2008 MID-YEAR COMMENTARY

AGM COMMERCIAL REAL ESTATE ADVISORS

July 23, 2008

Hello everyone. I hope you had a great first half of 2008, and a great July 4th holiday.

I am sending out a link to our 2008 mid-year market report. Here you can get both a Baltimore Metro area report and a national report. We use data provided by a company called Costar to compile this information, and it has proven to be quite good.

The link for the reports is: http://www.agmcommercial.com/reports/index.html

You can also get to these reports by clicking on our homepage and navigating to the link for "Market Reports." www.agmcommercial.com

The most telling sign of how the market has behaved over the last six months comes in the form of questions I get from clients. Six months ago, people were asking, "How's the market and have you been affected by the housing slowdown." Today, people are asking "How are you holding up?" The difference is meant to be somewhat humorous. Clearly, the commercial market has been devastated by the general deleveraging that is occurring across broad swaths of asset classes. Or to put it plainly: It is tougher to get loans, so there are fewer buyers, and as a result, prices are being pushed down. As I wrote in January:

> *In my opinion, the credit market has not become bad or tough; it has simply reverted back to the standards that have existed for years or even decades. A lot of the price appreciation we experienced over the last few years was not created by increased operating efficiency or effectiveness; it was created by ever more aggressive underwriting enabled by ever more aggressive debt pricing. To put it another way, the buildings weren't making more money. Rather, the buyers were willing to accept a lower return as the interest rates came down.*

I can now say with authority that the credit market is very tough. The CMBS market which funded its operations by selling the debt on the capital markets has reached a point that we would consider a near shut-down. Local banks are still making loans, but typically on more stringent credit standards than existed previously. With fewer dollars spread across the same assets, the price will fall. We have seen this start to become the reality in many markets. Institutions, which to their credit, are often the group most able to remove the emotional issues from a transaction, have adjusted their expectations both on the buying and the selling side. Stabilized properties have sold for higher and higher capitalization rates, often as high as 100 – 150 basis points over where they would have sold 12 or 18 months earlier.

The biggest value deterioration has come in vacant or non-stabilized properties. In 2006, vacant properties were often selling at a price that reflected the value that would exist if the property were fully leased and generating cash flow. The prices did not reflect any (or very little) risk premium in leasing, improvement requirements, and carry assumptions. In fact, from our analysis, many deals were done with a negative risk premium (meaning you would rather have a risky property than a less risky property)! That level of acceptance has disappeared from the market, and has created a large gap between the expectations of sellers and the expectations of buyers in today's market. As I said in January:

> *I believe we are going to see 6 – 18 months of very low activity. It takes a while for market players, especially sellers, to wrap their arms, heads, and hearts around the new market realities. Keep in mind that while we are often talking about "institutions", "developers", "entrepreneurs", "businesspeople", etc., we are still talking about people. Most people, if they are told that something is suddenly not worth as much as they believed a few months earlier will simply hold on to that asset. The institutional asset manager does not want to admit that their underwriting was wrong or that they failed to see a change coming in the market. The individual owner will typically believe the market value will return shortly (in the same way many homeowners are having difficulty dealing with the new market pricing.) Once the psychological shock wears off, I think we will see the market return to normal. Assets with stable income will once again sell for a reasonable rate of return based on the riskiness of the cash flow. Vacant or value-added opportunities will go back to selling for a discount to compensate for the added risk.*

I have had several conversations with people who want to sell a property that go something like this:

Seller:	I want $1,000,000 for my property
Me:	I think it is worth less and let me explain my reasoning. Based on what you want to lease it for, the maximum cash flow per year would be about $100,000 which would make it worth about $1,150,000.
Seller:	I agree.
Me:	The building is vacant and needs $200,000 in repairs.
Seller:	I agree
Me:	You haven't been able to lease it for 18 months since you bought it. I think I can get it leased, but it will take me 9 months, which costs me $50,000 in interest.
Seller:	I agree
Me:	Plus a tenant will want some improvements that will probably cost me $50,000
Seller:	I agree
Me:	So at $850,000 I am buying risk for the same return as buying a stabilized property.
Seller:	(Pause) But I wouldn't sell it for that.

Anecdotes aside, larger corporation and institutions typically have been quicker to adjust to the reversion to a more classical model of pricing. The groups that I have found has had the hardest time have been groups that purchased properties recently and are now realizing that the market has moved against them. The advice we have given to our clients is simple. To sellers, we tell them the fundamental axiom of finance: sunk costs are sunk. What you paid doesn't matter, only what the market will bear. To buyers and for ourselves as we look at properties for our investment funds, we live by and offer this tidbit: don't pay for someone else's mistake.

On a side note, AGM did dispose of one asset during the 2nd quarter that was held in a co-investment fund for roughly 2.5 years. The property was purchased completely vacant, neighboring property was assembled, and the building was renovated and leased. In so doing, we were able to generate cash flow that valued the building significantly higher than our input costs. The building, fully leased, sold for an 8% return (which is probably .75% – 1.0% higher than it would have sold for a year earlier). The equity partners were able to realize a 43.4% annualized compounded return.

On the leasing side, the market has tracked very closely with the overall economic "mood" of the country. While the hard statistics are in the report, as a generality, we have not seen many huge negative absorption events in the area such as massive layoffs or firings. The general comment I hear from people is something along the lines of "We're doing fine, but I keep hearing that everything is going to be terrible, so we are tightening the hatches to weather the storm." This has created a situation where many companies are simply not doing anything in terms of leasing new space. This was most noticeable in the 2nd quarter. For AGM, our deal starts fell significantly, and many deals that had been strategically planned, were postponed. Larger public firms are often dealing with reduced stock prices, which have driven up their costs to undertake new projects. The end result is that the 2nd quarter saw a general malaise in the leasing market that will self-correct over time as business confidence returns. In my view, the results of this will not be seen statistically until the 2nd quarter of 2009.

AGM was fortunate to participate in some of the larger leasing transaction of the first half of the year including the relocation of GSE System's 35,000 square foot headquarters and the relocation of Geosyntec's 17,000 square foot regional headquarters.

On a final note, despite the tougher economic climate that exists, we have continued to grow and add quality people when they come available. We were very fortunate to recruit Yasmin Dolan to our firm from Coldwell Banker. Yasmin is a Senior Director, and will be helping AGM further our efforts in office and industrial sales and leasing.

As always, please let me know if I or anyone at AGM can be of assistance. Have a great 2008!