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Perspectives on Commercial Real Estate:
Are we heading in the right direction, and why a "V" formation?

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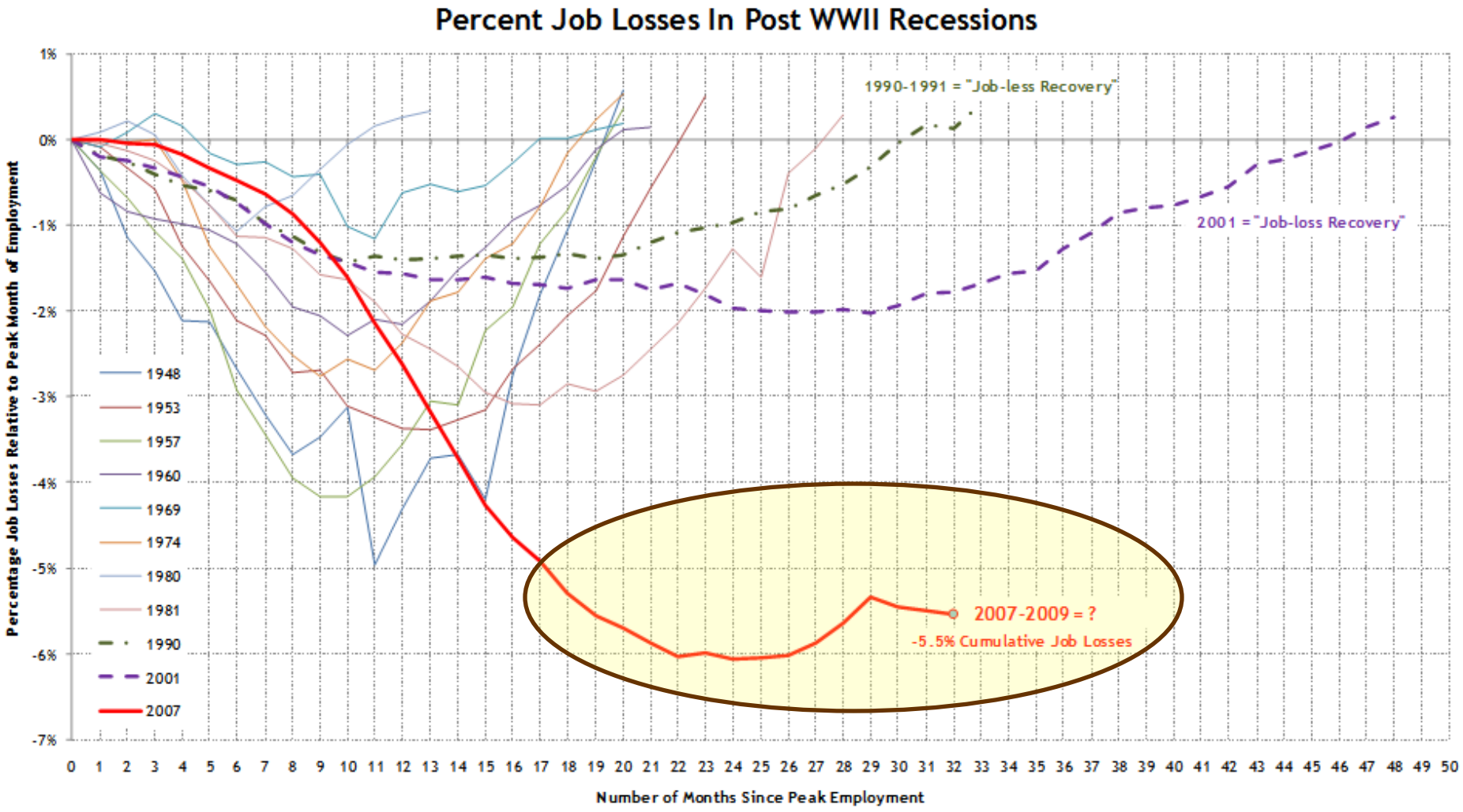
The opinions expressed are those of the presenter and not those of the Federal Reserve Bank of Atlanta or the Federal Reserve Board of Governors.

The oral comments are critical to context; without them, this presentation can be misinterpreted.

It is all about JOBS…

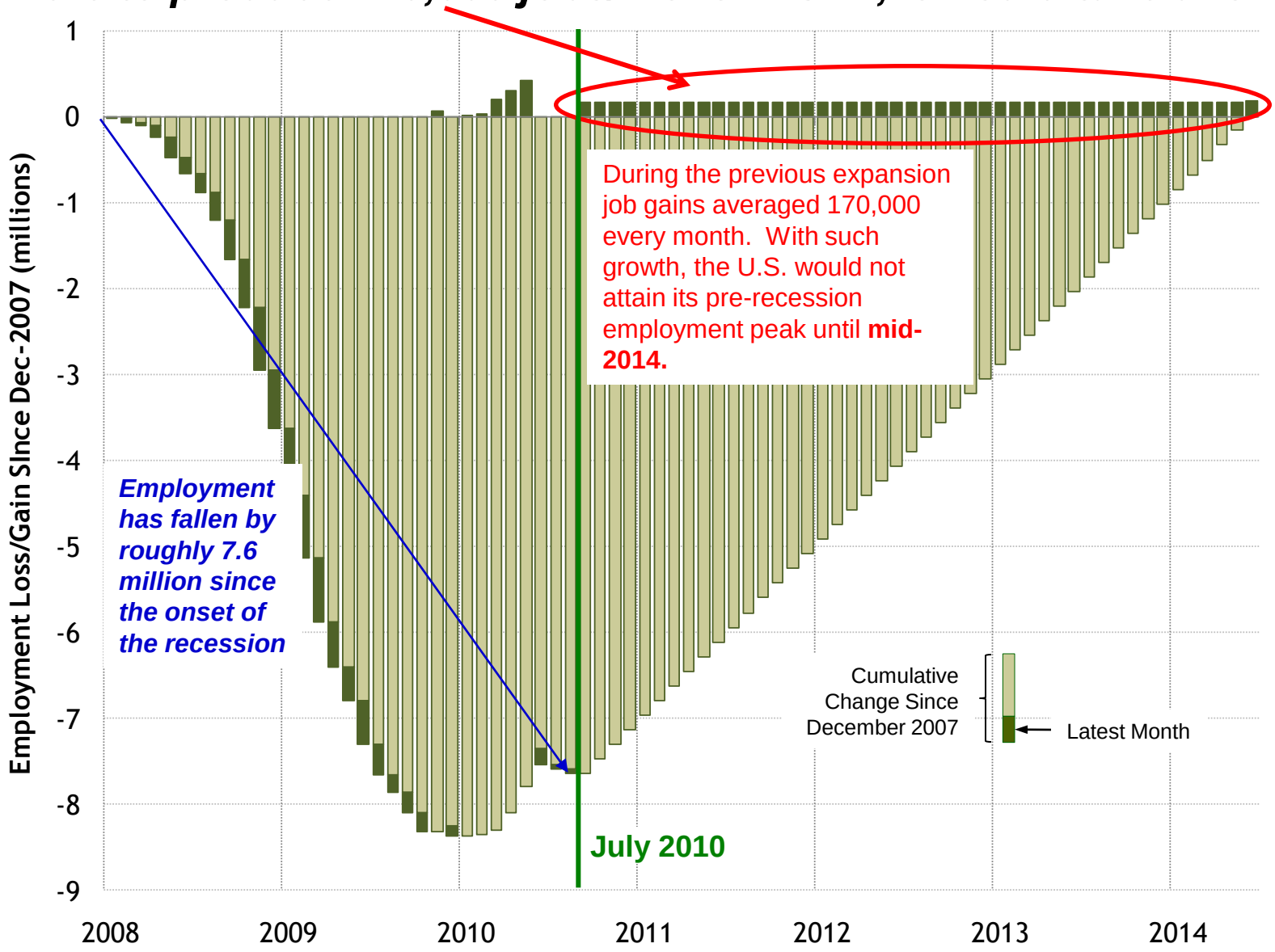
2007-2009 Job Loss worst of all post WWII recessions



Source: Bureau of Labor Statistics

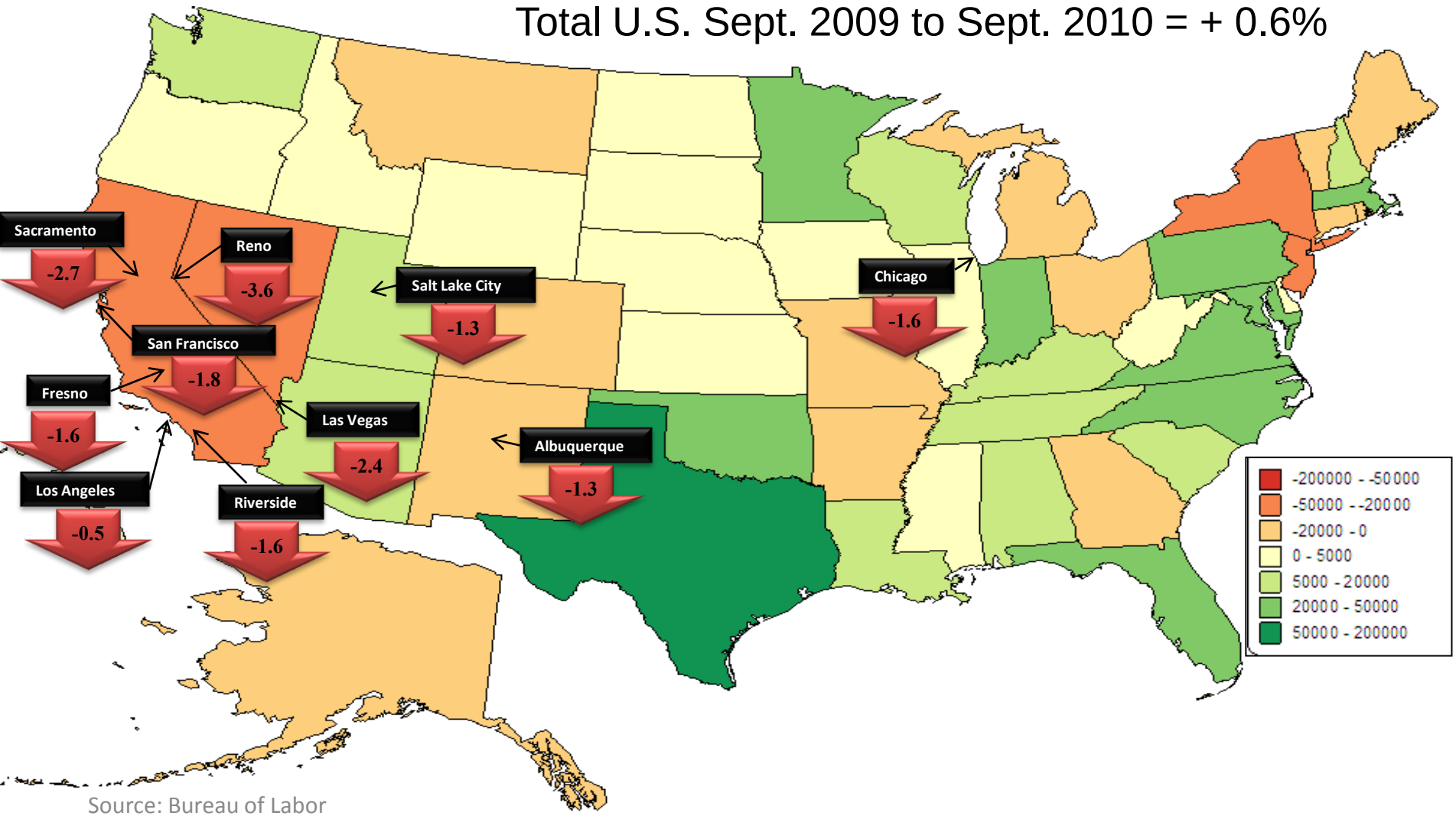
A Jobs Recovery: A Long and Winding Road Back

***IF** we were to produce 170,000 jobs/month ASAP, it would take until 2014…*



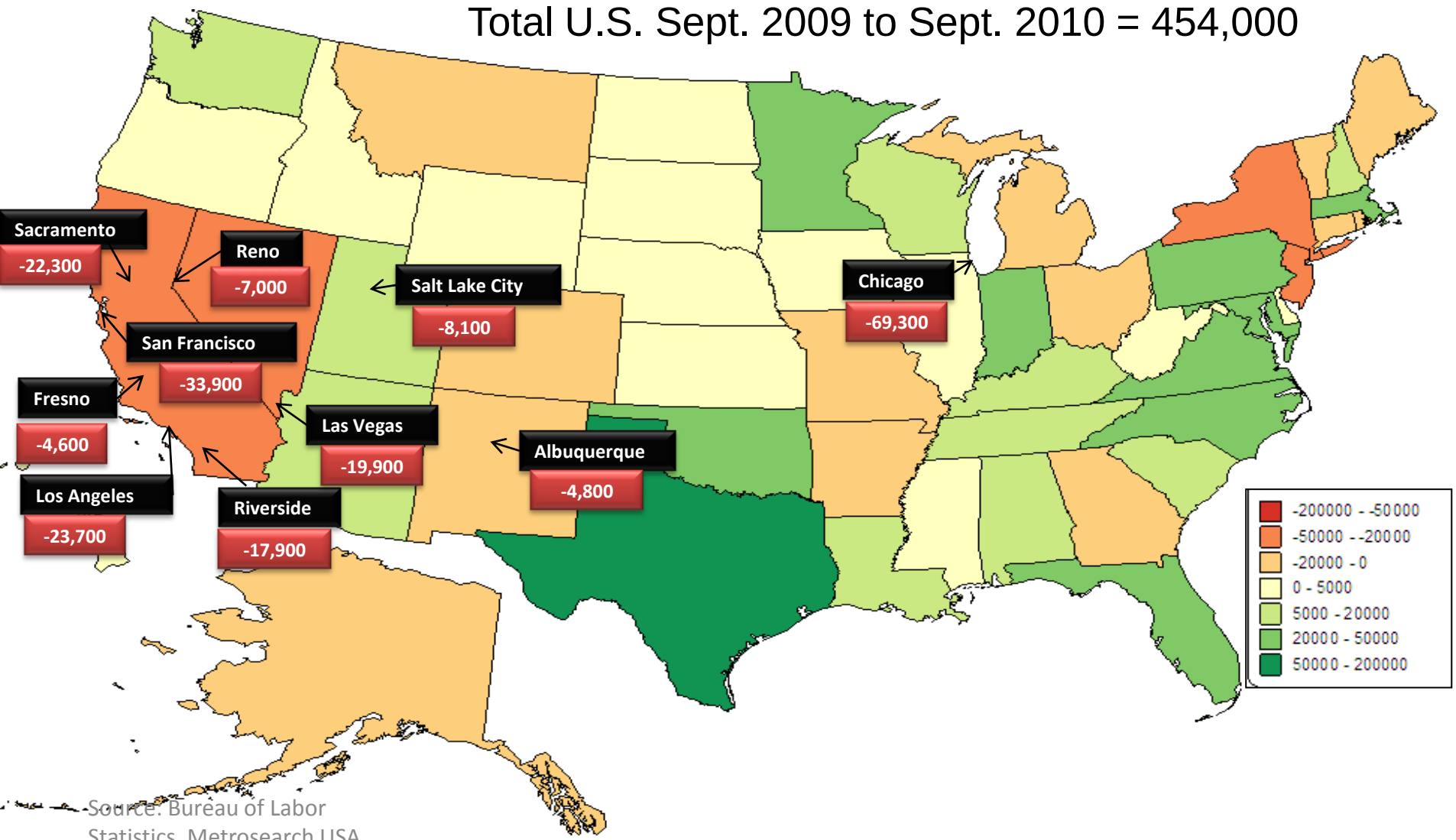
Source: Bureau of Labor Statistics

MSAs with the highest percentage of job losses over the last year are concentrated in the Southwest, the West Coast, and Chicago.



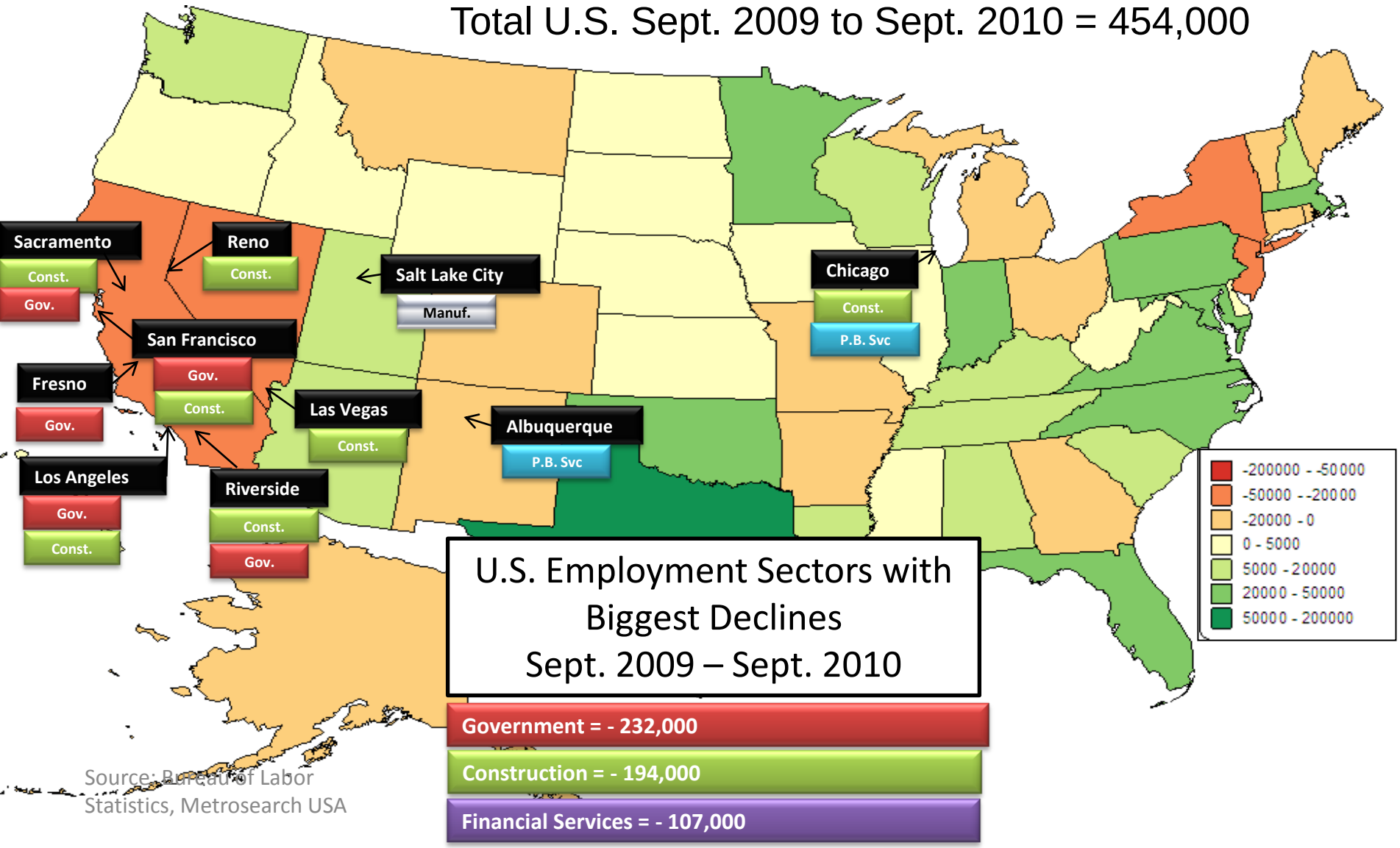
Source: Bureau of Labor Statistics, Metrosearch USA

Chicago leads the nation in net job losses, with 69,300 losses over the past year.



Source: Bureau of Labor Statistics, Metrosearch USA

Spurred by state and local budget restraints, the loss of Government jobs is the biggest drain in states like California. Continued cuts in construction and professional services continues to hurt the Chicago market.



How much damage to the Commercial Real Estate track?

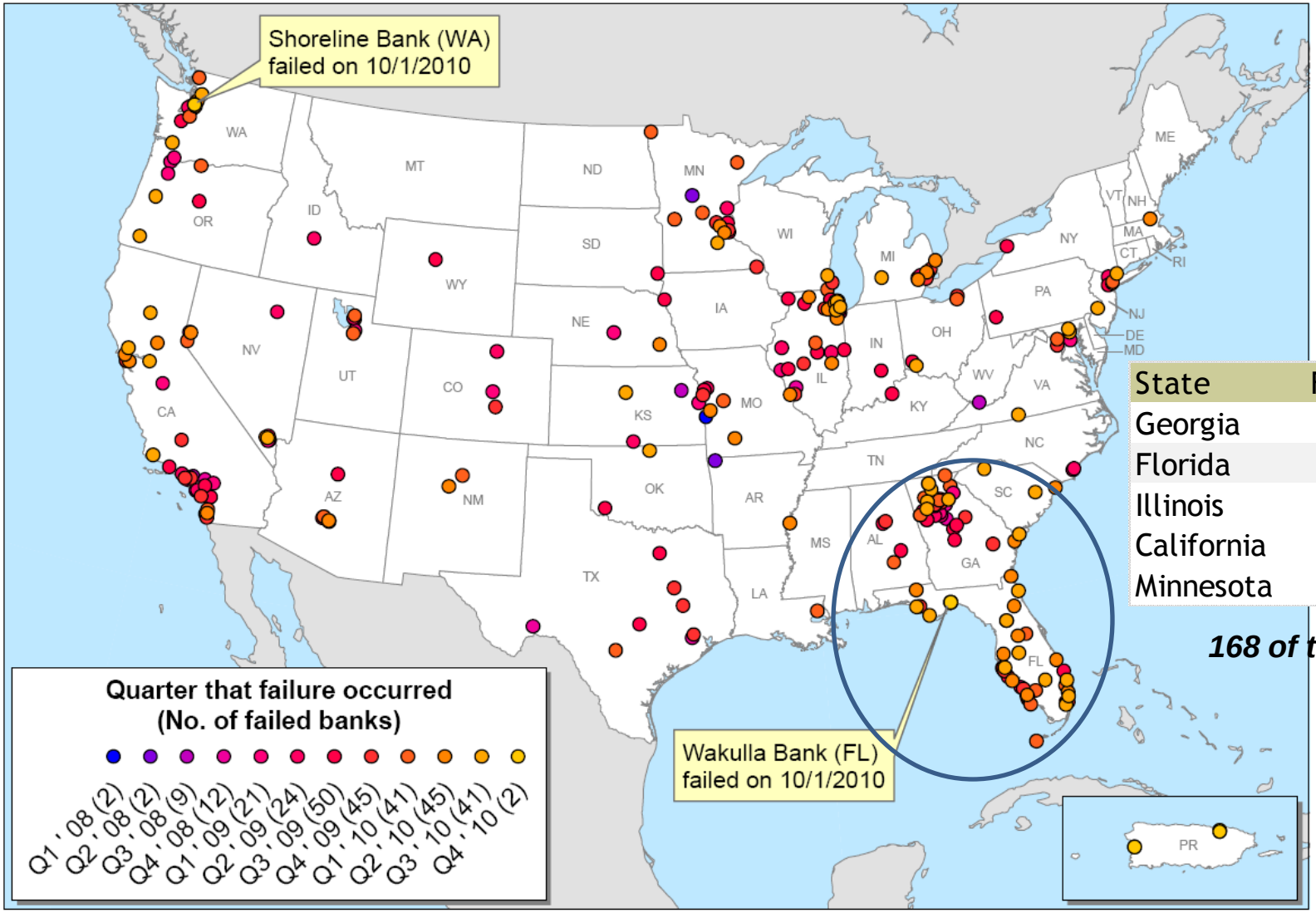
What dangerous crossings lie ahead to cross over to recovery?

Let's start with the Bank/Capital Rail first…

And then let's see why the current R.E. conditions are worrisome.

Bank Failures Across the US since 2008

What five states lead in bank failures?



State	Failures
Georgia	44
Florida	41
Illinois	37
California	32
Minnesota	14

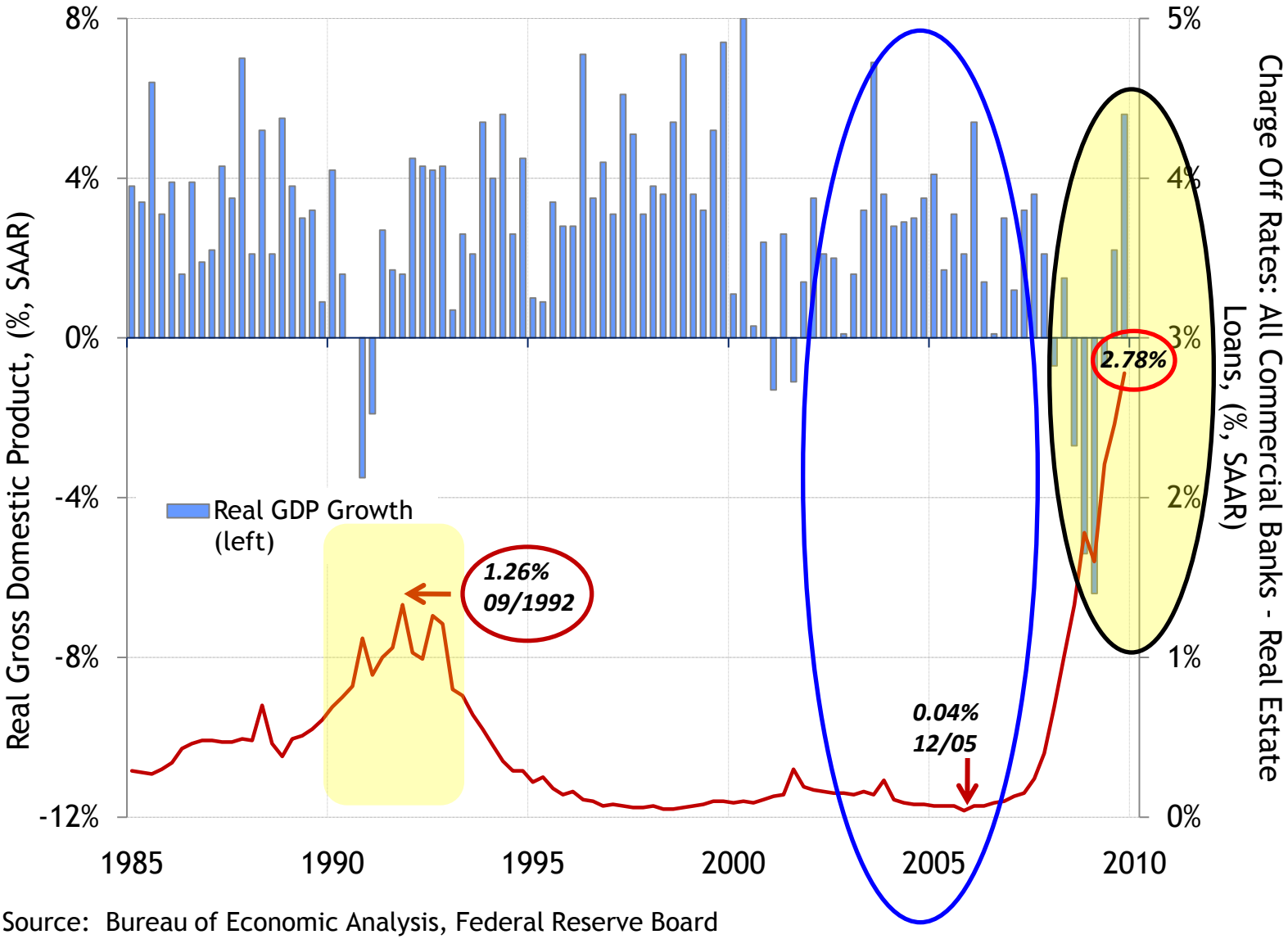
168 of the 294

Source: FDIC/SNL Financial. Data as of 10/1/2010.

Q. How much damage to the capital/bank side of the track?

R. We won't know until we get to recovery

2-4 yr lag in charge-off rates (CORs)



Source: Bureau of Economic Analysis, Federal Reserve Board

SAAR: seasonally adjusted annual rate

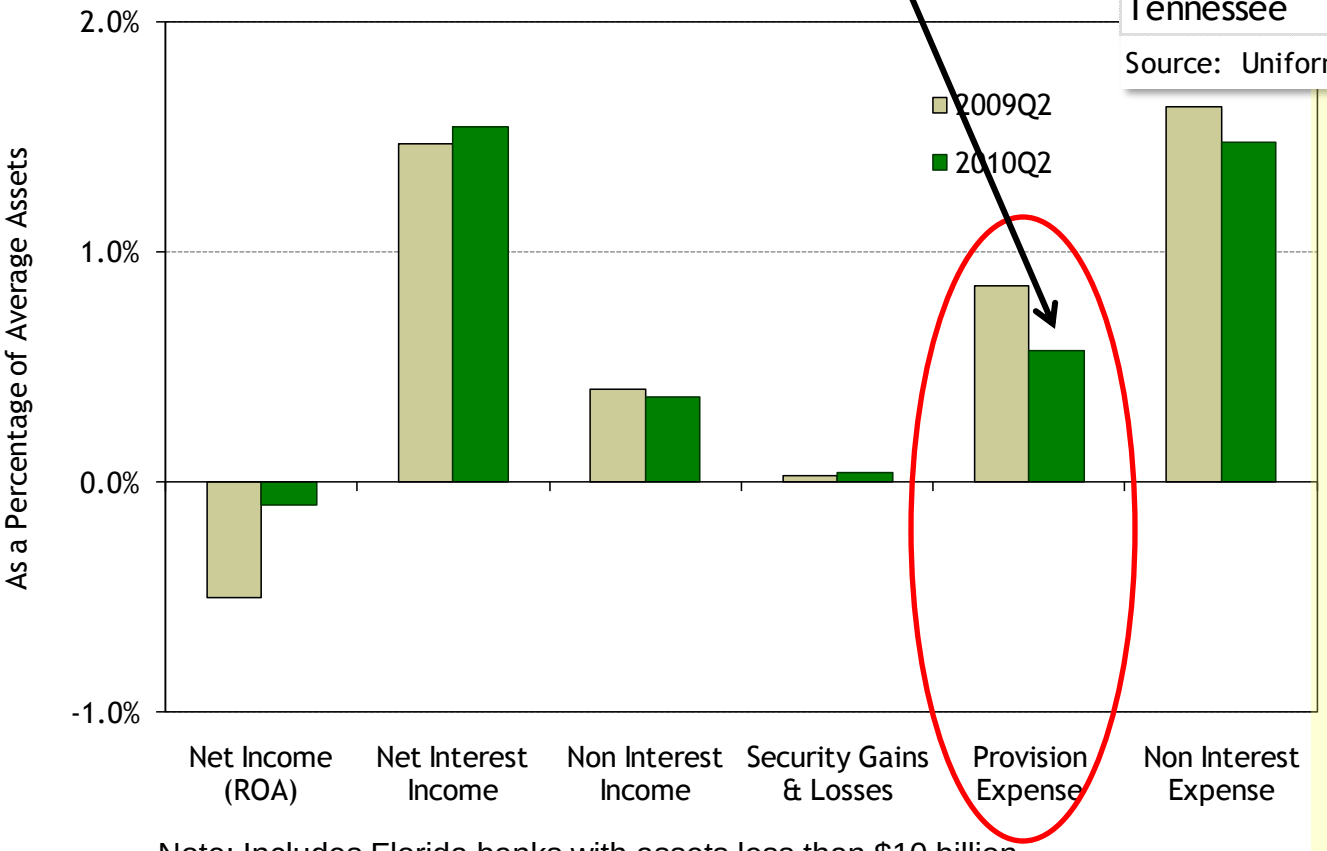
ROA on Banks outside Atl 6-D is 0.64%;
ROA for Banks in Atl 6-D is -0.11%
With these kind of ROAs…

Median Return on Average Assets (%)

	2010Q2	2009Q2
Out-ofDistrict	0.78	0.64
District	0.35	-0.11
Alabama	0.61	0.21
Florida	-0.35	-0.94
Georgia	0.04	-0.52
Louisiana	0.98	0.92
Mississippi	0.82	0.76
Tennessee	0.54	0.16

Source: Uniform Bank Performance Reports

Atlanta 6-D Bank Ratios Vs other 11-Ds



Note: Includes Florida banks with assets less than $10 billion.
Source: Bank Call Reports

Questions:

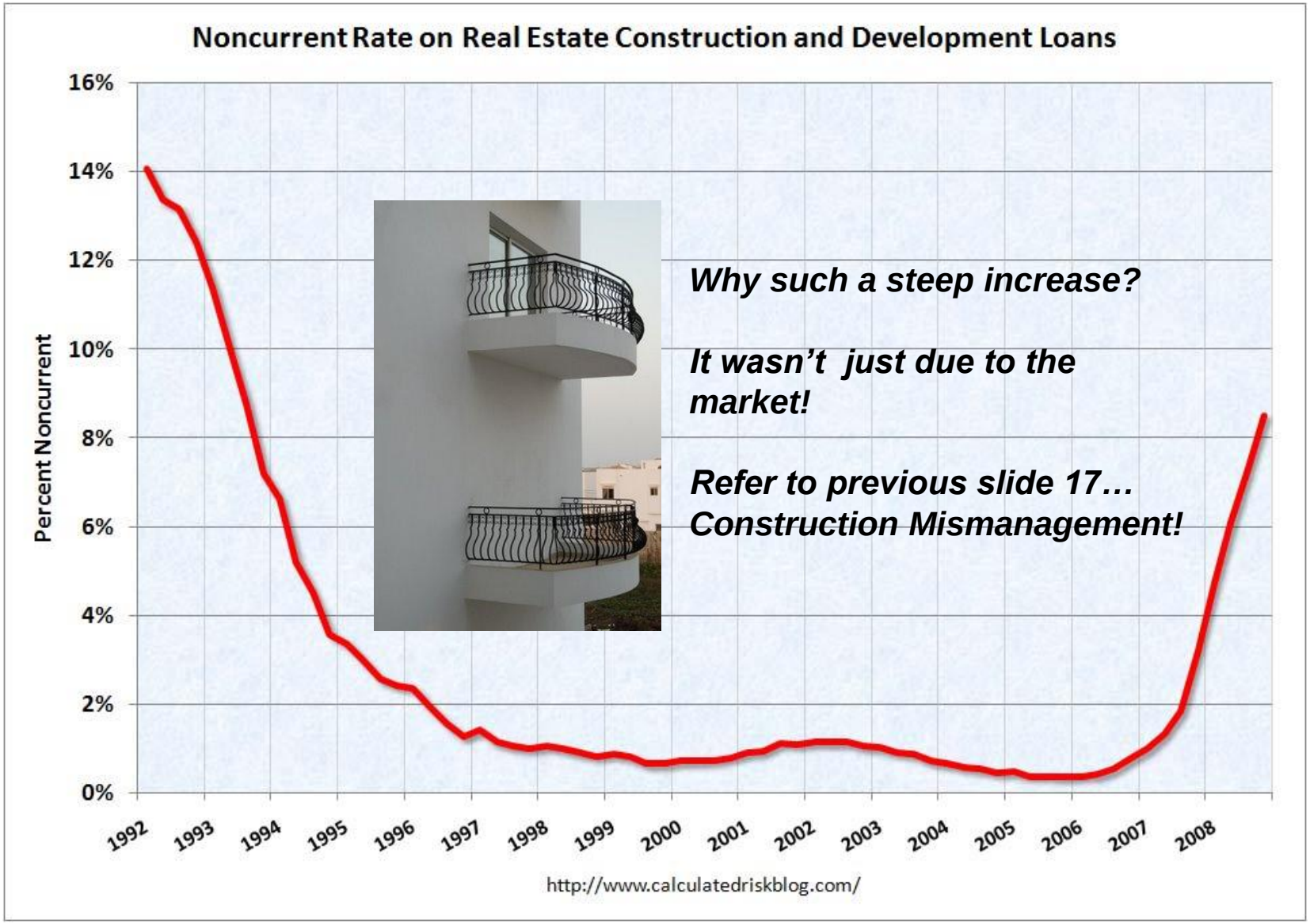
?-1: In light of economic conditions, mortgage losses, negative HPA, negative home equity, ReFi GAP in Commercial R.E. etc., do "declining Provisions" strike you as odd?

?-2: What does a negative ROA for Atlanta 6th Fed District, FL & GA banks suggest to you Vs the other 11 Fed Districts?

The "Noncurrent Rate" on C&D loans now exceeds 8%

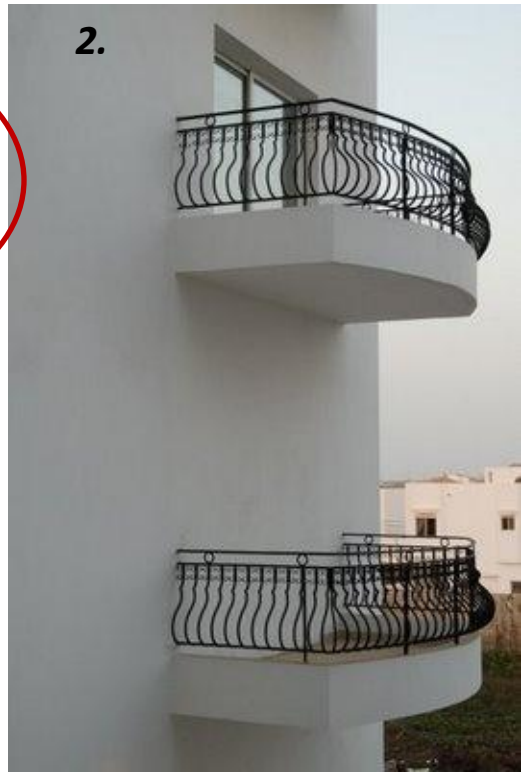
Q. Will it surpass the 1992 record of 14%?

R. Yes - If more of the following is in bank portfolios.



Construction Lending and Management of the process was NOT well administered by banks in this last cycle.

Construction Management is a material factor in construction lending losses.



Will the banks be there to lend with this kind of construction oversight?

How much capital to fix?

<u>Construction "mis-Management"</u>

Actual photos from UPDATE appraisals by banks with "Impaired CRE" projects.

The appraiser "assumed away" the construction defects (Hypothetical Vs. Extraordinary Assumption), and the Bank:

i) had a <u>"lax" construction mgmnt</u>;
ii) a weak <u>"Administrative" appraisal</u> review program; and
iii) had <u>not inspected</u> the collateral

Another hit to bank capital - GSEs forcing mortgage buybacks

March 5 (Bloomberg):

Fannie Mae and Freddie Mac may force lenders including Bank of America Corp., JPMorgan Chase & Co., Wells Fargo & Co. and Citigroup Inc. to buy back $21 billion of home loans this year as part of a crackdown on faulty mortgages.

U.S. banks could suffer losses of $7 billion this year when those loans are returned and get marked down to their true value, according to estimates by Oppenheimer & Co. analyst Chris Kotowski. Fannie Mae and Freddie Mac, both controlled by the U.S. government, stuck the four biggest U.S. banks with losses of about $5 billion on buybacks in 2009, according to company filings made in the past two weeks.
The surge shows lenders are still paying the price for lax standards three years after mortgage markets collapsed under record defaults. Fannie Mae and Freddie Mac are looking for more faulty loans to return after suffering $202 billion of losses since 2007, and banks may have to go along, since the two U.S.- owned firms now buy at least 70 percent of new mortgages.
"If you want to originate mortgages and keep that pipeline running, you have to deal with the pushbacks," said Paul Miller, an analyst at FBR Capital Markets in Arlington, Virginia, and former examiner for the Federal Reserve. "It doesn't matter how much you hate Fannie and Freddie."

Freddie Mac forced lenders to buy back $4.1 billion of mortgages last year, almost triple the amount in 2008, according to a Feb. 26 filing. As of Dec. 31, ***Freddie Mac had another $4 billion outstanding loan-purchase demands that lenders had not met, according to the filing. Fannie Mae didn't disclose the amount of its loan-repurchase demands***. Both firms were seized by the government in 2008 to stave off their collapse.

Foreclosure Fraud: It's Worse Than You Think
Tuesday, 12 Oct 2010
By: Diana Olick
CNBC Real Estate Reporter

There has been plenty of pontificating over the ramifications of foreclosure freezes on troubled borrowers, foreclosure buyers and the larger housing market, not to mention lawsuits, investor losses and bank write downs. There has been precious little talk of what the real legal issues are behind the robosigning scandal. Yes, you can't/shouldn't sign documents you never read, but that's just the tip of the iceberg. ***The real issue is ownership of these loans and who has the right to foreclose.*** By the way, despite various comments from the Obama administration,
foreclosures are governed by state law. There is no real federal jurisdiction.

Excellent job by Citi (Keith Horowitz and Josh Levin for coverage on the issue!

A source of mine pointed me to a recent conference call Citigroup had with investors/clients. It featured Adam Levitin, a Georgetown University Law professor who specializes in, among many other financial regulatory issues, mortgage finance. ***Levitin says the documentation problems involved in the mortgage mess have the potential "to cloud title on not just foreclosed mortgages but on performing mortgages."***

The issues are securitization, modernization and a whole lot of cut corners. Real estate law requires real paper transfer of documents and titles, and a lot of the system went electronic without much regard to that persnickety rule. Mortgages and property titles are transferred several times in the process of a home purchase from originators to securitization sponsors to depositors to trusts. Trustees hold the note (which is the IOU on the mortgage), the mortgage (the security that says the house is collateral) and the assignment of the note and security instrument.

The issue is in that final stage getting to the trust. The law demands that when the papers get moved around they are "wet ink," that is, real signatures on real paper. But Prof. Levin tells me that's not the worst of it. Affidavits assigned to the notes and security instruments are supposed to be endorsed over to the trust at the time of sale, but in many foreclosure scenarios the affidavits have been backdated illegally.
So with the chain of documentation now in question, and trustee ownership in question, here is one legal scenario, according to Prof. Levitin:
The mortgage is still owed, but there's going to be a problem figuring out who actually holds the mortgage, and they would be the ones bringing the foreclosure.

CMBS delinquencies keep rising - to a record 9.1%. (Sept 2010)

% 30+ Days	
Jul-10	8.71
Jun-10	8.59
May-10	8.42
Apr-10	8.02
Jan-10	6.49
Jul-09	3.71

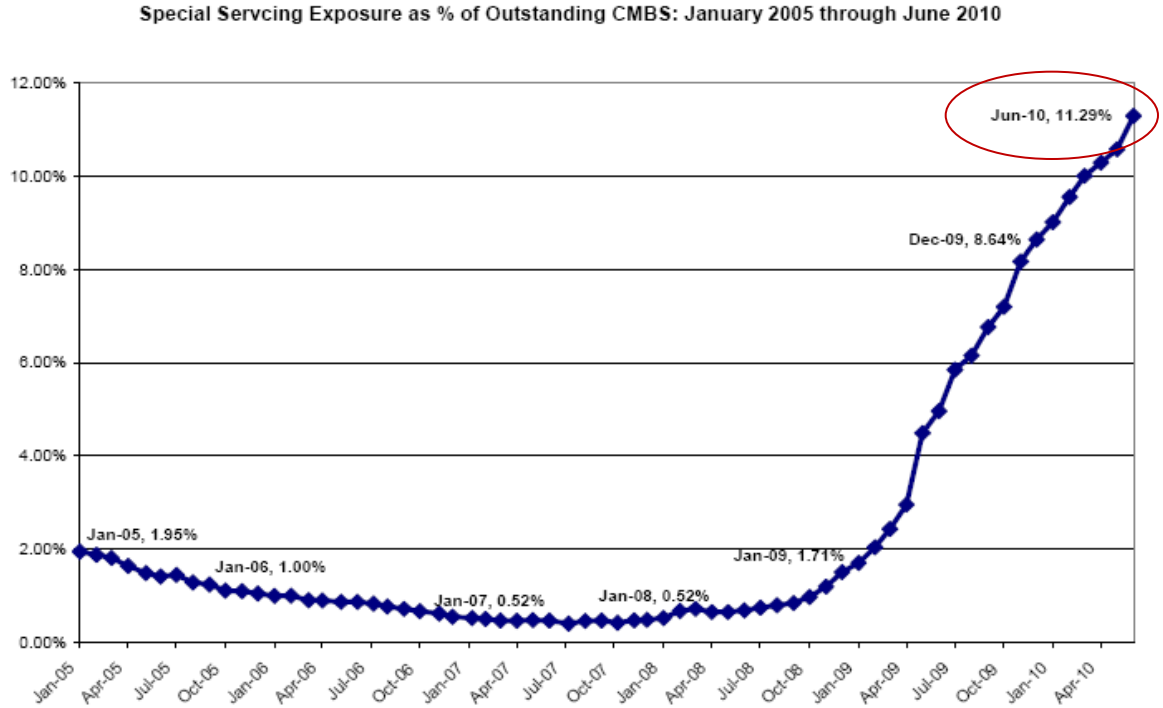
Update:

August delinquencies resumed a higher rate of delinquency.

And Sept kept pace with yet another new record rising from 8.92% to 9.10%. Why? What to expect Q4 2010 and 2011?

Moody's Nov CMBS Tracker puts Oct CMBS delinquency at 8.39% (4,042 loans totaling $52.7 billion – 1st time >4,000 loans

And, the leading indicator of default – LTSS – rises to a record 11.29%



Not So Fast: CMBS Delinquency Rate Jumps 35 Basis Points in November after October's Dip; Rate Back Near 9%

MF Passes Hotels for Distinction of Worst Performing Property Type :

Commentary: For months, we've spoken about the leveling off of the delinquency rate for U.S. commercial real estate loans in CMBS. Beginning in June, what had been 40 basis point increases each month started to turn into 10 to 20 basis point increases.
Finally, in October, came the first dip in the delinquency rate in over a year giving many (including us) the belief that the peak was nearing.
We frequently pointed out however that as special servicers became more adept at processing troubled loans, the delinquency rate would continue to see downward pressure.

The November numbers throw cold water on the enthusiasm that's built up over the last six months.

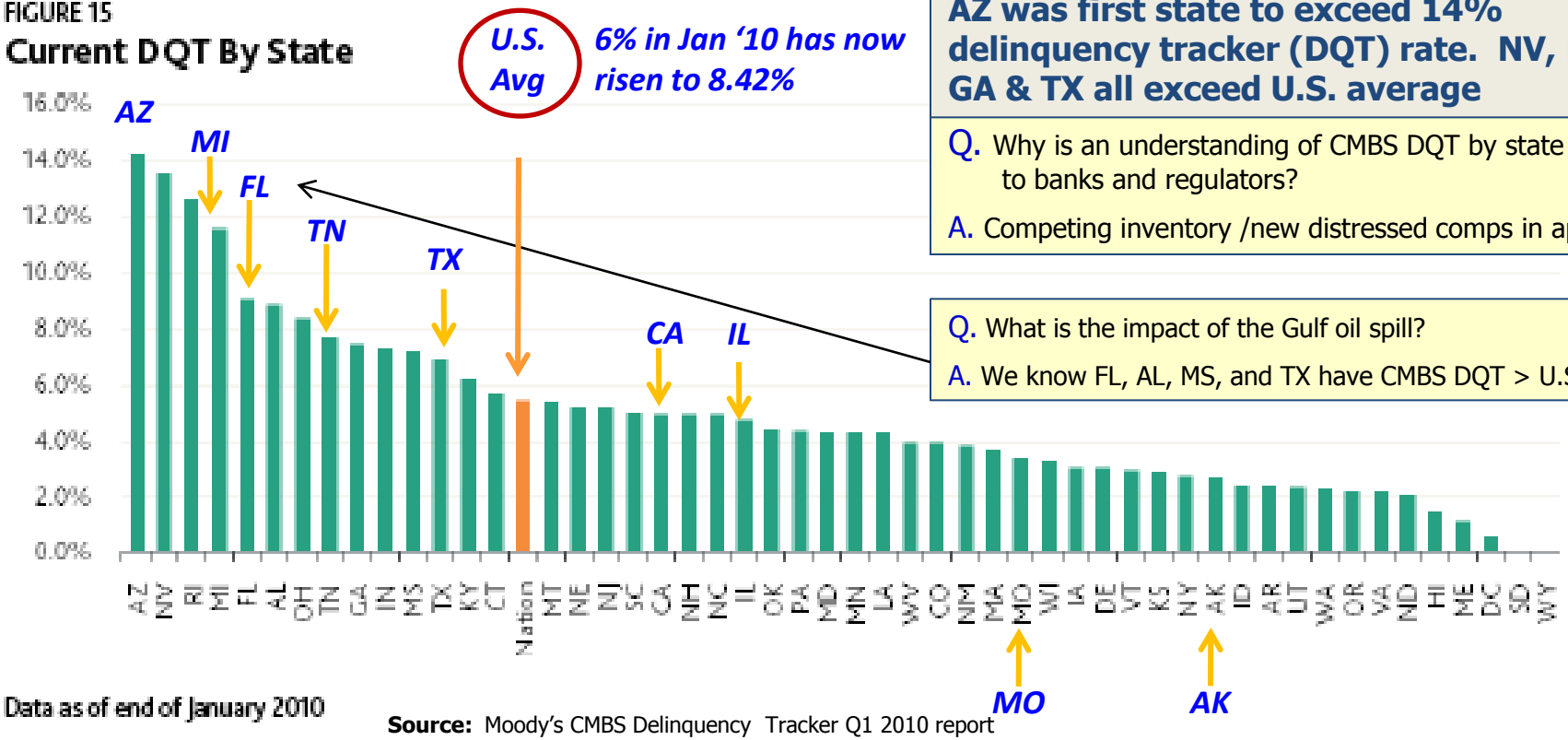
CMBS Delinquency by State
Q. Why so important to banks? R. Competing inventory

Delinquency by State

Figure 15 displays CMBS conduit/fusion delinquency by state. In January, Arizona became the first state to break the delinquency rate barrier of 14%. The delinquency rate in Arizona now stands at 14.23%. The second and third worst performing states, Nevada and Rhode Island, have delinquency rates of 13.51% and 12.64% respectively.

FIGURE 15

Current DQT By State



Data as of end of January 2010

Source: Moody's CMBS Delinquency Tracker Q1 2010 report

AZ was first state to exceed 14% delinquency tracker (DQT) rate. NV, MI, FL, GA & TX all exceed U.S. average

Q. Why is an understanding of CMBS DQT by state important to banks and regulators?

A. Competing inventory /new distressed comps in appraisals

Q. What is the impact of the Gulf oil spill?

A. We know FL, AL, MS, and TX have CMBS DQT > U.S. average

Banks are coming back to CMBS
Current Status*
Top 10 Banks: 7 of 10 are originating

Bank	CMBS 2.0 - Active
Bank of America	Yes
Barclays	*
Citigroup	Yes
Credit Suisse	*
Deutsche Bank	Yes
Goldman Sachs	Yes
J. P. Morgan	Yes
Morgan Stanley	Yes
UBS	*
Wells Fargo	Yes

* Based on public information.

Concluding Key Points regarding the Capital/Bank rail of the R.R. Track.

How much damage has been done to the capital side of the track?

Clearly, there has been a lot of damage to the capital/bank side of the track:

- ***"Charge offs" are climbing to 3% - more than 2X where they peaked in 1992***
- ***Loan Defaults have risen above 4%***
- ***The "noncurrent rate" for construction and development (C&D) loans is nearing 10%***
- ***Former government-sponsored entities (GSEs) are forcing banks to "buy-back" their defaulting mortgages***
- ***CMBS loan delinquencies have hit a record 8.71% and are forecasted to reach 11%***
- ***Loans Transferred to Special Servicing (LTSS) have spiked to 11.29% of all loans***

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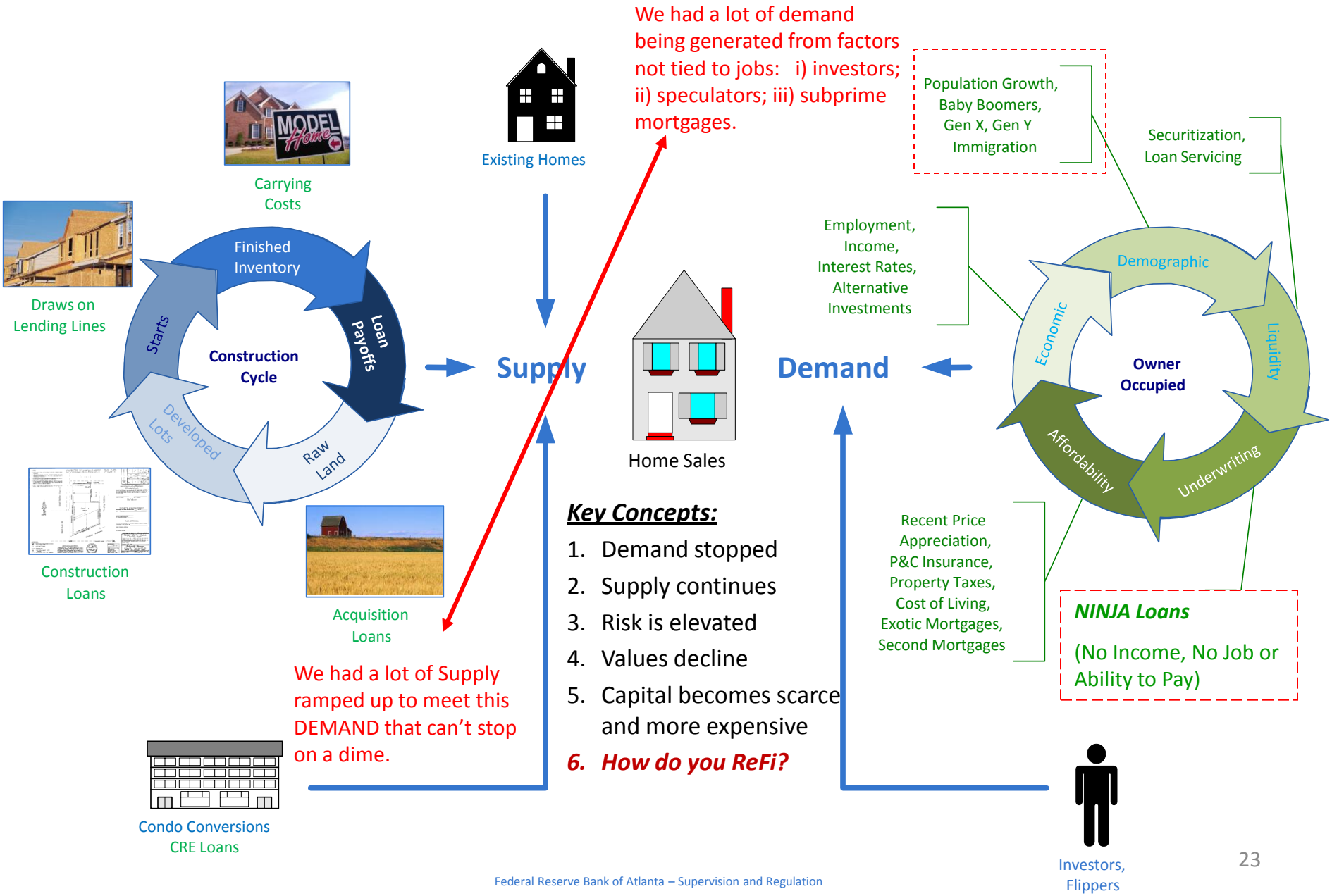
Before we look at CRE conditions…

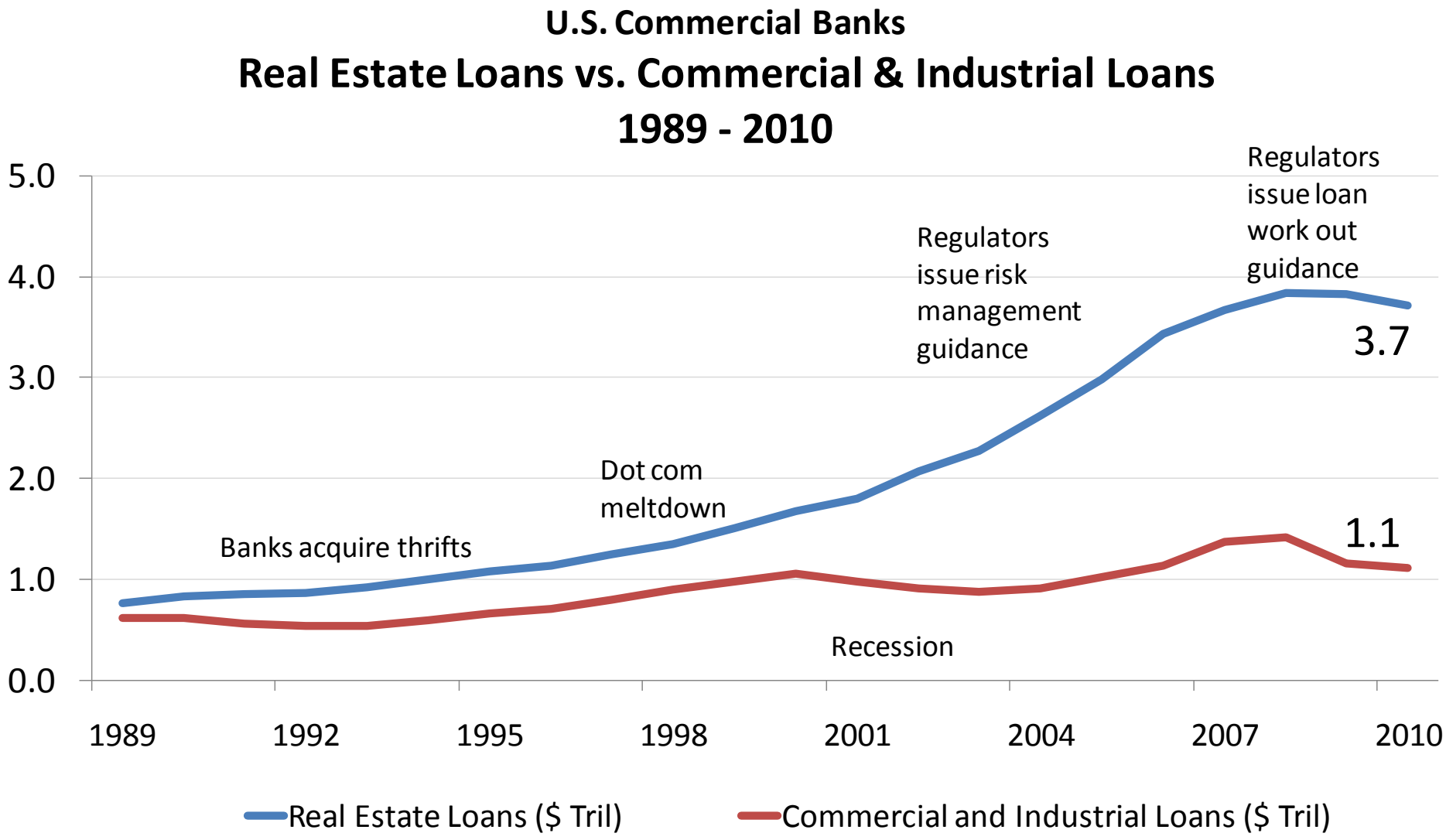
We need to clearly understand WHAT HAPPENED...
And
We need to define the size of the CRE Debt problem

How we got into this CRE crisis
holds the key to unlocking the door to solutions

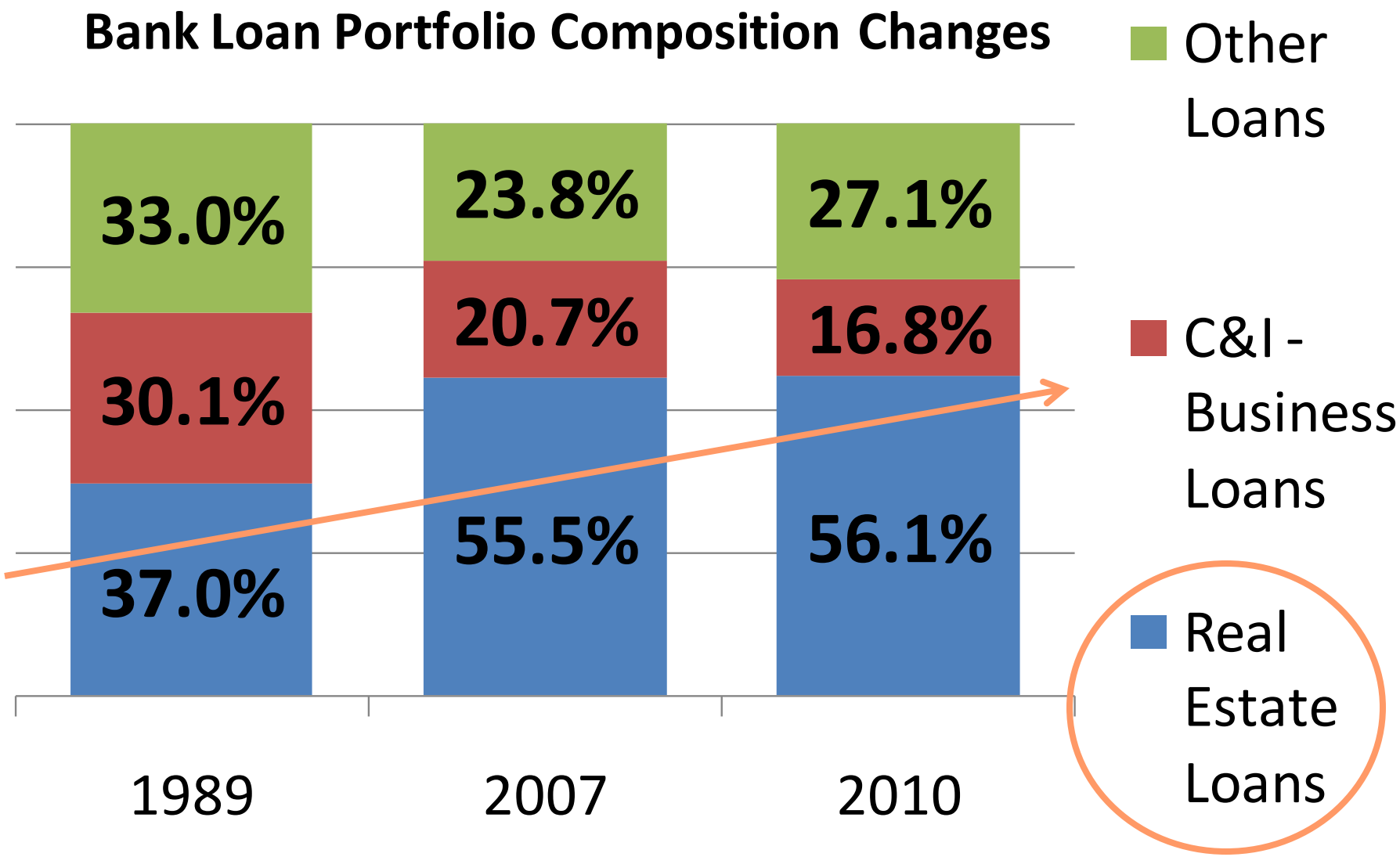
First, how did we get to this situation/dangerous intersection?



The "artificial demand" resulted in banks becoming concentrated in CRE Loans.

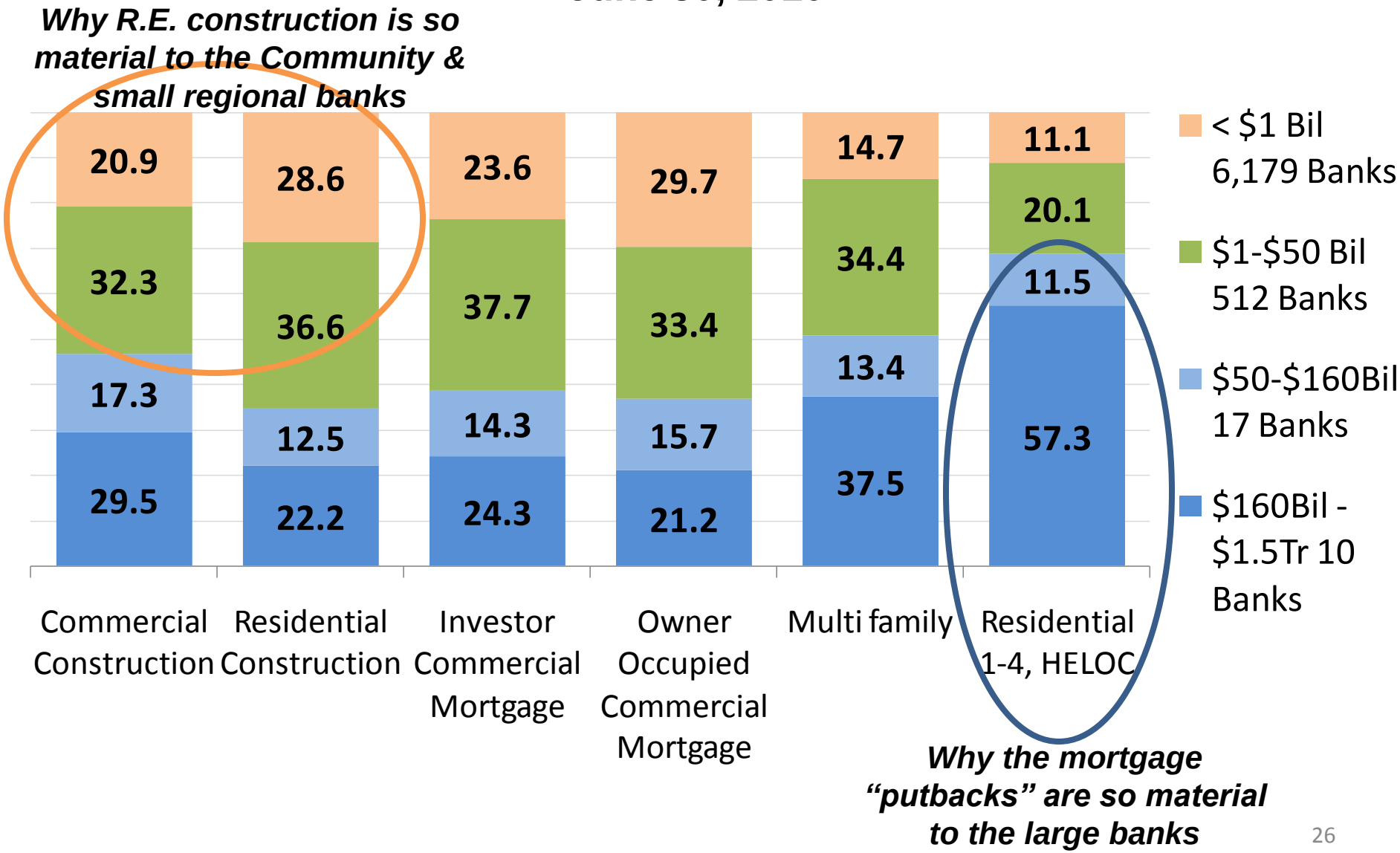


How CRE concentration grew in the Banks (From 37% of All Loans in 1989 to 56%)



Bank Real Estate Loan Type Distribution by Asset Size

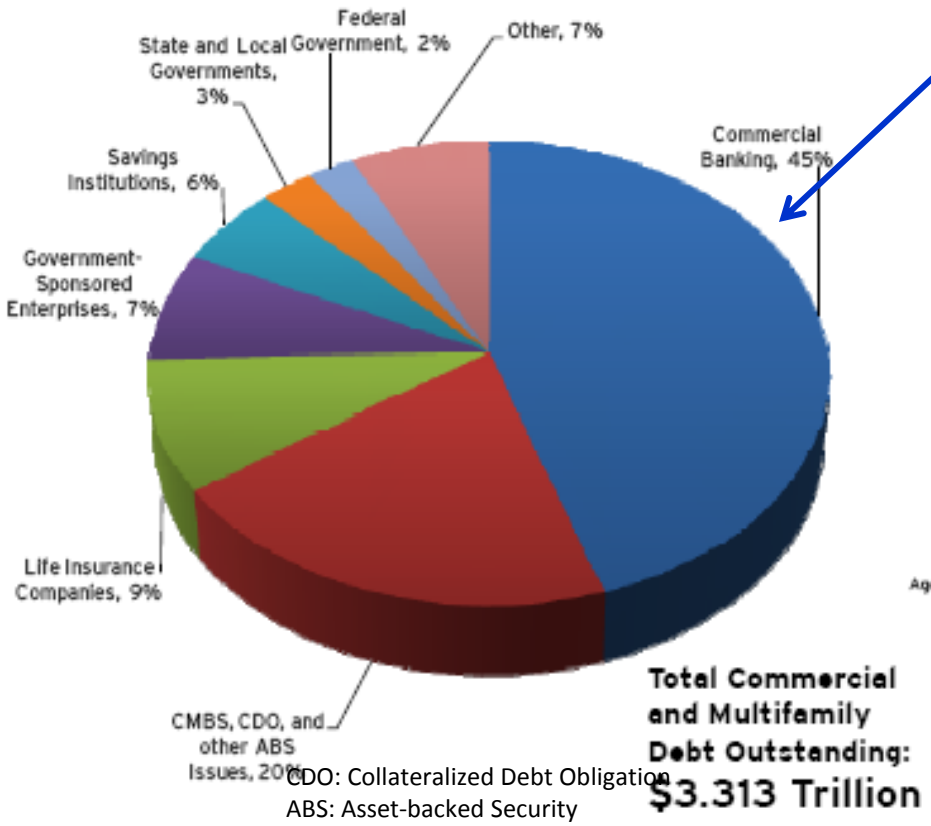
June 30, 2010



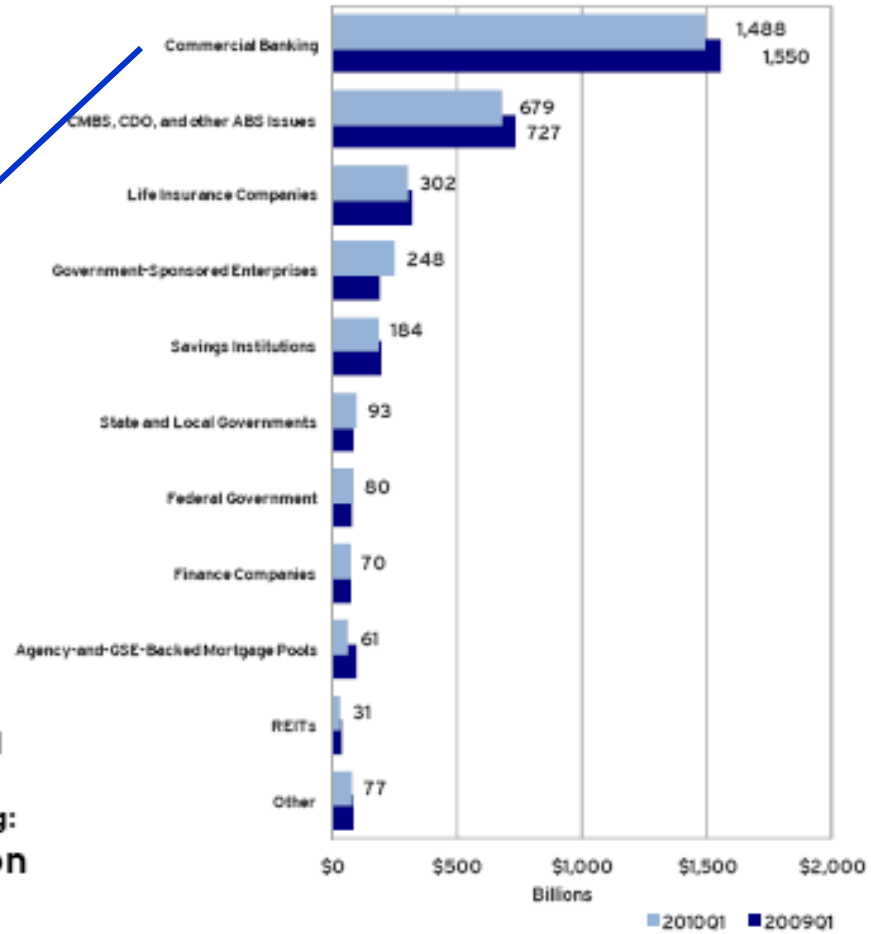
Q. How large is the CRE debt problem?

R. Banks have the largest piece & it quadrupled in from 1998 to 2010 ($800 billion to $3.3 trillion).

Commercial and Multifamily Mortgage Debt Outstanding



CDO: Collateralized Debt Obligation
ABS: Asset-backed Security



Source: Federal Reserve, latest data available as of June 10, 2010

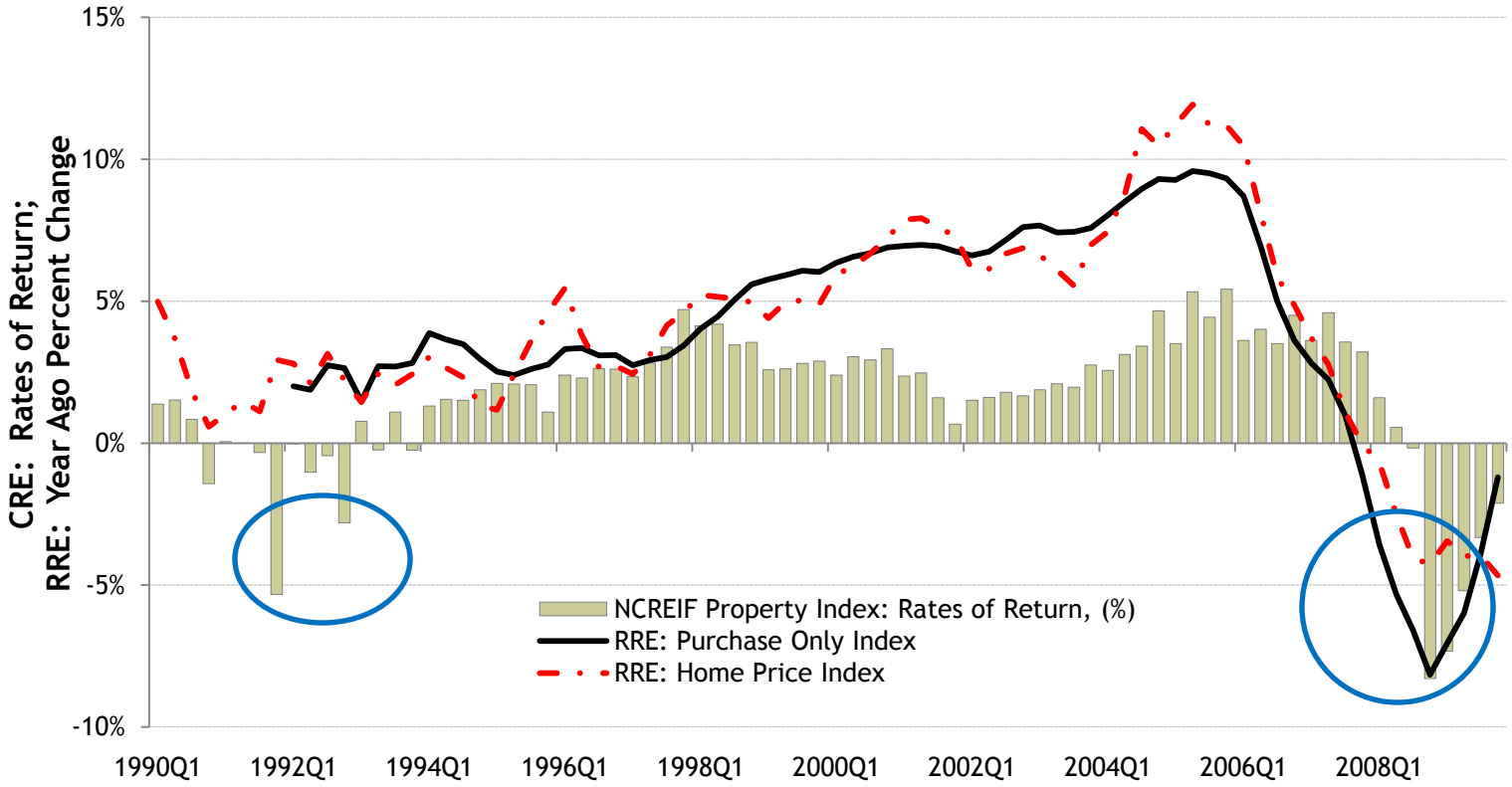
How much damage to the Commercial Real Estate track?

What dangerous crossings lie ahead to cross over to recovery?

Q. How much damage to the Commercial R.E. rail of the R.R Track?

R. Substantial damage to both rails: R.E. and bank capital

<u>Let's start with the R.E. side of the track…</u>

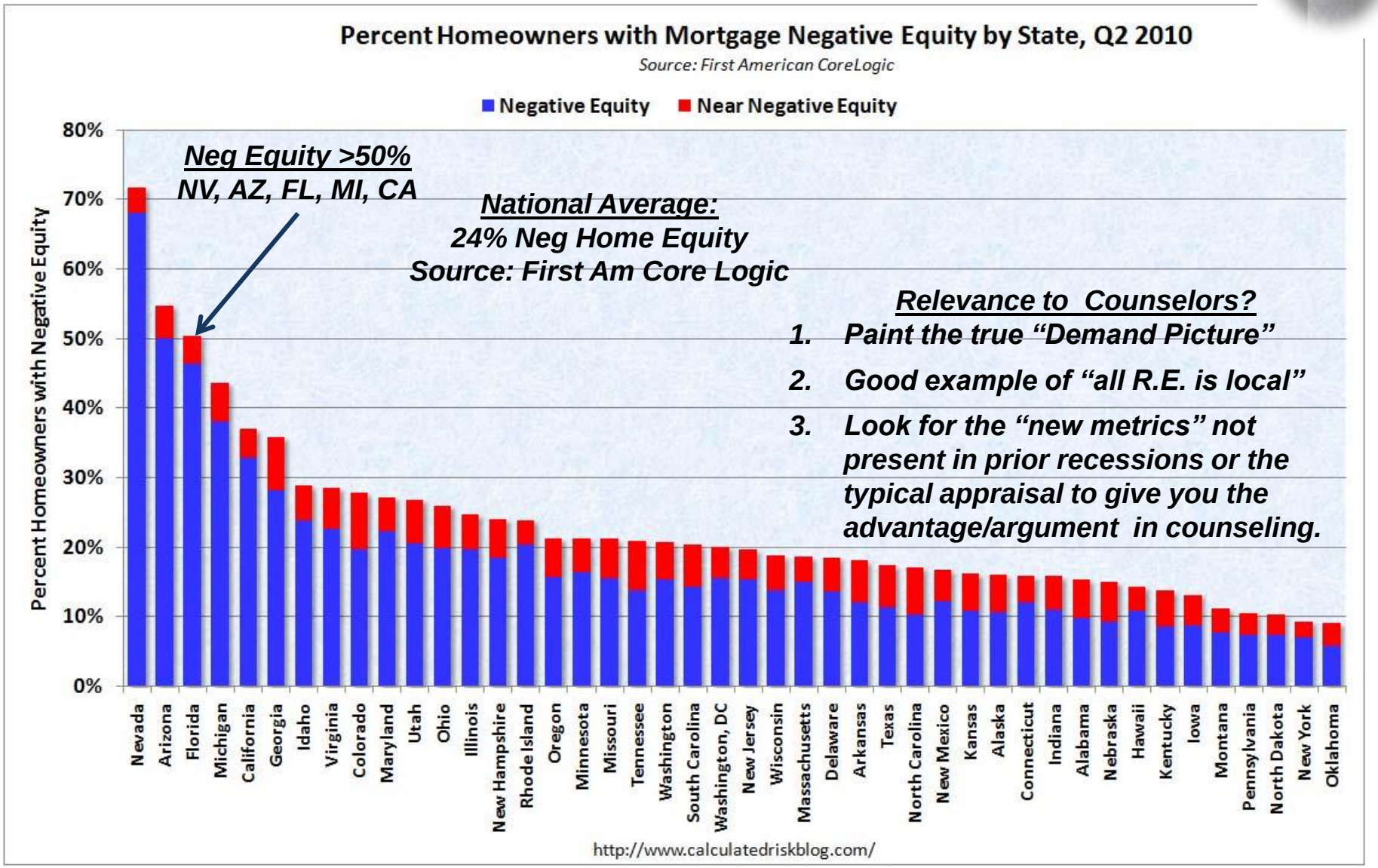


NCREIF: National Council of Real Estate Investment Fiduciaries
RRE: Residential Real Estate

Sources: Federal Housing Finance Agency Purchase Only Home Price Index, Case Shiller Home Price Index, and NCREIF Commercial Property Index

Let's first look closer at Housing, and then Income Producing Real Estate

***Negative Home Equity*: It affects 1 in 4 US households.**



Top 25 Markets for Negative Equity (2010Q2)

	Properties With a Mortgage Outstanding					$ Outstanding (billions)			
Market	Mortgages	Negative Equity Mortgages	Near** Negative Equity Mortgages	Negative Equity Share	Near** Negative Equity Share	Total Property Value	Mortgage Debt Outstanding	Net Homeowner Equity	Loan-to-Value Ratio
Nation	**47,802,783**	**10,971,224**	**2,356,100**	**23.0%**	**4.9%**	**12,707.0**	**8,875.8**	**3,831.3**	**70%**
Florida	**4,505,328**	**2,092,485**	**179,753**	**46.4%**	**4.0%**	**859.0**	**771.1**	**88.0**	**90%**
Las Vegas	449,205	327,138	15,043	72.8%	3.3%	73.5	96.1	-22.56	131%
Stockton	129,100	80,505	5,257	62.4%	4.1%	24.2	29.4	-5.19	121%
Modesto	98,742	58,892	4,875	59.6%	4.9%	16.6	19.6	-3.07	118%
Vallejo	92,418	53,536	3,835	57.9%	4.1%	22.3	25.6	-3.27	115%
Phoenix	966,635	541,595	42,781	56.0%	4.4%	190.6	189.3	1.35	99%
Reno	96,588	52,719	4,152	54.6%	4.3%	22.0	21.4	0.69	97%
Port St. Lucie	110,613	59,760	3,610	54.0%	3.3%	17.8	17.6	0.22	99%
Orlando	512,853	276,573	20,605	53.9%	4.0%	88.8	89.5	-0.69	101%
Bakersfield	153,522	79,891	7,298	52.0%	4.8%	23.6	24.7	-1.10	105%
Cape Coral	171,464	88,850	5,778	51.8%	3.4%	33.5	31.6	1.89	94%
Fort Lauderdale	445,092	229,006	16,037	51.5%	3.6%	90.0	85.8	4.17	95%
Riverside	861,023	441,962	38,869	51.3%	4.5%	200.6	201.9	-1.28	101%
Lakeland	119,600	59,125	4,935	49.4%	4.1%	15.5	15.5	0.01	100%
Miami	522,653	255,612	17,074	48.9%	3.3%	120.4	106.6	13.78	89%
Palm Bay	153,134	74,533	5,557	48.7%	3.6%	22.1	21.2	0.86	96%
Fresno	153,362	71,850	6,985	46.8%	4.6%	28.2	27.3	0.87	97%
Tampa	684,097	319,367	30,074	46.7%	4.4%	113.1	103.3	9.87	91%
Flint	75,872	35,244	3,882	46.5%	5.1%	7.9	7.6	0.33	96%
Detroit	270,865	125,602	14,278	46.4%	5.3%	32.1	29.8	2.24	93%
Visalia	69,237	31,027	3,346	44.8%	4.8%	10.8	10.4	0.42	96%
Deltona	127,566	57,071	4,956	44.7%	3.9%	19.4	17.5	1.87	90%
West Palm Beach	343,703	151,721	12,931	44.1%	3.8%	84.2	70.9	13.28	84%
Jacksonville	335,193	147,271	16,979	43.9%	5.1%	61.0	52.5	8.51	86%
Warren	523,010	228,916	28,934	43.8%	5.5%	85.6	76.8	8.79	90%
Sarasota	199,888	87,434	7,087	43.7%	3.5%	42.6	36.5	6.07	86%

US = 24%

FL = 48%

ORL=53%

This data only includes properties with a mortgage. Non-mortgaged properties are by definition not included. Only markets with 50,000 or more loans are included.

** Defined as properties in negative equity or within 5% of being in a negative equity position.

Source: CoreLogic

OCC / OTS Mortgage Modification Metrics Report:

Performance on home mortgages serviced by the largest national banks and federally regulated thrifts ***declined for the seventh consecutive quarter in the fourth quarter of 2009***.

The *OCC and OTS Mortgage Metrics Report for the Fourth Quarter 2009* showed the overall percentage of current and performing mortgages fell to 86.4 percent at the end of 2009, driven by an increase in mortgages that were 90 or more days past due. ***Prime mortgages***, which make up two-thirds of the mortgages in the portfolio, ***continued to have the greatest increases in delinquency***.

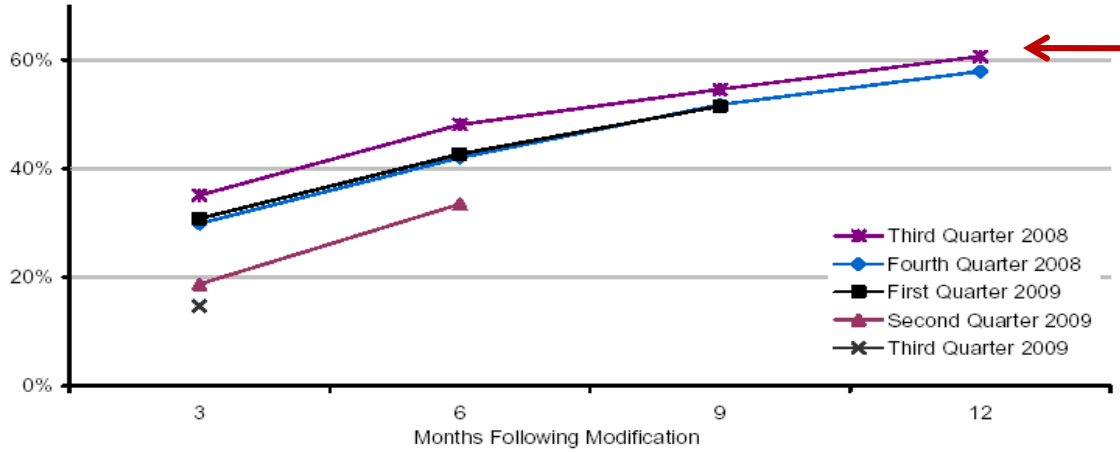
Table 39. **Number of Foreclosures in Process**

	12/31/08	3/31/09	6/30/09	9/30/09	12/31/09	1Q %Change	1Y %Change
Prime	295,952	409,313	497,266	540,762	527,792	-2.4%	78.3%
Alt-A	141,708	172,268	191,456	205,343	199,254	-3.0%	40.6%
Subprime	172,744	184,468	199,432	220,106	216,519	-1.6%	25.3%
Other	84,835	94,980	104,400	125,409	135,821	8.3%	60.1%
Total	695,239	861,029	992,554	1,091,620	1,079,386	-1.1%	55.3%
Percentages of Foreclosures in Process Relative to Mortgages in that Category							
Prime	1.3%	1.8%	2.2%	2.3%	2.3%	-2.7%	77.0%
Alt-A	4.0%	4.9%	5.4%	5.8%	5.6%	-4.0%	40.9%
Subprime	5.7%	6.4%	7.0%	7.9%	7.8%	-1.1%	37.9%
Other	1.7%	2.0%	2.3%	2.7%	3.1%	15.5%	82.7%
Total	2.0%	2.5%	2.9%	3.2%	3.2%	-0.5%	58.6%

Note:
In calendar year 2009, there was a 78% increase in "prime" mortgage foreclosures

Figure 11. **Modified Loans 60 or More Days Delinquent**

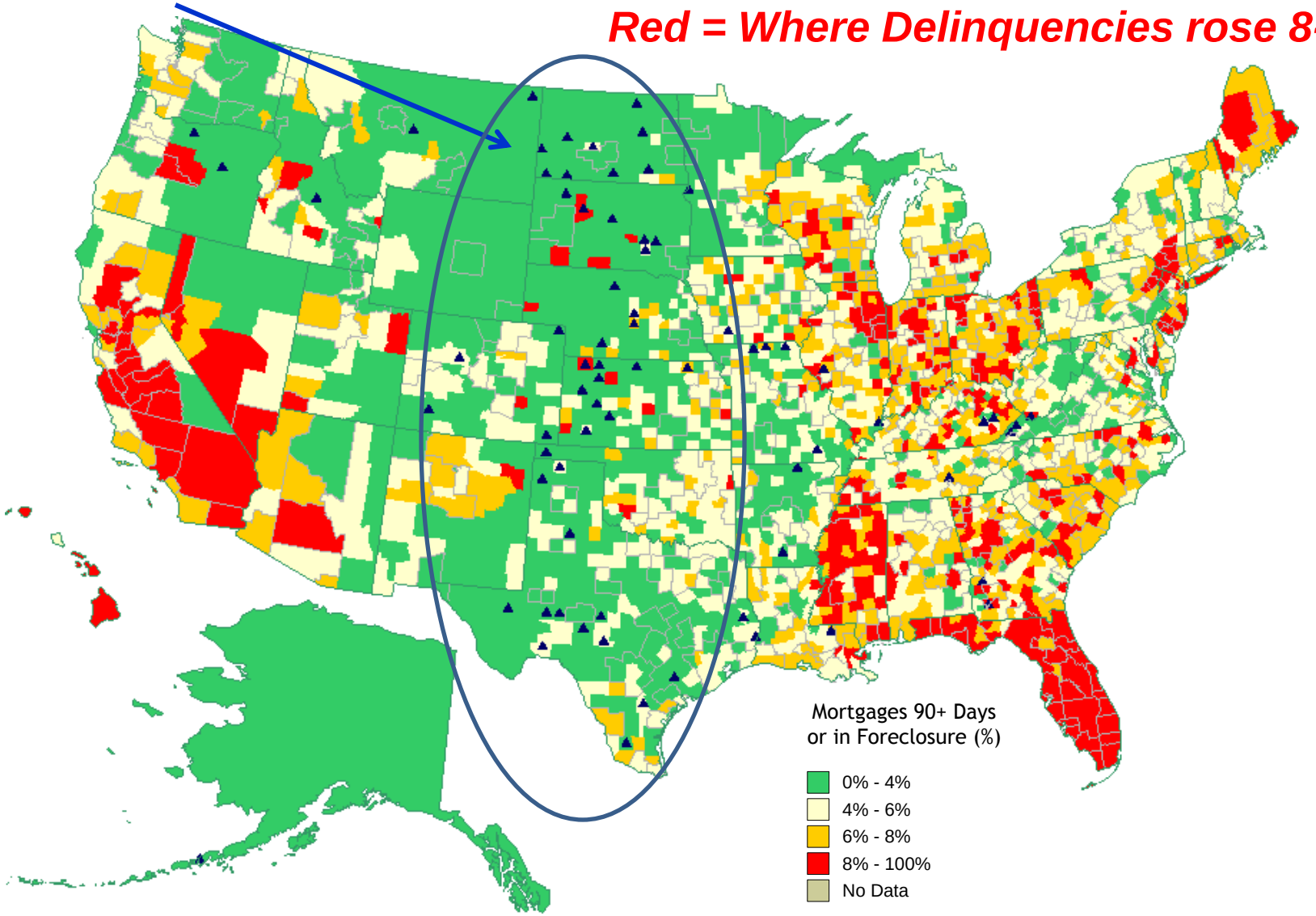
60+ Re-Default Rate for 2008-2009 Modifications



Note:
Nearly 60% of all loan modifications default again within 12 months

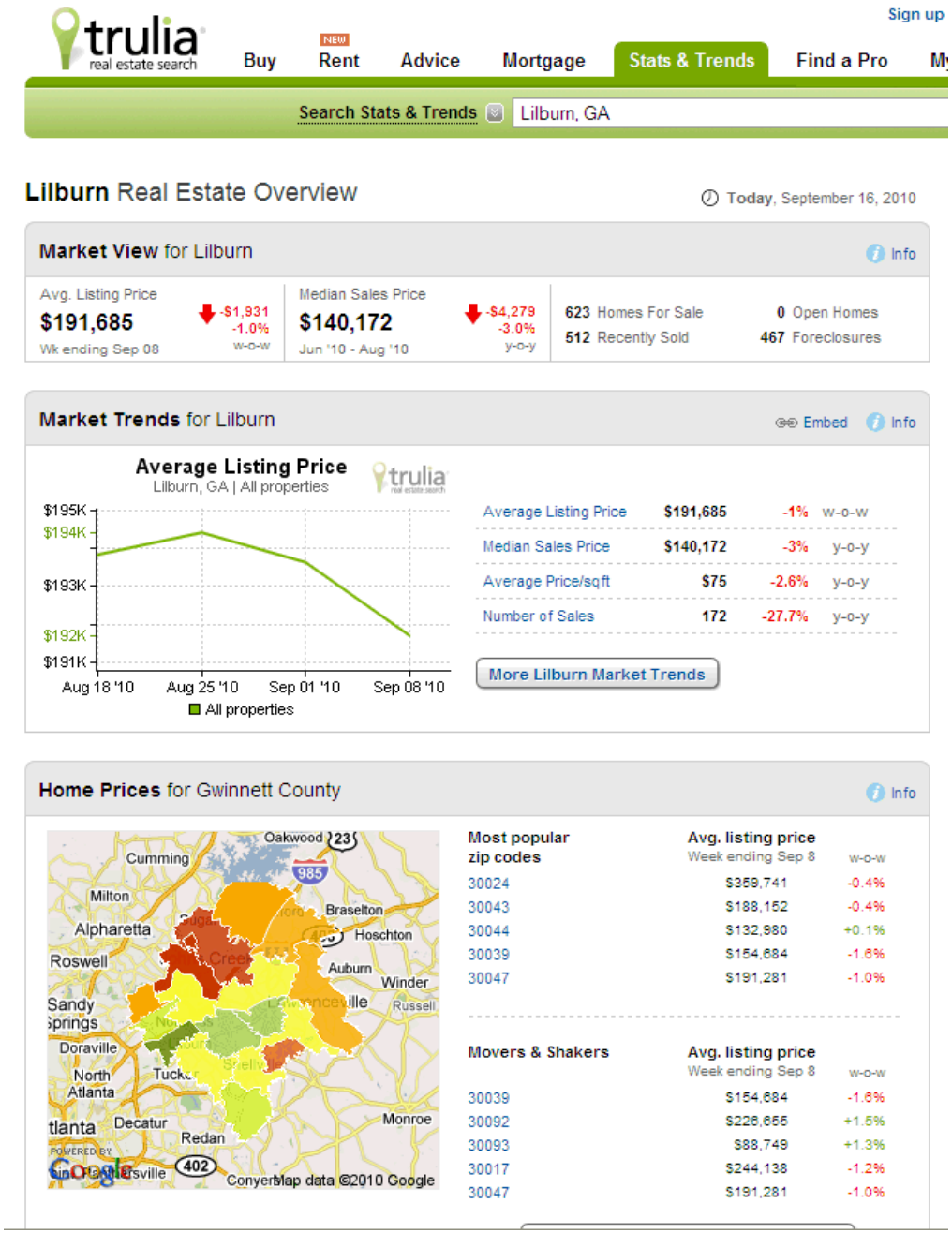
Mortgage Delinquencies: Where is it worst?
Triangles indicate where delinquencies have doubled over 2009

Red = Where Delinquencies rose 8-10%



Note: Triangles indicate counties where percentage of seriously delinquent mortgages have more than doubled over the past year.
Source: Lender Processing Services (LPS)

A great free resource: Let me teach you to be a fisherman Vs provide you fish.



Key Notes:

1. ***Trulia.com***
2. ***A free website***
3. ***View down to zip code***
4. ***467 of 512 sales were foreclosures in my neighborhood.***
5. ***A lot of homes for sale***
6. ***Trend lines and heat maps to make analysis easy. You are empowered on housing.***

So with this type of info easily at the disposal of appraisers at no charge, why do we still get such bad appraisal work? This should arm you to have a "fisherman discussion" with your banks.

U.S. Home Sales at Lowest Level in More Than a Decade

NY Times – August 24, 2010 By **DAVID STREITFELD**

Housing sales in July plunged to their lowest level in more than a decade, exceeding even the grimmest forecasts.

The National Association of Realtors said Tuesday that the seasonally adjusted annual sales rate of

3.83 million was 25.5 percent below the level of July a year ago.

Key Note: ↓25.5%

July was the first month that buyers could not qualify for a tax credit of up to $8,000, so analysts were expecting weak results. But their consensus called for a decline of about 13 percent. Jennifer H. Lee, senior economist for BMO Capital Markets, called the numbers "truly gut-wrenching."

Those on the front lines of real estate describe an absolute standoff between buyers and sellers. "What few buyers are out there circle a listing like a vulture, waiting from the day of its debut until it's left for dead, contacting us only after it has left the market to ask what it sold for and whether it's taking backup offers," said Glenn Kelman, chief executive of the online brokerage Redfin.

Mr. Kelman noted that what made the sales drop "even more breathtaking" was that it was happening in July, a month when demand typically peaks. "Prices will have to drop again in most markets before buyers come back in force," Mr. Kelman said, "and so sales volume will probably be in the tank at least until next spring."

July sales were down 27.2 percent from June.

It was the lowest rate for existing-home sales, which include houses, condos, co-ops and town houses, since 1999. For sales of single-family homes, it was the lowest rate since 1995.

Key Note: 1995 level

The number of homes on the market increased only slightly but the large drop in sales was enough to push inventory levels up to 12.5 months. A normal market has an inventory level of less than six months.

Key Note: 12.5 months What is equilibrium? (6 Months)

The drop in sales came despite the lowest mortgage rates in decades. The Realtor group was optimistic the fall-off would be temporary, as long as the economy improves — a rather big "if."

So we know the housing numbers, what are the residential land numbers?

VDL – Vacant Developed Lot #s are at 6-year levels

18-24 months is equilibrium (A long hold on land)

Market	New Housing MOS 2010Q2	New Housing MOS 2009Q2	VDL MOS 2010Q2	VDL MOS 2009Q2
United States*	**10.2**	**10.2**	**71**	**84**
Bradenton	8.8	6.7	85	94
Cape Coral	9.7	7.6	99	166
Deltona	10.0	8.3	145	186
Fort Lauderdale	15.3	18.3	54	111
Gainesville	10.4	13.4	137	185
Jacksonville	11.4	10.4	99	106
Lakeland	10.8	8.7	202	166
Miami	31.3	19.5	235	156
Naples	12.0	13.8	96	146
Ocala	9.8	7.1	420	199
Orlando	11.4	11.2	108	129
Palm Bay	8.7	7.5	106	134
Palm Coast	15.2	8.4	2,351	727
Port St. Lucie	21.7	13.7	540	674
Punta Gorda	29.9	18.7	2,692	2,035
Sebastian	18.5	10.9	333	214
Tampa	12.1	11.2	80	88
West Palm Beach	11.0	8.4	49	75

*Months Supply data are for MetroStudy Sum of Markets

Nation-wide, a 6-year supply of Fin-Vacant Lots

Method from 1978 Al Ed Memorandum to measure…Res Value decline

SUGGESTED METHOD 5 — Development Comparison Method

Many appraisers believe that the entrepreneur's profit should be taken on the total investment the developer has in the property. Data must be obtained from developers who have completed their projects. Data needed is the total sale price, land cost and total development costs and expenses.

A formula for computing the rate of profit can be based on the premise that the gross proceeds from sales equal the sum of land cost, development cost and profit.

Note:
Q. What is the max price a builder can pay for a finished lot?
A. 15%-20% of Home Price.

A = Gross proceeds
B = Land cost (or value)
C = Development cost
D = Rate of profit

Note:
The prices being paid today for residential land correlate to the technique.

$$A = B + C + [D\ (B + C)]$$

Solve for B: Land Value assuming Lot Prices dropped 50%

B=Land Value / A=Gross Proceeds / C=Land Costs (A&D) / D= Developer Profit

Land Value = Gross Proceeds - Land Costs (A&D) - Dev Profit

Project as Planned

B = ($100,000 * 10 lots) - ***30%*** - 20%
B = $1,000,000 - $300,000 - $200,000
B= $500,000

Market DemandDrops 50%

B = ($50,000 * 10 lots) - ***$300,000*** - 20%
B = $500,000 - $300,000 - $100,000
B = $100,000

Note: A 50% decline in retail lot prices results in an 80% decline in land value

Appraisal Institute®

Q. How do you know when land values have bottomed?

R. When land is worth more to the DEAD than the LIVING.

<u>A true Highest & Best Use case study:</u>

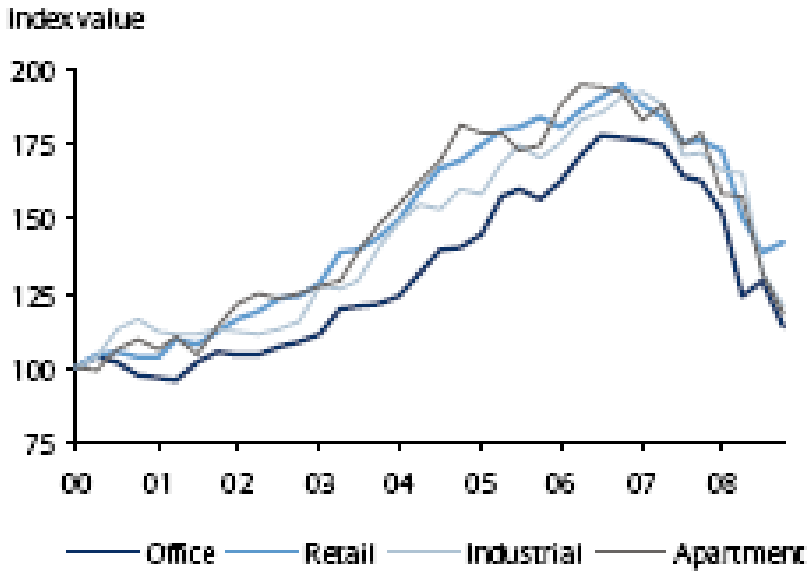
- ***Cemetery <u>corps (no pun intended)</u> are buying failed subdivisions.***
- ***Zoning, plot yield and IRR all excellent in "plot constrained" MSAs.***
- ***Sell entitlements back and infrastructure in-place is usable.***

Now let's take a macro look at Commercial Real Estate Values have followed declining home prices…Why?

2007 Peak to Q1 2010 trough CRE Value Declines:

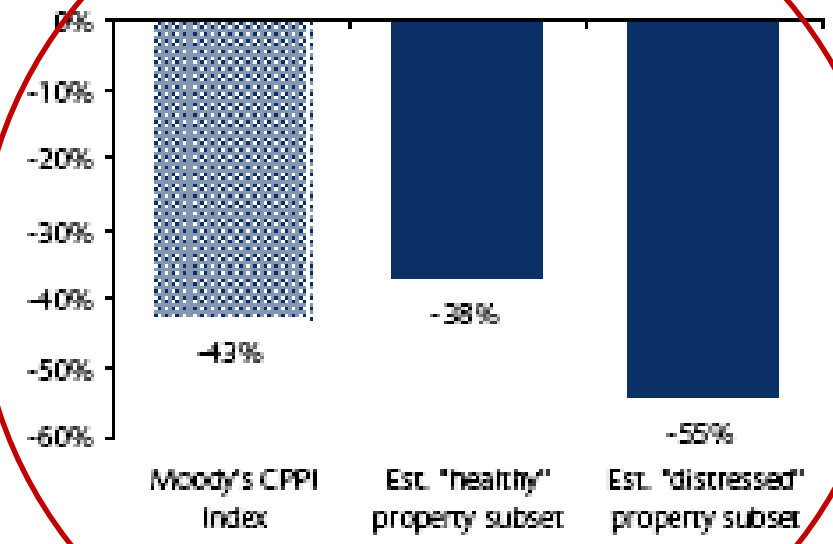
- ***43% overall avg. decline (moderated to 39% - expected to decline in 2H2010)***
- ***Worse decline for "Distressed" CRE (un-leased new constr. & 2nd –Tier MSAs)***
- ***Less decline (35%-40%) for "Healthy" CRE – The decline due to higher Cap Rates.***

Figure 7: CRE values by property type



Source: Moody's CPPI

Figure 8: Distressed versus non-distressed CRE prices



Source: Moody's CPPI, Real Capital Analytics, Prof. David Geltner

Source: Barclays Capital 2010 Outlook Report

Compare Commercial R.E. Decline Over Years

Period	Decline	Duration
1929 to 1933	-44%	4 years
1941 to 1943	-42%	2 years
1989 to 1993	-32% to -51%	4 years
1999 to 2002	-4% to -14%	3 years
2007 to Present	-40%...	3+ years…

Sources: Foresight Analytics, NCREIF, Bureau of Economic Analysis

Consistency between banks & regulators…Sometimes it's accounting (SOP-03-3)

Different Stories | One Chicago development faces foreclosure; the other gets a reprieve

BLOCK 37 Bank of America is pushing to foreclose.

SULLIVAN CENTER PNC has agreed to extend its loan.

SIZE

400,000 square feet of retail space

COST

$173 million mortgage principal

More than $190 million total cost so far, and expected to rise

ABOUT

One of Chicago's original 58 city blocks, zoned in 1830

Held previous landmark McCarthy Building, which the city, led by Mayor Richard Daley, cleared in 1989 for redevelopment

Six developers and architects have so far failed to complete projects on the block

Current owner Larry Freed purchased rights to the project in 2006

Current stores include Puma, L'Occitane en Provence

16 planned stores have yet to open

SIZE

750,000 sq. ft. of office space

250,000 sq. ft. of retail space

1 million sq. ft. total

COST

$170 million mortgage principal

More than $190 million total cost so far, and expected to rise

ABOUT

Architectural landmark designed by Louis Sullivan

Built in 1899; known as Carson Pirie Scott Building for decades

Renovation completed in 2010

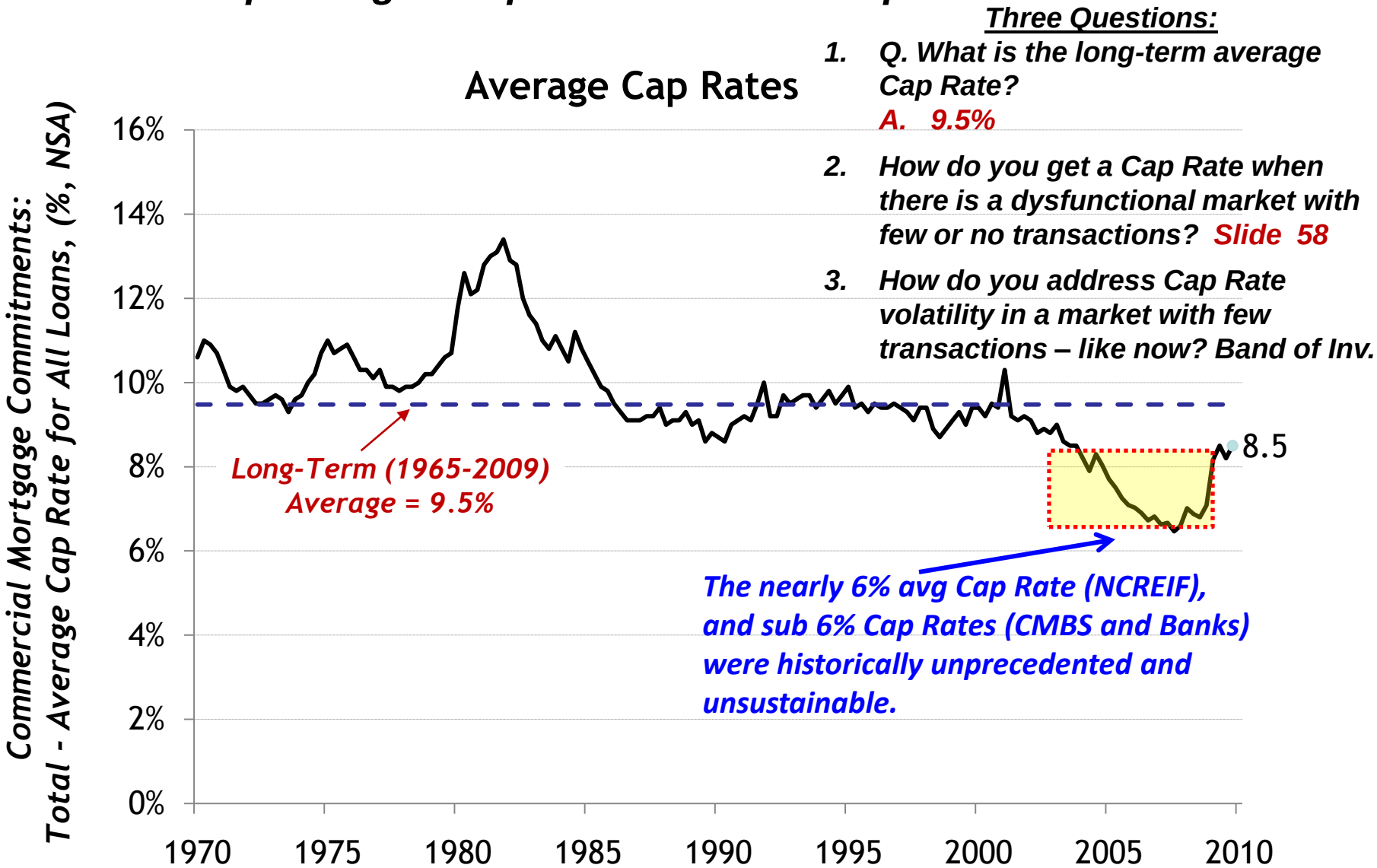
City paid $12 million to restore ornate black ironwork and cornice that face State Street

Tenants include Walgreen Co. and School of the Art Institute of Chicago

Sources: the developers; Block 37 website; City of Chicago Geographic Information Systems; photos by Carlos Javier Ortiz for The Wall Street Journal

Q. What is the Commercial R.E. metric that has had the most material impact on R.E. Values in this recession?

A. The 300 bp swing in Cap Rates Vs 20% drop in NOI.



Three Questions:

1. ***Q. What is the long-term average Cap Rate?***
   A. 9.5%
2. ***How do you get a Cap Rate when there is a dysfunctional market with few or no transactions? Slide 58***
3. ***How do you address Cap Rate volatility in a market with few transactions – like now? Band of Inv.***

Source: American Council of Life Insurers

Why is Cap Rate volatility such an important value concern?

What is selling… influences the Cap Rate more directly.

We now know what a 300 bp swing in Cap Rates does to value

$$\text{Asset Price (Value)} = \frac{\text{Annual Net Operating Income}}{\text{Capitalization Rate}}$$

Cap Rates	6.50%	7.50%	8.50%	Long-Term Average 9.50%	10.50%
Cash Flow Flat	$1,000	$1,000	$1,000	$1,000	$1,000
Value	$15,385	$13,333	$11,765	$10,526	$9,524
Change in Value from Baseline		-13%	-24%	-32%	-38%
Cash Flow Down 10%	$900	$900	$900	$900	$900
Value	$13,846	$12,000	$10,588	$9,474	$8,571
Change in Value from Baseline	-10%	-22%	-31%	-38%	-44%
Cash Flow Down 20%	$800	$800	$800	$800	$800
Value	$12,308	$10,667	$9,412	$8,421	$7,619
Change in Value from Baseline	-20%	-31%	-39%	-45%	-50%

Factors Driving the Decline in CRE Values:

Stage I:

Risk Premiums Return: A return in Cap Rates to LT Averages result in a 1/3 decline in values

Stage II:

Fundamentals Weaken:

2009 Vacancy Rates ↑ >>> NOI ↓ >>> Values ↓

Stage III:

Fundamentals Weaken Further:

2010 Vacancy Rates ↑ >>> NOI ↓ >>> Values ↓

Cap Rate skill set – Let's go back to the tool-bag (Band of Investment & Mortgage Equity techniques)

Pre-2007		***Post 2H08 and Today***	
Required Equity	***20%***	***Required Equity***	***30%***
Need to know:		Need to know:	
Equity IRR	10%	Equity IRR	20% ←
Allowable Debt	***80%***	***Allowable Debt***	***70%*** ←
Use Mtg. Constant	6.42%	Use Mtg. Constant	7.94%
Need to know:		Need to know:	
1. Interest Rate (5% - L+ <200 sprds)		1. Interest Rate (7% - Tr + 300 to 400 sprds)	
2. Loan Amort. (30 yrs)		2. Loan Amort. (30 years)	

Key Analysis Tool

Help you visualize the impact of:

1. ***Less expensive Equity; but***
2. ***More expensive Debt when rates rise***

Indicated Cap Rate:

	Equity	(.20 *.10)
+	Debt	(.80 * .0642)

Indicated Cap Rate: ***7.14%***

Q. How did we get to 4%-6% Cap Rates?

A. The market over-reacted. Leverage >80%?

Indicated Cap Rate:

	Equity	(.30 * .20)
+	Debt	(.70 * .0794)

Indicated Cap rate: ***11.56%***

Q. Why are Cap Rates at 8%-9% Vs. 11%?

A. We may be heading to 11%. Ask what is selling.

"Healthy" Vs. "Distressed" CRE

Conclusion

How much damage to the Commercial R.E. track?

Clearly, there has been a lot of damage to the Real Estate track:

- ***Home Prices have retrenched to pre-2004 levels***
- ***Approximately 25% of all households with a mortgage have "negative equity"***
- ***Commercial R.E. values have fallen 40%-45% from their 2007 peak***
- ***Transactions are off 85%-90% as investors and capital struggle with value***
- ***Appraisals are less reliable, and valuation problems block the track ahead***

Destination Recovery

What dangerous crossings lie ahead for CRE?

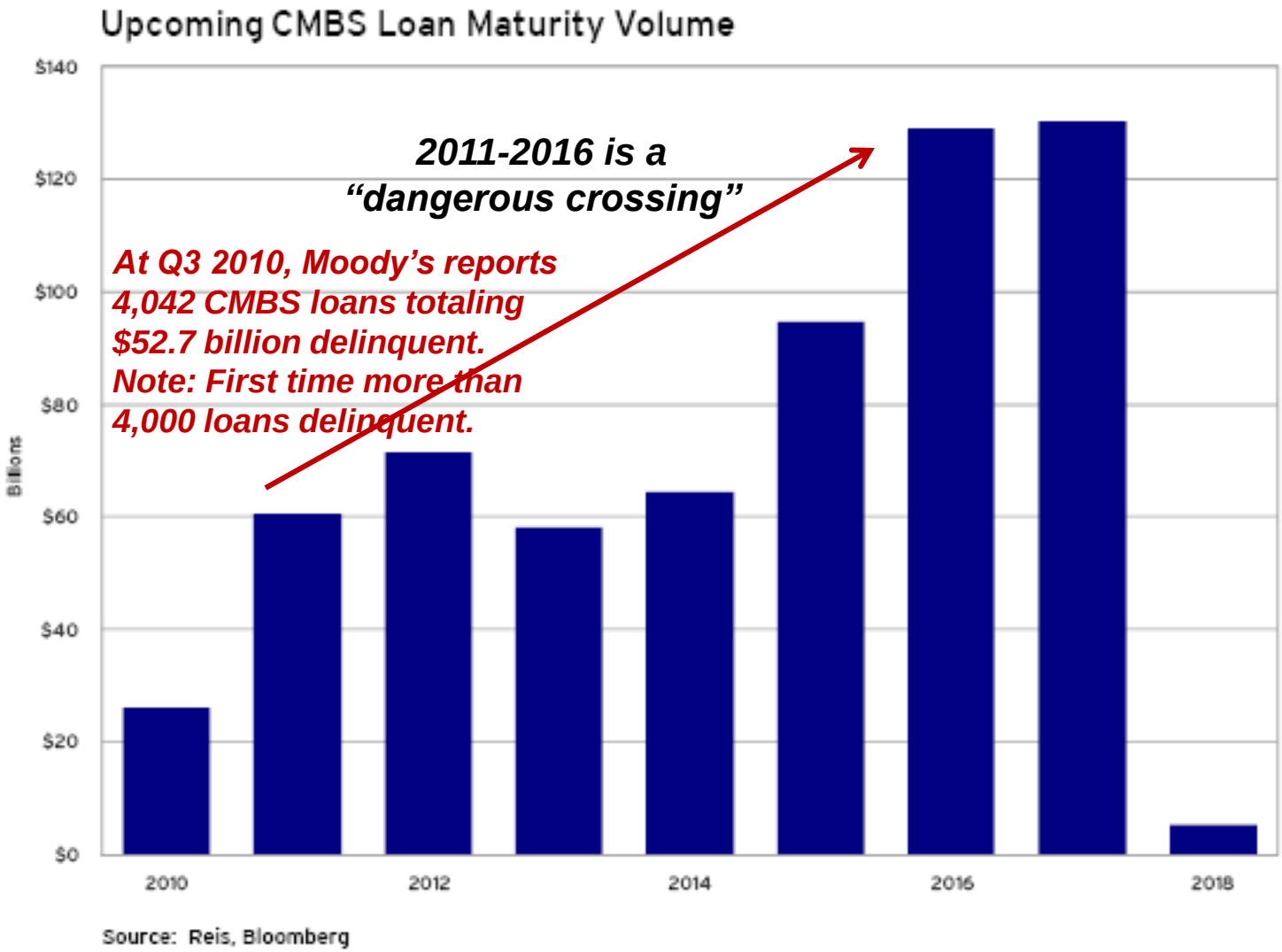
To navigate this kind of crossing,

it is critical that one correctly reads all the signals

<u>Signals</u> – Let's look specifically at <u>five</u> :

1. ***CRE debt maturities***
2. ***Recovery of CMBS***
3. ***Refinance-gap and cap rates***
4. ***Small business lending and linkage to CRE***
5. ***A few key "CRE leading indicators"***

#1 – R.E. Debt Maturities - What is the R.E. debt maturity profile 2010-2017? Is there a window in which this R.E. debt has to cross/refinance?



Other Debt & SNiCs Maturing Debt to compete by 2012

Total SNiCs commitments are > all US "CRE debt" & 7X all CMBS

$5.0 Trillion in Commitments Vs $3.3 Trillion Commercial R.E. debt

US Banks hold only 40% - FBO and Nonbank implications

Table 1: Distribution of SNC Commitments by Lender Type

Lender Type	2009 Total Commitments ($ Trillion)	2010 Total Commitments ($ Trillion)	2009% Total Commitments	2010% Total Commitments
U.S. Banks	$1.2	$1.0	40.8%	40.8%
FBOs	$1.1	$1.0	38.0%	37.9%
Nonbanks	$0.6	$0.5	21.2%	21.3%
Total	$2.9	$2.5	100.0%	100.0%

Loan Distribution by Credit Quality

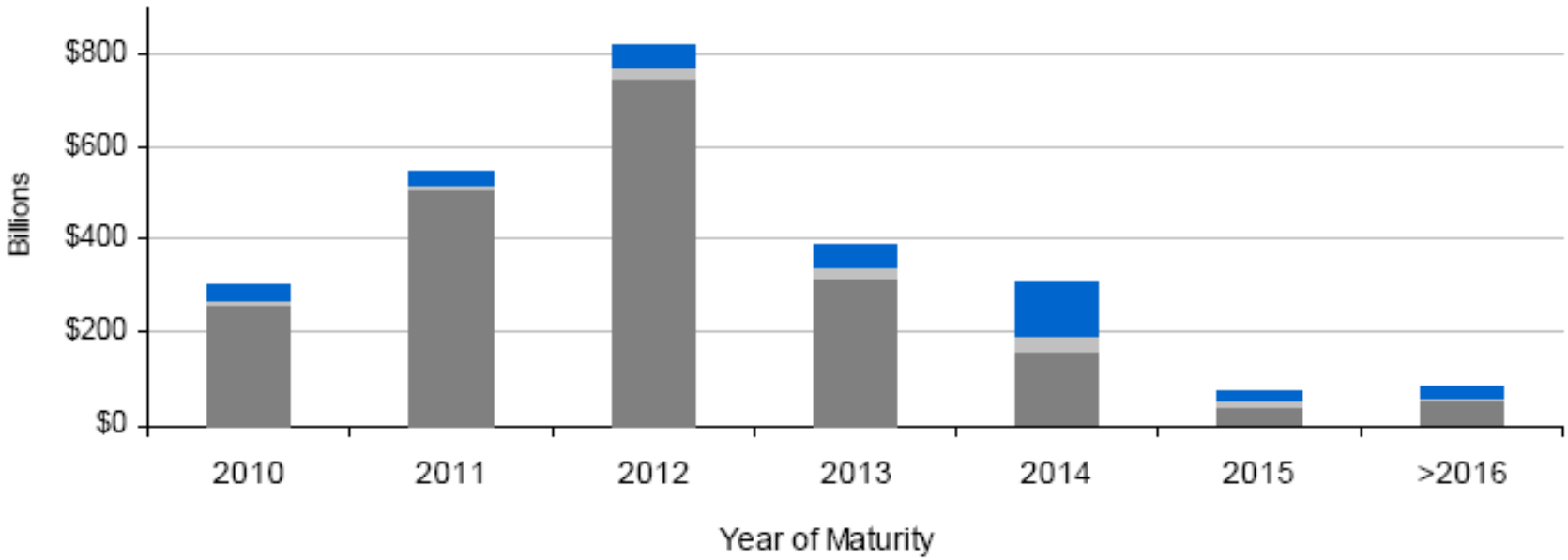
While nonbank entities owned the smallest share of SNC commitments, they owned the largest volume and percentage in dollar value of classified assets at $161 billion, or 52.9 percent of all classified assets (see Appendix C). U.S. banks owned $82 billion of classified assets, or 26.8 percent, and FBOs owned $62.0 billion, or 20.3 percent. In addition, 30.0 percent of nonbank assets were classified compared with only 7.9 percent of the U.S. bank portfolio and 6.0 percent of the FBO portfolio. FDIC-insured institutions owned $69.1 billion of classified assets, or 22.7 percent, a classified percentage of 6.7 percent compared to 9.3 percent in 2009. Of nonaccrual loans, nonbank institutions owned 57.8 percent with $87 billion. FDIC-insured institutions owned only $27.3 billion, or 18.1 percent.

SNiC & other Debt Maturity Profiles is as concerning as Commercial R.E.

2006-2007 Vintage SNiCs also had the weakest underwriting

69% of Criticized SNiCs were originated 2006-2007

Figure 3: SNC Portfolio—Maturity Schedule



Shared National Credits Review for 2010

Poorly underwritten credits originated in 2006 and 2007 continued to adversely affect the portfolio throughout 2009. Approximately 69 percent of criticized assets were originated in these years, and most will mature between 2012 and 2014 (see Figure 3).

#2 - Recovery of CMBS - How does capital come back to R.E.?
Let's look at the structure of post financial crisis issuance
AND…$10 billion new issuance in 2010 isn't $234 billion like 2007

	DDR 2009-DDR 1	BALL 2009-FDG	JPMCC 2009-IWST	RBSCF 2010-MB1
Deal Size	$400mm	$460 mm	$500 mm	$310mm
Deal Type	Single Borrower	Single Borrower	Single Borrower	Multi Borrower
Deal Priced	11/16/2009	12/3/2009	12/10/2009	4/9/2010
Deal Settled	11/25/2009	12/15/2009	12/23/2009	4/22/2010*
Collateral	1 Fixed Rate Whole Loan	1 Fixed Rate Whole Loan	1 Fixed Rate Whole Loan	6 Fixed Rate, First Mortg. Loans
No. of Properties	28	44	55	81
Loan Term	5 Yr / 30 Yr Amort	7 Yr	10 Yr	5 Yr
Sponsor	Developers Diversified Realty Corporation	Flagler Development	Inland Western Retail Real Estate Trust	RBS & Natixis
Originator	Goldman Sachs Mortgage Company	Bank of America	JP Morgan Chase	Royal Bank of Scotland
Operating Advisor	SitusServ L.P.	-NA-	-NA-	-NA-
Master Servicer	Wells Fargo Bank	Bank of America	KeyCorp Real Estate	Wells Fargo Bank
Special Servicer	Wells Fargo Bank	Bank of America	KeyCorp Real Estate	Wells Fargo Bank
Trustee	Citibank	Wells Fargo Bank	Wells Fargo Bank	Citibank
Rating Agencies	Fitch/Moody's/S&P	Fitch/S&P	Real Point/S&P	Moody's/Realpoint
LTV	51.70%	51.50%	73.35%	54.40%
Rating Agency Stressed LTV	64.31% (S&P)	73.13% (S&P)	73.35% (S&P)	65.3% (Moody's)
AAA Pricing	S+140	S+225	A1: S+150; A2: S+205	A1: S+80; A2: S+90
AA Pricing	S+327	S+400	S+360	S+190
A Pricing	S+374	S+450	S+420	S+290
BBB- Pricing	-	-	9.0% Yield	S+425
Features:				
TALF Deal	Yes	No	No	No
Ownership Restrictions	Borrower, Servicer, Special Servicer and Operating Advisor May Not Own	None	None	None
Additional Debt	No	Allowed	Mezz Debt - $125 mm	B Note - $4.4mm; Mezz Debt - $53.5mm
Special Servicer Termination Terms	≥17.5% of Certificateholders and/or Operating Advisor may terminate	Controlling Class May Terminate	75% of all Certificateholder may terminate	75% of all Certificateholder may terminate
Hard Lockbox with Cash Trap	Yes	No	No	Yes

Single borrower

No "scratched & dented" sponsorship

Low LTV; >1.80 debt service coverage ratio

Other key features:

- ***<10% lease roll-over during loan term***
- ***Change of management if vacancy rises >20%; etc.***

What concerns me most about CMBS…Strategic Defaults

Commercial Property Owners Choose to Default
Wall Street Journal – August 25, 2010
By KRIS HUDSON And A.D. PRUITT

Like homeowners walking away from mortgaged houses that plummeted in value, some of the largest commercial-property owners are defaulting on debts and surrendering buildings worth less than their loans.

Companies such as Macerich Co., Vornado Realty Trust and Simon Property Group Inc. have recently stopped making mortgage payments to put pressure on lenders to restructure debts. ***In many cases they have walked away, sending keys to properties whose values had fallen far below the mortgage amounts, a process known as "jingle mail."***

These companies all have piles of cash to make the payments. They are simply opting to default because they believe it makes good business sense.

"We don't do this lightly," said Robert Taubman, chief executive of Taubman Centers Inc. The luxury-mall owner, with upscale properties such as the Beverly Center in Los Angeles, decided earlier this year to stop covering interest payments on its $135 million mortgage on the Pier Shops at Caesars in Atlantic City, N.J.

"Where it's fairly obvious that the gap is large, as it was with the Pier Shops, individual owners are making very tough decisions," he said.

Banking-industry officials and others have argued that homeowners have a moral obligation to pay their debts even when it seems to make good business sense to default. Individuals who walk away from their homes also face blemishes to their credit ratings and, in some states, creditors can sue them for the losses they suffer.

But in the business world, there is less of a stigma even though lenders, including individual investors, get stuck holding a depressed property in a down market.

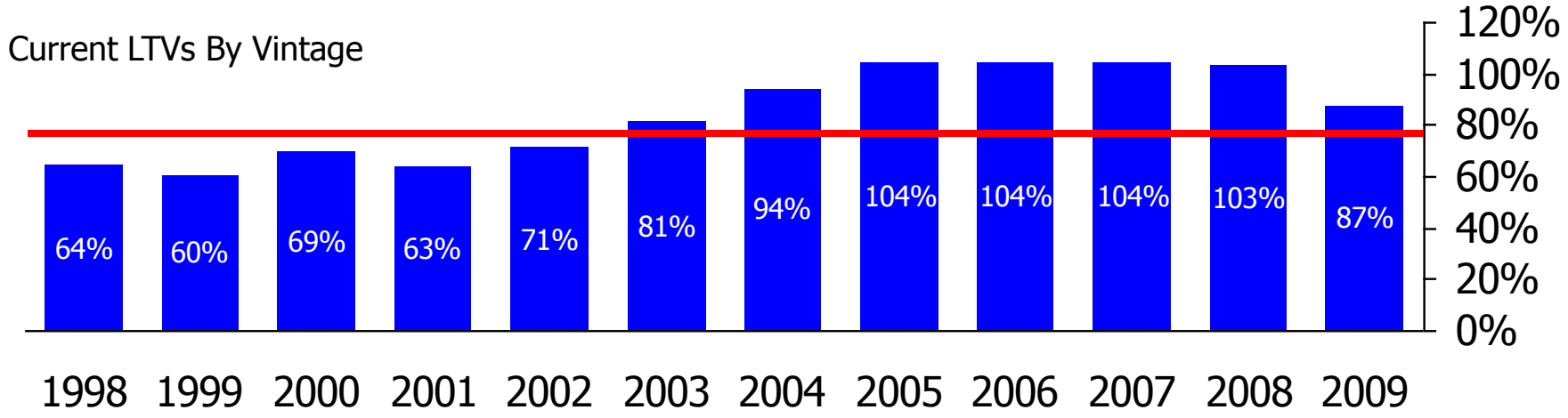
Investors are rewarding public companies for ditching profit-draining investments. Deutsche Bank AG's RREEF, which manages $56 billion in real-estate investments, now favors companies that jettison cash-draining properties with nonrecourse debt, loans that don't allow banks to hold landlords personally responsible if they default.

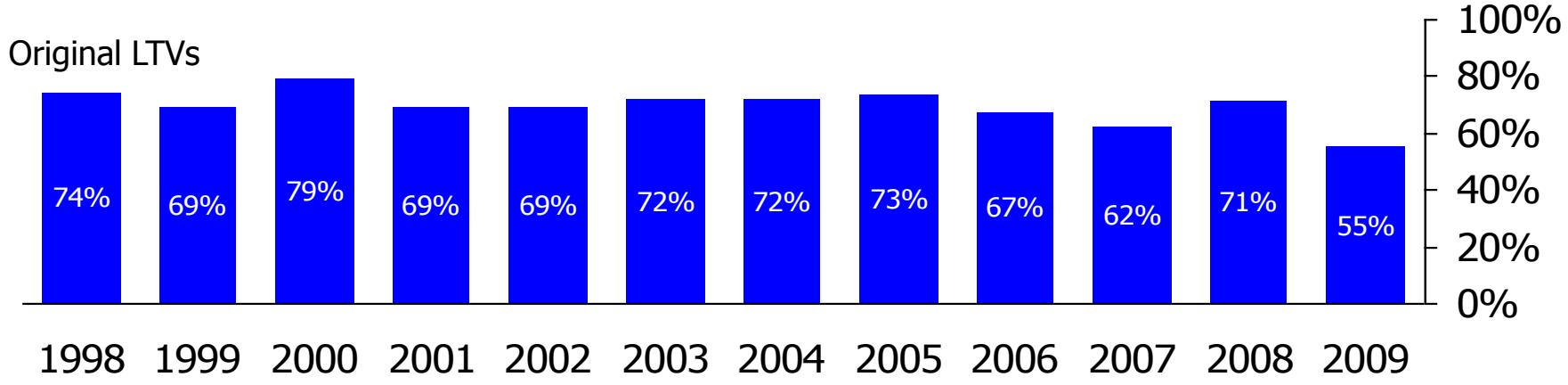
The theory is that those companies fare better by diverting money to shareholders or more lucrative projects.

More landlords are expected to follow suit. Of the $1.4 trillion of commercial-real-estate debt coming due by the end of 2014, roughly 52% is attached to properties that are underwater, according to debt-analysis company Trepp LLC. And as the economic recovery sputters, owners of struggling properties are realizing a big property-value rebound isn't imminent.Owners of commercial property have an easier time walking away than homeowners because commercial mortgages are typically nonrecourse. That means the biggest penalty for walking away is the forfeiture of assets and cash flow they may generate.

#3 - Refinance Gap and Cap Rates

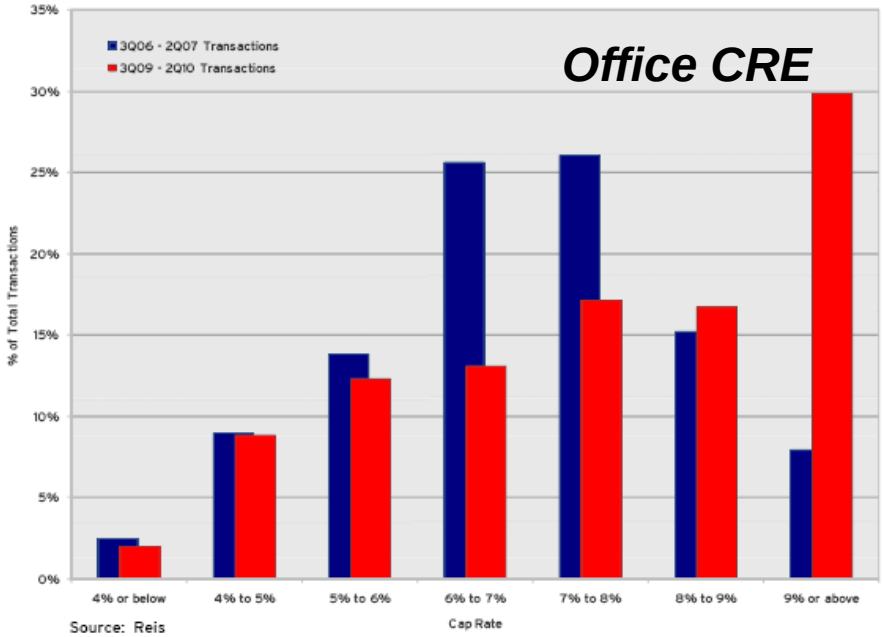
Refinancing Risk is High for 2004 - 2008 Vintage

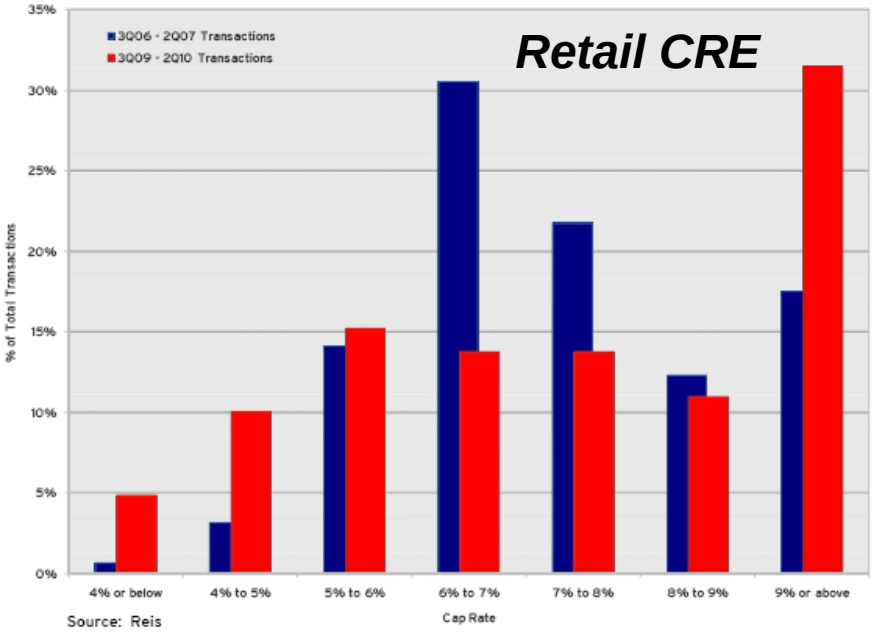




Source: Trepp and KBW estimates; data are for CMBS loans, National Real Estate Investor

Cap rate volatility in an environment of "few sales" - A few sales influence the value at any given point in time





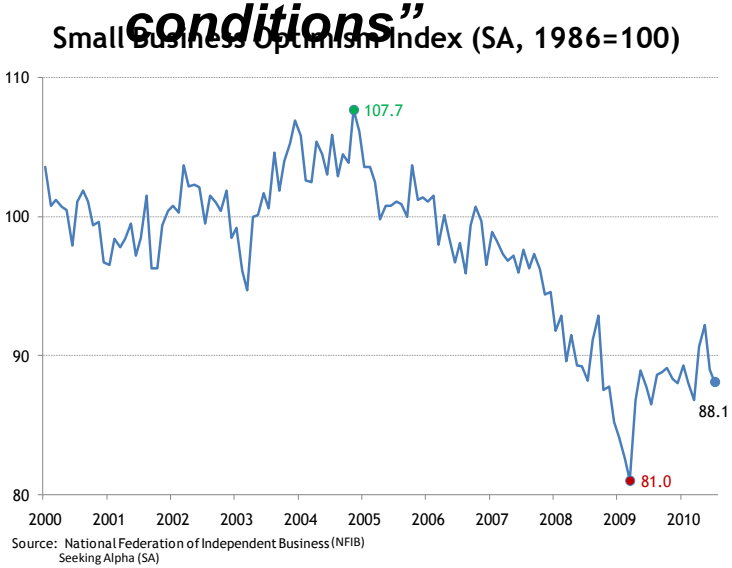
Apartment		Office		Retail	
New York	88	Phoenix	12	Los Angeles	46
Los Angeles	56	Los Angeles	11	Chicago	29
San Francisco	17	New York	9	Denver	14
Phoenix	15	Chicago	9	San Jose	12
San Diego	8	Orange County	8	Phoenix	12

Source: Reis Transaction Analytics Data; US domestic arms-length transactions of $2 million and greater

<u>Key Note:</u>
A dearth of CRE transactions creates a value challenge

Most sales are occurring in only the top 5-10 U.S. MSAs

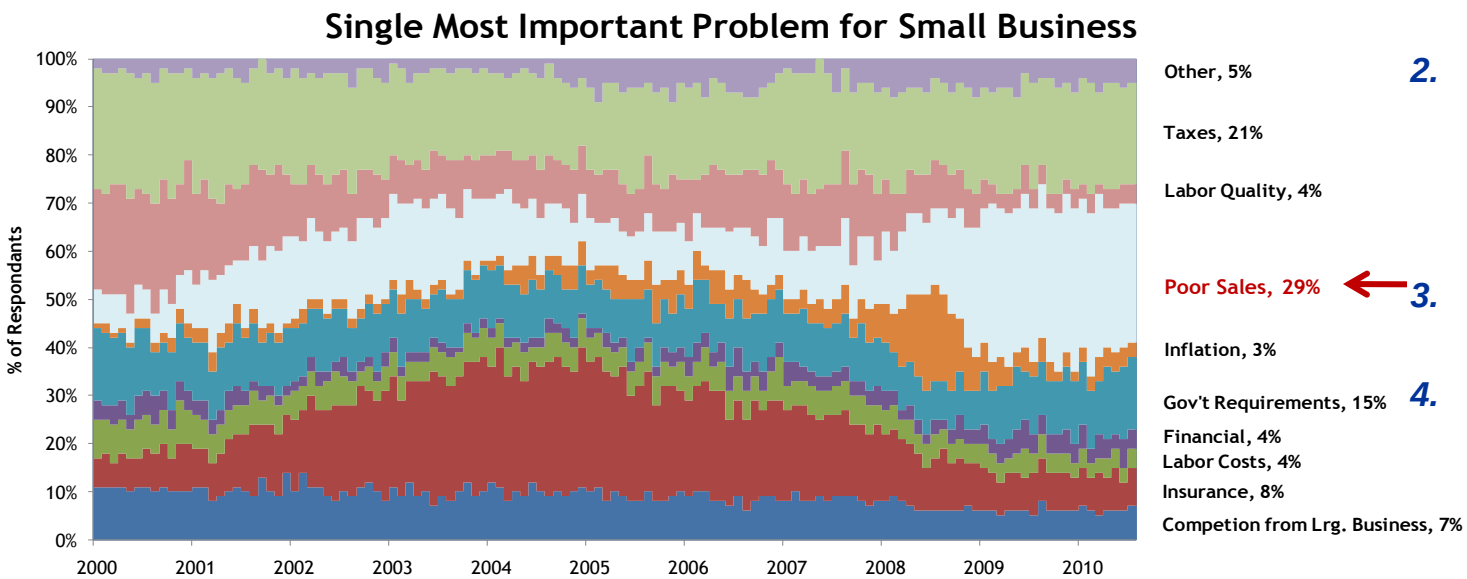
#4 - Small Business Linkages to Commercial R.E.: "As goes small business, so do Commercial R.E. conditions"



July 2010 Employment Trends

		Level (000s, SA)	Share of Sector	Growth M-t-M	Growth Y-o-Y
Goods-Producing		17,520	100%	-0.12%	-4.3%
Firm Size	1-49	6,394	36%	-0.12%	-5.7%
	50-499	7,666	44%	-0.04%	-3.1%
	> 499	3,460	20%	-0.29%	-4.1%
Service-Producing		89,451	100%	0.07%	0.0%
Firm Size	1-49	41,861	47%	0.07%	0.1%
	50-499	33,545	38%	0.07%	0.0%
	> 499	14,045	16%	0.07%	-0.6%

Source: ADP National Employment Report



Source: National Federation of Independent Businesses

5 Key Points:

1. *The NFIB Small Business Optimism Index has collapsed*
2. *80%-85% of all goods-producing and service employment is by companies with <500 employees*
3. *"Poor Sales" is the #1 small business problem*
4. *75%-80% of all business bankruptcies result in a retail or office CRE vacancy. As goes small business, so goes CRE conditions*

Article I had published in the St Louis FED on the linkage between small business and commercial real estate (CRE) www.stlouisfed.org/publications/br/articles/

BRIDGES | FALL 2010

As Goes Small Business, So Do the Conditions for Commercial Real Estate

By K.C. Conway

It's no secret that since Q4 2007, the U.S. economy has been mired in a "cascading economic recession." The seeds of this recession were a hybrid of over-leveraging and overbuilding earlier in the decade, which germinated artificial economic demand in the form of expanded homeownership, elevated home prices, inflated commercial real estate (CRE) values, excess commercial construction, and elevated consumer confidence and spending. These new sprouts then branched out with foliage in the form of employment growth and near-record small business formations. Strong sales and readily available credit were the nutrients feeding this plant growth.

So, what happened?

Answering this question will be the basis for academic papers into the next decade. In the interim, elected officials, policymakers and economists are wrestling to develop effective strategies now to arrest job loss, stubbornly elevated unemployment, declining real estate values and the expanding ripples of this recession.

This article is not intended to proffer policy answers; rather it is intended to aid in understanding the linkage between the health of small business and commercial real estate. One observation that should be clear from the key small business and CRE metrics that follow is that deciding howto address the woes of either small business or commercial real estate in isolation is a bit like trying to answer the question:*Which came first—the chicken or the egg?*

Let's explore this relationship by working the problem backward, from the present-day conditions. An examination of a few metrics establishes the inter-relationship of small business and commercial real estate. We'll call this the "Top 10 Correlations List," if you will, between small business and commercial real estate:

Retail Real Estate: Co-Tenancy and finally an answer to the question…
Is there "Goodwill" in RETAIL real estate?

Guess what were the largest two retail leasing transactions for Minneapolis Q2? Both were to **Goodwill at 22,524 sf (Coons Rapids Square) and 20,288 sf (13820 Wayzata Boulevard).** **Net market absorption was just +53,000.**

Minneapolis, MN

Period CRE Category	US Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	-0.2%	-5.0%	1H2010 experienced the most improvement in job loss in 2 years.
Business Bankruptcies (#)	61,148	606	684	Although still elevated, Business bankruptcies have begun to moderate.
MultiFamily - Occupancy (%)	93.0%	95.3%	94.6%	Despite additions to supply from apartments and condos, occupancy has recovered.
MultiFamily - Concessions (%)	-6.2%	-5.6%	-6.6%	Concessions have declined to half their peak in 2009 as occupancy has risen >95%.
Office - Vacancy (%)	16.3%	19.4%	17.9%	Vacancy will surpass 20% in 2H2010 due to weak demand and more new supply.
Office - Absorption (Sq. Ft.)	2,256,000	-124,000	-948,000	Leasing activity is insufficient to absorb more new supply (616,000 sf still underway)
Retail - Vacancy (%)	13.1%	14.1%	13.4%	Additions to supply and continued Business bankruptcies are behind the increase.
Retail - Absorption (Sq. Ft.)	-816,000	53,000	-27,000	1H2010 absorption was due to anchor store openings. Shop space absorp declined.
Warehouse - Vacancy (%)	15.0%	11.5%	10.9%	Healthy 1H2010 leasing of 1.9msf offset a larger vacancy increase from new supply
Warehouse - Absorption (Sq. Ft	-2,575,000	1,924,000	-2,439,000	Minneapolis was one of only 3 MSAs to see net leasing activity >1.0 msf in 1H2010
Hotel - RevPar for CBSA ($)	$75.21	$59.93	$53.62	RevPar is beginning to recover. Both Bus and Leisuretravel were up in 1H2010.
Hotel - RevPar for State ($)		$65.03	$60.10	In 1H2010, RevPar was recovering state-wide due to increased business travel.

Co-tenancy Clauses Can Cause Headaches in Resolving Lifestyle Centers

April 13, 2010: Retail Traffic Magazine, By David Bodamer

For much of the last decade, lifestyle centers were all the rage among developers. But even at the height of their popularity, there was a looming concern about the structure of their leases and the widespread use of co-tenancy clauses.

Co-tenancy clauses are provisions under which retail tenants are granted concessions if one or more tenants in a center leave or the project goes dark. Leases at regional malls and grocery-anchored shopping centers typically feature co-tenancy clauses in connection to project anchors.

But because lifestyle centers typically do not have anchors, in order to ensure top tenants sign onto projects, developers allow generous co-tenancy clauses. In many cases, these clauses are granted on lists of up to 10 retailers.

What that means is that if any of the 10 retailers on one tenant's list end up leaving a center, it could trigger concessions such as rent reductions or the right to go dark. As a result, these clauses are adding an extra wrinkle as lenders and receivers attempt to resolve distressed lifestyle centers. The use of these clauses means it's more difficult to project property income because a lender or receiver won't know if the retailers in place now will remain, even if they have long-term leases.

Throwing their weight around

Back in 2006, the retailers that were demanding—and receiving—co-tenancy clauses in lifestyle centers including names like Chico's, J. Crew, Anthropologie, Ann Taylor Loft, J. Jill, Coldwater Creek, Hot Topic, Talbot's, Z Gallerie and White House/Black Market. At the time, these were the most successful apparel chains operating. These retailers would commonly demand that all the others be locked into a center as a condition of their leases.

But times have changed. Many of the hot tenants in 2006 are troubled operators today. These moves have affected lifestyle centers across the country. The question of how big a problem they represent, however, depends greatly on how the leases were structured when the projects were built and the ultimate success of the projects.

Three kinds of co-tenancy

There are three distinct phases during which the provisions can take effect.

The first is during the lease-up period. After a tenant signs a letter of intent to occupy a project, it may have the option to pull out of the project if the other retailers or restaurants on their list don't sign by a specified deadline.

A second kind of co-tenancy covers the opening of a project. At this point, a tenant has signed on and undertaken the build-out of its space and training of its staff. But if the other retailers on a tenant's list don't open by an agreed-upon date, the tenant does not have to open its store either (and therefore, it doesn't have to start paying any rent on that space). Neither of those situations present issues for receivers or lenders today.

It's the third scenario where things become dicey. In some cases, tenants were granted ongoing co-tenancy provisions that cover the entire life of the lease. Here co-tenancy can take two forms.

In the first case, the named co-tenancy is dropped in favor of occupancy thresholds. Instead of being triggered by a specific set of retailers leaving a center, the overall vacancy rate is what matters.

In other cases, tenants retain named co-tenancy rights. In these cases, tenants can obtain concessions if just one of the tenants on its list ends up leaving a project early. In these cases, the tenant might have its rent reduced from a fixed rent down to paying a percentage of its sales. Or it might even have the option to vacate its lease.

Where are R.E. conditions improving around the U.S.?
(In growth restricted markets, like Austin, Baltimore, etc.)

Austin

Period CRE Category	U.S. Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	1.6%	-2.3%	One of only 4 first-tier MSAs with +job growth (Austin, Boston, Charlotte, Baltimore).
Business Bankruptcies (#)	61,148	373	280	Despite the positive job growth, business bankruptcies are up 30% from Q2 2009.
MultiFamily - Occupancy (%)	93.0%	93.2%	91.0%	Occupancy is up 200 basis points, and concessions are down by 25% from Q2'09.
MultiFamily - Concessions (%)	-6.2%	-7.9%	-10.7%	Re-establishment of job gr. is having a positive impact on MF occupancy and rents.
Office - Vacancy (%)	16.3%	18.0%	19.5%	Net absorption of 500,000 sf, and ltd new supply, are behind the improvement.
Office - Absorption (Sq. Ft.)	2,256,000	449,000	-301,000	Absorption has turned positive due to job growth and limited new supply (247,000 sf)
Retail - Vacancy (%)	13.1%	12.3%	12.9%	The decline is due to job growth, positive absorption and limited new supply.
Retail - Absorption (Sq. Ft.)	-816,000	132,000	-78,000	Retail absorption has been positive for two consecutive quarters.
Warehouse - Vacancy (%)	15.0%	16.2%	17.4%	As noted in prior CREMS, warehouse vacancy has peaked and is steadily declining.
Warehouse - Absorption (Sq. Ft	-2,575,000	-67,000	-736,000	Prior CREMS noted that absorption would trend positive by mid to late 2010.
Hotel - RevPar for CBSA ($)	$75.21	$68.53	$67.86	RevPar has halted its decline and has turned positive on increased business travel.
Hotel - RevPar for State ($)		$49.81	$49.18	Austin's RevPar is better than state-wide RevPar due to job gr. and less room supply

Baltimore

Period CRE Category	U.S. Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	0.2%	-3.2%	One of only 4 first-tier MSAs with +job growth (Austin, Boston, Charlotte).
Business Bankruptcies (#)	61,148	361	323	Despite the positive job growth, business bankruptcies are up 10% from Q2 2009.
MultiFamily - Occupancy (%)	93.0%	95.1%	93.8%	Concessions and limited new supply have enabled occupancy to climb back to 95%
MultiFamily - Concessions (%)	-6.2%	-2.2%	-4.2%	Concessions are nearly out of the market now that occupancy has recovered to 95%
Office - Vacancy (%)	16.3%	16.1%	14.5%	Vacancy is rising due to -1.5% office job growth, and 745,000 sf of new supply.
Office - Absorption (Sq. Ft.)	2,256,000	355,000	102,000	Absorption is volatile due to the timing of new supply coming on line.
Retail - Vacancy (%)	13.1%	10.2%	10.5%	Retail vacancy may rise in 2H2010 due to 686,000 sf of new supply comng on-line.
Retail - Absorption (Sq. Ft.)	-816,000	174,000	-208,000	Absorp was positive due to anchor store openings. Shop space absorp was negative
Warehouse - Vacancy (%)	15.0%	17.9%	17.5%	Vacancy has remained in a 17%-18% range since Q2 2009 and absorption negative.
Warehouse - Absorption (Sq. Ft	-2,575,000	-227,000	-368,000	Negative absorption has slowed as additions to supply have wound down.
Hotel - RevPar for CBSA ($)	$75.21	$78.94	$74.20	RevPar is recovering due to rising business travel. Leisure travel has yet to return.
Hotel - RevPar for State ($)		$85.41	$79.38	RevPar is also recovering state-wide due to increased business travel.

Where are R.E. conditions improving around the U.S.?
(And, improvement in a few "surprise markets" that lost jobs and were overbuilt)

Charlotte, NC

Period CRE Category	US Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	0.4%	-6.4%	Job loss has come to an end. Employment is re-establishing in Prof/Bus Services.
Business Bankruptcies (#)	61,148	291	167	With job growth re-establishing, business bankruptcies should peak in 2H2010.
MultiFamily - Occupancy (%)	93.0%	92.0%	90.8%	Like other southeast MSAs, occupancy is rising - paving the way for reduced conces
MultiFamily - Concessions (%)	-6.2%	-8.1%	-9.3%	Concessions peaked at Q4 2009, and are now coming out of the market.
Office - Vacancy (%)	16.3%	16.7%	15.0%	Vacancy has peaked with +0.7 office job growth and <200,000 sf of new supply.
Office - Absorption (Sq. Ft.)	2,256,000	-45,000	91,000	Absorp was negative due to additions to supply. 2H2010 absorp should be positive.
Retail - Vacancy (%)	13.1%	14.5%	14.3%	Retail is showing signs of a bottom with positive absorption and less new supply.
Retail - Absorption (Sq. Ft.)	-816,000	82,000	-228,000	Net absorption has ben positive for 1H2010. Monitor the 500,000 square feet of new
Warehouse - Vacancy (%)	15.0%	15.1%	12.5%	Vacancy continues to rise due to lack of demand (negative absorp) and new supply.
Warehouse - Absorption (Sq. Ft	-2,575,000	-1,012,000	-2,076,000	Net absorption is -10 msf over the prior 8 quarters (unprecedented in Charlotte).
Hotel - RevPar for CBSA ($)	$75.21	$50.68	$45.93	RevPar is beginning to recover. Business travel is the segment with the most increas
Hotel - RevPar for State ($)		$52.34	$47.76	State-wide RevPar is improving. Tourism was better in part due to Gulf Oil spill.

Denver, CO

Period CRE Category	US Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	-1.4%	-4.8%	The pace of moderating job loss continues, but employment is still contracting.
Business Bankruptcies (#)	61,148	896	651	Small business is not participating in the job growth. Bus bankruptcies are up 35%.
MultiFamily - Occupancy (%)	93.0%	94.0%	92.2%	Vacancy has peaked and concessions are coming out of the market.
MultiFamily - Concessions (%)	-6.2%	-5.2%	-8.5%	As occupanct climbs back near 95%, concessions are coming out of the market.
Office - Vacancy (%)	16.3%	16.9%	17.5%	With >1.0msf of net leasing in 1H2010 & new supply declining, vacancyhas peaked.
Office - Absorption (Sq. Ft.)	2,256,000	923,000	45,000	Net office absorption has turned positive. It is a good leading indicator to monitor.
Retail - Vacancy (%)	13.1%	13.0%	13.5%	Rising Bus bankruptcies and 1.1 msf of new supply are the two concerning metrics.
Retail - Absorption (Sq. Ft.)	-816,000	43,000	-141,000	Although positive, net absorption is modest and due primarily to anchor store leasing
Warehouse - Vacancy (%)	15.0%	13.2%	12.9%	With absorption turning positive in 1H2010, vacancy may havefinally peaked @13%.
Warehouse - Absorption (Sq. Ft	-2,575,000	123,000	-588,000	After -2.1msf of absorption in 2009, net leasing has turned positive in 1H2010.
Hotel - RevPar for CBSA ($)	$75.21	$66.19	$58.77	RevPar has reversed a 2-year trend of contraction and grew 10% in 1H2010.
Hotel - RevPar for State ($)		$76.58	$69.78	State-wide RevPar is higher than Denver due to ski and tourism at mountain resorts.

Where are R.E. conditions still deteriorating around the U.S.?
(In CA, FL and overbuilt SW markets, like Houston, Las Vegas and Phoenix)

Houston, TX

Period CRE Category	US Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	-0.6%	-2.9%	These numbers pre-date NASA Shuttle layoffs and off-shore drilling pan.
Business Bankruptcies (#)	61,148	969	746	Small business is a material part of job loss. Bus bankruptcies are up another 30%.
MultiFamily - Occupancy (%)	93.0%	89.6%	90.7%	One of the few CREMS markets where MF is not improving due to added new supply
MultiFamily - Concessions (%)	-6.2%	-9.0%	-7.0%	Additions to supply (2,785 units) are fueling concessions as new MF leases-up.
Office - Vacancy (%)	16.3%	16.5%	15.4%	Vacancy is rising due to: i) additions to supply; & ii) weak demand/negative absorptic
Office - Absorption (Sq. Ft.)	2,256,000	-283,000	-1,256,000	Negative 2.6% office job growth, & 6.3 msf of new supply are behind the neg absorpti
Retail - Vacancy (%)	13.1%	14.4%	14.1%	Vacancy will be volatile as 1.688 msf of new supply comes on line in by Q2 2011.
Retail - Absorption (Sq. Ft.)	-816,000	-252,000	24,000	Retail absorption buoyed by Hurricane Ike has dissipated. Monitor new supply.
Warehouse - Vacancy (%)	15.0%	10.3%	9.2%	Absorption recovered in 1H2010 due to warehouse demand assoc with Gulf Oil spill.
Warehouse - Absorption (Sq. Ft	-2,575,000	1,212,000	-729,000	Absorption was -2.5 msf in CY 2009. Is this reversal short-lived due to Gulf Oil spill?
Hotel - RevPar for CBSA ($)	$75.21	$54.84	$56.75	Houston is on of only a few C-REMS not to see a recovery in hotel RevPar.
Hotel - RevPar for State ($)		$49.81	$49.18	State-wide RevPar is recovering due to increased Bus travel in markets like Austin.

Phoenix, AZ

Period CRE Category	US Q2 2010	CBSA Q2 2010	CBSA Q2 2009	Q2 2009 to Q2 2010 Change / Key Comment
Job Growth (Tr-12 %)	-0.2%	-0.2%	-8.7%	While improved from a year ago, the new AZ illegal immigration law is anunknown.
Business Bankruptcies (#)	61,148	1,359	901	Phoenix ranks third in Bus bankruptcies behind Los Angeles and Atlanta.
MultiFamily - Occupancy (%)	93.0%	90.6%	88.0%	Occupancy is improving due to more aggressive concessions and less new supply.
MultiFamily - Concessions (%)	-6.2%	-13.6%	-13.5%	One of only 5 REMS MSAs where concessions rose in 1H2010 (Dallas, Houston, LV
Office - Vacancy (%)	16.3%	26.0%	24.6%	Vacancy is up mainly due to overbuilding. 11.7 msf have been added since Q1 '07.
Office - Absorption (Sq. Ft.)	2,256,000	-184,000	-831,000	Vacancy has not peaked due to continued negative absorp & 2.2 msf of more supply
Retail - Vacancy (%)	13.1%	16.0%	14.0%	Like office CRE, the problem is overbuilding. 6.56 msf added since Q3 2006.
Retail - Absorption (Sq. Ft.)	-816,000	-261,000	-494,000	CY 2009 absorption was -1.5msf. It's likely to remain negative with 766,000 sf U/C.
Warehouse - Vacancy (%)	15.0%	21.0%	20.1%	YE 2009 CREMS forecast vacancy to rise above 20% due to overbuilding.
Warehouse - Absorption (Sq. Ft	-2,575,000	383,000	-1,271,000	Positive absorp in 1H2010, & +3.6% Distribution employment, are seeds for recovery
Hotel - RevPar for CBSA ($)	$75.21	$55.31	$52.88	RevPar has reversed a 2-year trend of contraction and grew 5% in 1H2010.
Hotel - RevPar for State ($)		$40.71	$39.93	State-wide RevPar is recovering as well due to increased Business travel.

Concluding Remarks and Commercial R.E. observations

1. **A lot of damage has been done to Commercial Real Estate**
2. **Re-establishing job growth – especially at the small business level – is what will cure all**
   - ***Jobs, Jobs, Jobs!***
3. **We cannot under-estimate the small business and CRE linkage**
   - ***"As goes small business, so does CRE conditions (occupancy, rents, value, etc.)***
4. **Commercial R.E. debt maturities are concerning**
   - ***The combination of a large "refinance gap," coupled with this evolving "strategic foreclosure" behavior, suggests that CRE losses are still ahead of us. Borrower behavior is as critical a metric to monitor as market conditions.***
5. **And to conclude on a positive note,**

   there are three <u>improving trends in Commercial R.E. :</u>
   - ***<u>Multi-family</u> – occupancy is up to 92% nation-wide and concessions are coming out of the market***
   - ***<u>Hotels</u> – RevPar has ceased its decline and is rebounding due to increased business travel***
   - ***<u>Additions to supply</u> – winding down***

But let's answer the real question from my cover slide…
Why do geese fly in a "V" formation?

"Scientists have determined that the V-shaped formation that geese use when migrating serves two purposes:

1.First, it conserves their energy.

Each bird flies slightly above the bird in front of him, resulting in a reduction of wind resistance. The birds take turns being in the front, falling back when they get tired. In this way, the geese can fly for a long time before they must stop for rest.

2.The second benefit to the V formation is that it is easy to keep track of every bird in the group.

Fighter pilots often use this formation for the same reason."

http://www.loc.gov/rr/scitech/mysteries/…

As the geese take flight from the Canadian shoreline, they lift off from the water in squawking discourse. Yet, in a matter of seconds, a line begins to emerge from the mass of brown feathers. This line straightens, arches slightly, and then, as on cue, bends sharply to form a perfect V shape. Canada geese fly in V formation for a very pragmatic reason: a flock of geese flying in formation can move faster and maintain flight longer than any one goose flying alone.

Synergy is a law of nature.

What is synergy? How does it relate to leadership? We have a lot to learn from these geese.

By flying in "V " formation, the flock adds at least 71% greater flying range than if each bird flew on its own.

Whenever a goose falls out of formation, it suddenly feels the drag and resistance of trying to go it alone and quickly gets back into formation to take advantage of the lifting power of the bird immediately in front. When the lead goose gets tired, he rotates back in the wing and another goose flies point.These geese honk from behind to encourage those up front to keep up their speed.

Finally, when a goose gets sick, or is wounded by gunshot, and falls out, two geese fall out of formation and follow him down to help and protect him. They stay with him until he is either able to fly or until he is dead, and then they launch out on their own or with another formation until they catch up with their group.

http://theleadership.wordpress.com/2006/…

Maybe our banks lending and underwriting techniques need "goosing-up?"

Could banks be 71% more profitable by getting the metrics to fall into a proper "V" formation?

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THANK YOU

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