Message from the Chairman

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Realty Services

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Friends,

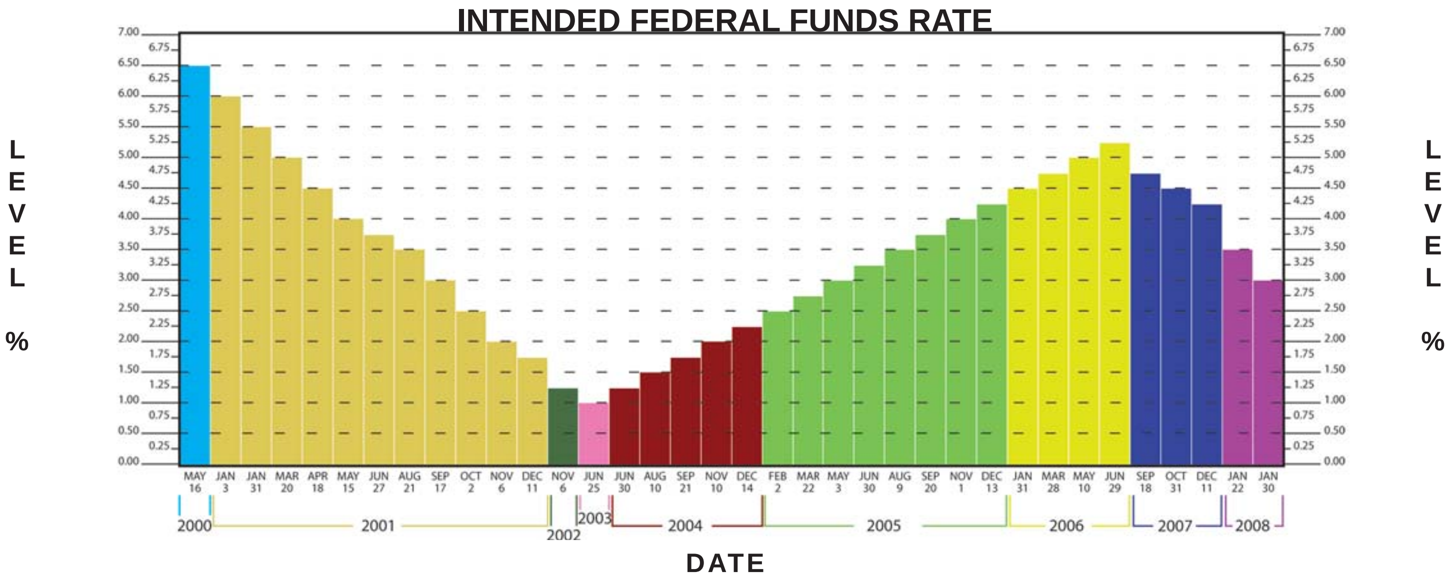
Given the current state of both the building sales and credit markets, the most commonly asked question I've been getting recently has been, "Bob, how did we get in this position?" My answer to this question has simply been that 2007 will be remembered as the year we started to pay for the Fed keeping interest rates too low for too long. Here is why and how we got here:

The market can be broken down into three distinct segments: the pre-August 2007 market; August and September of 2007; and October 2007 through today. To fully understand where we are today, it is very important to take into consideration what the Fed's policy on interest rate fluctuations has been going back to the early '90s. From 1994 through 2000, as we were coming out of the recession of the early '90s, the Fed kept the Federal Funds Rate between 5.5% and 6.5%. In 2000, with the overseas credit markets getting a little squishy, the Fed began a policy of cutting interest rates. Between 2000-2003, the Federal Funds Rate was dropped in 13 successive sessions from 6% to 1% (see graph). This extended period of interest rate cuts brought interest rates to a point where they were below the rate of inflation. Let's consider this for a moment; if interest rates are lower than the inflation rate, monies kept in the bank have less purchasing power in the future than they do today. This dynamic creates a tremendous incentive for people not to save and to purchase long term assets. What is the long asset of choice for many investors? Real estate. This created overwhelming incentive for people to buy apartments and to buy investment properties which led to excessive domestic demand in our real estate markets. This ignited tremendous upward pressure on pricing.

Looking at the Fed policy from mid-2004 to mid-2006, we observe a period of 17 successive sessions where the Federal Funds Rate was increased from 1% to 5.25%. During the period of 2000-2003 when the Fed was cutting rates, mortgage rates adjusted almost instantaneously. As the Fed was increasing rates from June 2004-June 2006, the lending rates did not increase in concert with the Federal Funds Rate increases. The market was simply not reacting. As the excessive demand continued and banks were competing viciously to put debt dollars on the street (which kept compressing spreads), our low interest rate environment persisted.

In the pre-August 2007 market, we were faced with a perfect storm of scenarios in our building sales market: 1. Low interest rates; 2. Low supply of available properties; 3. High demand both from domestic and foreign purchasers (it is important to note that in the period 2001-2007 there was more economic global expansion than during any other period in history); 4. Lower yield expectation on behalf of buyers; 5. A growing percentage of sellers were opting to effectuate 1031 tax deferred exchanges. Up until August 2007, prices had increased and tremendous amounts of capital were created, but the infrastructure in which to invest all of this capital significantly lagged behind. In addition, shortcuts were taken in the due diligence processes resulting in continually escalating prices.

During August and September of 2007, we saw a number of confluences: the sub-prime crisis started to have a tangible effect on the market; interest rates starting rising; recession fears started growing; institutions were coming to grips with the fact that multi-billion dollar writeoffs were eminent; unemployment started to escalate; consumer confidence was falling; consumer spending was slowing; the dollar continued to get weaker. All of this led to a tremendous amount of uncertainty, and for those two months, the market resembled that of 1990-1991 when



the market came to a standstill. During this period in the conflict of fear versus greed (in which greed normally wins 75% of the time), fear was winning. We also started to see cracks in the global economy. As a result, banks started to increase spreads and debt service coverage ratios, amortization returned as a component of almost every loan (was not the case previously) and loan to value ratios dropped. More equity was required and, given that equity is more expensive than debt, intuitively, one would think that prices would fall.

Let's look at the market from October 2007 through today. The Fed has started cutting rates and for four sessions in a row (plus an interim session cut) the Federal Funds Rate has dropped from 5.25% to 3%. Interest rates are coming down. There remains a very low supply of available properties, demand is still very strong and the influence of the U.S. economy relative to the global economy has become apparent. It is amazing to fathom that the U.S. Gross Domestic Product is 4.5 times the size of China's, and in fact Wal-Mart purchases more goods from China than the entire United Kingdom purchases. Layoffs have not been as severe as had been anticipated; however, GDP growth has been very low with a significant portion of that growth coming on the heels of increased exports based on the very weak U.S. dollar.

The question remains, are we headed into a recession? Economists use four main indicators to determine whether we are indeed in a recession: 1. Real personal income levels; 2. Employment; 3. Industrial production; 4. Retail and manufacturing sales. Currently, these indicators are approximately 40% positive, 40% negative and 20% unchanged. Most indicators are, unfortunately, at pre-recession levels but are much healthier than the levels we faced going into the early '90s.

We are facing a liquidity crisis. The fundamentals of the real estate market remain strong with residential vacancy hovering around 1% and office vacancies in Midtown Manhattan at 4.6% with a $74 per square foot average. The hotel market continues to thrive as the weak dollar attracts foreign travelers to New York, also as international travel becomes cost prohibitive, domestic travelers remain within the U.S.

We believe the volume of sales, in terms of the number of properties sold, will decrease approximately 20% in 2008. It is important to differentiate volume on a "number of transactions" basis from "aggregate dollar of volume of sales basis" as we believe the aggregate dollar volume of sales will be off more substantially as the number of billion dollar transactions decreases in 2008. Thus far, we have seen prices remain fairly stable as cap rates may be inching up slightly, but given the increases in rents that the market has experienced over the last few years, even with slightly increased cap rates, prices per square foot continue to escalate. For certain, transactions require more effort to close but there still is a good flow of activity.

Very truly yours,

Robert A. Knakal
Chairman

During Mr. Knakal's 24-year career, he has sold over 940 buildings having an aggregate market value of over $5.0 Billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1990, he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under forty years of age for outstanding achievement in the New York business community. In 2001, Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue between 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street.

Please give a call if you have questions about your property or the market in general.

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