# A CONVERSATION WITH THE CHAIRMAN

MASSEY KNAKAL
Realty Services

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# *Are We Out of the Woods Yet?*

*Dear Friends,*

*We sat down for our quarterly conversation with Massey Knakal Chairman, Robert Knakal to discuss his views on the New York City property sales market, economics and political initiatives that have effected the first half of 2009. We hope you find this interview informative and timely.*

**Q Now that the second quarter of 2009 has come to an end, how has market activity been?**

A In the first half of 2009, we have seen a little over $2.8 billion in transaction volume. Compared to the first half of 2008, this activity is down by about 73%. If we compare the $2.8 billion with the peak half year activity in each of the boroughs, the volume of sales is off by approximately 77%.

**Q What has been the fluctuation in the number of properties sold?**

A In the first half of the year there were 562 sale transactions closed which consisted of 670 buildings. The 670 buildings sold represent a reduction of about 61% from the first half of 2008. This 61% figure compares favorably to the dollar volume reduction percentage indicating that the average transaction size is decreasing. If we look at our statistical sample of 125,000 properties that we track in New York City, we have always calculated volume based upon the number of properties sold out of that sample. Over the past 25 years, the average turnover has been 2.6% with the lowest turnover hitting 1.6% in 1992 and 2003, both years at the end of recessionary periods and also years in which unemployment hit cyclical peaks. If we annualize the number of properties sold in the first half of the year, turnover will be running at about 0.92% this year.

**Q Is that figure surprising to you?**

A Yes it is. At the beginning of this year we projected that volume would run from 1.4-1.6%. This projection assumed we would hit a new all time low based upon the crisis in the capital markets which was exacerbated by Lehman failing and the fundamental dismantling Wall Street as we knew it on September 15th of 2008.

**Q Have you adjusted your projection for the year based on this first half activity?**

A We are now anticipating the volume to hit 1.2-1.4% for the year which would be a new record low.

**Q How have prices performed in the first half?**

A The office and retail sectors have been adversely affected the most. Consumer spending is way down which has affected retail sales and subsequently the retail market's performance. The office market has been affected by relentless increases in unemployment which has reduced demand for office space. Capitalization rates for these property types are up 200-225 basis points since their low point. The multi-family market continues to perform best as capitalization rates in the first half were up only 93 basis points from their low point.

**Q You mentioned consumer spending contraction which is affecting the retail sector. Some reports show consumer sentiment becoming more positive.**

A Sentiment may be slightly better because we have been living in the new reality for a while now and the old shoe is starting to feel comfortable. The fact is that the savings rate in the US has gone from -3% to nearly 6%. This 9% swing has removed nearly a trillion dollars from GDP and that, on top of the recession, is really hurting retail. Many economists are predicting that we may hit a savings rate of almost 10% in the near future.

**Q How do those cap rate increases you just mentioned relate to percentage decreases in value?**

A The increase in cap rates on office and retail properties would equate to about a 30-35% reduction in value. On the multi-family, side the decrease in value would be in the 15-17% range.

**Q How have REITS performed?**

A As I said in last quarter's Conversation, I believe REITS are a very good investment at the moment as I think their equities are undervalued. These companies own a significant portion of the better quality properties in the U.S. Access to public capital and the liquidity enjoyed by these public companies, particularly in this capital constrained environment, will be a significant competitive advantage for the better capitalized, higher quality REITS. Presently REITS have access to more than $30 billion in bank credit lines and have generated over $5 billion in liquidity since the middle of last year as they have reduced or eliminated dividends and in-kind payments. While credit lines may be reduced, this is still a massive amount of capacity that will be an essential element in helping strong REITS bridge through this tough economy and nearly frozen capital markets.

**Q Didn't REITS get caught up in the exuberance of the last few years?**

A Interestingly, in the 2005-2007 period, REIT acquisitions only accounted for about 11% of commercial real estate transactions. During the same period private equity and private owners acquired the majority of commercial real estate sold. So REITS should be well positioned to acquire assets from these entities at significantly more attractive prices as over leverage will cause distressed opportunities. The REIT dividend yield is generally at attractive spreads averaging over 250 basis points above the 10 year Treasury which is well above the long term average of about 118 basis points. Most REITS are trading well below any reasonable estimate of replacement cost. While this is highly subjective, it appears they are also trading at a reasonable discount to net asset value. By contrast REITS traded at about a 25% premium to net asset value in the mid 2000's.

**Q In your recent StreetWise blog, you indicated that the Stimulus Plan had not been as effective as people hoped it would be. Why do you think this is the case?**

A First, less than 20% of these funds have actually been deployed which is the reason why some say it hasn't worked yet and is the reason some say it is a flat-out failure. Second, the main objective of the stimulus was to create jobs. Our unemployment rate has continued to climb and it is difficult to find evidence that any jobs have been created. This is a massive program and we lose sight of its magnitude because "billions" and "trillions" are thrown around so easily today. The $787 billion of stimulus money represents about 5.5% of our GDP. The New Deal, which was rolled out during the Depression, amounted to only about 2% of our GDP at that time. Unfortunately, the unprecedented shift in economic power from the private sector to Washington D.C. is troubling. How can we believe that waste, fraud, inefficiency, abuse, incompetency and corruption will not be inevitable in a program this size? These factors have been observed under every administration irrespective of party affiliation.

**Q So you're saying jobs are the key?**

A Of course. I have been beating the drum of concerns about unemployment for over 2 years now. The fundamentals of the real estate market rely more on employment than any other metric. If people don't have jobs, they do not spend money and it hurts our retailers. If they don't have a job, they don't move to a larger apartment or purchase a new home. And if employers are not hiring, they do not have need for additional office space and, in fact, if they are cutting their workforce they will be shedding excess space.

**Q Do you think unemployment will continue to rise?**

A Unfortunately, I believe that it will. Most economists are predicting that unemployment will peak between 10-11%. Presently unemployment is at 9.5%, however, this figure is misleading. If you add to this figure the number of people who are not counted because they have stopped looking for work, those that have part-time jobs that would like to work full time, and those who have been asked to take unpaid leave, this figure balloons to 16.5%. There are presently 25 million Americans who are involuntarily idle. This is not a good thing for our economy or our real estate fundamentals.

**Q In previous "Conversations" you have discussed the importance of housing as a critical marketplace for the country. After all, it was the sub-prime crisis which has led to our financial crisis.**

A Well that's not completely true. If you look at the sub-prime problem; that market consists of about $1.3 trillion in total face value. In this recession about $7 trillion equity value has evaporated thus far. That is not all because of sub-prime loans. Sub-prime loans were clearly a part of the problem but the bigger issue has been the flight to cash in the face of arbitrary Government decision making that crushed asset value. Economic rules were discarded which increased uncertainty. Markets hate uncertainty.

**Q But aren't there positive signals in the housing market?**

A It really depends on how you interpret the data. Clearly, housing starts are rebounding as we saw June starts come in at an annual seasonally adjusted rate of 470,000. While this is an increase from prior months, it is still well below the normal rate of production of about 1.25 million homes per year. If you take into consideration that nearly 350,000 are destroyed each year, the new supply is only marginally meeting demand that exists. The problem that I have with some of the positive pricing data that I have seen is that while MLS home prices have risen marginally on a national basis for the past 4 months, the data does not take into consideration the fact that several of the large home builders have been offering below market financing and other incentives to increase the number of sales and the prices paid. These incentives, along with Federal tax credits and other concessions, would need to be taken into consideration when looking at the statistics. I find it hard to believe that the housing market will begin a full recovery until the direction of unemployment has reversed.

**Q You have been brokering investment sales since 1984. Has this recession been worse than what you witnessed in the early '90s?**

A It certainly has. To put things into perspective lets take a look at GDP growth. During the last few recessions growth was flat and not in noticeable decline. However, this recession is more like the recession in 1973-1975 and the double dip recession of 1980-1982 in that we have experienced a real decline in GDP. We have lost about 4.6% in GDP in about 10 months which is an extraordinary decline. Even if you assumed a normal growth rate of 3% a year, it would take us until 2011 to get back to where we were in terms of GDP at the end of August of 2008. Many economists believe that before the recession ends the U.S. will have experienced a reduction in GDP of about 5.5%. This GDP contraction has and will continue to take its toll on our commercial real estate market from a number of directions. Compared to this, the early '90s was a walk in the park.

**Q You have written a lot about the TARP Program. What are your present thoughts?**

A I think it is unfortunate that the TARP funds have not been used as fully as they might have been. Banks have not been lending the TARP money they received and with the constraints the government has placed upon recipients of these funds, most of the banks just want to get the money back to the government as quickly as possible. But for these constraints, banks could be lending that money which could be helpful to the market.

**Q Does the return of the TARP money mean the banking sector is becoming more healthy?**

A Again, it really depends on how you look at it. Banks are showing profits and are eager to return the bailout money to the Treasury. They have been able to do this, in part, by pretending that their loan portfolios across the board are healthier than they actually are. Government has eased the mark-to-market accounting rules which has also helped. With regard to toxic loans, some banks have been implementing a policy referred to as "extend and pretend" rather than face the music as to the value of these assets. They just don't want to take the losses but eventually they will have to face the music on these issues.

**Q So the banking industry is not out of the woods yet?**

A Well, thus far in 2009, 53 banks have failed and the FDIC's watch list has over 300 banks on it. For many banks, bad real estate loans have negatively impacted their Tier 1 capital ratios and it is very likely that dozens of additional banks will fail over the next year or two. On the flip side of the coin, banks presently have about $800 billion in excess reserves. These unprecedented levels, combined with the enormous increase in cash holdings, means that banks will begin to lend their excess reserves and the velocity of money will begin to rise. As this dynamic unfolds, inflation is likely to kick in. This is a huge concern for our marketplace. As inflation rises, interest rates will rise increasing the debt service costs for property owners and lowering the amount buyers will pay for properties.

**Q We've heard a lot about so-called distressed asset funds since the economy turned, but there still doesn't seem to be all that much activity. Why aren't we seeing the activity yet?**

A The main reason is that lenders, who would be the source of much of the distressed assets, are still involved in the process of determining their exposures and figuring out what the value of those assets are. There is a gigantic pipeline of potentially distressed assets that exist but, to date, those assets have only been trickling out of the pipeline. We expect that the pipeline will open up and there will be a lot of product coming to market after the summer or by the fourth quarter of this year.

**Q Do prices need to come down further for there to be movement among the funds? And how much longer will investors wait before we'll actually see an uptick in this type of activity?**

A It's more of a supply issue rather than a demand issue. I don't believe that most investors are sitting there waiting for prices to come down. Clearly, some are but more evident is that they are waiting for opportunities to come around. For instance, we sold a $75 million note for an foreign bank, collateralized by a portfolio of apartment buildings and we had 52 offers within 30 days on that note. We have another project selling the senior debt on a condominium development in Brooklyn. We received nearly 60 offers on that asset so, clearly, investors are not sitting on the sidelines. Buyers are already active, there just isn't a lot to look at right now. Any distressed assets that we've handled have seen very healthy activity with a lot of interest, even more interest than the private sellers have been receiving in the marketplace right now.

**Q Are banks more realistic about selling properties for a loss than they were 6 months ago? What are you seeing on that front?**

A In general, the realities of the current market are evident to everyone in the market whether it's a bank, broker or investor. Banks are reluctant to take write downs so many of them are kicking the can down the street waiting to put the inevitable losses off into other periods.

**Q Are all lenders doing this?**

A Every lender implements a different strategy when it comes to these distressed assets. There are some lenders who will go to an existing borrower and make an off market transaction with that borrower at a reduced price. There are other lenders that won't deal with the borrower under any circumstances even if the borrower is offering 99 cents on the dollar. There is every type of philosophy and approach in between those two. Some lenders will not sell any notes unless they get 100 cents on the dollar for them plus all the accrued default interest. They would rather go through the foreclosure process and then sell the property. There are other lenders that want to sell the paper as quickly as possible and move on to make new good loans. Every lender has their own strategy relative to how to handle these things.

**Q What are your other concerns?**

A Further distress in the market is certainly a concern. The speed of deterioration in loan performance is unprecedented, even relative to the early 90's. The total delinquency rate in June reached 4.1%, 2.2 times higher than in March and 3.5 times higher than in December. Delinquency rates are likely to continue to soar over the next 24 months with billions of dollars of pro-forma loans which never stabilized and resetting of interest-only loans. As these loans mature, there is massive maturity default risk. For instance, of the existing CMBS loans, a majority of them would not qualify if they needed to be refinanced today. There is well over $2 trillion in commercial mortgages maturing between now and 2013. Improvements in rent levels and vacancy rates between now and 2013 are also extremely unlikely to be sufficient to materially affect the scope of these problems.

**Q So you don't see adequate financing available?**

A It depends on the sector of the market. The market for properties under $50 million has been helped significantly by community and regional banks that are willing to make loans up to about 30 million dollars. Those banks have been consistently lending during this recession as spreads grew and risk was mitigated through lower LTV ratios. Nine figure loans are where the stresses emerge because the CMBS market, which had reached about $300 billion in 2007, has not seen any new issuance within the past year. Without this access to public capital the markets for larger transactions will remain very challenging.

**Q Many in the real estate industry were very upbeat about the TALF program. How has that program been working?**

A In theory, the TALF, which has been extended to include commercial real estate, could help the marketplace. However, to date there have been no transactions completed. Presently, there are a couple of large players that are trying to put together transactions utilizing the TALF program. Developers Diversified Realty is working on a large transaction which could be the first to utilize this program. Unfortunately, tight restrictions on the program will block small developers and small commercial property owners with heavy debt loads from participating in the program. Also, only extremely low loan-to-value loans will work and they must be rated AAA. Another concern about this program is that it is scheduled to sunset on December 31st of this year. Financing is normally a 60-90 day process so effectively the program is sunsetting in October. The industry is lobbying very hard for an extension to this program which is desperately needed.

**Q Finally, in your recent StreetWise blog, you referred to yourself as a "Realestatarian." What did you mean by that?**

A Today, we are living at a time where economics, politics and real estate have never been more closely tied. You have to consider each of these when trying to connect all of the dots and when it comes to politics, it really doesn't matter whether a Democrat or a Republican endorses a particular policy. I simply try to look at the issues from the perspective of the real estate market without making a political statement. I'm happy to leave the politics to the politicians. I'm just a real estate guy trying to figure out how policies and events will effect what I do everyday.

**Massey Knakal is coming out with in-depth quarterly reports on sales activity unlike anything the market has seen.**

**They include not only historical trends but details (with photos) on every sale in the City.**

**They will be available to our clients within the next few days.**

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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. In 2009, Real Estate Forum Magazine named Mr. Knakal one of the Top 10 Real Estate Investment Sales Brokers in the United States.

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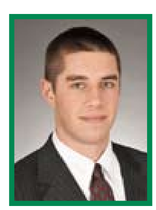

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