discussed since the early 1990's has become a hot topic of late. Although more of an accounting concept, appraisers need to be aware of fair value and are once again being asked to provide it in some appraisals.

As our clients bring up the issue of fair value and impairment, we have seen a variety of interpretations on how to calculate both numbers. The accounting area (CFO and other senior managers also) needs to read the various accounting standards that apply and make their interpretation of how the bank wants to calculate fair value and estimate impairment.

The financial regulators recently published their 'Policy Statement on Prudent Commercial Real Estate Loan Workouts.' This statement can be found at all their web sites – the OCC web site is as follows: http://www.occ.treas.gov/ftp/release/2009-128a.pdf (cut and paste this into your browser). We mention this statement as Page 30 of 33 provides a table that lists all the pertinent accounting standards. In addition to the items listed on Page 30, we recommend FASB Staff Position 141(r) also be researched and read.

PROPERTIES NOT REQUIRING A DISCOUNTED CASH FLOW (DCF) VALUATION ANALYSIS

Properties that are appraised using the Cost Approach, Sales Comparison Approach, and/or Income Capitalization Approach fall into this category. These include owner occupied properties of all types as well as income-producing properties that are at stabilized occupancy. Also, special use properties like churches.

To date, we have seen the following methods of arriving at fair value:

- Market Value less marketing expenses (includes sales commissions – we've seen 10%-15% deducted) and a further discount for any marketing period beyond 12 months.
- Market Value discounted over the entire marketing period at the loan interest rate.

Again, it is not our position to judge if either is right or wrong – usually in accounting there is no right or wrong anyway. We are sure there are even more methods we will encounter in the future.

PROPERTIES REQUIRING A DCF VALUATION ANALYSIS

These properties typically include subdivisions and condominium projects. The same method of estimating fair value we used in the early 1990's is also prevalent today. Everything in the DCF used for estimating market value is also used in estimating fair value, except no entrepreneurial profit is deducted (i.e. profit is $0) and the discount rate is the loan interest rate. Obviously in this case, fair value will be substantially higher than market value.

Fair value is simply a mathematical process that needs to be dictated by the bank's accountants.

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METRO AREA OVERVIEW – Nashville

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 35%-40% since the Summer of 2007.

NASHVILLE – Effective Revenue

YEAREND	APARTMENTS		INDUSTRIAL		OFFICE		RETAIL	
	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE
2006	$629	---	$2.90	---	$13.91	---	$12.68	---
2007	$652	+4%	$2.96	+2%	$14.55	+5%	$12.80	+1%
2008	$650	-0%	$2.98	+1%	$14.64	+1%	$12.87	+1%
2009	$625	-4%	$2.86	-4%	$13.40	-8%	$12.38	-4%

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.

NASHVILLE – Vacancy Rates

YEAREND	APARTMENTS	INDUSTRIAL	OFFICE	RETAIL
2006	5.5%	8.6%	11.1%	6.3%
2007	5.2%	8.9%	10.5%	7.0%
2008	7.6%	9.6%	10.5%	6.1%
2009	9.5%	10.4%	12.4%	8.0%
2010	9.9%	10.8%	13.9%	9.4%

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 all property types peaked in 2007/2008 and is projected to have a significant decline in 2009. Office is projected to be the weakest property type. Continued weakness is forecast into 2010 with the Office and Retail sectors expected to have the worst performance.

In comparison to other metro areas and National averages, the Nashville Retail sector is very strong. Even with the recent and forecast weakness, this sector is in much better shape than most other metro areas.

Home prices are down only 5%, which compares with significantly larger national declines. However, employment has declined and unemployment increased from 5.7% a year ago to 9.6% as of July. Nashville has faired better than most of the nation, but the national recession has begun to affect the metro area.

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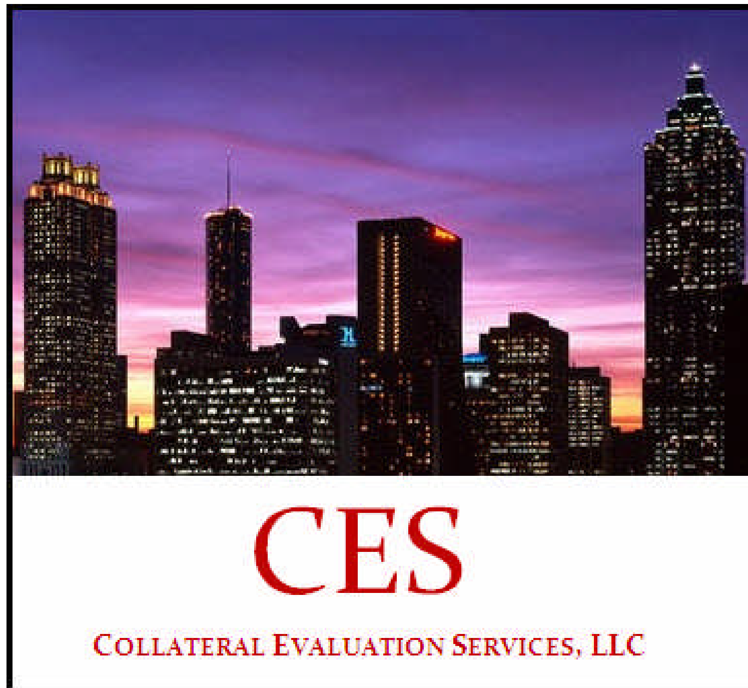

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