2009 YEAR- END MARKET COMMENTARY

AGM
COMMERCIAL REAL ESTATE ADVISORS

Hello everyone. I hope you have survived 2009, and were as excited as I was to buy a new calendar that said 2010.

Our 2009 year end market reports have been completed. 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.

Now for the details of the year that we will be trying to block from memory…

As many of you know, I have two young children, ages 7 and 5. Many of my friends have children who are younger and even some with babies. In discussing parenting with my friends we often talk about the changes we notice in our kids and we talk about what we have gone through. Of particular note for friends of mine that have younger kids is discussing the terrible twos. For my wife and I, the terrible twos were followed by what we then termed the “terribly horrific f*%^& f()J(! threes.” So what am I talking about here? A comparison can be drawn between that period of parenting and the real estate market over the last 2 years.

If you read my semi-annual commentary (available on our web site), you will know that since 2007, I have been discussing the counter-intuitive (fancy word for idiotic) pricing models that were being used, and warned that if we experienced any combination of two of three factors, we would have significant dislocations (fancy word for pain) in the market. The factors were higher interest rates (no), a slow-down in demand (yes), and a rise in vacancy (yes). If 2008 were the terrible twos, 2009 was an even-worse follow up.

There was no single measuring stick of commercial real estate that had a positive performance in 2009. Asset sales in 2007 were roughly $583 billion. In 2008, they were $150 billion (a 75% fall off). In 2009, they were just shy of $60 billion (a 90% fall off from 2007.) Please take a second to consider how severe of a drop that represents. Wall Street analysts go crazy if Best Buy’s top line goes down 1% or GDP drops 5%. The commercial real estate transaction volume fell by 90% over a two year period! Leasing of office space in Baltimore saw a positive net absorption of nearly 1,300,000 square feet, with much credit going to the defense and government sector users. However, that was more than offset by the delivery of nearly 2,300,000 square feet. Warehouse had negative absorption of nearly 1,900,000 square feet, and was compounded by an additional 500,000 square feet of new construction, thereby creating an additional 2,400,000 square feet on the market. Finally, retail had negative absorption of just over 1,000,000 square feet, and an additional 780,000 square feet was completed.

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Anything positive that can be taken from the market's 2009 performance was primarily due to the second half of the year. The start of the year saw many companies in a complete bunker mentality virtually paralyzed by fear. As the year wore on, there was a gradual acceptance, understanding, and eventually, forward looking planning. That process led to a strong pick up in leasing activity across the board over the last 6 months of the year. The acceptance of the state of the economy also allowed Landlords to become much more aggressive and adjust their expectations to the current environment, further enabling a rebound in leasing activity. Industrial vacancy stood at 11.4% at the end of 2009 (up from 10.4% at the start of the year), office vacancy stood at 13.4% (up from 12.1%) and the retail vacancy rose from 5.2% to 6.4%.

Sales activity has been virtually non-existent throughout the year for the two primary reasons that have been evident in the market for some time. Specifically, I am referring to the lack of liquidity and credit as one factor, and a still-significant bid-ask spread on the other. Or, to put it more simply, it is tough to get a loan and sellers are still priced with a memory of valuations from 18 months ago, and buyers have not stepped up to that pricing level. We have noticed a significant positive change in the tone of lenders for the types of smaller projects that we are often engaged in (under $10mm.) These types of lenders are banks that plan on holding the loan on their books for the duration of the loan, and scrutinize the deal as one would expect. The "shadow banking establishment" (which, through various different means, incorporates all lending done by selling the debt immediately as securitized notes) which funded much of the price appreciation we saw throughout the decade has still not returned in any capacity at all. To be sure, some transactions have occurred. The common thread we have seen are sellers willing to take a price more determined by the underlying health of the leasing market combined with well-capitalized buyers who can borrow at historic loan-to-value ratios of 75% or less.

One very important note regarding the pressures and opinions that exist among the participants in the commercial market is that it is absolutely vital to understand that the market's behavior is becoming more fractured each day. To illustrate what I mean, I want to reference a conversation I recently had with a client. That client, like many people, had read in the Wall Street Journal that commercial real estate is falling off a cliff and everything should be a tremendous steal. The fallacy of that broad brush comes from simple human behavior. We have seen a decline in valuations across the board for all commercial property types and in all possible situations over the last two years. Fully-leased and stabilized properties which once sold for a 7% return now sell for an 8.5% return (we call it a capitalization or "cap" rate and the higher it is, the lower the price for the same return.) That represents a fall in value of 18%.

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Significant to be sure, but the downward pressure on that type of property is somewhat alleviated by the simple fact that since it is performing, at some pricing point, the owner simply holds onto the property. In fact, while I do not believe there is enough data to make very hard conclusions about the second half of 2009 in Baltimore, across the country, cap rates have stabilized in the last six months, and in some cases, come down.

So where is the "blood in the streets?" Unstabilized properties with significant vacancy have become an ownership pariah. There has been a huge return of a risk premium, and to compensate for that, buyers want to own the properties at very significant discounts to what was almost always paid, and typically what is being asked for the property. How significant? It is very typical for us to underwrite a property and arrive at a value fully 75% less than what is being asked. Often in these cases, the property is worth not only far less than what was paid, but also far less than the debt. In essence, the owner CAN'T sell the property because they have negative equity, and it makes more sense to hold out as long as you can. As these properties go into special servicing or foreclosure, the overall appearance will seem as though the entire market is crumbling, when in fact it is only certain portions of it.

So where does this leave us for 2010? As I look into my crystal ball, there are certain trends that I feel confident will continue, and others that my previously mention children have as good a chance at getting right as I do. The things I feel confident about are:

1. The sales trends for stabilized properties will continue and could weaken or strengthen slightly, but should not change significantly. Cap rates will simply not have any pressure to make a major move (either up or down) for the upcoming year.
2. The sales trends for empty unstabilized properties will continue and get worse – perhaps much worse. This large subset of properties is what has the Federal Reserve and bank CEO's up at night. The debts are not slightly higher than the values, they are wildly higher. This is the group that is going to face a reinforcing downward pressure on pricing brought on by foreclosures, debt service, and lack of tenants.
3. There will always be the "friend of a friend" who got a deal that sounds almost impossibly good. It may be true, or it may not be true, but don't base your opinion of values and opportunities on a statistical outlier. Trust me - I want to be that person too.
4. Investors running around with other people's money with no risk to their own capital will take chances that may look good on the surface but simply don't make sense. That being said, this has been true for as long as I can remember. I mention it because there will be many organizations operating on this principal in the coming years.

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What do I not know? My wife would be happy to provide her constantly updated list, but as far as the commercial real estate market goes, my biggest uncertainty lies with the stability of the leasing market? The significant bounce we saw in leasing activity in the second half of 2009 needs to clarify as to whether it was well-timed and risk-evaluated investment, or simply pent up demand from 9 months of virtual stand-still. Similar to earnings for stocks, this is the fundamental base upon which all other parts of the market are built (asset valuations, financing, etc.) In my unverified opinion based on almost 2 decades of leasing, the market tends to track the stock market more than the debt market. Since, based on my 2009 investments, I clearly have absolutely no idea what I am doing in that arena, I cannot say where we will be a year from now.

On a personal level, AGM muddled through 2009. Our revenue was down, but we were able to put systems in place that have made our company significantly more efficient and effective. We were able to once again take part in some of the larger deals in the market place, most notably advising HEAD USA on its east coast distribution center and advising Delta Airlines on the sale of a former reservation center. Our investment projects have begun to have positive cash flow, and we continue to allocate significant time and energy into trying to identify interesting investment opportunities. We are grateful to our clients for continuing to place their trust in us, and we look forward to 2010 with open arms.

About The Author:

Gregory Friedman is one of the co-founders of AGM Commercial Real Estate Advisors and has practiced commercial real estate brokerage and investing since 1994. Greg has a BA from Washington University in St. Louis, and a Master Degree (finance) from Loyola University in Baltimore. He lives in Baltimore, Maryland with his wife and two children. His full biography can be accessed at the following web address: http://www.agmcommercial.com/people/friedman.html

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