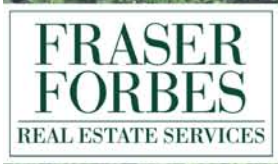


# FRASER FORBES REAL ESTATE SERVICES 2010 PREDICTIONS



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## 2010 Predictions

### **Preface:**

I may be biased, having spent the last 22 years in the land-sale business, but I believe that the economy ultimately follows what happens to the value of dirt – after all, you can't make more land. The relative value of land depends on a variety of factors, such as location, demand, supply, availability of credit and investment. I sit at ground zero, as CEO of the region's premier land-services firm. Having weathered three very down years in the land space, I have decided to step out and give predictions on land and its related value-influencing factors, to give hope to the prospects that land, as a bellwether, is possibly on its way back.

### **Land Supply:**

I consider land supply in two categories: Raw land that is in the various stages of entitlements, and land available for sale to builders as finished lots. Raw ground is generally never a serious problem, and it is found in increasing abundance the further you travel from the urban core. Land available as finished lots for builders is another story. There is the process to deliver land from its raw state to finished lots, which requires time, expertise and capital. In the D.C. metro market, there is a constrained supply – and shrinking supply – of quality single-family and town home-finished lots. The projects that have the best locations and ease in development get the attention first. There will be more demand in 2010 for quality opportunities, and because the standing finished-lot inventory is sparse at best except in some secondary markets, sales will increase for raw-land sales for single-family and town home deals first, followed by multi-family raw-land sales.

Land earmarked for commercial development is not in short supply. With vacancy rates across the region predicted to approach 14 percent, even in some downtown markets, the market is like a falling knife. I believe that there will be dramatic pain this year, and likely in 2011, as demand for existing space finds a way to meet supply. It's somewhat anecdotal, but I still see new buildings creeping up in markets that are covered with "for lease" signs.

### **Land Demand:**

The biggest demand for land consumption is from the national homebuilders, and they are back in buying mode because they have to feed the machine to not only survive, but also grow. Their lot inventories have dwindled, and they are feeling good about new home appreciation in 2010 and beyond. National land funds, like Westbrook Partners and Rockpoint, took down significant parcels in late 2009. Other land funds will follow. Regional homebuilders will become more aggressive as well this year, as they feel more comfortable and also feel compelled to keep up with the competition of the national builders. Apartment developers, too, will begin to come out of hiding. As housing demand increases, the need for close-in and first-stage housing will naturally follow along.

### **Supply Constrained Market:**

Our region is becoming more and more supply constrained as each day passes. Quality single-family and town home-finished lot inventory in the region is approximately 32,000 lots, of which approximately 18,000 are in core Maryland markets and 14,000 are in core Virginia markets. We have compiled the data on a county and submarket basis to suit your needs. Please contact us for more specific data.

Based on current absorption, many counties' inventory levels are in the 3-6 month range. In core market areas, equilibrium typically is approximately 5-6 months of inventory. These constraints have resulted in climbing demand for single-family and town-home lots, particularly from the national homebuilders who need to rebuild inventories to take advantage of this next cycle. They must build to thrive. The regional builders and land developers will follow suit as they see success in the market, and capital becomes more readily available. As the available finished lots are absorbed, we have seen more interest in raw-land purchases, including the two most recent transactions in the market representing in excess of 4,200 acres and 3,500 units.

## **New Land Comparisons:**

For landowners and lien holders (attention bankers), there is good news and bad news in the recent land sales. The good news is that land is trading again. The bad news is that it is trading at a level far below the values of the peak of 2005-06. We are more likely seeing 2002 pricing, which is dramatically lower based on the fact that the run-up was at its peak between those few years. It is a basic fact that most deals purchased between 2003 and 2007 are stressed assets today, and most lenders and borrowers are dealing with various exit strategies. Too often, these deals are just being kicked down the road by banks to confront the problems later. Time might be a friend if land appreciation garners enough speed. That hope is a risky proposition. We will see how it plays out.

The land trade in Montgomery County was Crown Farm, which was originally purchased by KB Home of Maryland and Centex Homes in 2005 for \$137 million. After interest carry, entitlement costs and proffers, the total project costs ballooned to \$220 million. Sunbrook Partners, a subsidiary of Westbrook Partners, completed this transaction after extensive negotiations with the original purchasers and lender. The current purchase price represented a discount to total project cost of 64 percent.

The land trade in Loudon County was the various parcels comprising Dulles South, which were originally purchased by Greenvest in 2005 for approximately \$250 million, excluding carry costs, etc. Rockpoint completed this transaction by outbidding several other groups. The current purchase represented a discount to the original purchase price of approximately 64 percent. These two transactions are the first significant transactions since 2006, in terms of size and price, and demonstrate the desire for debt and equity capital to invest in land in this region.

## **Consumer Confidence:**

If homes are selling, consumers are feeling more confident about the future of the economy. Unemployment is lower in the D.C. metro area than the national average, and this will continue – and possibly improve – in 2010. This follows

that we have seen reasonably strong sales in entry level and first-time move-up product, which started in the spring of 2009, with a preference to new product. I expect this to gravitate into the second-time move-up market and luxury end as well in late 2010, but primarily in the best close-in markets.

With factors that include the federal government's needs and its stimulus efforts, BRAC, homeland defense, technology and the like, the job market will continue to get fed. Accordingly, the D.C. metro market will continue to outpace the national market in job creation. Additionally, we are also an extremely desirable place to live given our quality of life elements.

### **The Banking Landscape:**

Consolidation will continue in the local banking market, both from outside-the-area banks and within the community banking market. There are a number of local banks that continue to try to ride out marginally capitalized balance sheets or where they have restructured significant projects in hopes that earnings will improve and new capital will become available. It is unlikely for several of the banks that the confluence of better days and fresh capital after stale capital will materialize. Consolidation of these weaker banks will improve the availability of credit in 2011.

Bank liquidity remains the number one issue with local and national banks. Lending has slowed for two reasons. First, banks have become inwardly focused on marginal and troubled assets. Second, organic core-deposit growth – core meaning not high-priced certificates of deposits or brokered deposits – has lagged way behind lending demand.

Additionally, as bank investors are rolling up and purchasing troubled charters in markets outside of the D.C. area, they will look to expand into the Baltimore and Washington markets. Interstate banking laws and regulatory hurdles will

limit this expansion in 2010, but beyond this year new banks with new capital will crop up in the area.

Several foreign banks have been looking to expand into the D.C. metro area. If these large, multi-national banks break into the market, competition will improve. Since growth in Europe and other foreign markets is slower to recover, and D.C. remains the premium market in the United States, investment in this market is almost a given.

### **Interest Rates:**

Short-term and intermediate-term interest rates (five years and less) will remain low and stable through 2010. This is a national prediction as well as a local prediction. The credit rate offered through the last half of 2009 by local and super regional banks, which has driven the available credit in the D.C. metro market, has and will continue to be set with a floor, ranging from 5.5 percent to 6.5 percent, even for good credits and low loan-to-values.

Borrower still question why, if prime hovers are 3 percent, are borrowing rate spreads not decreasing. The reason is that the cost of funds and cost of operating for banks has been adversely affected by the costs of capital and rates necessary to attract deposits. Neither of these two factors will change in 2010, so floors will continue to be a factor in borrowing costs. Remember that the historical and natural commercial rate has traditionally been viewed to me at near 8 percent.

The need for interest-rate floors has come about because the cost of doing business for banks has increased. FDIC assessments have nearly tripled, labor costs in this market are flat and occupancy costs have increased because of over-branching – both in the size and number of branches, a residual of the

most recent boom. Banks committed to larger and more branches two and three years ago, and the costs of those branches are now imbedded into the costs of doing business. Additionally, there is a continuing waterfall of credit costs working their way through the income statement in the form of legal fees, restructuring and charge-offs.

### **Availability of Credit:**

The D.C. metro market will see an improvement in the availability of credit for all types of businesses, albeit slow to come back for certain sectors. Well-capitalized projects and stable borrowers will see an increase in the competition for their business, but there will be conditions requiring deposit balances, and the structures will be more conservative than what was available a few years ago. The weakness in lending will most likely be in operating companies, where many banks continue to consider accounts receivable and inventory lending as “unsecured.” A resistance by banks to lend to operating companies will make some expansion more difficult and possibly affect the real estate market as well as further impair the recovery of the office and retail sectors.

### **Acquisition, Development and Construction Lending:**

A recent article in a local business newspaper showed that some banks appear to be lending more in the Acquisition, Development and Construction (“AD&C”) areas. There is some new activity and a few new projects, mostly inside the beltway, that began in late 2009. However, the main reason for the increase in AD&C lending is because existing projects are now seeing some movement and advances under existing commitments are now possible.

The biggest business news in 2009 was great news for the future of AD&C lending, and it went largely unnoticed. In the waning hours of the year, two land funds purchased a total of \$170 million in land in Montgomery and Loudoun counties. This means that raw-land development is on the horizon, and banks and appraisers now have comparables to appraise land assets. The only dark in that cloud may be that both transactions closed well below 2005 values.

For AD&C borrowers, expect cold to modest reception at the bank when you make your loan request for land. Bring plenty of equity when you come and have a clear exit strategy. Oh, and if you don't have a fat balance sheet, bring your personal guarantee.

### **Commercial Real Estate:**

Long-term lending on commercial real estate has long been a secondary-market business. With fewer and fewer credit tenants, declining values and even declining or stabilized rents, borrowing on the secondary market has dramatically slowed. Investors in 2010 will begin to open their credit doors to stabilized projects, particularly in the few "Tiffany" markets like Washington. The only question is how wide the doors will open.

Many of the larger community and mega-regional banks have taken advantage of the shyness of the secondary market and made loans on great buildings in prime locations with good spreads – for the banks, that is. The problem with this activity is that there simply isn't enough liquidity or loans-to-one-borrower capacity in the banks to accommodate the demand coming in the next 36 months, as conduit financing comes up for renewal.

The outlook on retail real estate is not as good. Strip centers are filling up with “C” and “D” credits, and retailing in general in the United States is boring and undifferentiated. The drift toward buying online, and the lack of unique retail experiences, will carry on, and the retail real estate market, with a few exceptions, will continue to look weak. One of the positive effects of this trend is that locally owned retailers will find new opportunities to grow, as landlords are focusing on the needs of the mixed-use projects and less on “brand” names, particularly since many of the “brand” names are, or have been, in contraction mode.

### **Commercial and Industrial Lending:**

Banks refer to all non-real estate lending or owner-occupied real estate as commercial and industrial (“C&I”). C&I lending is viewed by most insured-lending institutions as “unsecured” lending, which is to say, it isn’t easy to get a loan for operating companies. A slowdown in C&I lending can have a negative affect on a business’s ability to expand. Opportunities in the market to pick up new contracts, therefore increasing the need for new space and new employees – which means more residential activity – have been adversely impacted by the conservative approach of banks to lend to operating companies.

All C&I businesses have been affected by the recession. Many have contracted operations. However, with new government contracts and what appears to be the dawn of a residential sunrise, C&I businesses will need to find credit. Banks will begin to lend more C&I dollars in 2010, under tighter structures, personal guarantees and at higher rates. The real improvement in the C&I market won’t come until mid-year, when the proof that this isn’t a double-dip-recession creates confidence in the bellwether banks.

## **Equity:**

There is money out there. We will see more transactions and equity investments in 2010 than we have seen in 2008 and 2009 combined. Why? The money is here, and the values have discounted to investor expectations. Additionally, the vulture mentality of investors has attenuated a bit, as attention has turned toward much safer regional economies and the fundamentals of classic business investments.

Furthermore, expectations on returns have become more realistic. A 35-percent return today looks like the risk of a 70-percent return investment three years ago. Investors are re-evaluating the logic of taking a 15-20 percent return-risk today with true 15-20 percent risk and saying, "that isn't so bad compared to losing my shirt." Additionally, there are fundamentally sound investments that have weathered the recession well, core-markets, products and services with inelasticity for demand, and well-capitalized and run operations.

## **Conclusion:**

This battle-tested, 22-year land veteran and his team are excited with our prospects for success. We focused on survival these last few years, and now we are focused on growth and success. We are a much stronger and diversified firm offering our expertise in sales, financing, advisory and management services for ALL YOUR LAND NEEDS.

Respectively,

Richard O. Samit

CEO and Co-Founder

Fraser Forbes Real Estate Services