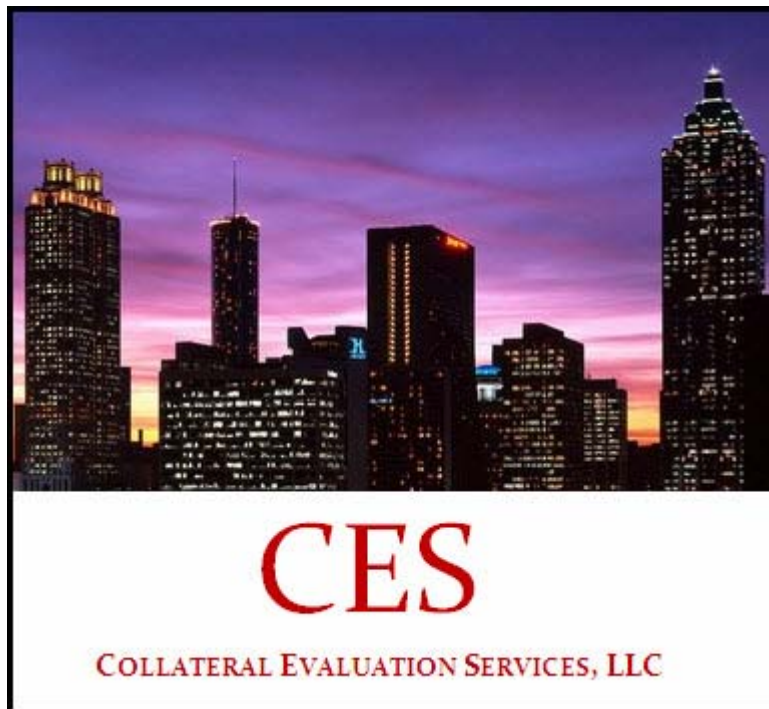


CES

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Real Estate Market Report – 2011



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Letter from the Managing Directors

Dear Reader:

Collateral Evaluation Services, LLC is pleased to present the initial 2011 edition of our *Real Estate Market Report*. As you may have noticed, the frequency of these reports has slowed since 2009. So as not to bore you with the same information from issue to issue, we attempt to match our publication schedule with changes in the marketplace.

In 2009, real estate markets were changing so quickly we published a report every month or two. Price declines slowed in 2010 so we published quarterly reports in the beginning of the year. The last half of 2010 seemed rather stagnant for the real estate markets, so we waited until now to send out this issue. We anticipate a second edition in 2011 in the Fall, unless of course something occurs to get the markets moving up or down.

As always, we welcome our new readers. This issue, and past issues, can be found on our website at www.ces-wm.com. If you would like to be removed from our distribution list, please email George Mann at the address below.

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, they can simply send us their email address and we will add them to our distribution list. Note that we do not share our mail list with anyone outside CES.

We have been asked if our market report can be quoted. Yes. We only ask that you give us appropriate recognition.

As always, we hope you find this report interesting, and optimally somehow of use in your everyday job. We believe CES brings an unique perspective of the national real estate markets. Since we review appraisals nationwide, we see market data and analyses from multiple appraisal firms in each market. This gives us a greater supply of market information to analyze than a single appraisal firm can provide. The assimilation of all this information provides the basis for our National Overview contained within this report.

Your comments are always appreciated. Please email them to George Mann at GMann@CES-WM.Com.

Everyone at CES wishes you a happy and prosperous 2011.

Sincerely,
Managing Directors
Collateral Evaluation Services, LLC
www.CES-WM.com

Mann's Take On Things

By George R. Mann, MAI, SRA, MRICS

"The Easy Part Is Over With"

As The Great Depression II celebrated its 5th anniversary this past summer, I mourn the loss of the easy years to forecast. Predicting a housing decline from 2006 on and then a commercial real estate decline in 2009 and 2010 was extremely easy. Now the difficult years set in for forecasting.

Bottoms are easy to forecast in the stock and commodity markets. Total capitulation always occurs and is easy to see when it does. However, the real estate market is more difficult due to the number of locations, the variety of property types, and even the different classes within each property type. As an example, we visit the word of the year (and possibly next few years) - 'bifurcation.'

Bifurcation is occurring in commercial real estate and to financial institutions. Trophy properties (literally only the best of even Class A properties) are back to record highs with cap rates getting as low as 4%-5% (the buyers' logic is these cap rates are acceptable if fixed loans at 3% are available – which we have seen for these select properties). As I continue to preach, price and value are two different concepts. These prices represent market prices, but they do not represent market value for these properties. Prices for trophy properties will come back to reality one of these days.

Marcel Erni, chief investment officer of Partners Group, voiced a similar concern: "Core real estate pricing is once again driven by capital markets rather than fundamentals, and by perceived rather than actual risk. Now is the time to explore less travelled roads."

As for all other properties, there has been almost no bounce in prices. Apartments might be appreciating, but the overall commercial real estate market is probably at the lowest prices seen in this downturn. No surprise, the rich get richer while the rest of us deal with an ugly reality.

As for financial institutions, bifurcation is simply stated as you are 'too big to fail' or you are not. The top banks are making record profits while the rest of the banks struggle with loans in workout and capital issues. In the early 1990s, people forecast there would be less than ten banks in the USA by the year 2000. They were a bit off. Similar forecasts are being made again as community banks deal with the onslaught of adding regulations (how many bankers will be voting for Dodd and Frank when they come up for re-election?). I can only say that many Americans, if not most, like to bank with people they know – thus I feel the forecast for the death of community banks is greatly exaggerated. Big banks serve their purpose, but there are still more than 7800 banks in the USA for a reason.

CES certainly is not going to be right on all its forecasts (if we were, we wouldn't be sending this out for free!), but some of our thoughts from our first market report published two years ago are worth noting:

- **For 2010, we believe (housing) prices will likely decline nationwide by 5% to 10%**, with some markets bottoming out and having no further declines. **The earliest CES sees a true market bottom in housing is 2011.** Even then we will probably have a mixture of markets still declining along with others seeing some appreciation.

- 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.
- The Office market should see significant weakness... as it will take time for leases to expire and companies to downsize, the vacated space is projected to hit the market in 2009 and 2010. It is difficult to see much absorption for this space in the current down cycle.
- Due to the number of store closings, **banks should review their retail center loan portfolio in great detail.** Centers that have had an excellent operating history can quickly become distressed properties. Larger tenants have lease clauses that allow them to end a lease if another large tenant vacates their center. Such clauses have a domino effect and a stabilized property can encounter significant vacancy in a short period of time. Also, many property owners are reportedly reducing rents (without reporting such on rent rolls) or not collecting rent at all. In general, retail centers should see the greatest value decline of all commercial property types.
- **For commercial real estate overall, 2011 is the earliest we should expect to see any upturn in values.**
- The first sign of light is our prediction of positive absorption in the national industrial property sector starting in 1st Quarter 2011. ((This was stated in our 2nd Quarter 2010 issue))

Home prices did decline about 4% in 2010, so that wasn't a bad forecast. As for 2011 being a possible bottom, we have to change that forecast to sometime down the road. The housing market looks bleak. Our advice not to speculate and buy houses in early 2009, or even thereafter, has been right on target. An investor would have been stuck with holding costs and further price declines.

The office market has been weak and the retail market has been awful as predicted. Industrial absorption did turn positive as we had forecast, but it did so a bit earlier than the first quarter of 2011. As for an upturn in commercial real estate overall, we are no longer sure that will occur in 2011.

We will give our updated forecasts on the following pages – however, as the title of this section states, it is going to be difficult to have a lot of confidence in such predictions. It is likely that some markets will continue to see declines while others may experience modest upturns – so a market wide forecast likely won't apply to a particular location.

In 2008, Moody's and other companies that track delinquencies, forecast the CMBS Delinquency Rate should increase from around 1% to 12%-14%+. The May 2010 figure was 7.50% and recently this exceeded 9%. With delinquencies slowing, it is unlikely the market will see the original 12%-14% that was previously forecast.

The CES National Overview follows.

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 24 months and the upcoming 12 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 December 2010. National prices declined 4.1% in 2010. As we forecast in the last issue, prices are no longer moving in unison. Some cities or pocketed markets and submarkets are seeing modest appreciation, while others are still declining.

As of early February, housing futures traded on the CME are projecting a 7% decline for home prices nationwide through the end of 2011. This has not changed since last Summer. 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 regarding housing prices.

As with the CME futures, the earliest CES sees any notable appreciation on a national scale is 2012. Even then we will probably have a mixture of markets and submarkets still declining while others see 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 as:

“San Diego and Washington state were the only two MSAs to report year-over-year gains in the fourth quarter with increases of 1.7 percent and 4.1 percent, respectively. Charlotte, Chicago, Cleveland, Dallas, Denver and Washington, D.C., showed improvements in annual growth rates in December compared to the previous month. However, Atlanta, Charlotte, Chicago, Detroit, Las Vegas, Miami, New York, Phoenix, Portland, Seattle and Tampa posted new index lows in December since peaking between 2006 and 2007.

The report noted that home prices across the country were at first quarter 2003 levels as of the fourth quarter of 2010. The 10-city composite is now only 3.9 percent above its April 2009 trough, while the 20-city composite is 2.3 percent above.

‘Despite improvements in the overall economy, housing continues to drift lower and weaker,’ David Blitzer, chair of Standard & Poor’s Index Committee, said in an accompanying news release. ‘Unlike the 2006 to 2009 period when all cities saw prices move together, we see some differing stories around the country.’

Both composites, as well as 19 MSAs, were down in December compared to the previous month. The 10-city composite fell 0.9 percent compared to the previous month while the 20-city composite dropped 1 percent. Washington was the only MSA to report a month-over-month gain in the fourth quarter with an increase of 0.3 percent. Tampa recorded the steepest month-over-month drop with a decline of 2.6 percent.

S&P/Case-Shiller hosted a free live teleconference Feb. 22 regarding the current state of the U.S. residential housing market -- as well as the potential for a double dip scenario – which included data from the December 2010 Home Price Indices. To watch a video of the teleconference, available through March 29, visit www.mymeetings.com/nc/join and enter the meeting number PG1253694 and pass code SANDP. “

Many of you have probably heard that Professor Shiller is projecting housing prices to decline about 20% from today's levels. This would place prices back at a long-term moving average. No timeframe is given.

Our forecast is more in line with the CME futures – a 5% to 10% decline in prices this year. As prices are still 20% above value, we reiterate our advice of early 2009 – it is best not to speculate and buy houses as investment properties at this time. The housing market appears to be headed for another three years of overall gloom, with some very isolated bright spots.

VACANT LAND, RESIDENTIAL SUBDIVISIONS, & CONDOMINIUM PROJECTS

These property types are lumped together as they are encountering the same market conditions – extreme weakness. What can we say about finished lots and raw land? We wrote the following awhile back and it has certainly played out as expected:

“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.”

We have seen a lot of bulk sales across the country for finished lots in the \$5,000 to \$20,000 per lot range. The investors figure at these prices they can wait a few years and surely get a higher price. We are also seeing appraisers conclude at these bulk sale indications as the argument is sales are the best indicator of value from market participants.

As we said above and continue to say, sale prices are not necessarily indicative of market value. Also, as one reviewer asked – If the DCF analysis says it is not feasible to pay the prices indicated by the bulk sales, then how can we conclude at the sales comparison approach (i.e. bulk sales prices)? Once again, it appears that speculators and developers are paying more for finished lots than they are worth.

If you are an appraiser, we still recommend performing a DCF analysis as most clients want to see it and it also is a good indicator of the intrinsic value of the property. IRRs in the PwC Real Estate Investor Survey (aka The Korpacz Survey) average just under 22%, 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 PwC 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.

These properties are extremely difficult to appraise and the above discussion shows why. As for a forecast, values are dead in the water and we don't see that changing for many years (for some properties, maybe decades).

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 fifteen months. Most appraisals we review now have only 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 All Property Type Aggregate Index measured a 0.9% decline in December, ending the year on a slightly negative note. In 2010, the National – All Property Type Aggregate Index declined 2.1%. However, the index has recovered 5.5% from the recession level low, which occurred in August 2010. Prices are down 30.7% from two years ago and have fallen 42.1% from the October 2007 peak.

Following are some points taken from the latest Moody's report:

- » The National — All Property Type Aggregate Index recorded a 0.9% decline in December, following three consecutive months of price increases. Commercial real estate prices remain choppy and in 2010, half the months measured increases while the other half saw declines.
- » December recorded the highest number of repeat-sales transactions since January 2008. A spike in transaction volume is typical for December as buyers and sellers attempt to close deals before the end of the year.
- » All four of the national property type indices had an increase in prices in the past quarter. The gains ranged from 3.6%-8.4%.

- » Three property types in the Top Ten MSAs experienced positive quarterly returns with retail measuring the only negative return. All four property types in the Top Ten MSAs are outperforming their respective national indices since the peak.
- » All four western property types experienced positive returns during the fourth quarter; however, all underperformed their respective national indices. Three of the four western property types are outperforming their respective national property types since the peak.

We continue to review appraisals that quote the institutional-grade cap rates in the PwC Real Estate Investor Survey while appraising non-institutional grade properties. As a reminder, cap rates for non-institutional grade properties as of the 4th Quarter 2010 Survey were as follows:

| PROPERTY TYPE | AVERAGE CAP RATE |
|---------------------------|------------------|
| Apartments | 8.21% |
| Warehouse Buildings | 10.31% |
| Medical Office Buildings | 10.27% |
| Suburban Office Buildings | 9.61% |
| Strip Shopping Centers | 10.66% |

The above cap rates have declined about 50-100bp from a year earlier.

Cap rates are forecast to remain steady this year. Albeit, if interest rates begin to tick up and then mortgage rates increase, we might see a surprise increase in cap rates. Remember that the cap rates you hear quoted in the press are for investment grade properties. Cap rates for the other 99.9%+ of the properties most of us deal with are not quoted in the press and they likely won't follow investment grade cap rates downward. Bifurcation, our word of the year.

Our discussion of the various property types follow.

APARTMENTS – Fundamentals turned around sharply in 2010 for this property type. According to Reis, Inc., the national vacancy rate dropped from a record high of 8.0% at the end of 2009 to 6.6% at the end of 2010. For 2011, they project vacancy to decline to 6.0% and effective rents to increase 4.0%.

With demand expected to far exceed supply in 2011, vacancy rates should decline significantly. As a result, concessions should disappear in most markets and **rents should increase 5%-10%. With cap rates forecast to hold steady, values should increase in line with rents.**

Although the national forecast is positive, weakness is likely to continue for older Class B properties and markets with double-digit vacancy rates (Source: IRR-Viewpoint 2011) – Atlanta, Charlotte, Columbia (SC), Fort Worth, Houston, Las Vegas, Naples (FL), Phoenix, Providence (RI), and San Antonio.

OFFICE – According to Grubb & Ellis, national vacancy was at 17.8% as of Yearend 2010 – up from 17.6% a year earlier. Reis, Inc. indicated a 17.6% vacancy rate as of Yearend 2010 – up from 17.0% a year earlier. These vacancy rates are near 18 year highs. Also according to Reis, Inc., effective rents have declined 1.5% from a year ago.

Grubb & Ellis is forecasting a vacancy decrease in 2011 to 17% and asking rent increases of 0.4%. The PwC Survey shows participants forecasting an average rent decrease of 0.14% with a range from +4% to -10%. There is not much positive to say about this sector – especially with job growth forecast to be anemic.

In the last issue, we estimated about 6 million total jobs will need to be added to get the office market back to pre-crash levels. Reportedly 1 million jobs were added in 2010 and 1.5 million are forecast to be added in 2011.

This property type is the last to recover and it looks like weakness will prevail for 2-3 more years.

INDUSTRIAL - Employment sectors that drive Industrial demand lost over 2.7 million jobs in 2009. However, 2010 employment increased almost 500,000 jobs.

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.

The table on the following page shows **the last four quarters have seen an average gain of 120,000 jobs in industrial sectors. The 4-quarter average turned positive in the 3rd Quarter of 2010, indicating that the national industrial market should see positive absorption beginning in the 1st Quarter of 2011.**

INDUSTRIAL SECTOR EMPLOYMENT - NATIONWIDE

| | 2009 | | 2010 | | | |
|----------------------------|-------------|-------------|-------------|------------|------------|-------------|
| | 3rd QTR | 4th QTR | 1st QTR | 2nd QTR | 3rd QTR | 4th QTR |
| Quarter Change * | -353 | -201 | +144 | +129 | +58 | +148 |
| 4-Quarter Average * | -827 | -673 | -276 | -45 | +33 | +120 |

* - In Thousands.

As expected, this is the first property sector to rebound. Per the employment analysis above, positive absorption was forecast to occur by the 1st Quarter of 2011. In fact, Grubb & Ellis says vacancy topped out in the 2nd Quarter of 2010 and declined in each of the next two quarters. We will gladly accept any indicator that continues to project turns in absorption within six months – not too shabby for the real estate markets.

According to Grubb & Ellis, national vacancy ended 2010 at 10.4%, down slightly from 10.7% a year earlier. They forecast vacancy will decrease to 10.1% by the end of 2011. According to Reis, Inc., effective rents declined 3.7% in 2010. Both Grubb & Ellis and Reis, Inc. forecast minor asking rent increases in 2011.

Unless there is a negative surprise (e.g. fuel prices), this property sector should do well in 2011. Market participants have begun to consider how the Panama Canal expansion to be completed in 2014 will affect distribution patterns. Also, China is proposing a 'land canal' (i.e. a railway) across Columbia to rival the Panama Canal. For those good at reading tea leaves, there will be some unique opportunities in this property sector this decade.

RETAIL – As we wrote last year, we could not see how the forecasts for a stronger retail market could play out when the fundamentals were so weak. In the end, yearend 2010 vacancy was 10.9% up from 10.6% a year earlier (Source: Reis, Inc.). Reis, Inc. projects vacancy to increase to 11.4% in 2011 and effective rents to decline by 1.4%. With unemployment still high (8.9% is a marked improvement over 9.8% just a few months ago), people saving at a 5%-6% rate, and inflation about to hit retail prices, **we tend to agree with Reis that 2011 won't be too rosy for retailers.**

As we first mention unemployment above, we want to point out that that “jobs added” may not be the type of jobs that will help bring the market back to pre-crash levels. APM’s Marketplace on March 4 did a report on the unemployment rates in the US, stating that in February the unemployment rate was 8.9%, which is the first time it has been under 9% in two years. Marketplace’s Janet Babin spoke with Dan Greenhaus, chief economic strategist at Miller Tabak. He pointed out that “In February there were about 8.3 million working part time jobs because they can’t find a full-time job. Before the recession, that number was closer to 4 million.” Long term unemployment caused by this recession has had a major effect on people’s ability to get back into the job market. So while jobs have been added, we may see decreases in the overall unemployment rates, but the rate of underemployment (hiring of part time rather than full time workers, or people working below their skill level) may actually increase without a major turn in the economy. This fact not only drives home our point about the retail sector, but also applies to a great extent to the economy as a whole.

Overall, we rate the property types from strongest to weakest as – Apartments, Industrial, Office, Retail. However, unlike 2008-2010 when almost all cities moved in the same direction, location once again becomes important. For example, Apartments may be strong in general, but there are some weak locations. Areas where it is difficult to add supply (e.g. New York, Washington DC) are performing the best. As each sector recovers, the degree of improvement will vary by city and property class.

COMMERCIAL PROPERTIES – Owner Occupied

The number of business closures has probably seen its zenith and the near term should either show a slow decline overall or some stability and maybe slight improvement. As a result, the amount of owner-occupied real estate being taken back by banks should be minimal in 2011. Regretfully, a lot of collateral is in OREO as a result of foreclosures from 2008-2010. This supply that banks must get rid of will overhang the marketplace and keep a lid on any price recovery.

As we have said since early 2009, 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. Most of the damage has already occurred, but there are still business that can be adversely affected by market risks beyond their control – what happens to a business if oil stays above \$100 per barrel or goes higher? What happens to those businesses that purchase commodities where prices are up 50%-200% (e.g. Cotton) in the past year? Knowing your customer’s business is extremely important at this time.

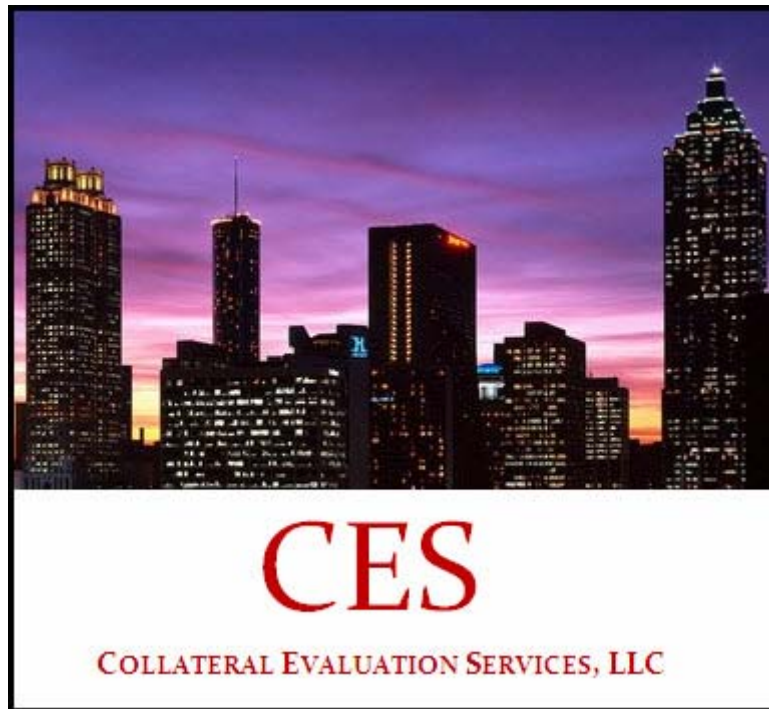
COMMERCIAL PROPERTIES – Vacant Land

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 12%-20% annually (we use 15%-20% 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 agricultural land that became a potential subdivision only to become agricultural 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! Note: George Mann's forecast for the next bubble to occur is 2027-2032) before we encounter this problem again – maybe by then we will have figured out a way to avoid the extreme price and value fluctuations.



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