2011
HAMPTON ROADS
REAL ESTATE
MARKET REVIEW

INVESTMENT

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Financial Support

The E. V. Williams Center for Real Estate and Economic Development (CREED) functions and reports are funded by donations from individuals, organizations and the CREED Council.

Disclosure

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General Overview

The sun is back out again for commercial real estate investment.

On nearly every possible metric, commercial real estate showed signs of stabilizing in 2010 with even more optimism for an improved 2011 as well. There is particular optimism within capital markets as national U.S. sales transactions for office, industrial, retail, and multifamily assets doubled in 2010, and many experts believe that volume could more than double again in 2011.

The health of the commercial real estate industry begins with the health of the overall U.S. economy. By all accounts, the recession has ended and a more protracted expansion phase has begun. The painful reductions in employment have begun to turn around, particularly in the higher growth industries of technology, education, and health care. Many economists expect job growth to accelerate in 2011 as corporate America has been reporting strong profitability and productivity gains that allow more room to make increased "people investments". As businesses increase hiring, the commercial real estate markets should show continued positive absorption of space.

During 2010 the office and multi-family property types showed particular evidence of recovery. Both of these property types ended 2010 with positive absorption and vacancy factors well below the previous cyclical peak vacancies of the early 1990s. Within the office sector, CB Richard Ellis reported 11 million square feet of positive absorption in 2010, led particularly by the Eastern region of the country.

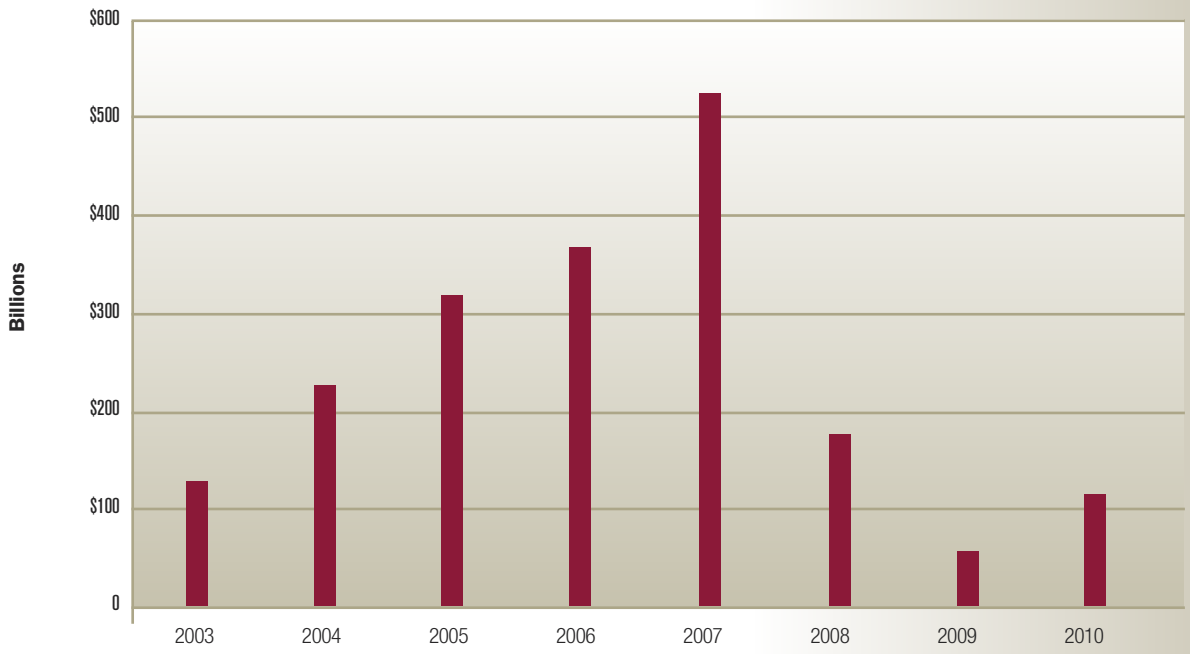
The retail and industrial property types showed signs of stabilization in 2010 with even stronger signs of recovery expected in 2011. The industrial and retail markets remained at the highest vacancy rate in the last 20 years at year-end 2010, but the return of bank credit for small businesses, consumer spending, and rising trade volumes all point to better days ahead.

While the market resurgence is clearly underway, there remains a sense of "survival of the fittest" throughout the entire industry. Investors and lenders remain cautious about what to move forward on, although the market optimism to some degree benefits all assets in all markets.

INVESTMENT SALES ACTIVITY WITH DRAMATIC GROWTH DURING 2010

While we are coming up from a relatively low base compared to the investment sales peak period of 2005 to 2007, it remains encouraging that sales volume doubled from 2009 to 2010, as reported by Real Capital Analytics ("RCA") in the below chart. For purposes of this metric, RCA tracks sales of $5 million or more for assets in the office, industrial, retail, and multifamily properties. In fact, December's volume of over $21 billion was the highest monthly amount recorded since the end of 2007.

Annual Investment Sales Volume



Source: © Real Capital Analytics, Inc. 2011

Among the many factors that can be attributed to the rise in real estate sales volume, a key factor is the fundamental faith in the economic recovery that allows underwriting of tenant creditworthiness and more accurate prediction of investment returns. Investors remain challenged to find higher yields in alternative investment types, and the low cost of debt allows positive leverage to accentuate real estate investment returns.

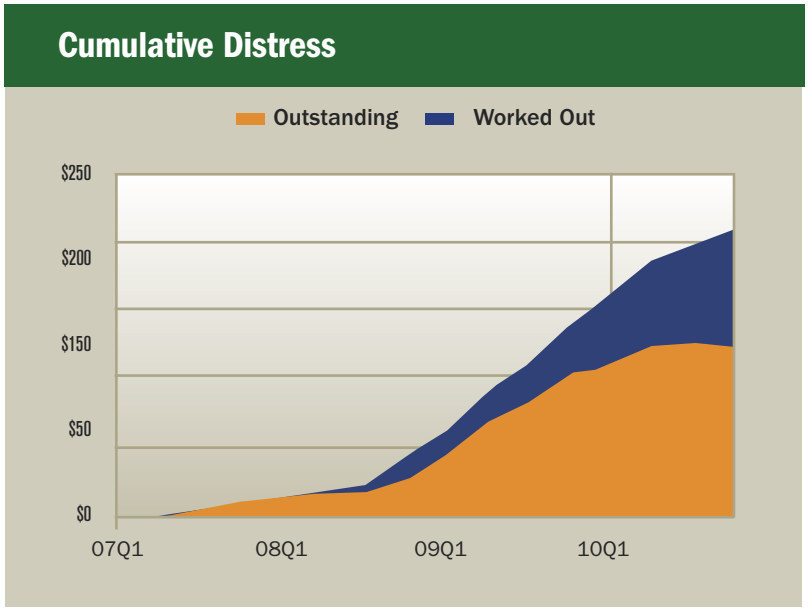
In terms of favored asset types, not much has changed since 2009. There continues to be strong demand for apartments as favorable government-sponsored financing remains available while rental demand is buoyed by the home ownership struggles that unfortunately continue for millions of Americans. Investors also continue to favor well-located grocery anchored retail centers, premier office buildings, medical office properties, and long-term single-tenant leased assets.

Within these property types, investment volumes have been particularly heavy for premium assets in primary markets. Given investors' preference to obtain higher yields with the lowest risk possible, the push toward "top-shelf" assets is backed by a belief that these assets hold value better in downturns and appreciate more in strong economies.

Investment volumes are also rising because more buyers realize that they should not expect huge price discounts on all assets available for sale. NCREIF, a national investment industry organization, reports that overall commercial real estate prices have already risen 30% from their trough, and as much as 50% for the premier properties in premier markets.

VOLUME OF DISTRESSED ASSETS HAS STABILIZED

A significant area of concern for the commercial real estate investment market has been the dramatic rise in distressed assets that occurred during 2008 and 2009. An encouraging sign for the real estate investment markets in 2010 was the clear stabilization of outstanding distress properties, along with increased volume of worked-out loans that are no longer considered in distress. The chart below prepared again by Real Capital Analytics shows that a rising percentage of the overall tracked distress properties has been worked out either through asset sale, loan restructuring, or loan extension.



It is also interesting to note that the rise in 2010 investment volume has a strong correlation to the rise in worked out loans in 2010. In fact, RCA reports that over 22% of the total sales volume was of distressed assets. Numerous well-capitalized investors remain positioned to take advantage of the buying opportunities from distress, but for the most part they have been very disappointed by the limited availability of high-quality investment product through that medium. Rather than a large tidal wave of opportunities in the short term, it appears that the overall maturity wave of loans will more likely lead to lower volumes of sales opportunities over each of the next five years.

The reason for that longer time frame is that Foresight Analytics estimates that $1.4 trillion of commercial real estate debt will come due between 2011 and 2014. Much of the debt coming due in 2012 and 2013, in particular, had a five year loan term on assets that were acquired at peak market pricing during 2007 and 2008. A large number of these associated assets have current values below the current loan balance and remain at risk to become distressed as the loan maturity dates get closer.

What is unknown is how the debt industry will change its patterns of dealing with borrowers in the years ahead. To date, many lenders have preferred to extend and amend loans to buy time for market recovery rather than moving forward to take title to the properties. Many experts expect lenders to be less willing to continue to do so if the individual property fundamentals and the borrower cannot show sufficient additional equity to bring to the table. The overlying market recovery should also make a big positive impact on the probability of a successful workout in each of these cases.

POSITIVE SIGNS IN THE COMMERCIAL REAL ESTATE LENDING MARKET

The Mortgage Bankers Association ("MBA") recently reported that the commercial real estate lending spiked in the fourth quarter of 2010 with the highest quarter over quarter increase in lending volume since mid-2007. Within that total volume, the MBA noted that the insurance industry originated more loans in the fourth quarter than any time since 2005. The year's overall reported volume of over $110 billion was a 36% increase over 2009.

While the MBA also reported that bank lending remained generally flat during the fourth quarter, most industry experts expect bank lending to show robust growth in 2011 as banks show improved profitability and seek to generate even higher earnings with their excess reserves and low cost of funds. The FDIC reports that year-over-year earnings improved for the fifth consecutive quarter in the third quarter of 2010.

As with the overall investment sales market, to date lenders have largely preferred to focus on lower leverage loans from well capitalized and experienced investors on premium properties in premium locations. As lenders have more confidence in overall real estate markets, lending volume for other non-premium assets (i.e. Class B properties or secondary market areas) should rise, particularly with more assets expected to be offered for sale in 2011.

Another encouraging sign in the lending market is the re-emergence of conduit lenders which adds to the market liquidity. Numerous well-known institutions including JP Morgan and Citigroup are rolling out conduit offerings (also referred to as Commercial Mortgage Backed Securities, or CMBS) with attractive loan terms including lower pricing, higher loan-to-value, and non-recourse terms. CMBS volume grew somewhat in 2010, but still 75% below the peak annual level in 2007.

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As all areas of lending sources show signs of improvement, the competition among lenders for the better offerings available is expected to lead to less stringent borrower terms. And of course, less stringent borrower terms are expected to add further momentum to the increase in sale prices as buyers have more favorable access to capital.

Investment Sales Activity in Hampton Roads Area in 2010

Over $151 million of office, industrial, retail, and multifamily assets sold in 2010 transactions of $5 million or more. The eight qualifying transactions are detailed below:

Property Name	Property Type	Purchase Price	Size	$/Size	Purchaser	Seller
Prime Outlets Williamsburg	Retail	$78,424,068	274,000 SF	$286.22/SF	Simon Property Group	Prime Outlets
Alta Great Bridge	Multi-Family	$26,675,000	192 Units	$138,932/Unit	Bell Partners	Wood Partners
Harbour View Medical Arts Building	Office	$12,550,000	48,517 SF	$258.67/SF	Health Care REIT	Lingerfelt Investments
Southport Center	Office	$8,300,000	61,594 SF	$134.75/SF	College Properties, LLC	Guardian Realty
Battlefield Corporate Center	Office	$8,000,000	96,720 SF	$82.71/SF	First Potomac Realty Trust	Mackenzie Fibres International
Cape Henry Plaza	Retail	$6,400,000	58,424 SF	$109.54/SF	Suburban Asset Management	Phillips Edison & Company
201 Dexter Street	Industrial	$6,000,000	445,000 SF	$13.48/SF	201 Dexter, LLC	Chesapeake Hardwood Products
Battlefield Woods Apartments	Multi-Family	$5,047,500	102 Units	$49,485/Unit	Lawson Realty Corporation	Continental Realty Services
	TOTAL	**$151,396,568**				

The largest sale of the year was a retail complex in Williamsburg that was part of a national portfolio of outlet centers. The Prime Outlets was one of twenty-one outlet store properties in a $2.3 billion transaction by Simon Property Group, a leading national retail owner.

Each of the other seven sales was a "one-off" sale, three of which were two national buyers showing confidence in the Hampton Roads area. Two of the national buyers were public Real Estate Investment Trusts which purchased individual office buildings in the area. Another two of the sales were multi-family transactions, one of which was to a major national buyer based in North Carolina. A local investor purchased the one other qualifying retail asset, a well-located grocery-anchored center in Virginia Beach.

It is also of note that two of the qualifying sales were owner-occupant transactions. Both Southport Center and 201 West Dexter (the one qualifying industrial sale) were purchased by investors that intended to occupy a large portion of the building for its own use. Debt financing remains readily available for these types of transactions, and recent changes to financial accounting regulations may point to even more investment sales to space users in the future.

We expect that Hampton Roads' continued economic stability should attract many national buyers in the months and years ahead as investors move beyond focusing exclusively on the top tier markets. Hampton Roads received national endorsement from the Brookings Institution as one of only five areas in the country that had positive job growth all four quarters of 2010.