

## INTRODUCTION

*By Collateral Evaluation Services, LLC*

### *“The Great Depression II – 5 Years Old”*

It was 5 years ago in June/July 2005 when we first started telling the world the bubble was bursting and we were on our way to The Great Depression II. Over the past five years, all markets have pretty much followed expectations. The stock market rally of the past year outdistanced our expectations, but that isn't surprising for a bear market rally. The 1930's bull market in The Great Depression I was one of the most impressive of all time, also. If you rode the DOW rally to 11,000+, hopefully you are in cash now as the bear resumes its hold of the financial markets.

As for the press, the most recent comedy has been the talk of a 'double dip' recession becoming a more likely possibility. Of course, we have numerous opinions about that and here goes ☺ First, calling this The Great Recession when everyone says they have never seen anything like this is like – well, fill in your own funny analogy here. It is The Great Depression II and all the people that have lost their houses, businesses, jobs, et al can confirm that. Second, it is humorous that government officials and economists are having to admit a 'double dip' is growing in probability. Everyone who faces reality and doesn't always wear rose-colored glasses knew we were heading back down in 2010 and maybe even 2011. Lastly, to have a 'double dip' doesn't an economic rally first have to occur? If this hasn't been an 'L-shaped' decline, we don't know what has. Again, ask John Q. Public how great of a bounce the economy has had over the past year – they should confirm it has continued to decline, not improve. Those who still don't think a 'double dip' will occur are right – we are simply continuing the same decline that began in June/July 2005 and had various market peaks after that (housing prices in late 2005, CRE prices in October 2007, etc.).

For trivia buffs, the stock market got back to its 1929 peak in 1954 – a 25 year period. The current 5-year old downturn is a baby in comparison. We aren't saying The Great Depression II will last 25 years, just that we are early into this process of correcting excessive debt and bubble prices. Granted we do believe land and home prices in bubble markets will take 25-35+ years to get back to 2005-2007 prices.

Lastly, re the economy, the Economic Cycle Research Institute (ECRI) Weekly Leading Index has accurately predicted every recession since 1970 – the only error being a false prediction in 1988 (albeit for any of us around back then I doubt we would say it was a time of economic expansion!). The Index turned negative at the beginning of 2008 and after following the strong stock market rise for the past year has once again turned negative thus predicting we are in a recession – whether it's the same one or a 'double-dip' we should save that debate for the history books 10-20 years from now. We bring up the ECRI as it is highly respected as being impartial – and to us, more importantly very accurate.

As a reminder from our last issue, we believe 2010 will be one of the worst years ever for CRE – not as much due to cap rate increases, but more due to double-digit declines in income. In 2008, Moody's and other companies that track delinquencies forecast the CMBS Delinquency Rate would increase from around 1% to 12%-14%+. The May 2010 figure is 7.50%. It looks like we are finally at the half-way point

of this cycle – put another way, all the money lost by banks and borrowers (and taxpayers?) to date will be lost again over the next year or two. Is there a TARP II to save the nation one more time?

The following is also re-stated from last issue so our new subscribers can know our bottomline forecast for real estate:

Although the government says the recession ended in the 3<sup>rd</sup> 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.

To be clear, we do not purposely try to be negative or just present bad news. We are realists and reality right now isn't too bright, nor is the future. However, as you read herein, the first sign of light is our prediction of positive absorption in the national industrial property sector starting in 1<sup>st</sup> Quarter 2011. For the past 18 months we have been watching for this signal and it is finally here.

In this issue, we drop our single city forecast and replace it with a detailed analysis of the residential sector. We thank Mark Mitchell, MAI of Prism Realty Valuation & Consulting ([mmitchell@prismrvc.com](mailto:mmitchell@prismrvc.com), (502) 553-3221) for providing this section of our market report.

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Also, if you would like to be removed from our distribution list, please email George Mann at the address below.

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](mailto: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 in a particular market and/or property type.

### SINGLE UNIT DWELLINGS

The latest S&P/Case-Shiller report reflect prices thru April 2010. 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%. Year-over-year from April 2009 to April 2010 prices are up 3.8%-4.6%.

As of early July, housing futures traded on the CME are projecting a 7% decline (NOTE: This is a significant change from a 1% increase being forecast earlier this year) for home prices nationwide through the end of 2011. The futures are forecasting national home prices will not get back to today's levels until the end of 2013. Said another way, 3 years from now we will be where we are today re housing prices.

As with the CME futures, 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. 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:

*"The April 2010 data for all 20 MSAs and the two composites do show some improvement with higher annual increases than in March's report. The month-over-month figures were driven by the end of the federal first-time homebuyer tax credit program on April 30," David Blitzer, chair of Standard & Poor's Index Committee, said in the report. "Other housing data confirm the large impact, and likely near-future pullback, of the federal program. Recently released data for May 2010 show sharp declines in existing and new home sales and housing starts. Inventory data and foreclosure activity have not shown any signs of improvement. Consistent and sustained boosts to economic growth from housing may have to wait to next year."*

Some more information we would like to share comes from Mark Hanson of Hanson Advisors. He lists the five main sources of housing inventory that will overhang this sector long into the future.

1. Eight million loans in some state of delinquency, default or foreclosure.
2. 100,000-125,000 new notices of default sent out monthly.
3. Short sales: "with almost 30% of the 57 million homeowners with mortgages owing 95% or more on their house, this pool of over 15 million that are short-sale eligible is a mega-threat."
4. Modification defaults, which are estimated to occur at a 70% rate.
5. Pent-up supply from people who have held off selling for three years as the market crashed "and now that sentiment has improved in certain regions will take advantage of this."

As we all learned in Econ 101, an ongoing excessive supply will result in prices being under constant pressure. The 3 year projection of price stagnation by the CME futures is in agreement with this logic.

One last observation by us comes via a line we saw in Bill Pittenger's *Real Estate & Economic Commentary*. Bill is a longtime acquaintance who is highly respected in the banking and real estate industry. We encourage all our readers to contact Bill to get on his mail list – E-Mail: [William\\_pittenger@comcast.net](mailto:William_pittenger@comcast.net) and Phone: 321-750-2768.

Bill notes in his June 29<sup>th</sup> issue that '...at peak, Florida had some 25% to 40% more homes than there were persons to occupy them.' Based on those percentages and projections of 0.8%-1.1% annual population increase for the State of Florida, it will only take 23 to 50 years to absorb this oversupply. Of course this ignores the fact that houses are still being built (yes much slower than historical levels, but still more supply is always coming online) and more than one person is needed to justify a new household and numerous other factors that would confuse the issue. But, do keep in mind that an unexpected influx of a million or two million people can take care of this oversupply.

One last item of note (we promise, this is it for the housing analysis), we saw a chart of housing prices going back 20 years and new home prices are back to 2003 levels as noted above, but existing home prices have declined to 1999 levels. We don't know about you, but when we sell our house it is an existing home, not a new home. Thus, the stats we continue to see about home prices are not telling the true picture for the public. As we just came across this information, we'll need to follow up on this in the next issue.

## 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 for the past six months, 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, Second Quarter 2010

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property type, etc.). Market participants seem to support the national surveys that show 25% to 35% IRRs are needed for these property types.

Korpacz IRRs average just under 20% but correspond to projects with a 7-year sellout period. Projects with 2-5 year sellouts would have IRRs more in line with RealtyRates (25%-35%). Even the Korpacz Survey has high end IRRs at 30% for six-month sellout projects.

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.

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 we have seen a substantial increase in the number of transactions over the past nine months. Most appraisals we review now have only 2009 and 2010 sales in them. In fact, many reports use all sales that occurred in just the last six to nine months.

The Moody's/REAL Commercial Property Price index posted a slight gain in April, after two sequential drops, coming in at a 1.7% increase for the month. As Moody's notes: "This price increase follows two consecutive months of slight price declines. The index currently lies at 113.10 and has fallen 16.4% in the past year. Prices have remained choppy since the low of 107.98 that was recorded in October 2009. Since that low, prices have rebounded 4.7%. The peak of the index occurred in October 2007 and prices are currently 41.1% below the peak."

Following are some points taken from the latest Moody's report, with the last item quite noteworthy for those of you in Florida and those who thought apartments were mostly immune to down cycles:

- The National — All Property Type Aggregate Index measured a 1.7% increase in April. This is the first increase in the index since January. Price movements have been choppy since the index low recorded in October 2009.
- Three of the four property types in the East declined in prices over the past four quarters. Retail was the only sector to have an increase.
- With the exception of the industrial sector, properties in the South underperformed their respective national property type index over the past four quarters.
- In the past year industrial prices in Southern California dropped 27.3%. This performance is significantly worse than the other three property types in the region, which fell 2%-20%.
- The Florida apartment market realized its largest one-year decline in value since index inception, dropping 29.9% over the last four quarters and leaving the index value down more than 50% percent from the peak four years ago.

We continue to review appraisals that quote the institutional-grade cap rates in the Korpacz Real Estate Investor Survey while appraising non-institutional grade properties. As a reminder, cap rates for non-institutional grade properties as of the 4<sup>th</sup> Quarter 2009 Survey were 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%

We must maintain confidentiality, but recently we were very tempted to give some kind of award to an appraiser who had four current sales with cap rates above 12% and used a 12.5% cap rate on a small retail/office building. For those of us who thought the world had ended when cap rates went below 10%, then way way below 10%, it is good to know the earth is still turning and some logic has returned to rewarding investors for risk associated with commercial real estate.

In general, reports we have read are projecting cap rates for 2010 and 2011 will level out or increase 50bp each year. That seems reasonable and might finally place returns for all types of real estate back in synch with the underlying risk. Lastly, for those who believe current cap rates are high, we found this fact to be interesting – the current national average cap rate is still below the lowest national average seen during the entire period from 1991 to 2003 (ranged from 8.75% to 10%). Cap rates have a ways to go on the upside to get back to ‘normal’ historical ranges.

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 in a wide range from about 8% to 13%. Previous surveys indicated cap rates should be 100-150bp higher than cap rates for normal apartment projects – this is due to the lack of control of the entire project. Expense ratios for these projects are often 60%-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. Reis, Inc. indicated a 17.4% vacancy rate at the end of the Second Quarter in 2010. These vacancy rates are at 17 year highs. Also according to Reis, Inc., effective rents have declined 5.7% from a year ago.

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 and another 7.7 million square feet of new office buildings completed in the 2<sup>nd</sup> Quarter of 2010.

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.

Thanks to our friend Bill Pittenger, another observation arose from his most recent newsletter. He shows a graph from the BLS that shows nationwide office employment has declined to levels last seen in 1999 (as an aside, current lows are also below 2003 levels). Trying to reach unique observations from the same data everyone else is looking at, it dawned us that this basically means that **ALL** office buildings constructed since 1999 are not needed! We have the same demand today for office space nationwide that we had in 1999 (technically probably less demand today as space needed per employee has likely been declining for 20+ years). We don't know how much total office space existed in 1999 or has been built since then, but if someone out there has that figure we would appreciate you sending it to us.

Current office space nationwide is about 4.4 billion square feet according to Cushman & Wakefield. About 3.6 billion square feet is occupied according to their current survey. Based on approximately 27 million office jobs nationwide (Source: BLS), we arrive at about 130 sf needed per office employee. When we find out how much square footage has been built since 1999 we can calculate how many office jobs must be created going forward just to get us back to 1999 occupancy levels – we assume vacancy back then was double digits as it has been for office space since the 1980's. To butcher a saying, brother can you lend us about 1.5 million new office jobs☺ Or since office jobs represent about 25% of total employment, we will need 6 million new jobs created nationwide.

One final way to look at all of the above is that the BLS stats show we have lost about 2.5 million office jobs since the 2007 peak. This equates to a drop in demand of 325 million square feet of office space. As we heard thru the grapevine, a major property owner said the problem isn't that we are oversupplied, it is that we are under-demolished☺

INDUSTRIAL - Employment sectors that drive Industrial demand lost over 2.7 million jobs in 2009. However, so far in 2010 employment has seen positive growth.

These employment sectors turned negative (i.e. net job losses) in the 4<sup>th</sup> Quarter of 2007. Employment growth generally leads absorption by six months – in fact, industrial absorption turned negative in the 2<sup>nd</sup> 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 70,000 jobs in industrial sectors. More job growth in the 3<sup>rd</sup> Quarter would result in the 4-quarter average turning positive – indicating that the national industrial market should see positive absorption beginning in the 1<sup>st</sup> Quarter of 2011.**

## INDUSTRIAL SECTOR EMPLOYMENT - NATIONWIDE

	2009				2010	
	1 <sup>ST</sup> QTR	2 <sup>nd</sup> QTR	3 <sup>rd</sup> QTR	4 <sup>th</sup> QTR	1 <sup>ST</sup> QTR	2 <sup>nd</sup> QTR
Quarter Change *	-1419	-695	-353	-201	+144	+132 **
4-Quarter Average *	<b>-730</b>	<b>-832</b>	<b>-827</b>	<b>-673</b>	<b>-276</b>	<b>-70</b>

\* - In Thousands.

\*\* - Preliminary figure.

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. We tend to agree with Reis, Inc. that forecasts no occupancy or rent growth for the retail sector until 2012.

**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.

**RESIDENTIAL MARKET ANALYSIS – USA and Florida**  
*By Mark Mitchell, MAI – Prism Realty Valuation & Consulting*

The state of single family residential building is defined by two methods - Status and Momentum. Status is the annual number of building permits (BP) relative to the historic average. For this analysis, we have used a sixteen-year monthly average of building permits. Momentum is the change from the current month to the same month a year earlier. We are using a four-month moving average to smooth aberrations in the analysis.

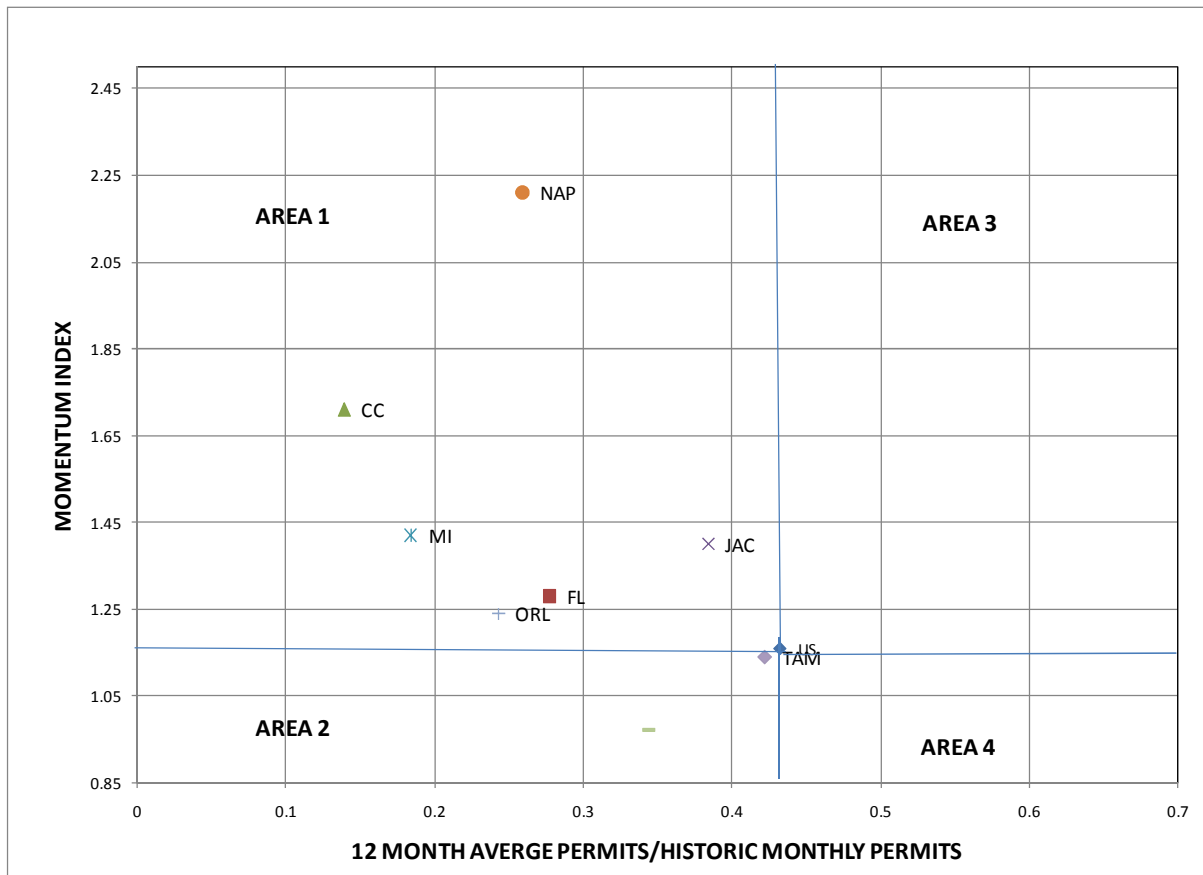
Area 1	Area 3
Negative Status- Monthly Percent of Building Permits are less than U.S.	Positive Status- Monthly Percent of Building Permits are greater than U.S.
Positive Momentum- Current monthly number of building permits exceeds previous years same month	Positive Momentum- Current monthly number of building permits exceeds previous years same month
Area 2	Area 4
Negative Status- Monthly Percent of Building Permits are less than U.S.	Positive Status- Monthly Percent of Building Permits are greater than U.S.
Negative Momentum- Current monthly number of building permits is less than previous years same month	Negative Momentum- Current monthly number of building permits is less than previous years same month

For the first analysis of 2010, we are looking at the major metropolitan areas in Florida and the second analysis is a cross sample of major metropolitan areas in the United States.

### **Measure of Construction Activity in Florida**

Momentum in Florida and most of the metropolitan areas have surpassed the U.S. for the first five months of 2010, indicating a small sign of recovery. Pensacola has shown the strongest status and a momentum of over 2.5 times the previous year. Metropolitan areas showing weakness include Tampa-St. Petersburg and Tallahassee. Both of these cities trail the U.S. and Florida averages.

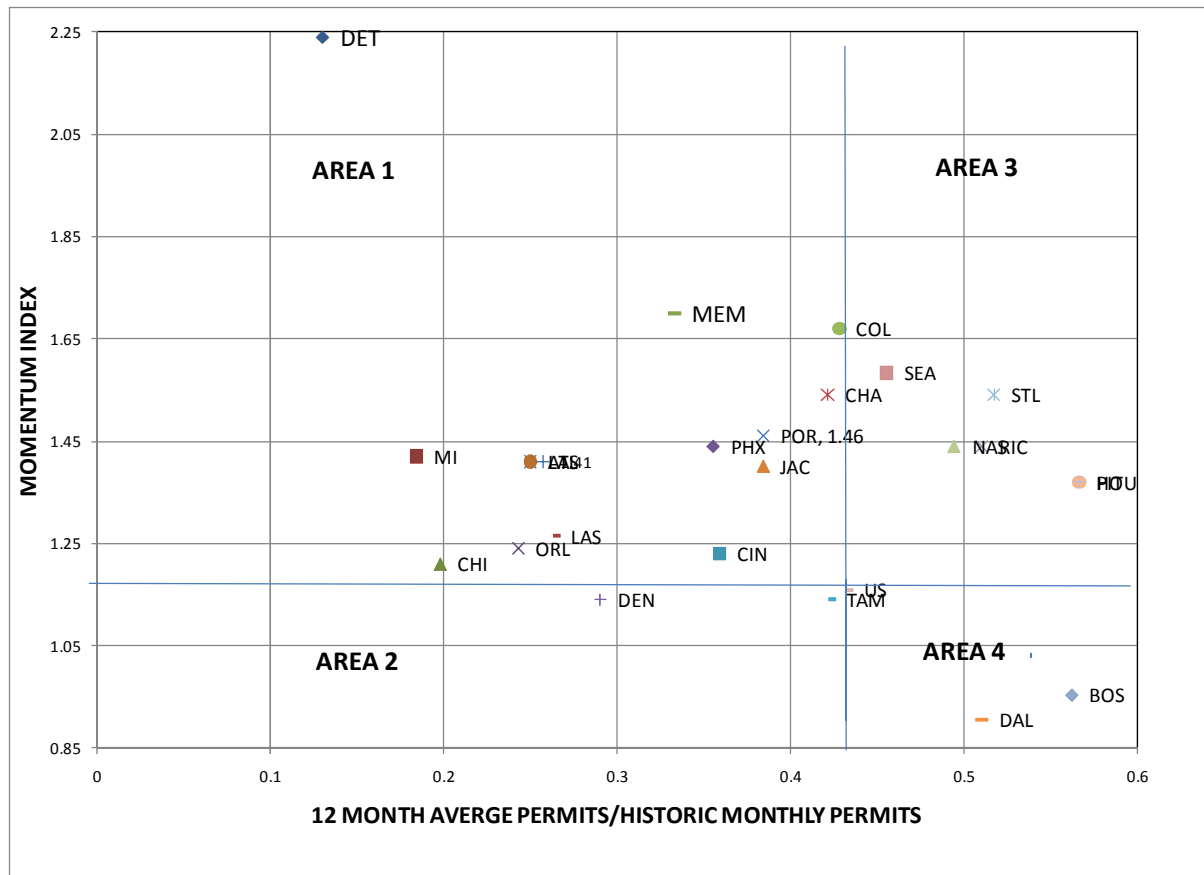
	Abbreviation	Last 12 Months BP Moving Average/ Historic Average	BP Moving Average of Previous Period
United States	US	0.432	1.16
Florida	FL	0.277	1.28
Cape Coral	CC	0.139	1.71
Jacksonville	JAC	0.384	1.40
Miami/Fort Lauderdale	MI	0.184	1.42
Naples- Marco	NAP	0.259	2.21
Orlando	ORL	0.243	1.24
Pensacola	PEN	0.581	2.77
Tallahassee	TAL	0.344	0.97
Tampa	TAM	0.422	1.14



## Measure of Construction Activity in United States By Metropolitan Area

Detroit leads the momentum index for the first five months of 2010. Other metropolitan areas showing higher momentum than in 2009 include Miami, Chicago, Orlando, Las Vegas, Memphis and Los Angeles. Denver and Tampa construction activity has declined in 2010 and are lagging the U.S. averages for status and momentum.

	Abbreviation	Area	Last 12 Months BP Moving Average/ Historic Average	BP Moving Average from Previous Period
Detroit	DET	1	0.13	2.24
Miami/Fort Lauderdale	MI	1	0.184	1.42
Chicago	CHI	1	0.198	1.21
Orlando	ORL	1	0.243	1.24
Las Vegas	LAS	1	0.25	1.41
Atlanta	ATL	1	0.25	1.41
Kansas City	KC	1	0.257	1.41
Los Angeles	LAS	1	0.263	1.26
Memphis	MEM	1	0.333	1.70
Phoenix	PHX	1	0.355	1.44
Cincinnati	CIN	1	0.359	1.23
Jacksonville	JAC	1	0.384	1.40
Portland	POR	1	0.384	1.46
Charlotte	CHA	1	0.421	1.54
Columbus	COL	1	0.428	1.67
Denver	DEN	2	0.29	1.14
Tampa	TAM	2	0.422	1.14
Dallas	DAL	3	0.51	0.91
Boston	BOS	3	0.562	0.95
Seattle	SEA	4	0.455	1.58
Nashville	NAS	4	0.494	1.44
Richmond	RIC	4	0.51	1.44
St. Louis	STL	4	0.517	1.54
Pittsburgh	PIT	4	0.566	1.37
Houston	HOU	4	0.566	1.37
United States	US		0.432	1.16



Within the analysis above, Area 3 is considered the best place to be and Area 2 is the worst. Cities in Areas 1 and 4 have some positives and some negatives going for them.

Lastly, as with any general analysis of a city or state or national area, specific submarkets may differ. Inferior and superior submarkets make up the average to total statistics used in any analysis.

## CES' NEWEST SERVICE - CUSTOMIZED CRE MARKET REPORTS

In December 2006, the Agencies issued a joint Guidance entitled 'Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.' Among the various items required by this guidance are two areas that CES has substantial experience in:

- Market Analysis
- Portfolio Stress Testing and Sensitivity Analysis

Our attached brochure details recent portfolio evaluation projects we have worked on and the benefits such an assignment can bring to your bank. In addition, as a result of client demand, we have added customized market analyses to our menu of services.

Per the December 2006 Guidance, "...Board of Directors or a designated committee thereof should...review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the institution lends." (Emphasis Added)

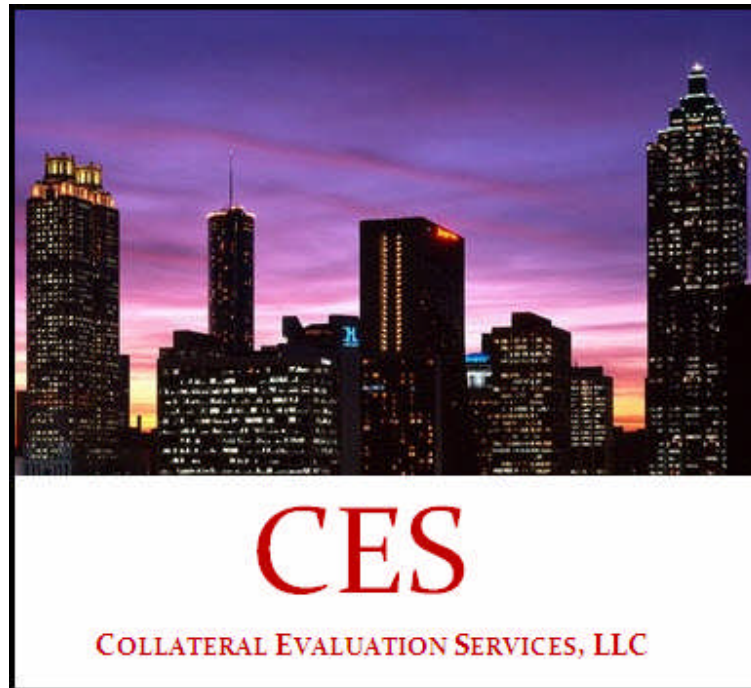
Bank examiners are instructed to refer bank management to the Board's real estate lending standards regulations and guidelines that set forth an expectation that a bank monitor real estate market conditions in its lending area. A bank's failure to monitor the real estate market conditions could be cited as a violation of the real estate lending standards regulation (12 CFR 208, Subpart E).

Instead of incurring the cost of additional staff, or using existing staff already dedicated to many other functions, CES provides a more affordable alternative. Our national experience and access to data sources in all markets will result in a unique product that can assist with your real estate risk management – we do not provide the standard template that simply shows a lot of data, but no analysis. We recognize that an analysis of the data is where we make this a 'value-added' service.

Pricing is dependent on the number of markets, property types, and frequency of publication. Quotes are provided upon request. Please contact George Mann at 804-241-6044 or [GMann@CES-WM.Com](mailto:GMann@CES-WM.Com) to discuss this service.

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As an aside, the *Real Estate Market Report* remains a free publication. The above is a customized, detailed report that we are making available to financial institutions.



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# Collateral Evaluation Services, LLC

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## Presentation of

## Portfolio Evaluation & Analysis Services <sup>TM</sup>

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**CES**

## ***Portfolio Evaluation & Analysis Services™***

In this difficult environment, CES is the premier choice for valuing your Commercial Real Estate (CRE) loan portfolio. Not only is it important to know where loan loss reserves and impairment values should be today, but also to have a projection for the next 12-24 months. CES provides this service with its loan-by-loan analysis of your CRE portfolio.

The August 21, 2009 'Capital Markets Update' published by C&W Sonnenblick Goldman states:

*"Anecdotal evidence suggests that the CRE portfolios of many regional banks continue to be over-valued by 20%-50%."*

The managing directors of CES have participated on over 35 due diligence projects involving financial institutions with assets ranging from \$100MM to \$20 Billion. Per the quote above, our recent projects have confirmed the over-valuation of CRE portfolios.

- OCC examiners gave our client approval to hire CES to value a portfolio of CRE loans with initial LTVs below 60%. Although loan renewals were several years away, examiners wanted a current value placed on the collateral so as to monitor the portfolio. CES evaluated 97 properties in 9 days. Our portfolio analysis resulted in a reduction of the total collateral value from \$380 Million to \$292 Million. The final report noted all loans with LTVs above or DSCRs below bank targets. This project saved our client \$400,000 in appraisal fees.
- Bank examiners required a \$5-\$10 Billion bank to have independent reviews performed on all their real estate appraisals. In less than a month, CES reviewed 70 appraisals with a total collateral value of \$4 Billion. All reviews were USPAP compliant with CES either agreeing with the appraised value or providing its own value opinion. CES reviews were used to estimate loan loss reserves and impairment amounts for the reporting of 2<sup>nd</sup> Quarter Earnings.
- Our client was looking to purchase a package of loans from a community bank. CES evaluated 70 properties in 4 days. This portfolio involved smaller properties all located in one state. Our portfolio analysis resulted in a reduction of the total collateral value from \$150 Million to \$105 Million. CES also provided Fair Value Opinions on real estate facilities that were purchased.
- CES evaluated all the CRE collateral in the loan portfolio of a \$15-\$20 Billion bank. Over 200 properties located from Florida to California were evaluated in 10 days. Our portfolio analysis resulted in a reduction of the total collateral value from \$7.5 Billion to \$5.7 Billion. We also provided projections 12 and 24 months into the future so our client could forecast loan loss reserves and estimate the capital needed from investors.

As shown in the real-world projects above, an analysis of the real estate in your CRE loan portfolio can provide the following benefits:

1. A current valuation of the portfolio to compare with the last known valuations
2. A projection of valuations 12 and 24 months out to use as a basis for estimating future loan loss reserves and other impairment amounts
3. Identification of segments of the portfolio that might be more vulnerable than others
4. An early alert to re-assess risk ratings based on current collateral coverage

The CES **Portfolio Evaluation & Analysis** service saves you the expense of ordering appraisals on every piece of real estate collateral in your portfolio. Our portfolio analysis can identify which loans most warrant a new appraisal or evaluation and which property segments to monitor closely.

Bank Examiners are citing institutions for not monitoring their real estate collateral on an ongoing basis – even if a loan renewal or refinancing won't be occurring for a year or two. Our **Portfolio Evaluation & Analysis** can show your examiners that you have been monitoring your collateral in a timely manner.

### ***Closing Statement***

CES is unique as a "full service" provider of collateral evaluation services. The range of services we provide, shaped by our exceptional experience and expertise, cannot be matched. CES is the only company that a financial institution needs to obtain cost-effective, expert evaluation of its real estate collateral. In these specialty consultant areas, we welcome the opportunity to design a program specifically to meet the goals and objectives of each client's needs.

For additional information or to schedule a face-to-face meeting to assess your specific needs, please contact one of the following Managing Directors.

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### ***Special Loan Review Assignments***

Outside of appraisal, environmental, construction loan management, and all of the other facets of our business, we also participate in Specialized Loan Review assignments. In this type assignment, we team with Financial Performance Partners, LLC (An Ernst & Webb Company), a financial consulting and engineering firm out of Cincinnati, Ohio that specializes in Bank due diligence. In these Specialized Loan Review assignments FPP is the lead consultant and governs the loan review process, while CES provides professional assistance in the evaluation and analyses of values underlying collateral real estate tied to loans under review.

A due diligence assignment with FPP might consist of a comprehensive evaluation of targeted loan and/or mortgage-backed securities portfolios with a Loan Review Specialist establishing new credit risk parameters for each loan in order to project Allowances for Loan and Lease Losses (ALLL) and other Impairments.

In assignments like the one mentioned, CES provides current evaluations on the real estate collateral securing the loans and makes recommendations for a new allocation of interest reserves. The scope of the overall assignment is geared toward assessing potential credit rating downgrades and charge-offs for loans expected to go into default and is based upon a combination of the adjusted credit ratings for the overall portfolio.

In addition, FPP can provide Business Model Optimization, Core & Ancillary System Assessment & Conversion (Business Systems Analysis), Merger Integration, and Operational Due Diligence. Should your institution be interested in any of these services, we would be glad to introduce you to FPP.

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