Errata:

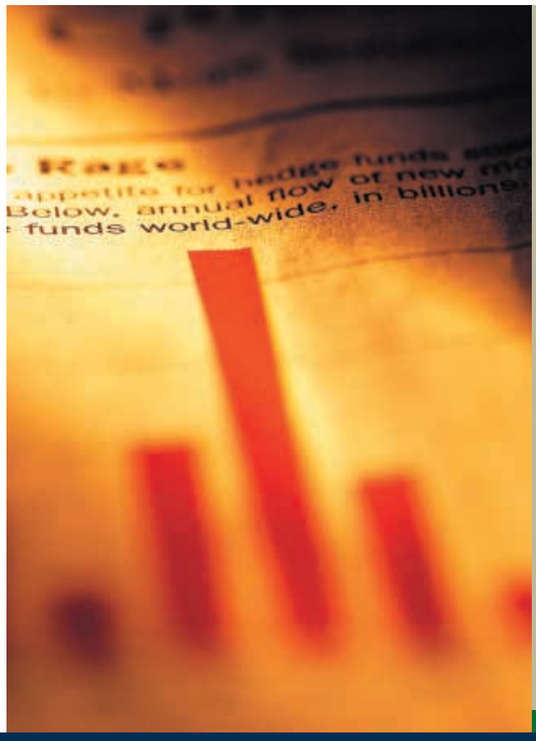
Page 82: Commercial Versus Residential Heading: 6th line should read: "The commercial real estate industry has…."

Page 85: Chart title should read as "US COMMERCIAL PROPERTY SALES".

Page 86: Chart at the top: the purple line (above and to the right of Next 5 Years) should light blue.

Page 89: MultiFamily Properties Chart at bottom: Should read "MULTIFAMILY MARKET".

Page 90: 2007 Apartment Sales Chart: 3rd and 4th columns should say Units and $/Unit, respectively.




# INVESTMENT

## 2008 HAMPTON ROADS REAL ESTATE MARKET REVIEW

## Acknowledgements

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# General Overview

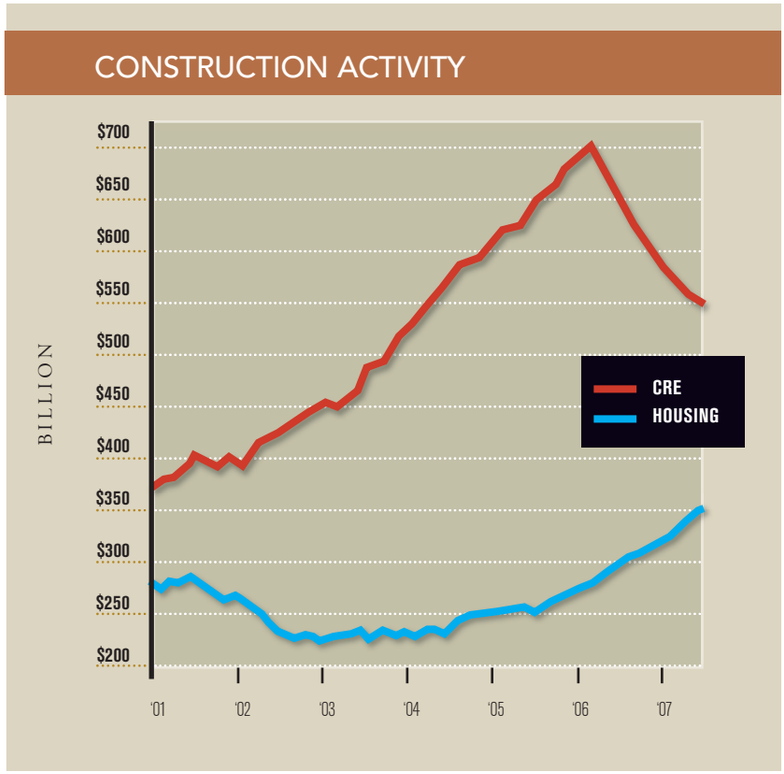
The real estate story making all of the national headlines at this time is in the residential market, not the commercial real estate market. But this overview will discuss how the nationwide slowdown in housing does actually impact our commercial market through the capital markets. But even with this correlation, commercial real estate should continue to perform strongly as an investment class nationally. And within that context, Hampton Roads should continue to perform well as a market area overall and within each of the four core product types (office, industrial, retail, and multifamily).

## COMMERCIAL VERSUS RESIDENTIAL

While the "spin-doctors" of commercial real estate began to say during 2007 that there was minimal to no connection between the falling residential markets and the healthy commercial markets, no experts are saying that in 2008. With that said, the severe change in the residential market is not expected in the commercial market. Dennis Yes key, national director of Deloitte & Touche LLP's Real Estate Capital Markets Group, recently noted that "The commercial real estate industry as caught a cold from all the coughing and sneezing of the housing market, which is deathly ill." The differing levels of sickness can best be explained by three key differentiators.

> Since 2004, commercial real estate construction has picked up but still arguably at controlled levels which can be absorbed without significant market correction.

The first key differentiator between the commercial and residential markets is the amount of new supply over the last 7 years. While new residential construction doubled nationally from 2001 through 2006, new commercial real estate construction was minimal and flat from 2001 to 2004 still largely recovering from the last slowdown of commercial real estate started in the late 1990's. Since 2004, commercial real estate construction has picked up but still arguably at controlled levels which can be absorbed without significant market correction. The severe slowdown in the residential market nationally has impacted the Hampton Roads area also although not the same extent of other markets where overbuilding was even more rampant over the last 5 to 7 years. The following chart shows the controlled new commercial real estate construction nationally as compared to the residential construction boom.




The second key differentiator between the commercial and residential markets is the disappearance of a large sector of the buyer pool for residential properties. Speculative investors with no intent to occupy the properties or own them long term were a substantial percentage of residential buyers, particularly in the highly publicized condominium market. The demand for commercial property has been far more diverse and driven by solid fundamentals as a core asset class which will be discussed to a greater extent in a section below.

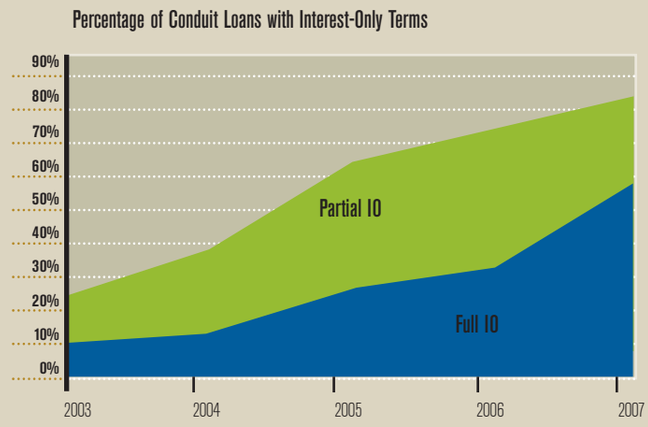
The third key differentiator between the commercial and residential markets was the aggressiveness of the lending community during the boom of 2001 to 2006. As aggressive as lending and underwriting was for commercial property during that time period, most commercial lenders continued to require minimum equity of 0% to 20% while residential investors could buy with 0% to 5% equity. With the fall off in demand for residential properties after a period of massive new supply, prices have begun to fall and foreclosures have begun to be prevalent. By contrast, commercial investors have more substantial equity at risk and are in a better position to weather potential declines in pricing. And with that said, the lack of new construction and high cost of any potential further new construction has been a buffer for commercial prices.

## CAPITAL MARKETS

The massive over-leverage in residential real estate is the key driver for the changes in the capital markets we are now experiencing. The soaring housing and mortgage finance markets with low interest rates and high origination volume are now a thing of the past. Recent estimates project the losses stemming from the sub-prime residential mortgage meltdown to be as high as $400 billion. While this story will continue to make national headlines and further erode national consumer confidence, it should be noted that the $400 billion in losses represent only 3% of U.S. gross domestic product which is currently $13 trillion. This perspective allows more sophisticated investors to put this market correction actually in favorable contrast to previous financial crises such as the S&L crisis of the 1990's.

On the commercial side, delinquencies and defaults are actually near record lows. The turbulence in the capital markets is a perhaps unwanted but necessary wake-up call to further tighten the lending fundamentals but not to leave the market entirely. Commercial loans had until recently allowed lower near-term debt service coverage ratios with the expectations that occupancy and in-place rents would grow substantially during the loan period. The reliance on future improvements in Net Operating Income can best be illustrated by the significant increase in interest-only loans between 2003 and 2007. These loans reduced (i.e. partial interest-only) or eliminated (i.e. full interest-only) the requirement that the borrower pay down loan principal each year. The following chart shows that the percentage of conduit loans that had interest-only terms grew from less than 25% in 2003 to over 80% in 2007.

LAX UNDERWRITING & AGGRESSIVE LENDING




The availability and price of commercial real estate loans has changed dramatically since the sub-prime residential melt-down began. Commercial loans made on a go-forward basis will focus more on the in-place rent roll and require higher amounts of investor equity (likely 25% to 30%) with more significant reserves for future contingencies. Buyers are much more cautious to tie down their financing assumptions before proceeding on deals today, and buyers are very frustrated with the lack of clear and speedy response the lenders are giving them today. Peter Ruggiero, national managing director for Colliers International's investment services group, recently stated, "The market is not sick; it's just indecisive."

## COMMERCIAL REAL ESTATE AS INVESTMENT CLASS

While commercial lenders are frustrated that their hands are being tied far more than solid commercial fundamentals should dictate, the key issue for commercial real estate as an investment class is that the capital markets do remain open for commercial investments. Commercial market fundamentals remain healthy, and the predictable and transparent contractual cash flows of commercial real estate still appear relatively attractive to alternative investment opportunities.

Commercial real estate as an investment class has boomed from 2001 through 2007 primarily through a mix of portfolio and one-off investments. The entire 6 year period was also highlighted by strong growth in the public Real Estate Investment Trust sector, but the availability and low cost of private debt and equity led to a "privatization" boom for the REIT's that began in 2005.These privatizations were effectively large portfolio acquisitions and were primarily done by real estate investors planning to "flip" the assets on a one-off or smaller portfolio basis at even higher prices. The following chart prepared by Real Capital Analytics, a New York-based research firm, shows the huge increase in U.S. commercial property sales over $5 Million in value since 2001.

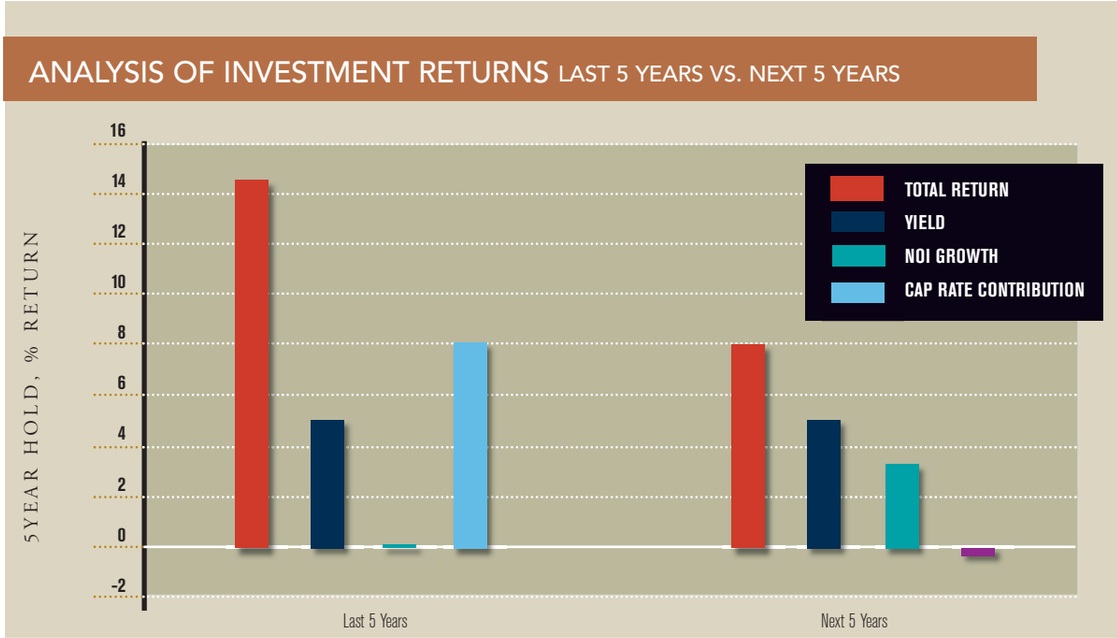

The run-up in commercial real estate investment was fueled in part by a massive wall of liquidity looking for a home. In the United States during 2006, for instance, for every dollar that was spent on buying commercial real estate, there were two more dollars that did not get placed. Commercial real estate has been viewed very favorably relative to other asset classes, and investors viewed the available returns as perfectly acceptable even as cop rates and expected yields declined during the boom period. Capital supply and demand fundamentals gave sellers the upper hand during this period, and that trend is expected to be largely over although the supply of investors will continue to be plentiful. With average yield rates on commercial real estate investments still expected to be higher than those for many other investment alternatives, commercial real estate likely will continue to be a preferred investment class from a risk-adjusted basis.

> Since 2004, commercial real estate construction has picked up but still arguably at controlled levels which can be absorbed without significant market correction.

A recent National Real Estate Investor survey of more than 1,000 private and institutional real estate investors shows that a majority still want to invest more funds in the sector while only 7 percent plan to decrease their investments in real estate over the next 12 months. This survey was conducted after the first national recognition of the slowdown in the U.S. economy as evidenced by anemic job growth figures. As investors aim to move forward in this period of uncertainty, the key question for each potential transaction is what is fair market pricing.

At the current time, most commercial owners are still optimistic that strong fundamentals will keep sales prices on par with recent records if not continuing to climb, while most buyers believe that a market correction will lead to better purchase opportunities in the coming months. Accordingly, most buyers and sellers aren't seeing eye-to-eye, and each side appears to be waiting for the other side to blink.

Within this overall pricing gap environment, disparities are accentuated in lesser quality assets. The quality of assets can be reviewed in this regard in terms of geographic area and submarket within that area as well as the physical condition, tenancy, and other relevant features. Assets in marginal locations or with significant deferred maintenance or downside risk will be most negatively impacted, as investors flock to quality and security in times of uncertainty.

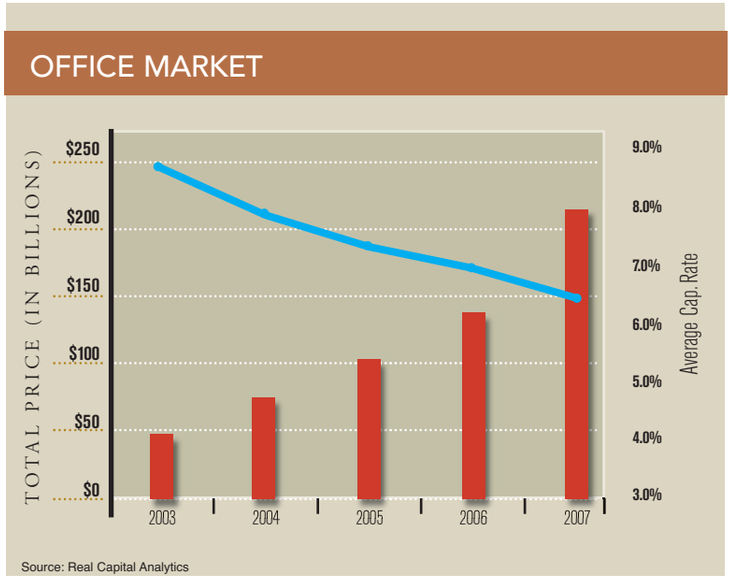


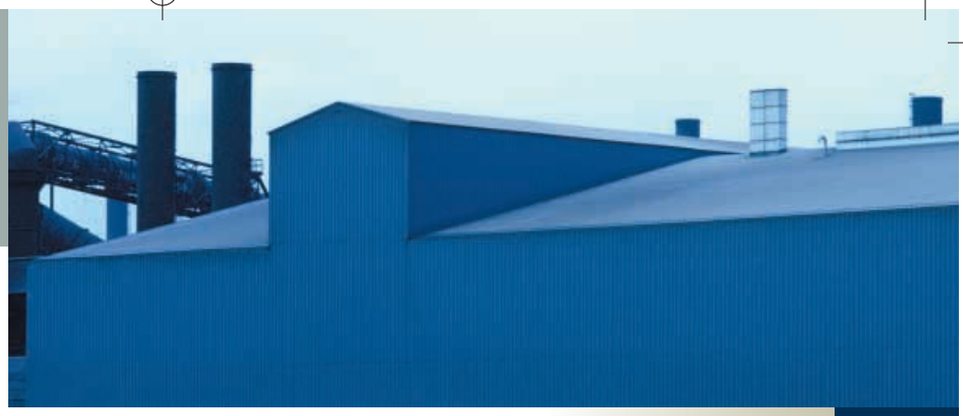

A large part of the rise in commercial pricing in recent years has been from investors' willingness to accept lower returns rather than real growth in asset operating performance. Going forward, commercial real estate investors will have to work harder to achieve above-market returns. With the combination of less generous capital market pricing and slowing economic growth, the question is not whether cap rates will rise, but rather the timing and magnitude of the increases. A recent Torto Wheaton analysis highlighted that declining capitalization rates were the largest positive contributor to total returns over the last 5 years but certainly are not expected to be over the next 5 years.

## OFFICE PROPERTIES

During the last 5 years, commercial real estate investment in office properties has increased dramatically in terms of volume while also seeing cap rates decline dramatically. The following chart using data gathered by Real Capital Analytics, a New York-based research firm, shows the evolution in the office investment market from 2003 to 2007.

During this 5 year period, office landlords have enjoyed falling vacancies and rising rents with limited new construction adding supply to the market. While office fundamental remain sound, the softening U.S. economy will lead to slower growth in rents and lower space absorption levels.





While these factors will impact the Hampton Roads market also, the area has clearly benefited from the nationally favorable trends. CB Richard Ellis market research tracked 7 office investment sales of $15 Million or more during 2007. These sales included the largest downtown and largest suburban office sales in our market's history.

## 2007 OFFICE SALES OF $15 MILLION OR MORE

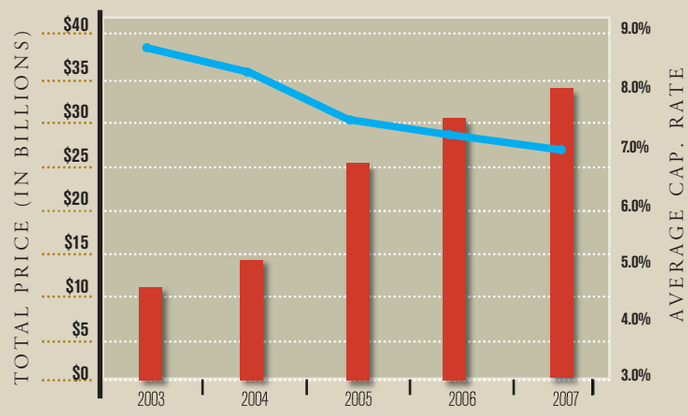
| Property Name | Purchase Price | s.f. | $/s.f. | Seller | Purchaser |
|---|---|---|---|---|---|
| Gee's Group Portfolio | $61,100,000 | 337,335 | $181 | Gee's Group | Guardian Realty Investors |
| 150 West Main | $56,000,000 | 226,450 | $247 | St. Joe Commercial | EOLA Capital |
| Greenbrier Office/Flex Portfolio | $36,000,000 | 325,106 | $110 | Brookfield Real Estate | First Potomac Realty Investment LP |
| Starmount Portfolio | $32,379,116 | 268,086 | $121 | Starmount Company | CBL & Associates |
| 500 E. Main St. | $29,820,511 | 228,541 | $130 | Harbor Group International | NPV/Direct Invest |
| Patrick Henry Corporate Center | $18,575,000 | 98,883 | $188 | Carr Properties/JP Morgan | KBS REIT |
| Patrick Henry Corporate Center | $16,378,700 | 98,883 | $166 | Columbia Equity Trust | Carr Properties/JP Morgan |

# INDUSTRIAL PROPERTIES

During the last 5 years, commercial real estate investment in industrial properties has also increased dramatically in terms of volume while also seeing cap rates decline dramatically. The following chart using data gathered by Real Capital Analytics, a New York-based research firm, shows the evolution in the industrial investment market from 2003 to 2007.

During this 5 year period, industrial landlords have enjoyed robust absorption levels but have also seen significant amounts of new construction and less robust growth in rents. The national slowdown in consumer demand, industrial production, and the overall economy will negatively impact absorption and rental rates as well. One remaining positive factor is that global exports have been particularly buoyed by the weak U.S. dollar.

## INDUSTRIAL/WAREHOUSE MARKET




Source: Real Capital Analytics

The Hampton Roads market should continue to be a national leader in the warehouse market with the positive trends in global trade and the excellent infrastructure of the Ports of Virginia. While CB Richard Ellis market research tracked only 2 industrial investment sales of $15 Million or more during 2007, there were another 5 industrial sales transactions under $15 Million but over $5 Million.

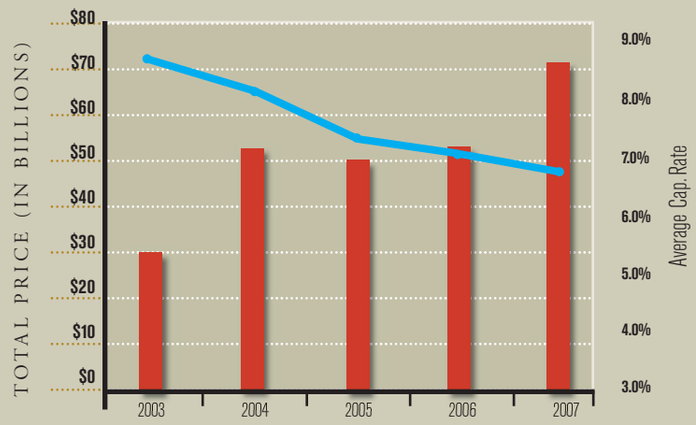
## 2007 INDUSTRIAL SALES OF $15 MILLION OR MORE

| Property Name | Purchase Price | s.f. | $/s.f. | Seller | Purchaser |
|---|---|---|---|---|---|
| Commonwealth Storage Portfolio | $36,000,000 | 652,780 | $55.15 | Commonwealth Storage, Inc. | Not Disclosed |
| Stock Building Supply | $16,450,000 | 285,600 | $57.60 | Kempsville Building Materials | Marc Realty, LLC |

# RETAIL PROPERTIES

During the last 5 years, commercial real estate investment in retail properties has also increased dramatically in terms of volume while also seeing cap rates decline dramatically. The following chart using data gathered by Real Capital Analytics, a New York-based research firm, shows the evolution in the retail investment market from 2003 to 2007.

## RETAIL MARKET




Source: Real Capital Analytics

During this 5 year period, retail landlords have enjoyed robust absorption levels and rent growth while consumers defied economists' expectations and kept raising their level of spending despite rising energy prices. But with employment growth slowing and the appreciation in home values clearly on a reverse course, retail vacancy is up and rents are likely to decrease. One trend that is clearly a result of the worsening economy is that shopping center landlords expect bankruptcy filings to increase and are becoming more proactive with struggling retailers.

The Hampton Roads market should continue to have strong retail market fundamentals, and national investors continue to look for opportunities to invest in Hampton Roads. Our CB Richard Ellis market research tracked 5 retail investment sales of $15 Million or more during 2007 including major properties both in South Hampton Roads and on the Peninsula.

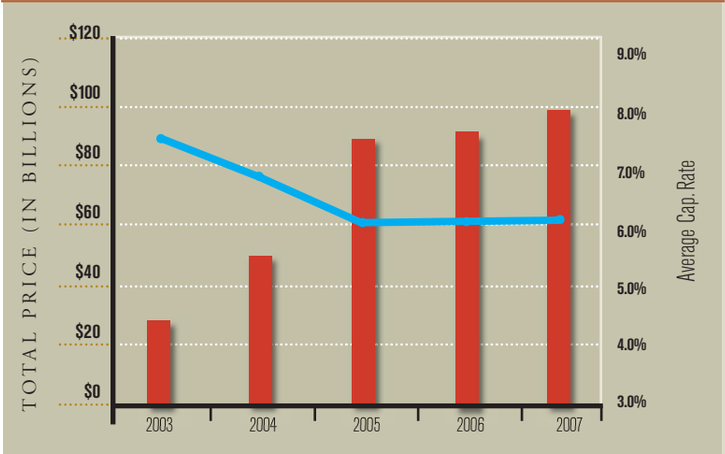
## 2007 RETAIL SALES OF $15 MILLION OR MORE

| Property Name | Purchase Price | s.f. | $/s.f. | Seller | Purchaser |
|---|---|---|---|---|---|
| Denbigh Village | $35,951,662 | 318,287 | $113 | Developers Diversified | Inland Real Estate Corp. |
| Lynnhaven North | $32,000,000 | 173,191 | $185 | North Mall Associates | Steven D. Bell & Co. |
| Cypress Point | $23,748,850 | 117,958 | $201 | Edens & Avant | DLC Management Corp. |
| Best Buy - Jefferson Ave | $21,100,000 | 110,017 | $192 | Townsend, LLC | IM Properties |
| Crossroads at Chesapeake Square | $19,180,000 | 119,985 | $160 | Crossroads at Chesapeake Square, LLC | Inland Real Estate Corp. |

# MULTIFAMILY PROPERTIES

During the period of 2003 to 2005, commercial real estate investment in multifamily (apartment) properties also increased dramatically in terms of volume while also seeing cap rates decline dramatically. Since 2005, multifamily investment volume and cap rates have been consistently strong. The -following chart using data gathered by Real Capital Analytics, a New York-based research firm, shows the evolution in the multifamily investment market from 2003 to 2007.

## RETAIL MARKET




Source: Real Capital Analytics

During this 5 year period, multifamily landlords have enjoyed strong occupancy and rental rate growth, particularly in areas with high barriers to entry in terms of new supply and areas with above-average economic growth. Going forward, the slowdown in the housing market features both good news and bad news for the multifamily market. The good news is that when the housing market falters, the apartment market typically benefits from higher demand as more people are forced to rent rather than pursue home ownership. The bad news is that when the housing market falters, more homeowners decide to place their houses or condominiums that they would prefer to sell on the rental market. This unplanned supply of potential rental competition effectively serves as "shadow competition" and may impact multifamily absorption and changes in rental rates.

The Hampton Roads market should continue to have strong multifamily market fundamentals including low current vacancies and very limited amounts of new construction. CB Richard Ellis market research tracked 11 multifamily investment sales of $15 Million or more during 2007 including major properties both in South Hampton Roads and on the Peninsula.

## 2007 APARTMENT SALES OF $15 MILLION OR MORE

| Property Name | Purchase Price | s.f. | $/s.f. | Seller | Purchaser |
|---|---|---|---|---|---|
| Marina Shores | $80,750,000 | 392 | $205,995 | BNP Residential Properties | Babcock & Brown |
| Bristol at Ghent | $48,300,000 | 268 | $180,224 | Bristol Development Group | Associated Estates Realty |
| Latitudes | $45,906,542 | 448 | $102,470 | BNP Residential Properties | Babcock & Brown |
| Myrtles at Olde Towne | $33,091,371 | 246 | $134,518 | Prudential/Roseland | Triple Net Properties |
| Mayflower Seaside Towers | $33,000,000 | 265 | $124,528 | Colonial Properties Trust | Fairfield Residential |
| Watermans Crossing | $24,686,681 | 260 | $94,949 | America First Investors | Sentinel Real Estate |
| Jefferson Point | $24,100,000 | 208 | $115,865 | Harbor Group International | AEW Capital |
| Heights at Olde Towne | $19,908,629 | 148 | $134,518 | Prudential/Roseland | Triple Net Properties |
| Dockside | $18,500,000 | 190 | $97,368 | Bluestone Realty | Urdang/Breeden |
| Oyster Point Place | $15,801,159 | 278 | $56,839 | Praedium Group | National Commercial Ventures |
| Heritage at Freemason Harbour | $15,600,000 | 184 | $84,783 | Collins Enterprises | ING Clarion Partners |