

Boston Realty Advisors Insider Report

REAL ESTATE IN CRISIS

Fall 2008 has finally marked the beginning of the investment real estate bubble deflation. Throughout all asset sectors including multifamily, retail and office, properties have reverted back to lenders, and buyers' aggressive "business plans" for income growth have not been achieved.

**National Association of Real Estate Investment Trusts
(All Asset Classes)**
-49.16% YTD - 2008

Industrial REIT Segment
Losses of 88.11% YTD - 2008

Lodging & Resorts Segment
Losses of 66.57% YTD- 2008

Regional Shopping Malls
Losses of 66.34% YTD - 2008

Self Storage
Losses of 14.59% YTD - 2008

(According to the New York Times- 12/14)

In the immediate future, cash-strapped institutions and private investors will have to sell assets under distress. In Q1 2009, both the multifamily and retail markets will experience an aggressive de-leveraging event, as values decline and lenders' borrowing criteria continues to tighten. Investors who financed assets in 2005 through 2007 with short term or mezzanine financing will not be able to secure permanent financing. Many assets were purchased based on aggressive underwriting of income growth and high risk short term debt. These lofty income targets and reckless buyer financing will produce ample fallout of high quality assets.

We estimate that sales velocity of (fee and/or debt) assets will increase in 2009, and 30%-40% of the property sales will be classified as "distressed." Target sellers are: 1) owners that cannot place permanent financing on their assets; 2) corporations who need to raise money on their balance sheet; and 3) property owners who have difficult times leasing. New market pricing is now taking into account: 1) future vacancies; 2) increased LTV's and lending requirements; 3) reduced corporate credit ratings of tenants; and 4) rising unemployment.

MULTIFAMILY

Multifamily rents throughout the US will soften in 2009 and 2010 as unemployment rises and wages decline. However, US apartment vacancies on moderate and affordably priced units will remain low due to the lack of financing and the continued instability of the consumer residential mortgage markets. Con-

A REPORT ON THE CLIMATE OF THE MULTIFAMILY, RETAIL AND LAND MARKETS IN NEW ENGLAND AND BEYOND

trary to the rest of the US market, Boston apartment rents will not decline, but will remain flat in 2009 and 2010, outpacing US national trends, where most rents will decline. In 2008, Boston rents have risen 4.2%, while vacancies had decreased to 3.5%. Furthermore, Boston's local economy is one of the strongest in the United States, as identified by the lowest commercial vacancy rate in the country for any urban area. Diverse economic drivers such as education, medical, biotech, pharmaceutical will continue to stimulate the Boston economy.

Sales of multifamily properties in Massachusetts, like the rest of the country, have declined over last year's record pace. In transactions under \$10 million, deal volume has fallen 46% versus last year and 34% versus 2006. I think it is important to note that the previous two years have been unprecedented, thus it is not surprising to see these dramatic declines, despite all that is happening on Wall Street.

The silver lining in all of this is that deals are still getting done and buyers are still willing to enter the market. Additionally, sellers are starting to adjust expectations to meet the market. We are seeing more deals at higher capitalization rates. While sellers will lament "the good old days" of 5 percent cap rates (with no built-in lender, maintenance or vacancy reserves!) the market really is a better place in the long run with increasing investor returns and properties sold with better fundamentals.

REAL DISTRESS

In the September 8th article in Barron's, "Out of Control," the article identifies major apartment owners like Tishman and Apollo who are in serious trouble with their recent acquisitions of apartment assets. The following four causes of distress will create reasons for owners and lenders of apartment assets to sell at deep discounts. This will occur in Q1 2009 and beyond.

- 1) Aggressive rental income assumptions
- 2) Reckless debt financing
- 3) Up and coming market "repricing"
- 4) Challenging credit markets

Sales Velocity will come from the following sources:

- 1) Assets purchased at auction (fee sold by lender)
- 2) Assets purchased from unstable, motivated sellers
- 3) Debt purchased at steep discounts to par

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MARKET ANALYSIS

PRICING

Cap rates for apartment assets in NY and Boston have increased about 125 basis points in the last twelve months. We predict that due to market distress, cap rates will continue to expand by a minimum of 200 to 300 basis points. The fundamental change that will occur in underwriting is that buyers will be unwilling to pay for future value in terms of rental growth and higher occupancy. Properties will also price for potential future market turbulence. Boston Realty Advisors believes buyers will be able to buy apartment assets at a positive spread of 200 to 300 basis point from cost of debt to net effective yield (cap rate). Traditionally over the last 75 years, cap rates for multifamily have hovered between this rate. Additionally, assets will be underwritten conservatively with future decline of occupancy and rental rate.

LEVERAGE

Buyers in the marketplace will look to use Fannie Mae multifamily financing at a non-recourse level of 50%-55%. These deals are currently being offered in today's market. We have witnessed a slight easing of the credit market, and the 50% - 55% leverage product should remain available through the next 12 months. The 1% - 50% LTV debt level has remained extremely stable. Quoting rates is a moving target, but the most recent comp we have is a five year term, fixed, 240 basis points over the 10 YR US treasury. The typical amortization is between 25 and 30 years. Leverage is non-recourse at this time up to about 50% LTV. The level between 50%-65% has springing recourse based on either appraisal OR reduction in NOI.

COST OF LEVERAGE

Pricing for multifamily assets with the suggested leverage above is running roughly 220-250 Basis Points over the ten year treasury. This rate is about 6.5%. We believe that rates will increase an additional 100 basis points over the next six months.

IMPROVEMENTS/OTHER COSTS, EXPENSES

The positive trend is that construction costs and labor costs continue to drastically fall. Additionally, contrary to months ago, utility costs have also softened considerably, adding more net operating income to the bottom line. On the municipal level, a risk to watch are aggressive increases in municipal property tax rates.

RETAIL

Unlike the multifamily asset class, the retail market is in absolute chaos. Lower consumer spending and tanking consumer confidence will lead to many retailer defaults and bankruptcies. We are predicting "Darwinist times" where only the strongest retailers will survive. Furthermore, retail assets that are in strong locations with necessity based retailers will out perform the market. The enclosed chart references the recent performance of the top 25 retail REITS. Most shocking is the rumored up and coming bankruptcy of General Growth Properties (NYSE: GGP), the second largest retail REIT in the world.

With all of this, the retail real estate sector is one of the weakest asset classes. This will provide large opportunity for well heeled, hawkish investors.

Buyers will most likely target the following retail assets in 2009:

- Necessity based retail centers in AAA locations in the Greater Boston Area with strong demographics, pedestrian/car counts (further validation of this strategy is the following snapshot: October 08, same store sales for Saks and Nordstrom, down 11.7% and 12.1% respectively. For Wal-Mart and Costco, same period, up 1.4% and 5.6% respectively.).

- Assets that are multi-tenanted that have necessity based retailers such as supermarkets and discount chains.

There will be many distressed retail centers available for purchase, through foreclosure, purchasing debt and or purchasing retail properties from motivated sellers.

Retail Vacancies in the City of Boston, vacancies should increase to 8-11%, while suburban vacancy rates should increase to 13-17% (as new product is currently under construction and will be delivered in 2009 and 2010).

Buyers will look for retail assets that yield 10% cap rates or better. Underwriting will take in account market risk, predicted vacancies and predicted retailer defaults. Typical retail buyers' investment criteria will be retail assets in AAA locations or assets with the targeted mix of retail tenants will be considered.

For purchasing retail assets, banks will require less leverage (LTV's hovering 45-50% for non-recourse) and higher spreads with the cost of leverage (50-100 basis points higher than multifamily).

In summary, over the next 24 months, there will be ample opportunity to purchase distressed retail assets. There will be major challenges ahead with retailer credit risk and vacancies, but with historically affordable cost of debt and purchasing in high caliber, long term fundamentals of purchasing great retail in terms of location and tenant mix, will be a winning strategy.

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LAND ENTITLEMENT

There will be many opportunities to purchase distressed land. Typical buyers will option or purchase “dirt” and adaptive reuse projects at deep discounts in 2009. As construction financing is basically non-existent at the current time, owners of permitted land or non-performing assets are under potential major distress to sell. There may be opportunities so compelling, both in pricing and location, that it makes sense to purchase an option or inventory the land outright. Additionally, construction costs continue to plummet. In terms of financing, there are still unique financing programs through HUD that allows developers to leverage up to 90% loan to cost to build rental product.

Completed Land Transactions may happen in 2009 if they meet the following criteria:

- Basis is right on land pricing
- Clarity on construction financing (lender commitment before hard deposit)
- Clarity on construction costs (full and complete bid on construction costs)
- Preleasing and tenant commitments
- Potential to option and only risk working capital, as opposed to making outright acquisition

There is variable risk with permitting, construction costs, leasing and changing financing/leasing cycles. Even when purchasing land in AAA locations, risks pursue, as identified by the up and coming foreclosure of the prized Robinson-May Property in posh Beverly Hills.

ABOUT BOSTON REALTY ADVISORS

Boston Realty Advisors provides a full spectrum of investment sales dispositions through conventional marketing programs and auctions. In early December, Boston Realty Advisors has teamed up with Sheldon Good & Company to provide auctions in New England. Additionally, Boston Realty Advisors provides asset management services for lenders and banks who have real estate owned (REO). Boston Realty Advisors has been named a Power Broker by Costar in 2008. For more information regarding the firm, please visit www.bracommercial.com.