Real Estate Market Report – Spring 2012
Letter from the Managing Directors

Dear Reader:

Collateral Evaluation Services, Inc. is pleased to present the Spring 2012 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. We do not share our mail list with anyone outside CES.

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

As always, we hope you find this report interesting, and optimally somehow of use in your everyday job. We believe CES brings 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 hopes your year has started off on a good foot and the remainder of 2012 is prosperous.

Sincerely,

Managing Directors

Collateral Evaluation Services, Inc.

www.CES-WM.com
Mann’s Take On Things

By George R. Mann, MAI, SRA, MRICS

“The Seven Year Itch”

As The Great Depression II approaches its 7th anniversary this past summer (according to my pronouncement at that time in 2005), I am at a loss for things to discuss. This depression has played out so close to the forecasted script it leaves little to talk about.

How much longer do we have might be a good topic. My gut says we are at the half way point. Maybe Clint Eastwood’s Super Bowl commercial saying we are at halftime and about to start the second half was talking about the length of the depression. Not really, but let’s call it coincidence. Aside from a gut instinct, supply and demand fundamentals are telling me there will be at least 2-3 years before we see a true recovery.

In regard to the $2 Billion Popularity Contest to be voted on November 6th, for a year now I have been saying it’s about a 100% certainty Obama gets re-elected. I didn’t keep the article I read in which a professor said he analyzed a dozen indicators that had correctly predicted the winning presidential candidate for the past 100 years or so. The bottom line is that all twelve indicators show Obama winning. That’s good enough for me to go with as a forecast. At least I don’t have to listen to politics for the next eight months.

I don’t mean to disappoint those who enjoy reading my semi-annual rant. But, I think I will let our market analyses on the following pages have the limelight this issue. Maybe in September/October when we write our Fall 2012 report I will have some issues to rant about.

Until then, the CES National Overview follows.
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% in 2012; Prices have already experienced a “double-dip” for this economic downturn (technically, prices just made a ‘triple-dip’ in December).
- Housing prices are projected to be stagnant through 2013.
- 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.
- Home ownership has declined significantly (almost back to 1980 levels) in this Depression and further decline is expected.
- Shadow inventory is estimated at 2.5 million homes, while only 500,000 homes are listed for sale. As the shadow inventory is brought to market, prices will face continued pressure.

Multi Family

- Vacancy rates are at all-time lows.
- Demographic trends will continue to create demand in this sector. Vacancy is forecast to continue downward.
- The amount of stock in expansion is forecast to grow through 2014. This expansion will consist of strong demand and rental growth as well as decreasing vacancy and overall cap rates.
Industrial

- Absorption turned positive in the last half of 2010. Occupancy should continue to increase with rents also increasing for specific segments; unique opportunities will present themselves as a result of the Panama Canal expansion being completed in 2014.
- Although fundamentals are projected to be strong, overall rent growth for this sector is not expected to occur until 2016.

Office

- Weak for next 1-2 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.
- Relatively strong fundamentals are expected over the next few years, but the Depression was so severe it will take many years before rental increases occur.
- Income and value declines can be expected for those properties with 5-year leases signed in 2007. As these leases come due, rent rates will decline significantly and/or vacancy will increase.

Retail

- Weakest of the four main property sectors; not much improvement forecast over the next five years.
- Effective rents are back to 2005 levels.
- According to the Urban Land Institute, the online retail market share is now at 10%.
- Vacancy for regional malls is at an all-time high.

Non-Investor – Owner-Occupied

- 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.
- An increasing number of banks are telling CES that they plan to become more aggressive in selling their OREO properties. This must occur for the CRE market to begin a rebound, but while these properties are being sold, prices will face downward pressure and likely decline further.
SINGLE UNIT DWELLINGS

According to Standard & Poor's Case-Shiller home-price indexes, U.S. home prices fell in December from a month earlier, ending 2011 at the lowest levels since the housing crisis began in mid-2006. December prices broke below the lows seen in 2009 and again in early 2011. Prices were down 4% in 2011 and are down 33.8% from their peak in the second quarter of 2006.

"While we thought we saw some signs of stabilization in the middle of 2011, it appears that neither the economy nor consumer confidence was strong enough to move the market in a positive direction as the year ended... After a prior three years of accelerated decline, the past two years has been a story of a housing market that is bottoming out but has not yet stabilized," said David Blitzer, chairman of S&P’s index committee.

The housing market remains sluggish despite soft prices and interest rates that have been hovering around historic lows. A weak job market, abundant foreclosures and tighter mortgage requirements have continued to weigh on the market.

Another contributing factor to the slow recovery of the housing market stems from the student loans for the now dubbed ‘boomerang generation.’ Named for their return to living at home after graduation, many young adults in this generation are having a hard time getting out on their feet after college, mainly due to inability to find jobs and large amounts of student loan debt. According to Nancy Marshall-Genzer’s report on Marketplace, the current collective student loan debt in the US is $870 billion, which is greater than our nation’s total credit card debt.

Saddled with this large amount of student loan debt, these young adults are having a hard time transitioning to independent living after college. Post-college graduates would normally get a job and move on to purchase starter homes. However, with the difficulty in finding jobs and the instability in the job market, young adults graduating during The Great Depression II are more often moving back in with their parents to save money, pay off debt, and ensure financial stability.

These so-called ‘boomerangers’ are creating a ripple effect that will impact more than just the housing market. As they are not buying new houses or moving into their own apartments, they are not purchasing home goods first-time homebuyers typically need. Their hesitation to make investments in houses, home goods, new cars and other products upon getting their first job out of college adds to the slow recovery process.

Of the 20 major U.S. metropolitan markets, 18 of them reported prices were lower than during November. Only Miami and Phoenix moved higher, up a scant 0.2% and 0.8%, respectively. Year-over-year, only Detroit saw improvement, up 0.5%.

The Case-Shiller index of 10 major metropolitan areas and the 20-city index were down 1.1% in December from a month earlier.
Year-to-year, unadjusted December prices declined 3.9% for the 10 major markets while the 20-city index dropped 4%.

On a brighter note, The National Association of Realtors reported that sales of previously owned homes in the U.S. rose in January to the highest level in nearly two years and the inventory of unsold homes contracted to a level considered healthy by economists. Existing-home sales increased 4.3% in January from December to a seasonally adjusted annual rate of 4.57 million. It marked the highest level of sales since May 2010, when the housing market was lifted by federal tax credits.

Housing futures traded on the Chicago Mercantile Exchange (CME) are projecting stagnant prices through the end of 2013. Prices are forecast to increase 1.5% to 3% in 2014 and 2015. Over the past few years the futures have been reasonably accurate.

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 1-2+ years, the current oversupply will diminish and a firmer market should exist around 2013-2014.

**FORECAST**

Our forecast is in line with the CME futures – flat prices for the next two years. Prices will be under pressure in those areas where more foreclosures are brought to market. However, this should be offset by those markets experiencing some strength. 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 exhibit sustained weakness. Project values are very specific to the local market as nearby projects greatly influence a property’s retail price 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 20.25%, 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 4th 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 4th Quarter 2011 RealtyRates Developer Survey (3rd Quarter 2011 data) shows the national average discount rate for residential subdivisions is 35.70%. This is up from 35.13% in the prior quarter. The national average condo project discount rate is 21.09% down from 21.62% in the previous quarter, exclusive of entrepreneurial profit as noted above.

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 2.4% increase in October. This followed a 1.4% decrease in September. The index is currently near its 2-year average price level and near its 2003 levels.

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

- We anticipate that the bottoming process will be prolonged for the next 12-24 months. We expect the recovery to be led by multi-family and hotel, with retail and office lagging.
• All four of the national quarterly property type indices reported positive price movements. Apartments and retail led the way, increasing 6.3% and 10.4%, respectively over last quarter.

• Primary market prices have cooled off in the last few months with three of the four Top Ten MSA property type indices lagging their national counterparts this quarter.

• Three of the four western region property types, apartment, office and retail, recorded gains this quarter. The laggard was West Industrial, down 1.0% versus the prior quarter.

• Distressed transactions comprised 25.9% of all repeat-sales in September, largely in line with recently observed levels.

• September transaction volume was relatively high at 255 repeat-sales observations. The average monthly transaction count for 2011 is 192 compared with 144 for 2010 and 96 for 2009.

We continue to review appraisals that quote the institutional-grade cap rates in the PwC Real Estate Investor Survey while appraising non-institutional grade properties. As a reminder, cap rates for non-institutional grade properties as of the 4th Quarter 2011 Survey (3rd Quarter 2011 Data) were as follows:

<table>
<thead>
<tr>
<th>PROPERTY TYPE</th>
<th>AVERAGE CAP RATE</th>
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</thead>
<tbody>
<tr>
<td>APARTMENTS</td>
<td>7.43%</td>
</tr>
<tr>
<td>WAREHOUSE BUILDINGS</td>
<td>9.65%</td>
</tr>
<tr>
<td>MEDICAL OFFICE BUILDINGS</td>
<td>9.47%</td>
</tr>
<tr>
<td>SUBURBAN OFFICE BUILDINGS</td>
<td>8.97%</td>
</tr>
<tr>
<td>STRIP SHOPPING CENTERS</td>
<td>9.72%</td>
</tr>
</tbody>
</table>

SOURCE: 4th 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. However, the chance of a surprise increase in market rates has become slim with the Federal Reserve guaranteeing low interest rates into 2014.

Remember that the cap rates you hear quoted in the press are for investment grade properties. Cap rates for the other 99% 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 and continued positive throughout 2011. According to REIS, Inc., the national vacancy rate dropped from a record high of 8.0% at the end of 2009 to a record low of 5.2% at the end of 2011. In 2011, effective rents grew by 2.3%. For 2012, they project vacancy to decline below 5% and effective rents to accelerate their growth rate. Absorption and completions are getting more in line in 2012, and in 2013 it is possible completions may once again outpace absorption.

Rents have been strongest for Class A projects and this is projected to continue throughout 2012. Class B and C projects have not fared as well with increasing rents and this too is projected to be the case in 2012. Rents are expected to increase 3%-5% in 2012, with Class A faring better and Class B/C faring worse. With cap rates forecast to hold steady, values should increase in line with rents. The supply of new apartments might start to affect rent growth in 2013, but until then this property type looks great.

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 2012) – Columbia (SC), Houston, and Sarasota (9.5% vacancy).

Industrial

Employment sectors that drive Industrial demand lost over 2.7 million jobs in 2009. However, in each of the years 2010 and 2011 employment increased by almost 500,000 jobs. Moody’s Economy.com forecasts slow industrial employment growth in 2012 and 2013 followed by more rapid growth from 2014-2016.

From a historical perspective, 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 that the last four quarters has seen an average gain of 164,000 jobs in industrial sectors. The 4-quarter average almost turned positive in the 3rd Quarter of 2010, this lead the national industrial market to see positive absorption beginning in the 1st Quarter of 2011.
INDUSTRIAL SECTOR EMPLOYMENT – NATIONWIDE

<table>
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<tr>
<th>Year</th>
<th>Quarter</th>
<th>2010</th>
<th>2011</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>3rd QTR</td>
<td>4th QTR</td>
<td>1st QTR</td>
</tr>
<tr>
<td>Quarter Δ * (Change)</td>
<td>+58</td>
<td>+148</td>
<td>+180</td>
</tr>
<tr>
<td>Four (4)-Qtr. Avg. *</td>
<td>-1</td>
<td>+120</td>
<td>+129</td>
</tr>
</tbody>
</table>

* - 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 has experienced significant improvement since the summer of 2010.

According to Grubb & Ellis, national vacancy ended 2011 at 9.5%, down from 10.4% a year earlier. They forecast vacancy will decrease to 8.7% by the end of 2012. Although fundamentals are very strong, rent growth has been difficult to come by. In fact, some participants call for strong fundamentals for years to come but no rent growth until 2016.

As with the Apartment sector, various segments are performing quite differently. Class A distribution space and large blocks of logistic space have been and should continue to outperform other segments. Smaller, second-generation warehouse space is underperforming despite significant rent concessions being offered. This is likely attributed to weak confidence in the small business community. We concur with Grubb & Ellis that overall vacancy should decline. Rent growth will be very specific to the segment and property location.

As an aside, 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. Houston and Tampa are already expanding their ports and planning large intermodal facilities.

Office

According to Grubb & Ellis, national vacancy was at 16.8% as of year-end 2011, down from 17.8% a year earlier. REIS, Inc. indicated a 17.3% vacancy rate as of yearend 2011, down from 17.6% a year earlier. These vacancy rates are near 18-year highs. Also according to REIS, Inc., effective rents have increased 1.65% from a year ago. According to Grubb & Ellis, Class A rents were flat and Class B rents were down about 1% from a year ago.
Grubb & Ellis is forecasting a vacancy decrease in 2012 to 15.7% and asking rent increases of 1% for Class A space and no increase for Class B space. REIS, Inc. is forecasting a vacancy decrease to 17.0% and asking rent increases of 1.9% in 2012, with vacancy decreasing to 15.0% by 2015 and rents increasing between 2-3.5% per year through 2015.

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 1.5 million jobs being created in 2012, about the same growth as experienced in 2011. Due to this relatively slow growth (compared to historical 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 1-2 more years. REIS’ 5-year forecast is for vacancy to decline to 15.0%. 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

Year-end 2011 vacancy was 10.9% up from 10.6% a year earlier (Source: REIS, Inc.). REIS, Inc. projects vacancy to remain at 11.0% in 2012 and effective rents to increase by 0.7%. With consumer confidence still low and housing prices weak, we agree with REIS that 2012 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 will start off slow but may increase to between 2% and 3% per year by 2015.

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. As each sector recovers, the degree of improvement will vary by city and property class.

COMMERCIAL PROPERTIES – Owner Occupied

The number of business closures has probably seen its zenith and the near term should either show a slow decline overall or some stability and maybe slight improvement. As a result, the amount of owner-occupied real estate being taken back by banks should be minimal in 2012. 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.

The latest survey published by the National Federation of Independent Business (NFIB) reveals the following interesting statistics regarding real estate and credit markets:

- The number of small-business owners accessing credit has not increased over the course of the last three years. An estimated 1.6 to 1.7 million small employers (out of 5.8 million) obtained credit from a financial institution in each of the last three years. However, the demand for credit increased in 2011. The flat number acquiring credit and increased demand effectively means that all new 2011 market entrants were effectively shut-out. This implies that credit standards changed or that nothing but poor credit risks entered the market during the year.

- Real estate supports much small-business financing. Small employers continue to own large amounts of real estate and related issues continue to be a major drag on small-business recovery. Overall, 92 percent of those surveyed own some form of real estate. Nineteen (19) percent are currently using the proceeds from a mortgage to help finance the firm and a non-mutually exclusive 15 percent are currently using their real estate for business collateral. Eighty-nine (89) percent own their residence, 18 percent a second home, 20 percent their business premises, and 31 percent investment real estate that includes none of the former types. This suggests that a full small-business economic recovery is not likely to occur until the real estate problem is addressed and repaired.

- There were more attempts to obtain credit in 2011. Fifty-seven (57) percent of small employers sought credit from a financial institution in the last 12 months, a nine percent increase over 2010. Demand for credit lines and credit cards each rose more than one-third over the previous year. The demand for line renewals and loans were flat. More attempts resulted in more rejections rather than more small-business owners receiving credit.

A disconnect appears between lenders and small-business owners. Lenders think credit standards have not changed or have eased over the year. Small-business owners think that the credit market tightened in 2011, even in the latter part of the year when optimism was beginning to rise again. However, owners also appear more sanguine over their immediate economic prospects than do lenders.

- Small-business owners continue to deleverage, part of a trend since at least 2009. Eighty-eight (88) percent of small employers either have credit outstanding or access to it (lines or cards), including 47 percent with credit lines, 29 percent with a business loan, and 79 percent with a credit card(s) used for business purposes. Twenty-eight (28) percent with a card use it for credit; the remaining owners use it as a means of payment (transaction device) exclusively.

COMMERCIAL PROPERTIES – Vacant Land

Commercial land did not have the bubble that the residential land market experienced. Many of the appraisals that we review show declines up to 50% have occurred 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.