

CES

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Real Estate Market Report – Fall 2011



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Letter from the Managing Directors

Dear Reader:

Collateral Evaluation Services, LLC is pleased to present the Fall 2011 edition of our *Real Estate Market Report*. 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 conveys a 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 great Fall and Holiday Season.

Sincerely,
Managing Directors
Collateral Evaluation Services, LLC
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Mann's Take On Things

By George R. Mann, MAI, SRA, MRICS

"Time Heals Everything"

All of us have likely experienced a hurt of some kind that feels like it will never go away. But the pain inevitably subsides and the axiom 'time heals everything' holds true again. Right now you are probably wondering if this is a real estate market report or a self-help article.

My point is the *only* thing that will heal our economy is time. For centuries, central banks and governments have tried fruitlessly to alter the ebb and flow of economic tides. No one and no entity can stop the movement of millions or billions of people (let me interrupt myself to note that on Halloween of this year the Earth's population will hit the 7 billion mark – go ahead and say it, that's scary!). Yet Ben Bernanke, The EU, The White House, Congress, et al. still attempt to alter the course of mass psychology. As always, they have failed and will continue to fail.

Operation Twist is the latest failed attempt to end The Second Great Depression. I am trying to figure out the logic of this program. If we are paid almost no interest for short-term deposits and now 2% or so for long-term bonds, how are we supposed to spend money and improve the economy? Pay me 8% or 10% interest and I have money to spend. Pay me 2% interest and I will hold my principal and meager interest and watch the world go round.

The elderly, who try to live off their investments, are hurt by this program. The middle class that try to build savings and retirement are hurt. About the only entities to gain from this are large corporations (except for pension fund accounting that will cause major problems over the next few years) who can issue more debt (just what the world needs!) and those who have equity in their house and can refinance at lower rates (assuming the entire country hasn't already refinanced in the past year or two at record low mortgage rates). Bernanke cannot honestly believe those people who are underwater in their house loans are going to refinance and have money to spend, can he?

In 2020, when we look back on The Lost 15 Years and how The Second Great Depression played out we will see that only time healed the devastation. It has been quite entertaining to see the talking heads say that 'this is different' and the USA is not going to have a lost 10 or 20 years like Japan. We continue to basically follow our own (First) Great Depression and Japan's last 20 years – asset and credit bubbles play out the same way regardless of country or century.

I continue to ask (myself, not out loud) if US population is growing at 1% per year, why do we expect our GDP to grow faster or anyone to make more on their money than 1% per year? Of course, we have had GDP growth and returns greater than that for the past 100 years. We can thank the printing of money for making this happen. Since the Federal Reserve was created in 1913 the value of our dollar is down 99%. In real-terms it is doubtful we have seen more than a 1% return. In fact, adjusted for inflation the price of housing today is the same as in 1890.

This is how time will heal our current downturn. If we go back over the last 20 or 30 years or longer and figure out where we should be based on a 1%, or heck give us a 2%, annual return then we will know when The Second Great Depression will be coming to an end. Whether it was GDP growth or home

price appreciation in the past decade, those excesses have to be taken away to the point where we have long-term growth rates closer to 1%-2%.

For those who 'play' the markets (after all, the stock market is simply the world's largest casino), you have likely heard the terms overbought and oversold. These conditions revert back to the norm in one of two ways. An overbought situation (like that for housing and credit in the 2000s) is cured either by a significant and quick decline or by sideways movement within a range for a long period of time. The end result is the same – returns over a long period are back to normal.

Great depressions are ugly in that the declines are significant but the 'recovery' period is also extended. The Dow Jones Industrial Average (DJIA) got back to its 1929 high in 1954 – 25 years. From 1966 to 1982/1983 the DJIA traded between 577 and 1051 with multiple bear and bull markets. This period of stagnation was needed to erase the excess gains of the 1950's to 1966 bull market.

Gold hit bubble prices in 1980. Not until a few years ago did it break those levels. Adjusted for inflation, it still has not reached 1980 levels. Silver still has not surpassed its 1980 bubble prices. The dot.com bubble burst in 1999/2000 and the NASDAQ won't likely get back to those levels for another decade or two.

The point is only time can heal The Second Great Depression. The rest of this decade is likely needed to rid our country and the world of its excesses. We are nowhere near the 'norm' for asset or credit prices. Professor Shiller indicates home prices have 15% to 20% more to fall to get back to the long-term trendline. We can either do that by declining in the next year or two by that amount or stagnating at current prices for 5+ years and letting the trendline catch up. Extend and Pretend isn't much fun is it?

The amount of debt held by the public has declined since 2008. However, to get back to pre-bubble levels, it will need to decline by 3 to 4 times the amount it has to date. In other words, the public does not need, or apparently want, more debt regardless of low interest rates. They are deleveraging and they are probably only 20%-25% of the way there. Seeing Bernanke and others trying to push more debt onto people without jobs or onto those who are already overleveraged is repulsive to say the least.

I will leave this rant with some stats from the Federal Reserve Board (FRB) itself. At the peak of the housing bubble in 2006, the total value of U.S. residential housing was \$23.5 trillion with \$10 trillion of debt. That indicated total equity at \$13.5 trillion.

By 2010, the total value of U.S. residential housing had declined 32% to \$16 trillion. However, total debt remained at about \$10 trillion. Thus, total equity was (is?) down to \$6 trillion. Total equity declined 56%. I doubt those infomercials that told you about leverage mentioned it cuts both ways. Just put 5% down and you can make 50% on your equity! Someone please tell that to the reported 25% of the 50 million U.S. homeowners that are now underwater.

Two things to note from the above information. First, supposedly the stats are for first mortgages only. As of August 2010, there were 13.2 million HELOCs (Home Equity Lines of Credit) totaling \$649 billion outstanding. Reports indicate that maybe 95% of these borrowers have 'negative equity.' Thus, the number of homeowners underwater might be far greater than the 12.5 million estimated by the FRB.

Second, total debt was about \$5 trillion and total equity was about \$8 trillion in the year 2000. You can make a variety of assumptions about whether total debt will decline or total equity will increase to those levels. What will happen with total value? However you think this will turn out over the next five years,

it is likely that a decline in total debt in the trillions of dollars is a necessity. This is part of the deleveraging discussed above.

There are several quotes regarding this issue that baffle me:

1. A headline in the Financial Times said Tim Geithner told “EU leaders to stop bickering and act over debt crisis.” Maybe he wasn’t around a television or the internet while our Congress showed how to professionally handle the raising of the debt ceiling.
2. The National Association of Realtors (NAR) is opposing the Bank Regulators’ desire to require 20% equity on homes for loans to be sold to the secondary market (there is a lot more to this, but for simplicity that is the main issue). NAR says a study shows it will take the average family 12 years to save for a 20% down payment. And that is a bad thing? This got me to thinking though. If it takes 12 years to save 20% of the house price, then that means it takes 60 years to have enough money to pay for that house. And this is just paying all equity, not interest on a loan which actually makes the money paid about 3 times as much! Which kept me thinking....It takes people 60 years to have enough money to pay for a house, yet we are going to give them 30-year loans? If they will not have enough money in 60 years, what makes us think they will have it in 30 years? – and paying huge amounts of interest in addition to the price/equity? Maybe somewhere in all of this lies the problem with our entire housing and debt market. Thankfully, no one listens to NAR anyway as they have produced the most erroneous stats and forecasts of any organization for decades.
3. An article in the Financial Times (in my humble opinion, the best newspaper around) said that of the 48 million jobs to be created in the USA between now and 2018, only 1/3 would need someone with a bachelor’s degree or higher. This certainly raised the question of why would the younger generation go to college if there is no need. Of course, maybe countries like Germany will be hiring our college graduates. Nevertheless, my focus is always on numbers. Let me calculate....48 million jobs....6 years/72 months....or maybe 7 years/84 months if you count all of 2018 itself. Either way that works out to about 570,000 to 670,000 new jobs per month every month for 6-7 years! It takes about 125,000 jobs per month to keep up with population growth (which we aren’t doing yet). Some analysts say it takes 250,000 jobs per month to start lowering unemployment. Who is kidding themselves that we are going to add 600,000 new jobs per month over the most of the rest of this decade! Thank goodness some small business somewhere produces rose-colored glasses.

I will end this with what was the funniest, but is now the most pathetic, quote around – “The odds are increasing for a double-dip.” We have made fun of this quote since 2009 when people asked about it as if we were in some kind of major recovery. Watching Bernanke over the last twelve to eighteen months say there is almost no chance of a double-dip to now saying the odds are increasing has been enjoyable. But, when my step-daughter recently said – “How can it be a double-dip when the first dip has never ended!?!” I just had to laugh at how foolish the talking heads look when John Q. Public knows the ‘recession’ did not end in 2009 as stated by the official sources. ‘They’ think they can tell the public all is ok and getting better and that will be self-fulfilling. The public is out of work, underwater, in debt, and not buying anything the talking heads and government officials are trying to sell them.

In fact, Kenneth Rogoff, Professor of Economics and Public Policy at Harvard points out in an interview with Tess Vigeland on Marketplace Money that we are not actually in a recession and have not been. In the interview, Rogoff explains that we are in a contraction rather than a recession. He states, “a contraction is a much much more severe version of a recession. It’s accompanied by a financial crash.

You have a recession, they last a year, at most two years. And then, once the recovery starts, six months later, you're back to where you started. Twelve months later, you're perhaps back even at trend, you've made up for lost ground." It is evident by the fact that we never fully recovered from the 'recession' that we cannot continue to say it was 'just a recession'.

As we send this out, the Economic Cycle Research Institute (ECRI) has forecast the U.S. economy will fall into a recession. The ECRI correctly foresaw a severe decline in 2008 even before Lehman collapsed. Their record has been in excellent in forecasting recessions for many decades. Although we don't see this as a second recession, the point is a downturn from where we are is highly likely.

Only time will heal the excesses that have been dumped on the public and future generations. Regretfully, healing hurts and that cannot be avoided either.

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.

Key Observations

Residential Housing (1-to-4 Units)

- Housing prices are forecast to decline 5%-10% in 2011; Prices have already experienced a 'double-dip' for this economic downturn.
- Housing prices are projected to be weak into 2014.
- Home sales over the next three years should exceed new supply and therefore absorb the current oversupply.
- Residential subdivisions and condo projects with retail prices under \$200,000 should experience the greatest demand over the next few years.

Multi Family

- Apartment Sector – Currently strong with solid occupancy and rent gains forecast over the next five years.

Industrial

- Industrial Sector – Absorption turned positive in last half of 2010; occupancy should be steady over next five years with rents increasing about 2% per year; unique opportunities will present themselves as a result of the Panama Canal expansion being completed in 2014.

Office

- Office Sector – Weak for next 2-3 years due to anemic employment growth; permanent decline in demand has occurred as the average employee now occupies 160 square feet versus 200-250 square feet in the past.

Retail

- Retail Sector – Weakest of the four main property sectors; not much improvement forecast over the next five years.

Non-Investor – Owner-Occupied

- Owner-Occupied Properties – An eye should be kept on companies in industries that will be adversely affected by oil prices staying above \$100 per barrel and commodity prices being elevated; however, some companies will be in industries that benefit from both of those items.

SINGLE UNIT DWELLINGS

After falling 4.1 percent during the first quarter, the National Home Price Index gained 3.6 percent in the second quarter — although prices are still down 5.9 percent from a year ago, according to the Standard & Poor's/Case-Shiller Home Price Indices released Aug. 30. Nationally, prices were back to early 2003 levels.

Prices in the 10-city and the 20-city composites, as well as in 19 of the 20 metropolitan statistical areas, were up in June compared to the previous month. Portland, Ore., was the only MSA that remained flat compared to the previous month. Both composites and 12 of the MSAs have increased for three consecutive months.

However, both composites and all 20 MSAs were down in June compared to a year ago. The 10-city composite was down 3.8 percent compared to a year ago, and the 20-city composite was down 4.5 percent.

Both composites and 13 of the MSAs saw year-over-year improvements but remained in negative territory. Minneapolis reported the steepest annual home price decline at 10.8 percent, followed by Portland, Ore., at 9.6 percent.

“This month’s report showed mixed signals for recovery in home prices. No cities made new lows in June 2011, and the majority of cities are seeing improved annual rates,” David Blitzer, chair of Standard & Poor’s Index Committee, said in the report. “Looking across the cities, eight bottomed in 2009 and have remained above their lows.”

Since last summer, housing futures traded on the Chicago Mercantile Exchange (CME) have been projecting a 7% decline 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, 2 years from now we will be where we are today regarding housing prices.

Shadow inventory is another key indicator of the way in which this market is headed. According to CoreLogic, shadow inventory has decreased from 1.9 million units in July 2010 to 1.6 million units as of July 2011. This represents a change from a previous 6-month supply to a current 5-month supply of inventory. This represents a 22% decrease from the January 2010 peak of 2 million units. It is also interesting to note that the aggregate current outstanding mortgage debt on this shadow inventory is down 18% from a year ago. This slowdown in shadow inventory accumulation is a positive sign for the overall housing market.

The weakness in housing is a simple case of excess supply and weak demand. Total annual demand for housing is about 1.4 million units. This is based on the national population increasing 2.7 million each year and around 200,000 dwellings being demolished each year. Recent housing construction has averaged 600,000 units per year. With demand exceeding supply for the next 2-3+ years, the current oversupply will diminish and a firmer market should exist around 2013-2014.

FORECAST

Our forecast is more in line with the CME futures – a 5% to 10% decline in prices this year. The housing market appears to be headed for another two years of overall gloom, with some very isolated bright spots. New loans on purchases of rental properties should be looked at very closely as price appreciation does not appear to be likely in the foreseeable future.

VACANT LAND, RESIDENTIAL SUBDIVISIONS, & CONDOMINIUM PROJECTS

In general, as long as the housing market remains weak these property types will also exhibit sustained weakness. Project values are very specific to the local market as nearby projects greatly influence a property's retail prices and sales rate.

Discount rates are a general item that can be applied to local properties. IRRs in the PwC Real Estate Investor Survey (aka The Korpacz Survey) average 21%, but correspond to projects with a 9-year sellout period. Projects with shorter sellout periods have discount rates approaching 30%. The latest data available was as of 2nd Quarter 2011.

RealtyRates has 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.

The 2nd Quarter 2011 RealtyRates Developer Survey (1st Quarter 2011 data) shows the national average discount rate for residential subdivisions is 35.66% - this is up from 35.13% in the prior quarter. The national average condo project discount rate is 22%, exclusive of entrepreneurial profit as noted above.

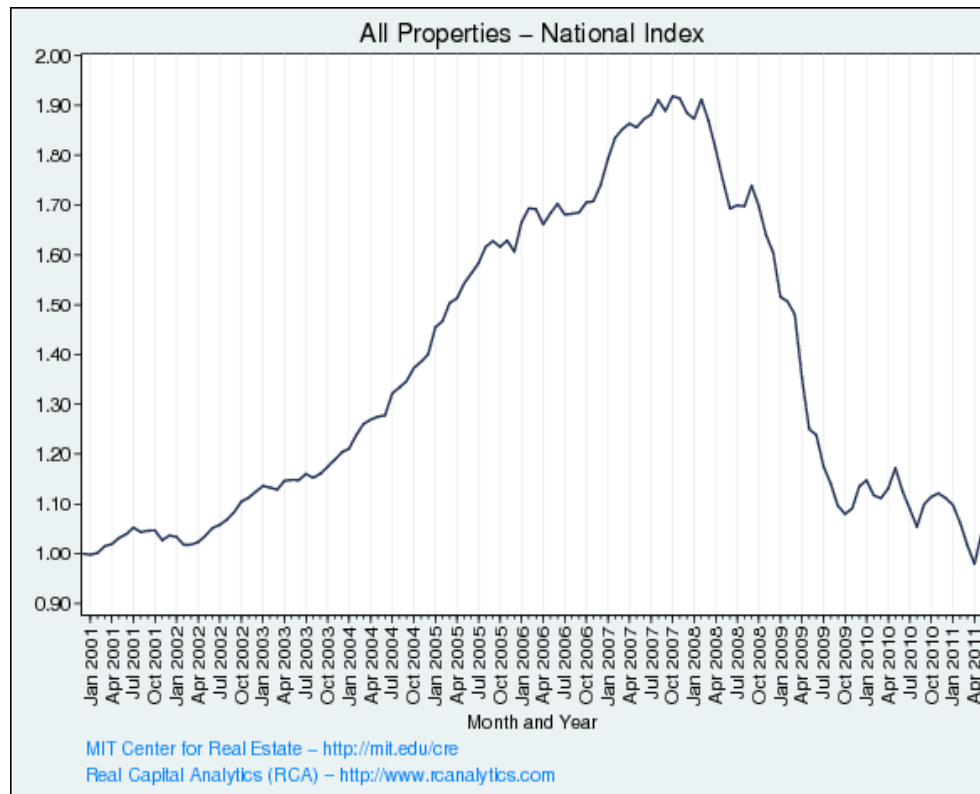
Las Vegas is a classic example of the national decline in raw land values. According to Applied Analysis, raw land prices peaked at \$900,000 in late 2007. Now, the average price is about \$138,000 per acre. One specific property is the 1,000-acre Park Highlands tract that was purchased by D.R. Horton and four other homebuilders for \$639 million. Recently the tract was valued at \$19 million. We have seen 95% declines in raw land values in many areas of the country.

Forecast

According to an economist at Wells Fargo, the median affordable home price today is \$185,000. As such, projects priced around this level are most likely to see reasonable sales activity. High priced projects and second home projects are expected to remain very weak over the next few years.

COMMERCIAL PROPERTIES – Income Producing

The Moody's/REAL All Property Type Aggregate Index measured a 6.3% increase in May, the largest monthly increase ever recorded. However, prices remain at 2001-2002 levels.



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

- National — Despite a recent uptick in transaction volume, the large share of distressed transactions precludes a broad market recovery at this time. Distressed sales have comprised at least 20% of the repeat-sales transaction volume for 17 consecutive months.
- In this month's "From the Lab" section, we continue to analyze subsets of transaction data, this time looking at one of the best performing groups (major assets in six large cities excluding distressed transactions) and one of the worst (a national sample of only distressed transactions). In a case of the strong getting stronger and the weak getting weaker, major asset/major market prices have recovered more than half of their post-peak losses, while prices for distressed transactions continue to bounce around the bottom.
- All four property type indices in the East regional subset have realized double digit price gains over the past year and have outperformed their respective national indices during this period. Eastern office and apartments both realized gains of more than 20%.

- Three of the four southern regional subset property types (apartment, industrial and retail) have experienced double digit price increases over the past four quarters. Southern office was the exception, setting a new post-peak low.
- Florida apartment prices increased by 23.8% in the past four quarters, the first positive movement in this subseries since its peak in 2006.

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 2nd Quarter 2011 Survey (1st Quarter 2011 Data) were as follows:

PROPERTY TYPE	AVERAGE CAP RATE
APARTMENTS	7.73%
WAREHOUSE BUILDINGS	9.82%
MEDICAL OFFICE BUILDINGS	9.97%
SUBURBAN OFFICE BUILDINGS	9.14%
STRIP SHOPPING CENTERS	9.83%

SOURCE: 2nd¹ Quarter 2011 PwC Real Estate Investor Survey

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. The chance of a surprise increase in market rates has become slim with the Federal Reserve guaranteeing low interest rates into 2013.

However, 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.

Our discussion of the various property types follows.

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 5.3% and effective rents to increase 3.8%.

With demand expected to far exceed supply in 2011, vacancy rates are expected to decline significantly. As a result, concessions should disappear in most markets and **rents increase 5%-10%**. **With cap rates forecast to hold steady, values should increase in line with rents. We concur with REIS' 5-year forecast for vacancy rates to slowly decline to 4.8% and rents to increase about 4% per year.**

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.

Industrial

Employment sectors that drive Industrial demand lost over 2.7 million jobs in 2009. However, 2010 employment increased almost 500,000 jobs. About 800,000 new jobs are expected for 2011.

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 below shows **the last four quarters has seen an average gain of 149,000 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

Year	2010				2011	
	1st QTR	2nd QTR	3 rd QTR	4th QTR	1st QTR	2nd QTR
Quarter Δ * (Change)	+144	+129	+58	+148	+180	+209
Four (4)-Qtr. Avg. *	-400	-116	-1	+120	+129	+149

* - In Thousands.

SOURCE: Department of Labor, Bureau of Labor Statistics

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. This sector should continue to improve as long as employment growth remains positive.

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. **We concur with REIS's 5-year forecast for the vacancy rate to decline to 9.9% and rents to increase about 2% per year.**

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.

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%. REIS, Inc. is forecasting a vacancy decrease to 17.1% and asking rent increases of 1.6%. Through the first half of 2011, vacancy has not changed and rents have increased 0.7%.

The Nation lost 8.8 million jobs in the Second Great Depression. Reportedly two million jobs have been gained since the bottom. Forecasts call for 1.0 to 1.5 million jobs being created in 2011. Due to this relatively slow growth (compared to previous recessionary downturns and rebounds); economists project 'full employment' will not occur until sometime between 2014 and 2017. Economists are also forecasting 6.5%-7.5% unemployment to be the new 'normal.' This would be up from the historic average of 5.7% experienced since 1948.

A lower level of 'full employment' results in a permanent reduction in the demand for office (as well as industrial) space. Also, recent studies suggest the average office employee now occupies 160 square feet versus 200-250 square feet in the past. This is another significant and permanent decline in the demand for office space in all markets.

This property type is typically the last to recover and it looks like weakness will prevail for 2-3 more years. REIS's 5-year forecast is for vacancy to decline to 14.3%. CES believes employment will increase faster than others are projecting in the later years and we see vacancy declining to 12% five years out.

Retail

Yearend 2010 vacancy was 10.9% up from 10.6% a year earlier (REIS, Inc.). REIS, Inc. projects vacancy to increase to 11.3% in 2011 and effective rents to decline by 0.2%. With unemployment still high over 9%, 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. We also agree with their 5-year forecast for weakness thru 2012 and then improvement thru 2015. Annual rent growth should be low around 1%-2%.**

FORECAST

Overall, we rate the property types from strongest to weakest as – Apartments, Industrial, Office, and 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.

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. Banks must get rid of this supply that is hanging over the marketplace and keeping 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 the 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.

Lending to small businesses does not appear to be a supply-side issue as much as a demand-side issue. The April 2011 'Small Business Economic Trends' report published by the National Federation of Independent Business (NFIB) revealed 93% of survey respondents said '...all their credit needs were met or that they were not interested in borrowing.' Fifty-three percent said they do not want a loan. Credit availability is not holding back loan growth it is a lack of demand.

The June 2011 'Small Business Economic Trends' report summarizes small business conditions as follows:

NFIB's monthly Small-Business Optimism Index dropped one tenth of a point (0.1) in June, settling at 90.8, basically unchanged from the previous month. While some indicators rose slightly, including expected capital outlays, pessimism about future business conditions and expected real sales gains pulled the Index down, causing a small but disappointing drop for the fourth consecutive month. Although June marked the second year anniversary of the recovery, it appeared there was little happening to make small business owners more optimistic.

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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