Hello everyone. I hope your first six months of 2009 have been successful, and that you have had a great July 4th holiday.

Our 2009 mid-year reports are available. I am in the same situation where for legal reasons, I can no longer post the official report, but I would be happy to email it to anyone who would like to receive it. It you are interested, please simply email me and I will forward to you immediately. We again have 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.

From a leasing perspective, the first half of 2009 was probably the most interesting half year in my years as a commercial real estate broker. It really saw two competing forces at work, namely strict reduction of expenses competing with pent up demand. The first stemmed from the incredible volatility seen in the capital markets starting in the last quarter of 2008. The second stemmed from how long that volatility has lasted. This volatility made it impossible for companies to judge what their cost of capital would be, and therefore created an environmental where everyone was in wait-and-see mode. And everyone did just that – nothing. As we got into 2009, the capital markets were still very volatile, yet certain deals needed to get done simply out of necessity (due to lease expirations, consolidation plans, etc.) What all of this led to was the resolution of demand which had built up in 2008, and a flurry of activity was seen. Often the resolution was simply for a company to renew its lease at its current facility. Other large companies used the opportunity to save money through consolidation. What was missing from the demand side was any accommodation of growth. Few companies, if any, were at all concerned about managing continuing increasing in capacity.

What made the leasing activity even more interesting was the lack of depth in the market. There were certainly several large transactions that occurred. However, there were many more landlords chasing those deals than there were deals to be had. Several of the transactions closed with terms that had not been seen for many years and which many people thought would not be seen again. Overall office vacancy jumped from 12.1% to 12.7%. Overall warehouse vacancy rose from 10.4% to 10.5%, and overall retail vacancy jumped from 5.2% to 6.2%.

Sales activity was equally difficult to wrap one's arms around. We did start to see an acknowledgement on the part of sellers that the asset pricing was (and is) mostly unrealistic. Pricing of stabilized properties has fallen, but we have seen a tremendous closing of the bid-ask spread for these income producing properties. The largest market dislocation has happened in speculative and unstabilized projects. Often these were purchased using very optimistic assumptions which have simply not panned out. As we value properties, it is very typical for us to arrive at a conclusion that a risky property is worth 20% – 40% of the asking price. These types of projects have really languished on the market, and are by far the hardest to value.

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To put it in simpler terms, I was having a conversation with a local developer, and we were discussing the evolution of pricing since 2003. We discussed a hypothetical building that delivers a $100,000 per year net income. In 2003, it would have sold for $1,000,000, meaning it was worth a 10% return. In 2005, it was still making $100,000 but it sold for $1,111,000 making it worth a 9% return. In 2007, it was still making $100,000 but it sold for $1,250,000 making it worth an 8% return. This hypothetical example played out throughout our market and throughout the county. Building valuations were increasing not because of operating efficiency, but simply due to capitalization rate compression. This process is now reversing, and we have already seen a jump of well over 100 basis points for similar credit deals over the last 12 months.

The question I get more than any other from clients is "when do you see a turn-around coming?" I hate to sound like a broken record, but in January, we wrote the following:

…demand for space… is the most fundamental driver of everything and anything that happens in commercial real estate. Companies use space, whether warehouse, office, retail, flex, or any other type to conduct trade, store goods, or sell items. As those levels of activity decline, the demand for space gets reduced.

What does all of this mean? It means that I am no smarter than anyone else, but that the full recovery in the commercial real estate market will happen once employment rises. It seems over the last few months, people and markets have cheered a deceleration of job losses. For us to have a healthy commercial real estate market, these reports need to turn into job gains. Until that time, I think the leasing market will remain flat but not dormant. Asset pricing will fluctuate depending on the financing environment, but I believe return rates will stabilize along their long-term historical averages based on credit quality.

I sometimes wonder why it takes painful lessons to be reminded of the stuff you already know or learned. I would like to learn a valuable lesson, just once, by winning the lottery. But since that hasn't happened, I reflected on an email I saw from a lender named Doug Weil with Northmarq Capital who laid out his reflections on the state of the market and lessons learned. He wrote:

There are cycles to all aspects of our lives, as well as to baseball and real estate investing. But as much as things change, they always revert to the norm. Thus, remember the old adages from past lessons learned.

Never Invest Long and Borrow Short - Lesson learned during the REIT slowdown of the 70's but forgotten by the second generation at General Growth.

Remember Historical Interest Costs – When rates are below 7.5% borrow long, when they are above 9% borrow short. The last four years were an aberration. There is debt available today for quality properties at 50-60% of value at 7.5% or better rates

It's 50 Cents Stupid –In the 90's, if you could buy at 50 cents of replacement value or 50% of the last sale price, you could not go wrong. We are not quite there yet.

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<u>Real Estate Has Ten Year Cycles and Seven Year Memories</u> – Expect rents and occupancies to continue to deteriorate for another 12 months, resulting in a rise in defaults. Assets need to be re-priced to produce positive leverage and when they are, the buyers will reappear in droves. There is plenty cash on the sidelines.

The last point he makes is incredibly insightful (and my personal favorite.) Hopefully everyone reading this will be retired in another 10 years, but should we still be writing these notes at that point, I think it will be worth reflecting on.

Here at AGM Commercial Real Estate Advisors, we are "hanging in there." There have been other years in the business that were more fun, but overall, we are still successfully doing deals throughout the area. We were fortunate to be able to represent Head USA in its renewal of its East Coast distribution center of 106,000 square feet. We have also been fortunate to represent 7-Eleven in its continued expansion, and have helped them secure several sites in the region. In addition, we have been very active in evaluating opportunities for co-investment. As values have fallen, we hope to be in position to benefit from more attractive pricing.

We continue to prepare for a longer storm, but stock up on sunscreen for the rebound. Hopefully, that comes sooner rather than later for everyone. As always, if there is anything we at AGM Commercial can do for you, please let us know. Have a great second half of the year.

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