Investment

2009 HAMPTON ROADS REAL ESTATE MARKET REVIEW

Acknowledgements

Author

J. Scott Adams, CCIM
President - Mid-South Region
CB Richard Ellis

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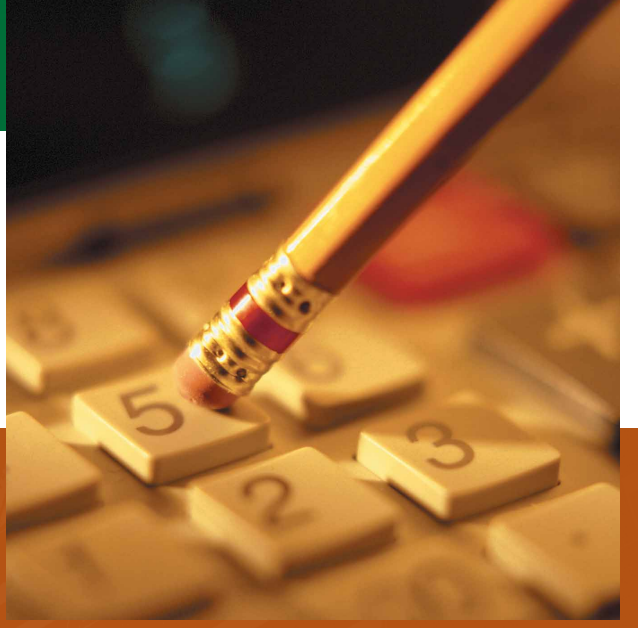


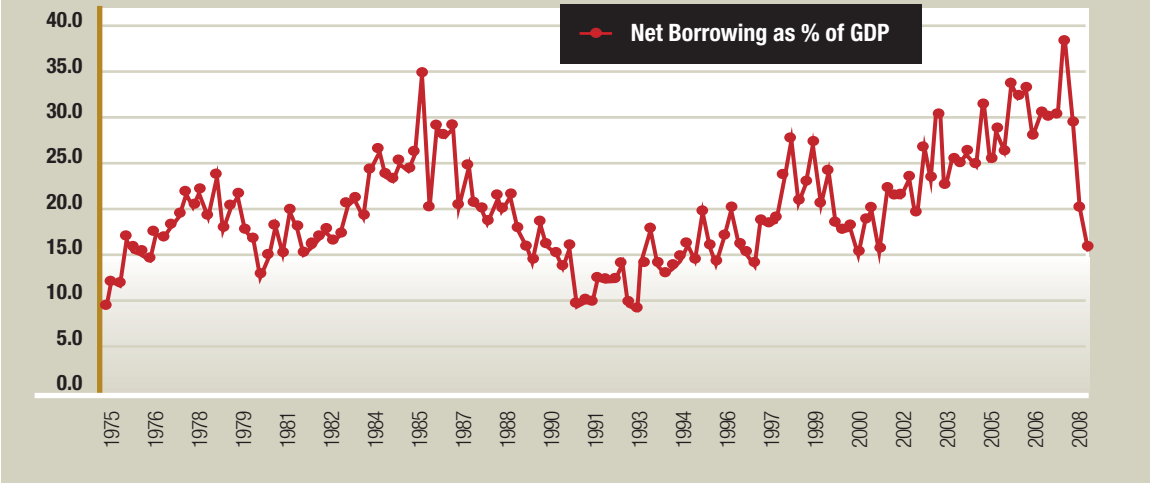
General Overview

While the fundamentals of commercial real estate remain relatively stable at this time, the signs of weakening across all product types are quite obviously upon us. The national economic recession is highlighted by sharp declines in consumer demand and businesses retrenching amidst great uncertainty. These declines will inevitably lead to lower rents and leasing levels with increasing delinquencies and distressed assets.

What is even more painful to commercial real estate currently is the near evaporation of real estate lending. All business sectors are going through a de-leveraging process, but the application to commercial real estate has exposed just how much the investment markets are reliant on debt to make transactions happen and to be able to hold on to assets as existing loans come due. The following graph from the Federal Reserve shows how our country's reliance on debt grew dramatically from 2000 to 2007, before falling off even more dramatically in 2008.

Table I

Lending Has Shut Down Very Quickly



Source: Federal Reserve

COMMERCIAL VERSUS RESIDENTIAL

In last year's report, we were concerned that the dire issues with sub-prime mortgages in the residential market would have some impact on the commercial real estate markets as well. Unfortunately, the decline into a global credit crisis has been far more severe than was expected, and in some ways the results have been even harsher for the commercial industry.

With residential lending, the loans in place typically are repaid fully after a set period of time, and so long as payments continue to be made there is no requirement to re-establish the loan itself. In commercial lending, however, the loans are usually set for a 5, 7, or 10 year period with big payments due at the end because the loans amortize over a longer period of time (typically 25 or 30 years). Commercial borrowers are faced at the loan term maturity with the need to "re-finance", or "take out" the existing loan with a new one. Our commercial system has basically relied on the assumption that there was no risk for such a re-financing event to occur.

THE FINANCING CRISIS

Unfortunately, the assumption of the availability of refinancing sources is no longer valid. Owners of commercial real estate with loans coming due are learning that new loan terms are extremely stringent with markedly lower proceeds. The lower loan amounts available are caused by the laws of supply and demand; lenders have the upper hand with far more demand for loans than available supply.

Specifically, lenders today are using far stricter underwriting terms with concern over tenant creditworthiness, market fundamentals, and general economic factors. As borrowers with existing loans see the new loan source offering fewer dollars than their existing loans in many cases, they are forced to raise additional equity or make the decision to sell the property. In the worst case though, the borrower may not be able to accomplish either scenario, and the lender may find themselves actually the pending owner of the property.

The real question then is what happened to the available loan funds? Why did loan to value ratios slip from as high as 85% to 90% of asset values a year and a half ago to down to 60% to 70% of even adjusted values today? This swing can be tied to 2008's near collapse of the credit markets starting with the Lehman Brothers bankruptcy and continuing with a series of high profile intervention moves by the federal government.

While the government has infused billions of dollars into the banking system with the public expectation that new loans would be made, the banks are being privately encouraged to build capital cushions to protect against future losses from other existing loans on their books. Until the banks have a full understanding of the true condition of their portfolios, new loans will be sparse. This period of self inspection is occurring while over $530 billion in commercial mortgages are expected to come due in the next 3 years according to the research firm Foresight Analytics.

The securitization market was originating loans, bundling them and selling bonds based on the cash flow available from these pools of loans collateralized by a diversity of underlying assets. The demand for these bonds had grown, causing two opposing phenomena. First, an ever expanding group of players built platforms to originate these bonds providing more aggressive underwriting and secondly, yields on the bonds had grown extremely tight, driving down interest rates. The securitization market was efficient and allowed banks to originate long-term, fixed-rate loans to borrowers without retaining loans on their balance sheets. When the market for the bonds suddenly evaporated, many banks were left holding aggressively underwritten loans which they are not designed to maintain thereby putting severe pressure on their balance sheets.

Other historical sources of commercial real estate lending such as credit companies and insurance companies also built large securitization platforms and have been left in the same predicament as the banks. While many traditional life company lending platforms had previously been left behind by borrowers who had instead opted for securitized loans,

life companies now have the upper hand and are only lending on choice assets while continuing to monitor their overall investment portfolio. Local banks generally have limited capacity due to legal lending limits, and many have significant issues with development loans or business loans on their books which are facing their own repayment risks.

GROWTH IN DISTRESSED ASSETS

As commercial real estate borrowers face the uphill battle of refinancing and even performing on their existing loans, lenders are seeing an increase in delinquencies. As delinquencies are protracted, those loans first become classified as non-performing, and the loans may eventually be foreclosed by the lender at which point they are classified as Real Estate Owned ("REO") by the banks.

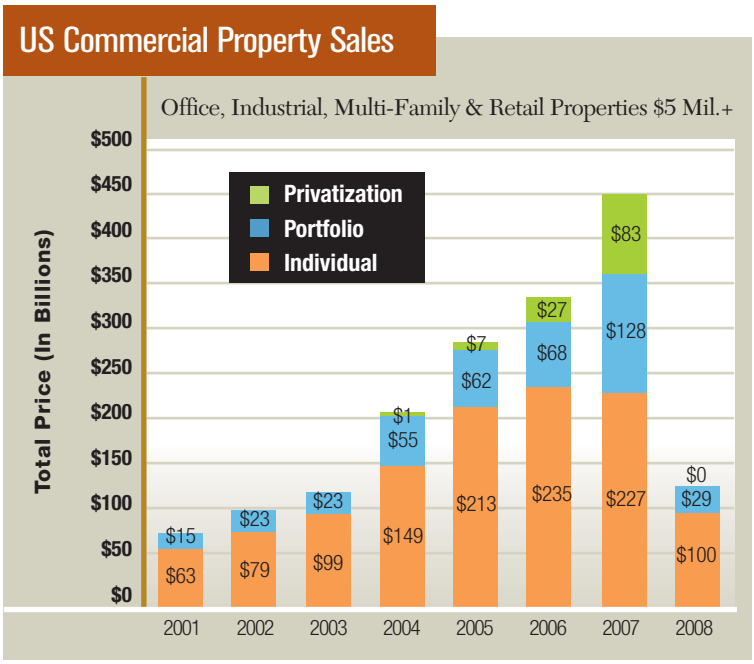
A first step by lenders facing balance sheet scrutiny is to try to sell their existing loans. Many national and regional investors see an opportunity to buy the loans at 35% or greater discounts to principal balance. The buyers of the debt can then either work with the existing borrower, perhaps on market-adjusted terms, or even be in position to take over the asset ownership directly.

Most lenders would prefer not to have to take the second step which is to foreclose on the loan and then have to be in position to sell the asset itself. Most lenders are working closely and carefully with existing borrowers to give them time to work through existing market challenges. The assets that are typically being taken over are highly leveraged assets, either with failed development or redevelopment efforts or from acquisitions made at peak market pricing with little equity invested.

At the current time, the majority of distressed assets taken over by lenders appear to be in the residential and land product types rather than in office, industrial, multifamily, or retail areas. The spectre of increased distress and potential discounted pricing on bank's Real Estate Owned is causing a wait and see attitude by most investors.

CAPITAL MARKETS

While investors are extremely cautious overall and aggregate investment volume is down, thousands of sale transactions are still occurring across the country. Many casual industry observers assume that all near-term sales will be distressed assets at sharply discounted prices, but this is not the case. Well-located, strongly performing assets with solid long-term fundamentals are trading at prices perhaps 15% to 20% below 2007's peak pricing. Core assets with no near-term lease rollover are the most desirable investments, and assets that can be sold with existing assumable loans or seller financing are particularly attractive.



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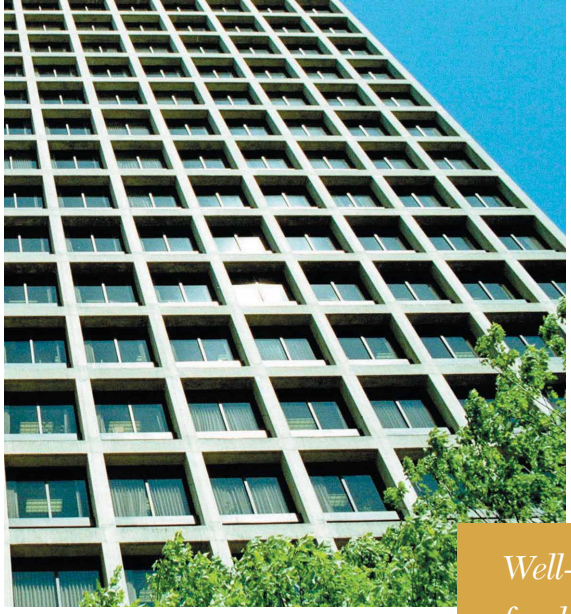


Those potential buyers of real estate looking for acquisition loans today find a whole new world of lender analysis. Lenders are looking for a high debt service coverage ratio from the in-place net operating income, while also paying more careful attention to who the buyer is. Lenders are looking for financial strength of the borrowers themselves and want customers that they can count on for multiple transactions and other benefits (i.e. deposit base for bank lenders). And, if the loans are actually offered, borrowers are seeing higher loan rates as lenders add spreads of 400 basis points or more to the U.S. treasury rates to account for the perceived risk of real estate loans. These higher spreads are offsetting the benefit of the government's sharp lowering in the index rates themselves.

Well-located, strongly performing assets with solid long-term fundamentals are trading at prices perhaps 15% to 20% below 2007's peak pricing.

The changed world of real estate lending is largely accountable for the huge drop-off in investment volume during 2008. The chart on the previous page was prepared by Real Capital Analytics, a New York-based research firm. The graph shows the decline in U.S. commercial property sales over $5 million. While individual asset sales declined by over 50%, portfolio sales declined by 75% and the privatization of publicly held real estate was nearly completely extinct.

WHERE WE GO FROM HERE

As opposed to past cyclical declines in the commercial real estate industry, the 2008 slowdown was not caused by overbuilding. The supply excesses are far more limited than in previous cycles, but will grow as demand is reduced by the economic slide. During this period, all owners need to continue to focus on basic asset management for their properties with a push to retain existing tenants, outperform others to attract new tenants, and reduce existing operating expenses.

At a minimum, new sales or re-financing efforts should be expected to take longer, and more careful preparation and hard work will be needed than prior to the credit crisis. The de-leveraging of our industry must be seen as a long-term positive, although there will be short term pain and fall-out as a result. While opportunistic buyers would like all sellers to see distress everywhere and expect price decreases of 40% or more, most owners should choose to hold their assets if they can, rather than sell into such difficult headwinds.

While national headlines will likely continue to be very negative during all of 2009, commercial real estate is used locally, and Hampton Roads has many factors which should help it outperform other parts of the country. The defense industry, Hampton Roads ports, and a growing health care industry are particularly encouraging signs for our area. Those areas of Hampton Roads with accessibility and outstanding infrastructure and tenant amenities should hold up best and should see the least harsh impact of the changed environment.

The following pages highlight the impact of the national observations on the office, industrial, retail, and multi-family product types overall and within Hampton Roads.

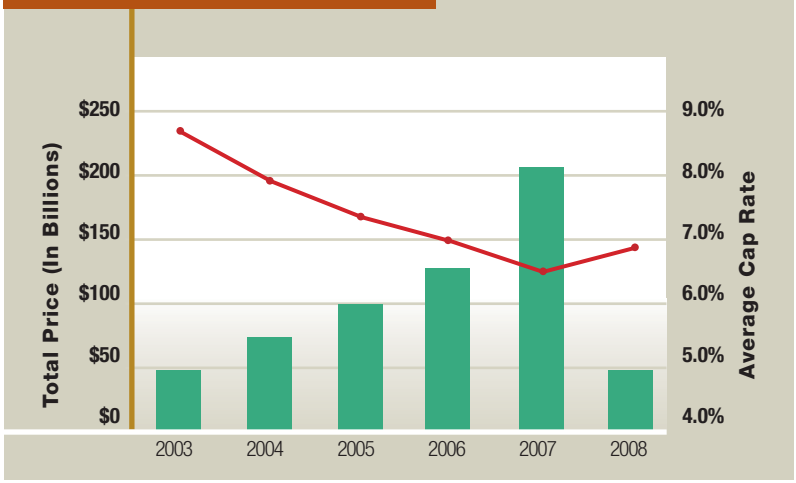
OFFICE PROPERTIES

The sharp run-up in national office investment sales from 2003 to 2007 fell off dramatically in 2008 as the decline in capitalization ("cap") rates over the same period began to reverse as well. The following chart using data by Real Capital Analytics shows that office investment sales reported over $5 million fell below $50 billion for the first time since 2003. Average cap rates were still under 7.0% but, with the current lending environment, there is reason to expect that cap rates will continue to move toward the 2003 cap rate level of approximately 8.5%.

Low net absorption caused by massive national job losses and corporate cost-cutting may slow the office market recovery until 2010 or later. National markets with heavy exposure to banking and financial services, as well as the housing industry, are facing the most severe near term declines. Other markets with strong foundations with the government, energy, trade, and healthcare sectors are continuing to show relatively strong performance. Office building owners are focused on bridging the downturn with longer-term leases and focus on operating fundamentals to maintain cash flow as high as possible.

During 2008, the volume of office investment sales within Hampton Roads actually remained on par with recent years. Our CB Richard Ellis market research tracked the following 6 investment sales of $10 million or more. These sales include major transactions both in downtown Norfolk and in the suburban markets of both South Hampton Roads and the Peninsula.

National Office Market



2008 Office Sales of $10 Million or more in Hampton Roads

Property Name	Purchase Price	SF	$/SF	Seller	Purchaser
World Trade Center	$54,000,000	366,175	$147	UBS Realty	Harbor Group International
JFCOM Building	$51,681,632	351,075	$147	Rubicon America Trust	Urban America
Harbour View Medical Portfolio	$34,123,250	116,311	$293	Tri-City Development	Montecito Medical Investment
Executive Tower and Pinewood Plaza	$20,728,398	207,000	$100	Asset Capital Partners	CSG Partners
Town Point Center	$12,755,000	131,259	$ 97	Parkway Properties	Harbor Group International
Former Symantec Building	$11,165,625	98,506	$113	Symantec Corporation	Municipal Partners

INDUSTRIAL PROPERTIES

The sharp run-up in national industrial investment sales from 2003 to 2007 also fell off dramatically in 2008 as the decline in capitalization ("cap") rates over the same period began to reverse as well. The following chart, using data by Real Capital Analytics, shows that industrial investment sales reported over $5 million fell back to the 2004 level. The average cap rate of the 2008 sales was just over 7.0%, but was still 100 basis points lower than the 2004 average cap rate.

The hype and excitement regarding industrial properties took a tremendous fall during 2008. Prior to the credit crisis and recession, the industrial market benefited from strong global trade, continued economic growth, and high levels of consumer spending. The national and global economic slide, in turn, leads businesses to require fewer goods to be manufactured, shipped, and stored. Industrial users are accordingly focused on being more efficient with their space usage and investing in enhanced logistic management systems and technology. Warehouses located near ports and airports are generally outperforming more remote facilities, and investors are still drawn to the lower retrofit cost benefit of owning industrial assets.

During 2008, there were no reported industrial investment sales within Hampton Roads of $10 million or more.

RETAIL PROPERTIES

The run-up in retail investment sales from 2003 to 2007 was less dramatic than the office and industrial property types over the same period but experienced an even greater fall in 2008. The following chart using data by Real Capital Analytics shows that retail investment sales reported over $5 million fell below $30 billion for the first time since 2003 while the average cap rate was still 225 basis points lower than the 2003 average.

The retail investment market has reacted swiftly to the declining housing market, end of cheap and plentiful credit, and increases in both tenant defaults and job losses. Consumer spending has slowed dramatically, amidst the actual impact of the recession and the perceived impact of the loss of wealth with lower home and investment values. The declines have been lessened with the decline in energy prices since mid-2008, and there is an expectation that the new government administration will institute a second major fiscal stimulus package to help consumers. The retail sectors which appear to be holding up the best are grocery anchored centers in high income areas as well as urban retail in primary "24 hour" markets.

During 2008, our CB Richard Ellis market research tracked the following 6 investment sales of $10 million or more. These sales include major transactions both in South Hampton Roads and the Peninsula.

National Retail Market

2008 Retail Sales of $10 Million or more in Hampton Roads

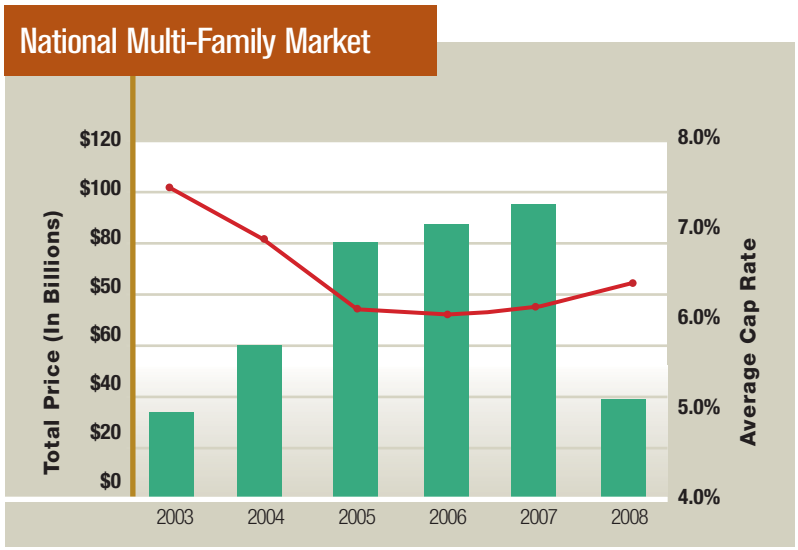
Property Name	Purchase Price	SF	$/SF	Seller	Purchaser
Jefferson Commons	$79,664,251	400,000	$199	Goodman Company	Inland Western Real Estate
Haygood Shopping Center	$24,870,000	178,526	$139	Klaff/Acadia	Steven D. Bell & Co.
Williamsburg Market Center	$23,780,000	120,920	$196	Robert Brown & Associates	Waitzer Properties
4725 Virginia Beach Boulevard	$13,000,000	123,577	$105	Greendale, LLC	Rachael Joe, LLC
Dam Neck Crossing	$11,900,000	138,571	$ 86	Dam Neck Crossing Assoc. (Hardy Butler)	Private Investor
Freedom Ford	$10,300,000	93,275	$110	Freedom Industrial, LP	Harbor Group International

MULTI-FAMILY PROPERTIES

The strong and consistent 3-year run of multifamily investment sales from 2005 to 2007 ended in 2008. The below chart using data by Real Capital Analytics shows that multifamily investment sales reported over $5 million fell below $40 billion for the first time since 2003 while the average cap rate was still 100 basis points lower than the 2003 average.

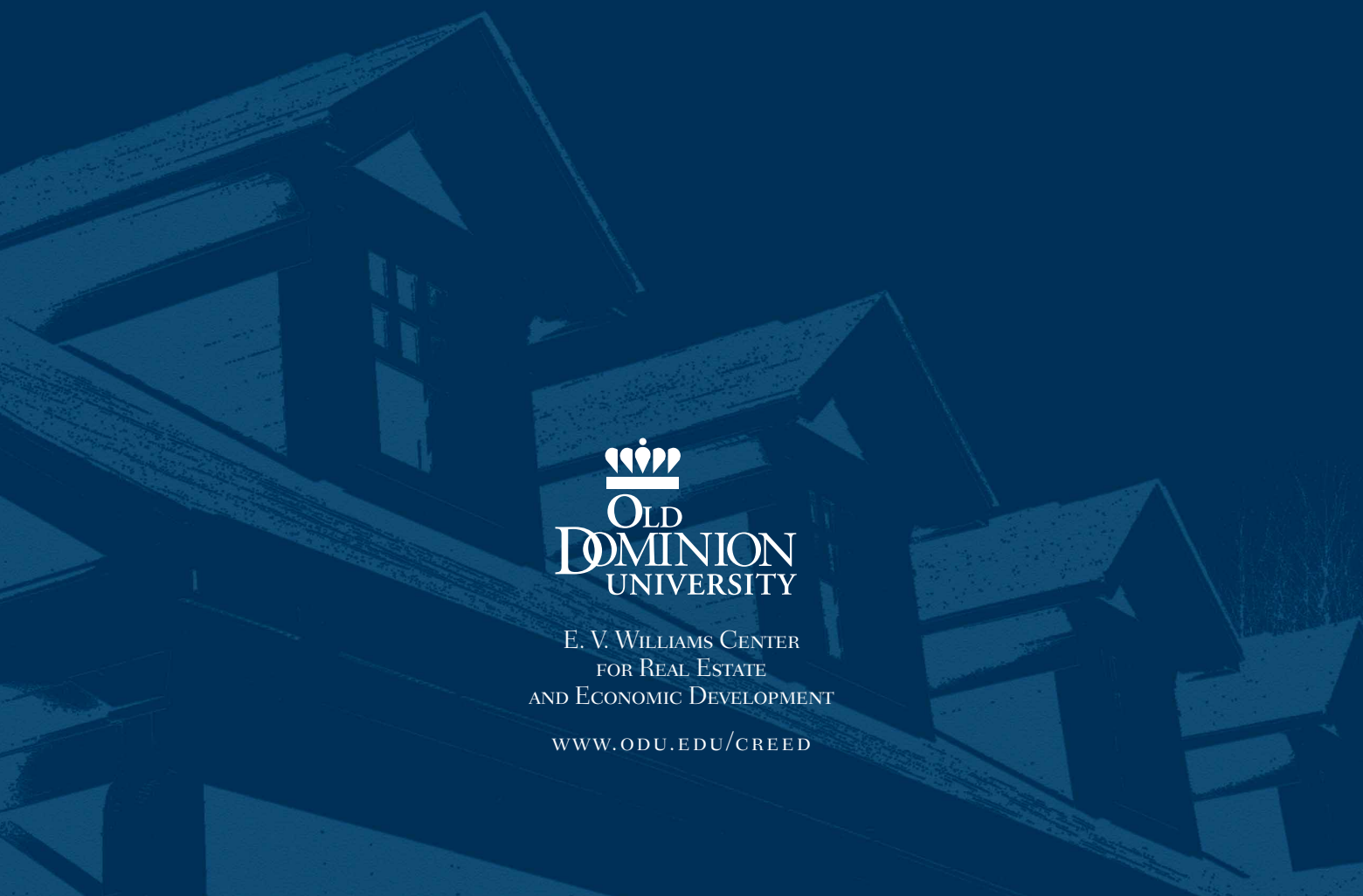
The multifamily investment sales market remains, by most accounts, the best risk adjusted core real estate investment. While the positive impact of the housing correction for the multifamily market is that the number of rental households is increasing, the economic slowdown has a direct negative impact also. Like other commercial product types, many multifamily owners are offering more rent concessions and lower rents, while expecting a reduction in tenant credit quality. The shadow competition of the possible renting of for sale product (i.e. condominiums and houses) is also of concern when evaluating the health of individual markets. And while the multifamily industry uniquely benefits from government sponsored lending sources (i.e. Fannie Mae and Freddie Mac), there is concern that the government will restrict their lending further in light of overall credit concerns.

During 2008, our CB Richard Ellis market research tracked the following 4 investment sales of $10 million or more. These sales include major transactions both in South Hampton Roads and the Peninsula.



2008 Multi-Family Sales of $10 Million or more in Hampton Roads

Property Name	Purchase Price	Units	$/Unit	Seller	Purchaser
Mariner's Cove & Steeplechase	$70,200,000	678	$103,540	AIMCO Joint Venture	Harbor Group International
Runaway Bay	$48,739,000	440	$110,770	AIMCO	Harbor Group International
Watermans Crossing	$29,650,000	260	$114,038	Sentinel Real Estate	Harbor Group International
152 Jenness Lane	$11,045,000	213	$ 51,854	Timberwoods Mutual Homes	Community Partners



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