A CONVERSATION WITH THE CHAIRMAN

MASSEY KNAKAL Realty Services

2nd Quarter 2009

Economics, Politics and Real Estate Have Never Been More Closely Related

REBNY REAL ESTATE BOARD OF NEW YORK chip

Dear Friends,

We sat down for our quarterly conversation with Massey Knakal Chairman, Robert Knakal to discuss his views on the economy and the implications for our local NYC building sales market. We hope you find this interview informative and timely.

Q What has happened to the building sales volume in the first quarter of the year?

A Sales volume was extraordinarily low. In 2008, volume in the under $100 million market was down 40% from 2007 levels. The over $100 million market was affected much more adversely. **We do not have the final figures for the first quarter yet but are anticipating that if extrapolated in annual terms, the volume of sales was probably running at about 1.2%.** If you recall, our projection for turnover this year was "1.6% or lower," representing the percentage of the 125,000 multi-family apartment buildings, mixed-use, commercial and retail properties that exist in the five boroughs in our niche. Since 1988, the average turnover has been 2.5% and we have only dropped to 1.6% in two other years, 1992 and 2003, both at the end of recessions. The very low turnover in the first quarter is the result of the uncertainty in the marketplace in the fourth quarter of 2008 after Lehman Brothers failed. People were shell shocked and there were not a lot of contract signings in the fourth quarter. Those that were signed resulted in closings in the first quarter. **We anticipate the level of activity to pick up in the second quarter as first quarter contract signings showed a reasonable increase.**

Q How were prices affected in the first quarter?

A Well, that depends on the segment of the market that you are referring to. Clearly, the over $100 million market saw very significant reductions in value but there have been so few transactions it is very difficult to quantify what that reduction was. 1540 Broadway is the transaction everyone points to which occurred at about 70% less than it had at the height of the market. I don't think you can draw a conclusion about the entire market based upon one transaction. With regard to the under $100 million market, we have seen pricing differ based upon product type. **The multi-family sector has been holding up the best, where capitalization rates have increased only 50-75 basis points from their peak.** Retail properties and office buildings have been much more greatly impacted by the economy as the increase in unemployment has affected demand for office space and rents have been tumbling. Capitalization rates on office buildings are up in the neighborhood of 150-200 basis points from their peak. **With regard to the retail property market, consumer spending, although up slightly in March, is still at extraordinarily low levels which is putting tremendous stress on retailers.** For these reasons cap rates in this sector are also up by about 150 -200 basis points.

Q You indicated the multi-family sector was doing best, have you seen any tangible effects of the bills passed by the assembly in January?

A Everyone in the marketplace is concerned about the status of these bills. **If the bills are passed by the Senate in June there are two things that are**

certain. There will be a massive of the erosion of the tax base from the multi-family segment over time and the level of deterioration of the housing stock over the next several years will be extensive. The Democratic majority in the Senate is, for the first time in quite a while, truly jeopardizing the housing stock in the city. Thousands of construction and related jobs will also be lost if the Senate passes these bills into law.

Q How has the recent J-51 decision on Stuy-town affected the market?

A The answer to that will really depend on the result of the appeal. **If upheld, the decision could have devastating financial consequences for owners who de-regulated apartments based on luxury de-regulation in buildings covered by rent stabilization while they were getting J-51 benefits.** Since 1993, it has been standard practice for owners of buildings getting J-51 benefits to de-regulate apartments based on luxury de-regulation and collect market rents from the de-regulated tenants. The DHCR opinion letter permitted this practice. The court's ruling will wreak havoc on affected owners and could endanger their financial stability. It raises the prospect of rent rollbacks and rent overcharge complaints. The financial viability of the buildings themselves could be affected. The difference a de-regulated apartment can make in the profit or loss of a building is substantial.

Q Although the multi-family market has been doing well, we have discussed in the past huge increases in expenses including heating oil. Has that expense moderated?

A After hitting a high of $147.00 per barrel in July of 2008, oil prices fell down into the low $30's early in 2009 and, on Friday, I believe was trading around $50 a barrel. **It appears the market is hitting somewhat of an equilibrium point as OPEC has announced a production reduction of 4.2million barrels a day since September when the market price hit the low $30's.** This is an important metric to watch as it does have a tangible effect on the value of multi-family properties.

Q Is there any activity in the development market?

A There have only been two land sales in the post Lehman (September 15th) environment. One was 1133 York Avenue which was purchased by Sloan Kettering Hospital and the other was a small site purchased in midtown by the Korean Government. Both of these were user purchasers. **There is a significant gap between seller's expectation and buyer's pricing in today's market.** Land that was worth $400 or $500 per buildable square foot a year and a half ago is now worth between $150-$200. There are plenty of buyers at that level but sellers have not reached the capitulation point thus far.

Q In the past you have indicated that the weak dollar has helped our local hotel industry. How has the dollar performed in the first quarter?

A During the first couple of months of the year, the dollar surged but then stumbled as the quarter came to a close. Since the global financial crisis intensified last year, investors have consistently been seeking out the dollar as a safe harbor. Even after a roller coaster ride of a quarter, the dollar still ended the quarter on a positive note. It strengthened 5% against the Euro, 9% against the Yen and 4% against JP Morgan Chase's trade weighted basket of 16 currencies. **The dollar's gains were much more impressive in the days leading up to March 18th when the Federal Reserve shocked markets by announcing that it would directly purchase U.S. Treasury Bonds.** This historic announcement sent investors rushing to sell the dollar. This resulted in the worst single day drop against the Euro since the European Currency was established a decade ago.

Q Why is the Fed buying U.S. Treasury Bonds?

A The Fed's move was initiated to bring down borrowing costs in a very troubled economy. They cannot lower the near-zero federal funds rate any longer so now they are using alternative ammunition. The downside of this is that it creates real fears that the move could produce inflation in the long run, since it effectively means printing money to buy U.S. debt. This inflation would in turn erode the dollar's value and cause foreigners to think twice about borrowing dollar denominated assets. It will be interesting to see which of two potential dynamics will take hold if this occurs. Generally, in an inflationary market, dollars are diverted toward hard assets, real estate being a prime candidate. However, the inflationary environment brings higher interest rates and foreigners may view this higher cost of borrowing as a deterrent.

Q If the government is going to purchase such a massive amount of T-Bills that should drive interest rates down, correct?

A That was the Fed's goal. Intuitively, you would think this would occur but even with the Fed purchasing T-Bills, last Friday the ten year yield ended the session at 2.917%, as high as it was in mid March. As this ten year yield approaches 3% it poses a challenge for the Federal Reserves program to buy about $300 billion in Treasuries over the next 6 months. **As the yield on the ten year note rose, the yield spread with the two year note widened in what is technically termed the steepening of the benchmark yield curve.** As this yield curve grows, its stresses real estate lender's margins putting upward pressure on mortgage rates. As the Fed has only begun its purchasing program, it is hoped that as they continue to purchase, it will drive the yield down.

Q Have you seen a lot of distressed assets come to market?

A The flow of distressed assets to the market has only been a trickle through what it is a very long and dense pipeline. We have sold several notes and a few properties which lenders had taken via foreclosure. But **we expect the flow of these assets to come to market with significant force beginning around the third quarter of this year.** We are presently analyzing hundreds of assets for various lenders and based upon this activity we believe we will see significant opportunities later this year.

Q How did REITs perform in the first quarter?

A Overall, the Dow Jones Equity and REIT Total Return Index, which tracks 113 stocks, posted a negative return of about 32% in the first quarter. That was slightly better than the negative 39% return in the fourth quarter of 2008. This index is now down about 68% from its February 2007 peak.

Q Do you think REITs are undervalued?

A Yes, I think they are undervalued. Although analysts say that REITs are trading at an average 5% discount to the value of their underlying assets, I find that analysis humorous because the only way to calculate the underlying asset value of most REITs today is to throw a dart a board. Notwithstanding the difficulty in calculating today's market value, it does appear that the REITs are undervalued. **I also believe it is a very positive sign for the market that the TALF 2.0 & 3.0 should help to stimulate the lending market for larger properties which are the typical targets for REIT buyers.** It should also help REITs effectuate refinancings. **It is encouraging that two big REITs recently successfully completed equity raisings.** That could be a sign that we are at or near the bottom for that sector.

Q With such a lack of transactions in today's market, how are you determining value when meeting with a potential seller?

A The value of a property today is dependent upon sale transactions which have occurred subsequent to September 15th of 2008. We are not only looking at closings subsequent to this date but also want to look at contract execution dates. **The world changed on September 15th and any information prior to that date is irrelevant when calculating today's values.** We are not only looking at these post Sept 15th contracts which have closed but are looking at transactions which have been placed under contract recently to give us an indication of current value today.

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Q What were the conditions in the credit markets during the first quarter?

A Parts of the credit markets showed signs of improvement in the first quarter. Government programs helped stabilize short term debt markets where companies and banks fund their most immediate and basic needs. There was also a fairly healthy increase in new debt raised by high quality or investment grade companies. But this improvement in the credit markets has been uneven. Other credit markets are still mostly frozen. Lower quality companies are shut out unless they want to pay exorbitant spreads to borrow money and markets for securitized debt, which are the lifeblood of the consumer economy, remain stagnant.

Q You always talk about the activity of the portfolio lenders. Are they still active?

A **Yes, we are very fortunate that in our niche portfolio lenders have remained active and, if anything, have become slightly more aggressive as more lenders are entering the market.** We have seen new banks formed and start ups have branched out from what were investment banks to compete with the portfolio lenders to put capital into the real estate market. The government's meddling with the compensation structure of firms which have received TARP funds is starting to show tangible signs of executives abandoning those firms. The likelihood that taxpayers will see a return of a significant portion of that money back is dwindling as top talent leaves those firms, but that is another topic for another day.

Q Has that created downward pressure on mortgage rates?

A Interestingly, it has not. There is still not an overabundance of active lenders today. Even as the Federal Funds rate descended towards zero, commercial mortgage rates remained consistently around 6%, give or take a fraction. The average 30 year residential mortgage remains low at about 5% which has induced a wave of refinancings. Despite the government's planned purchases, Treasury bond yields have been rising. In the first quarter, the 30 year increased to 3.6% from 2.8% and the 10 year Treasury yielded 2.9% at the end of the quarter up from 2.2% at the start. Meanwhile, rates that companies pay to borrow for short periods in the commercial paper market fell to less than 1% in most cases. Likewise, interbank lending rates such as LIBOR remained in check ending the quarter down at about 1.2%, down from 1.4% at the beginning of the year. Excluding debt extended in government sponsored markets, companies with high credit ratings sold over $210 billion worth of debt in the first quarter which was one the busiest quarters for such transactions in the past 7 years. However, the average risk premium on investment grade bonds, or yields relative to risk free Treasury bonds, is as high as at the year's start, about 600 basis points over comparable Treasury bonds.

Q You always say that unemployment is the key to our real estate fundamentals; it appears that job losses are continuing.

A **Last Friday, the government announced that our market lost another 663,000 jobs in March pushing the unemployment rate to 8.5%. This is the highest rate since 1983 and we are not even close to being done with job losses.** More startling is that the January job loss number was revised and increased to approximately 750,000. That was the highest monthly total since 1949. This brings the total number of jobs surrendered to this recession to over 5 million. In January, when the present administration was working on the stimulus package, they were operating under the assumption that unemployment would reach 8.9% by the end of the year without the extra Federal spending.

Well, we have the extra Federal spending and we are now getting close to the 8.9% level and it is only April. **Unemployment is so important because it has the most profound impact on the fundamentals of real estate, both in the commercial and residential markets.** It is now fairly clear that the economy is going to be losing jobs at a substantial rate for many months to come. Even more discouraging is the fact that the broader gauge of unemployment, which counts those who want to work but stopped looking for a job and people who are part-time workers who want to be employed full time, climbed to 15.6%. At this point, we are simply looking for reductions in the number of monthly job losses and most economists feel that unemployment will peak at about 10%.

Q Did they say when they think that will occur?

A Well, unemployment is a lagging indicator. It is very likely that unemployment will not peak until 3-6 months after the economy has bottomed out. Presently, the most optimistic economists are projecting a recovery to begin in the third quarter of this year while the most pessimistic economists see that happening sometime in the first half of next year. It would appear that unemployment won't peak until sometime during the first half of 2010. It is at that point that the fundamentals within our real estate markets will be their most stressed.

Q What do you see as the biggest challenges for commercial real estate moving forward?

A **The biggest challenge will be the fate of securitized mortgages that mature whether they are performing or nonperforming and the owner has no source of refinancing proceeds.** Will the special servicer hold the landlord in default? Will extensions be granted? Will a foreclosure commence? These are questions that have not been addressed yet but there are several hundreds of billions of dollars of securitized loans that will be maturing over the next couple of years and this is an extremely important issue.

Q You have written commentaries about the TARP and the TALF. Have these programs started to affect the market?

Well, the Term Asset-Backed Securities Loan Facility, or TALF, is an offshoot of the TARP. In February, Secretary Geithner pushed to energize the consumer lending markets through initiating TALF 1.0. After weeks of negotiations however, few investors have signed on and only 4 transacttions have been completed. The plan was for TALF to bring new investors to the market for asset-backed debt which suffered from a lack of buyers. The program was offering investors inexpensive loans from the Fed to purchase securities backed by car loans, credit card payments or student loans. TALF 2.0 and 3.0 are dealing more with other toxic assets on the balance sheets of financial firms such as residential mortgage backed securities and commercial mortgage backed securities.

Q Are these programs working?

A That depends on your perspective. Risk premiums in the consumer asset-backed debt markets have fallen more than 200 basis points since January in some cases. **But investors have been reluctant to engage with the government fearing that the government can capriciously change the rules midstream.** TALF 2.0 deals with residential mortgage backed securities. Investors have similar concerns about government intervention in the RMBS markets where rates have come down but the administration's plans to modify mortgage loans will significantly impact the underlying collateral. They are essentially asking investors to buy something that could be different the day after it is purchased. The loan modification program has hit a snag as senior lenders and home equity lenders fight over how long each will sit in the barber's chair.

Q TALF 3.0 deals with the commercial securitization market. In the past you have said that you feel this is very important, do you still feel that way?

A **Getting the securitization markets back to functioning status is critical.** The sheer amount of refinancings that is required cannot be met by bank lending alone. We need access to public capital and securitization is the way to do that. It is hoped that if the private public partnership investment program works, that it will free bank's balance sheets of toxic assets which will increase capital ratios. If it works, it should create incentives to banks to lend the tremendous amounts of cash that they are sitting on.

Q Do you think that program will work?

A It is difficult to know. It certainly won't hurt, at least in the short term. The long term implications are more significant. **I believe equally important are the modifications recently made to FASB's mark-to-market accounting rules which will also have the same impact of freeing up bank capital.** One thing that few people realize is that banks are sitting on more cash today than they have ever, but their capital ratios are very low based upon the mark-to-market losses that they have had to realize. The modifications in the mark-to-market rules are critical and not many people have spoken about this yet. Basically, anything that is done to create motivation or ability for banks to lend money to the real estate markets are a positive thing.

Q How will the modifications for mark-to-market accounting affect the marketplace?

A The essence of mark to market accounting revolves around the principal of valuing assets at market prices and is sometimes flawed because markets have ceased to function. The modification of the rules includes changes that would lessen the needs for banks to take earnings hits when assets run into trouble. Some investor groups are concerned that these modifications would allow executives to cover up losses. They should, however, enhance bank capital ratios. Under one of the changes adopted last week, the definition of an asset that is "other than temporarily impaired" will change. Once an asset gets that designation, it triggers a write down in value that feeds through the bottom line. In the case of banks, that may put capital below regulatory requirements. Currently, to avoid this designation management must assert that it has the intent and ability to hold onto the asset until its value recovers. Under the new rule, companies could avoid that classification by stating that they intend to hold onto the asset and that it is more likely than not that they will. This is a looser standard. The new rules draw a distinction that is especially relevant to mortgage backed securities. The market for these securities has largely dried up but banks say that most homeowners are still making their mortgage payments. The rules say that once an asset is other than temporarily impaired, only losses related to the underlying creditworthiness would affect earnings and regulatory capital. Losses attributed to market conditions would be disclosed and accounted for elsewhere. The bottom line is that this should enhance the availability of credit in the marketplace

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Q Have you seen any evidence that the TARP is working?

A AIG and others that have been helped significantly by TARP funds are still operating so I guess you can say that is positive. However, you have to be careful when you have the government as your partner. A favorite movie of mine is Goodfellas and there was a scene in which the boss, Paulie, becomes a minority partner in a restaurant. As things progress it becomes obvious that Paulie is controlling everything. It appears the government is taking the same position relative to firms that received even $1 of TARP money. Not only do they want to limit bonuses but now they want to determine appropriate salaries for everyone right down to the secretaries and assistants. It was thought this was only going to be for top executives. **It is clear that the government wants to control the banking system. Last week, four banks returned their TARP money which I can completely understand.** It appears that the government is not making it easy for the banks to return this money. If banks are forced to keep TARP cash, which was often forced on them in the first place, the government can works its will on the financial system to an unprecedented degree that is what's happening right now. Stuart Varney of Fox Business News makes a good point, "If Rick Wagoner can be fired and compact cars can be mandated, why can't a bank with a vault full of TARP money be told where to lend?" Our prosperity has never been based on the political allocation of credit- until now.

Q Governor Patterson recently released New York State's new budget. Any thoughts?

A Yes, it is a travesty. The $132 billion budget increases spending by 10.1% which is $12.1 billion over last year's final budget. In explaining this significant spending growth, the state has maintained that it is due to economic stimulus funds. Without accounting for the stimulus money, spending still increased by 4.7% or $5.9 billion. This budget closes a record $17.7 billion deficit, primarily with new revenue. **There are 137 new or increased taxes, fees and fines totaling $4.1 billion. Combined with the stimulus dollars, these sums make up 80% of the increase in the budget. Genuine spending cuts represent only 20% of the bridge.** The Governor's spending proposal is the floor bid in a legislative negotiating process that generally points in one direction, up. New revenue includes billions to come from an income tax hike that will raise the top rate by 31% and kick in at $200k for single filers. Bridging any budget deficit has to be accomplished with a sensible combination of increases in taxes and a reduction in government spending. The Governor has talked about the need for spending reductions for many months now but, ultimately, the gap will be bridged by increasing taxes. It is only a matter of time before people start leaving New York as the tax structure here makes the city much less competitive regionally.

Q Will Real Estate taxes increase?

A Of course they will. The Mayor has already indicated an increase in the tax rate. Additionally, even with real estate values falling, assessments have continued to increase and probably will continue to do so exacerbating the overall tax burden on the real estate sector.

Q You discussed your perspective on the state budget, what are you thoughts about the massive Federal budget?

A That's a question that can take a long time to answer but, to just hit the highlights, the budget proposes immense increases in non-defense spending and taxes and the tripling of our national debt. It adds $6.5 trillion to the deficit and leaves future U.S. tax payers with the tab. This is in addition to the looming issues the country will have with Medicare and social security. Another problem I see is that the administration's forecasts project a 3.2% growth in GDP in 2010. Most economists would be pleased if it was 1/3 of that. This massive deficit is really a tax on everyone. Every dollar of debt the administration runs up means that future taxes must be a dollar higher in present value terms. Unless we dramatically cut spending this is leaving an unimaginable burden on the next generation or generations as the case may be.

Q You track the national housing market and in an earlier commentary you mentioned house prices have to bottom out before economic recovery can occur. How is housing performing?

A **The latest Case-Schiller index which tracks house prices in 20 major metropolitan areas fell 19% for the three months ending at the end of January compared with the year earlier period.** This decline follows an 18.5% decrease in value for the 3 month period ended December 31st. This is a new record low for that index. Although the government is looking at mortgage modification programs and a number of things to try to stabilize the housing market, it will be difficult to see the market stabilize prior to unemployment peaking.

(Cont'd from Page 7)

Q **When do you expect the real estate markets in New York to recover?**

A Today, I am only concerned about the assets I have to sell today. I remain optimistic about New York City's future, but we need to take things one day at a time.

For weekly observations on the New York City Investment Market, please visit Robert Knakal's blog, **StreetWise** – a joint initiative of Massey Knakal and GlobeSt.com – at **www.knakalstreetwise.wordpress.com**

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During Mr. Knakal's almost 25-year career, he has sold over 1,000 buildings having an aggregate market value of over $5.8 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.

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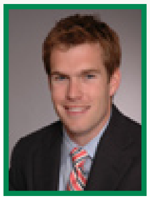

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