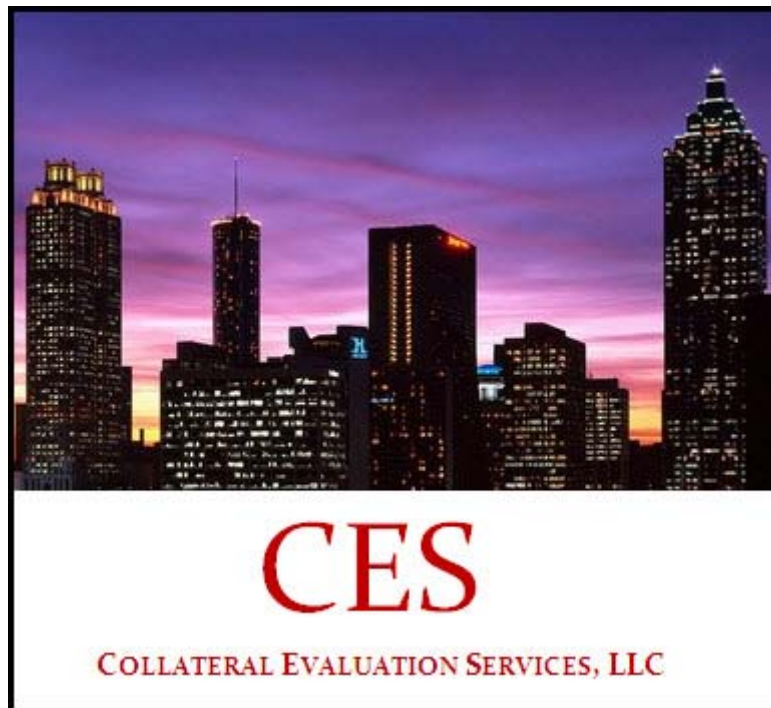

Real Estate Market Report – First Quarter 2010



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INTRODUCTION

By Collateral Evaluation Services, LLC

“Different Decade, Same Stuff”

Except for the hedge funds that made billions by taking the opposite stand of Wall Street, not too many people are going to miss 2009. Regretfully, this time next year we will probably be saying the same about 2010.

For commercial real estate, 2010 is going to be more painful than 2008 and 2009. In 2008 and 2009, cap rates adjusted significantly while net operating income (NOI) didn't change much. Thus, the decline in values (over 40% on average nationwide) wasn't felt unless you had to re-finance your property. 2010 is the year NOIs adjust and thus the pain will be very real. It takes cash to pay debt service. If NOI declines 10%-15%+ this year, a lot of highly leveraged properties may be returned to the banks.

Although the government says the recession ended in the 3rd Quarter of 2009, past studies indicate it takes about two years for consumer optimism to return. **The Summer of 2011 seems like a good time for housing and commercial real estate to be at a bottom.** Until then, pick and choose your investments carefully. And maybe by then we'll know if hyperinflation is going to occur or not.

Our one line DOW prediction is a decline to 9000 is underway. After hitting 9000, we are not really sure what to forecast, but maybe in the 2nd Quarter market report we'll have a better idea of where the DOW is headed.

This issue contains our first ever guest column. This may become a standard feature – so any aspiring journalists out there, feel free to contact us with your ideas. Also, we are likely to add a section solely dedicated to the residential markets next quarter.

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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. If someone wants to subscribe, simply email us your email address and we'll add you to our distribution list. 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.

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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 Area Overview.

SINGLE UNIT DWELLINGS

The latest S&P/Case-Shiller indices were released on January 26th. National prices declined about 33% from their peaks in 2006 through May 2009, which placed home prices back at their 2003 levels. Since May 2009, prices have increased about 5%, albeit a small decline occurred in November.

As of early February, housing futures traded on the CME are projecting a 1% advance for home prices nationwide through the end of 2010. This is a reversal from forecast declines throughout 2009. However, a further decline into the Summer of 2011 that developed last quarter remains and has actually intensified (6% decline now forecast versus 4% last quarter).

For over a year, our forecast for 2010 has been 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. Based on the CME futures above, we might simplify the forecast to say that **some time over the next 18 months housing prices should decline about 5%.**

Even then we will probably have a mixture of markets still declining along with others seeing some appreciation. The Case-Shiller indices are already showing some advances in various markets, while many others are still declining. S&P/Case-Shiller sum it up best:

“While we continue to see broad improvement in home prices as measured by the annual rate, the latest data show a far more mixed picture when you look at other details,” said David Blitzer, chair of Standard & Poor’s Index Committee. “On balance, while these data do show that home prices are far more stable than they were a year ago, there is no clear sign of a sustained, broad-based recovery.”

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.

At this point in time, it is widely known that most of these properties have seen value declines from 40% to 95%+. No sense beating a dead horse and repeating the analysis that explains why and how this has

occurred. We are down that much and, other than some life in projects with end units under \$200,000, these properties are flat lining.

As we mentioned last quarter, we have seen some appraisers mention that surveyed market participants are looking for **Internal Rates of Returns approaching 35% (inclusive of entrepreneurial profit) in some of the weakest markets.** One appraiser in Florida informed us of his conversation with an active purchaser (private equity) of condominium projects. This buyer said they would not look at any project that would take more than 2-3 years to sellout. And they paid 40 to 60 cents to get their full \$1 back in 2-3 years. Assuming they pay 40 cents for 3-year projects and 60 cents for 2-year projects, the IRRs equate to 29% to 36%.

Also, per the last issue of our market report, bulk condo sales are becoming more common. The entire Corus Bank portfolio (about \$4 Billion) was purchased in October 2009 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.). Market participants seem to support the national surveys that show 25% to 35% IRRs are needed for these property types.

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 also 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.

What can we say about finished lots and raw land? A divergent market may just be getting underway and we'll try to explain why. Remember, in a few years when this is commonplace, you can say you saw it here first.

Finished lots, and especially raw land, are more affected on a percentage-basis than finished houses and condo units. Maybe in a future issue we'll show the math, but basically if housing prices have declined say 20%, finished lot prices have declined 40%-60%. The percentage decline is even greater for raw land. Simply put, lot prices and raw land prices decline significantly more than improved home prices.

Even bank examiners realize this. They attended the rollout of a seminar on distressed properties and afterwards requested that the Land Residual Technique be added to the materials so appraisers could see how to do it and then include it in their appraisals. The examiners know that if there are no sales, then an alternative method of valuation is needed. The percentages discussed above are from the Land Residual Technique.

And this is where we expect the divergent market will develop. If we do the math, whether a static model or a discounted cash flow, we will likely come up with conclusions that either finished lots or raw land have no value (likely negative value!). This shouldn't come as a surprise as many transactions have occurred in the last two years where the purchaser of finished lots paid nothing for the infrastructure

costs and even less than what raw land sold for just a few years ago. The only problem – they probably still paid too much!

Thus, it is likely that when a development approach or land residual technique is run the resulting indication of value will be (substantially) lower than the few sales that will occur for bulk lots (already prevalent in Florida) or raw land. The same issue we had at the bubble top will be at hand – price does not equal value.

Where will you conclude as an appraiser? At the Land Residual Technique which most closely reflects what a developer will actually encounter? Or at the Sales Comparison Approach because that is what market participants are paying for raw land and bulk lots? Will it make a difference in your decision if one approach is at \$500,000 and the other is at \$3,000,000? Fun times ahead for all.

COMMERCIAL PROPERTIES – Income Producing

As with residential development values discussed above, there is no need to further discuss how we got to today's values that are 40%-45% lower than back in 2007. Most market participants have come to grips with this new reality and brokers are indicating that 2010 should start to see more sales as prices are lowered to realistic levels. The initial transactions are likely to be Class A properties only as some financing is available for those and prices are more acceptable to the seller than he/she will likely get for a Class B or C property.

CES continues to applaud appraisers as the vast majority of appraisals we review contain 2009 sales. In fact, we just reviewed an appraisal that had a comparable with a sale date of February 28, 2010 – and you thought time travel wasn't possible. It's easier to appraiser when using future sales, than historical sales☺

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

After 13 consecutive months of falling values, the Moody's/REAL Commercial Property Price Index increased 1 percent in November, according to a report by Moody's Investors Service released Jan. 20.

The index measures the change in sale prices for commercial real estate property based on the repeat sales of the same assets at different points in time. Commercial real estate prices were down 43 percent as of November since reaching peak prices, according to the report.

"The positive 1 percent return recorded in November represents a bit of good news for the commercial real estate market, but the sector is not yet out of the woods," Moody's Managing Director Nick Levidy said in a news release. "We anticipate further deterioration in property fundamentals and increases in cap rates."

According to the report, monthly declines tapered off in 2009 and future falls in values will be milder than the declines recorded in early 2009. However, Moody's says that prices will resume falling as

rental rates and occupancy levels continue to decline and yields rise. "Those things together will result in lower property values," Connie Petruzzello, an analyst at Moody's, said in the release. Moody's expects prices to fall between 45 and 55 percent from peak prices reached in 2007 before leveling off.

Sales volume fell to 362 transactions in November totaling \$4.1 billion, with lower-end properties making up the largest percentage of activity, Reuters reported. According to Levidy, properties with short-term leases, including multifamily properties, may show signs of sustainable recovery later this year, while other sectors will require more time, Reuters reported.

As we noted in our Page 2 Introduction, cap rates have been the cause of most of the value decline since 2007. Per the 4th Quarter Korpacz Real Estate Investor Survey, cap rates for non-institutional grade properties are as follows:

PROPERTY TYPE	AVERAGE CAP RATE
Apartments	9.70%
Flex/R&D Buildings	11.27%
Medical Office Buildings	11.36%
Suburban Office Buildings	10.16%
Strip Shopping Centers	11.29%

The vast majority of community bank loans (and therefore appraisals) are on non-institutional grade properties. For the most part, cap rates have returned to the historical norm of 10%-12%. A few years back people joked that 7% was the new 10%. Guess us old-timers can now joke that 10% is the new 10%:) Or it might actually be 11% and 12% for awhile.

In general, reports we have read are projecting further increases in cap rates for 2010 and 2011 – maybe 50bp each year. That seems reasonable and might finally place returns on real estate back in synch with the underlying risk.

Our discussion of the various property types follow.

APARTMENTS – Vacancy rates are at record highs and expected to increase further in 2010. As with most commercial real estate, market participants are modeling a decline in income for 2010. In addition, according to the Korpacz Survey, the market is forecasting a 74bp increase in cap rates over the next six months. The combination of these factors alone suggests a 10%-20% value decline for this property sector in 2010. At least with apartments, a national increase in population means the demand side is positive and one day this market will improve.

In addition, appraisals we have reviewed show cap rates for 'fractured condo' projects are 100-150bp higher than cap rates for normal apartment projects. Expense ratios for these projects are often 70%-80% because of much higher real estate taxes and HOA dues.

OFFICE – According to Grubb & Ellis, national vacancy was at 17.6% as of Yearend 2009 – up from 14.8% a year earlier. Effective rents declined 12% in 2009 versus a 4% decline for asking rents – showing how significant concessions have become.

Grubb & Ellis is forecasting a vacancy increase in 2010 to the 18.5%-19% level. The Korpacz Survey shows participants forecasting an average rent decrease of 2.35% with a range from +3% to -20%. Also, according to the Korpacz Survey, cap rates are forecast to increase 69bp (next six months) and values to decline an average of 8.75% (annual for 2010). Not much positive to say about this sector – especially with job growth forecast to be anemic.

Regarding job growth, one item to note. It takes about 100,000 new jobs every month to keep unemployment level and you could say the economy in balance. Thus, as you hear any positive monthly numbers from the government, remember anything below +100,000 is really a negative. They won't tell you that of course. Once we break +100,000 per month we might actually be on our way to a recovery.

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 674,000 jobs in industrial sectors.**

INDUSTRIAL SECTOR EMPLOYMENT - NATIONWIDE

	2008		2009			
	3 rd QTR	4 th QTR	1 st QTR	2 nd QTR	3 rd QTR	4 th QTR
Quarter Change *	-371	-843	-1419	-695	-353	-229
4-Quarter Average *			-730	-832	-827	-674

* - In Thousands

According to Grubb & Ellis national vacancy ended 2009 at 10.7%. They forecast vacancy will increase, but hit bottom, by the end of 2010. Effective rents declined 12% in 2009 and are not expected to rebound until sometime in 2011. The latest Korpacz Survey shows cap rates for institutional-grade warehouse properties increased 207bp in 2009 and are forecast to increase another 48bp over the next six months. Most surveys project this to be the first property type to rebound.

RETAIL – An extremely overbuilt property type combined with a population that is worried about losing their jobs and are now actually saving money – how this plays out in 2010 will be very interesting. Is this a new world order where the American public will be frugal and save going forward? How will web-based purchasing affect the brick and mortar stores? A lot of questions with no obvious answers.

Most owners will probably remember 2009 as the year every lease was renegotiated. Although projections mostly call for a further increase in vacancy and a decline in effective rents (albeit not as bad

as say the industrial sector), a lot of people like 2010 for retail if for no other reason than the expectation that 2011 will see a rebound.

CES is probably a little skeptical of the few positive forecasts – mainly because of the fundamental equation of supply and demand. Tenants vacated 27 million square feet last year while 10.8 million square feet came on line (Source: Grubb & Ellis). Even more space is forecast to come on line in 2010! Without job growth and a likely decline in incomes overall, we are flummoxed at how this supply and demand scenario can turn out positive in the next year or two.

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.

COMMERCIAL PROPERTIES – Owner Occupied (NOTE: No change in this analysis from last issue.)

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 9%-18% annually (we use 12% in our analyses) 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.

Similar price increases and decreases have also occurred for the parcel of ag land that became a potential subdivision only to become ag land again today. This is a common scenario we see in many areas of the country. Basically, this shows that the Highest & Best Use of a property can change as market conditions change. Price increases of 500% can be taken away with price declines of 95%. It should be a few decades (hopefully!) before we encounter this problem again – maybe by then we will have figured out a way to avoid the extreme price and value fluctuations.

MONTHLY TOPIC – Developing Capitalization Rates During Turbulent Market Conditions

By Hank Schneider – Marshall & Ilsley Bank

The implosion of the commercial real estate market in the past 12 to 24 months has created challenges for appraisers trying to value properties during this turmoil. This is particularly true for income properties, as many of the variables used in estimating the value of an income property have changed significantly. Rents are down, vacancy is up and some tenants are not paying full rent. While market information is available to support conclusions for rents and vacancy rates, information needed to develop an accurate estimate of capitalization rates may not be as available and can often be outdated when it is. The three primary methods of developing capitalization rates; published surveys, market sales, and band-of-investment, each can give unreliable results during periods of market turmoil.

Published Surveys

Surveys such as the Korpacz Real Estate Investor Survey, RealtyRates.com and other publications can be slow to reflect changing market conditions. Due to the time involved in collecting the data from market participants, analyzing it and publishing the results, the average capitalization rates and other information in these reports are based on data that is several months old the day that the surveys come out. Additionally, the averages reflect closed sales, which may have been negotiated months before the sale closed, making the information even older. As a survey is used until the next edition of it is published, the information in a survey can be up to six months old until more current data is available. While this is not as much of a factor during periods of relative stability, this can result in inaccurate conclusions during times of market turmoil.

In a market when cap rates have changed well in excess of 100 basis points in one year, this can be a significant issue. While the information in publications such as Korpacz can be very useful tools in developing capitalization rates, it is only indicative of what the market WAS doing three to six or more months ago, when the data was collected. In times of rapidly changing markets, the published data can be useful in showing trends. For example, Korpacz includes the changes in capitalization rates and other data since the most recent edition and over the last 12 months. Market participants are also surveyed as to where they expect capitalization rates to be in the next 12 months.

For example, the Fourth Quarter 2009 Korpacz Survey shows that for Phoenix office space, institutional grade cap rates have increased 185 basis points in 12 months and that market participants expect rates to increase an additional 50 basis points in the coming 12 months. When markets are changing, the use of historical average rates, combined with information on trends and expectations of market participants can be useful in developing capitalization rates to be used in current appraisals.

Data in publications such as Korpacz is reflective of larger transactions that involve institutional investors. As such, the capitalization rates in the surveys may not be directly applicable to smaller properties for which a higher capitalization rate may be appropriate. Korpacz includes information showing market derived capitalization rates and IRR's for institutional-grade and noninstitutional-grade properties. Frequently the variance between these rates can be significant. In the 4th Quarter 2009

First Quarter 2010

Page 10

Korpacz Survey, the capitalization rate for institutional-grade National Suburban Office space was 8.75%, while the average rate for noninstitutional-grade properties was an average of 10.16%, 141 basis points higher.

Surveys cite average rates, but there can be a wide range of rates that go into the averages. When appraisers use rates that vary significantly from market averages for the subject's property type or market, appropriate support needs to be shown. An appraiser may conclude that a lower than average cap rate is appropriate for the subject because there is a tenant with strong credit on a long term lease, a superior location, etc.

Market Sales

The primary weakness of deriving cap rates from Comparable Sales is changing market conditions. If the market has changed since the closing date of the sale used, the cap rate extracted from the sale is no longer accurate. For example, if a property sells at an 8.0% cap rate and values in this market have declined 20% since the comparable sold, based on the same net operating income (NOI), the indicated cap rate now is 10.0%.

If rates are extracted from comparable sales that had market condition adjustments, then the extracted rates from the sales can also be adjusted. As noted above, the average cap rate for Phoenix office buildings has increased 185bp since the 4th Quarter of 2008. Thus, a November 2008 sale with a cap rate of 7% would equate to about a 9% cap rate in today's market.

Another indication of current cap rates would be listings and checking with market participants (brokers, property owners, etc) for their assessment of what's going on in the market currently.

Built-up Rates (aka Band-of-Investment)

The Band-of-Investment equation is $Ro = (LTV \times Rm) + (Equity \times Re)$.

Built-up capitalization rates should reflect the financing that a typical buyer for the property being appraised could expect to obtain as of the date of the appraisal. For example, a 10,000 square foot, 4 tenant strip retail center would be expected to be purchased by a local, non-institutional investor and the financing assumptions should reflect this. Due to turbulent market conditions, appraisers should periodically check with lenders to determine what financing would be available for the property type being appraised. In today's market, banks are typically limiting LTVs to 50% to 60%. Some loans can have a higher LTV, but the interest rate jumps significantly. Obviously the LTV will depend on the property type, location, leases, creditworthiness of borrower, et al.

Besides a decline in LTV ratios that has occurred since 2008, the cost of debt has also changed significantly. The Mortgage Constant (Rm) that is used in current Band-of-Investment calculations is significantly higher than in recent years – interest rates are up and amortization periods are down.

The last part of the Band-of-Investment equation is Re – Return on Equity (aka Cash-on-Cash Return). This figure is difficult to support from market sales at this time. Page 12 of the RealtyRates Investor

Survey contains Equity Dividend Rates for almost every property type. Currently the average Re ranges from 11% to 14%. Other published surveys may also contain information on Equity Dividend Rates.

Distressed Properties

One last topic involves distressed properties. A wide range of properties can be classified as 'distressed' – from totally vacant buildings to fully leased buildings (but leased long-term at well below market rates). For purposes of this discussion, we are addressing partially leased properties (e.g. 60% occupancy).

In almost all appraisals, cap rates are applied to projected NOI over the upcoming 12 months. However, some market participants are currently applying cap rates to the actual NOI over the PAST 12 months. This also occurred in the last major down cycle in the early 1990's. Investors are thus giving no value to the vacant space and consider that their potential entrepreneurial profit if they can get it leased.

We have even heard market participants are taking the most recent 6 months of actual NOI and annualizing that figure – the reason being NOI is declining so rapidly for commercial real estate. Therefore, when appraising properties with partial occupancy the derived cap rate may need to be applied to actual NOI and not projected NOI (granted projected NOI may well be lower for 2010 than actual NOI was in 2009!).

Summary

Appraising real estate in today's real estate market requires appraisers to develop estimates based on murky and often conflicting information. Financial institutions are relying on their approved appraisers to do the research needed to make estimates and draw value conclusions based on the best information possible. We understand the difficulty of your task and appreciate and value your work.

EDITOR'S NOTE: The standard caveat is needed for the article above. The opinions set forth are those of Hank Schneider only and they do not necessarily reflect the opinions of his employer.

METRO AREA OVERVIEW – New Orleans

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 national value declines around 40%-45% since the Summer of 2007.

NEW ORLEANS – Effective Revenue								
YEAREND	APARTMENTS		INDUSTRIAL		OFFICE		RETAIL	
	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE	EGI	CHANGE
2007	\$815	---	N/A	---	\$15.86	---	\$12.90	---
2008	\$793	-3%	N/A	N/A	\$16.06	+1%	\$12.93	0%
2009	\$755	-5%	N/A	N/A	\$15.73	-2%	\$12.74	-1%
2010	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

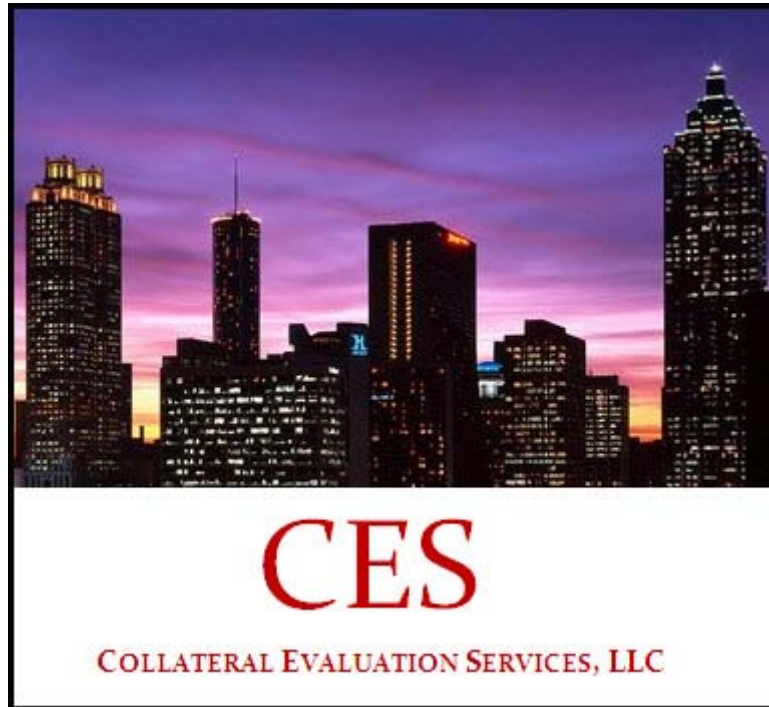
Source: REIS, Inc.; EGI – Effective Gross Income, CES estimate using REIS data. Average monthly EGI for apartments and average annual EGI per square foot for industrial, office, and retail segments.

NEW ORLEANS – Vacancy Rates				
YEAREND	APARTMENTS	INDUSTRIAL	OFFICE	RETAIL
2007	4.4%	N/A	10.4%	9.8%
2008	7.7%	N/A	11.3%	10.3%
2009	11.0%	N/A	12.0%	11.0%
2010	N/A	N/A	N/A	N/A
2011	N/A	N/A	N/A	N/A

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.

Most property types bounced back strongly in 2006 and 2007 after the significant decline in 2005 due to Hurricane Katrina. Since 2007, Apartments have weakened significantly while the Office and Retail sectors started showing some weakness in 2009 – in line with the national recession.

REIS does not provide forecasts for the New Orleans market. It looks like the commercial real estate market has stabilized in general, but is being slightly affected to the downside by the national recession. Thus, 2010 should show some weakness.



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