# A CONVERSATION WITH THE CHAIRMAN

MASSEY KNAKAL
Realty Services

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*Dear Friends,*

*As September 2008 drew to a close, we sat down for our quarterly conversation with Massey Knakal Chairman, Robert Knakal to discuss his views on the economy and how these factors are affecting our local New York City building sales market. This interview replaces Mr. Knakal's "Commentary" for this week which will resume next Monday night. We hope you find this interview informative and timely.*

**Q For the past couple of weeks everyone has been talking about the 700 billion dollar bail out plan. It passed last Friday. How will this plan affect the real estate market?**

A The first thing I would like to say is that I feel the plan should not have been called a "bailout." Secretary Paulson, Chairman Bernanke and the present administration could have done a much better job of conveying the rationale for this plan, its importance to the American people and the implications for the world's financial markets. That is why it failed to pass the house last Monday. An explanation of the repercussions of the evaporation of credit on all Americans should have been conveyed more clearly right from the beginning. That being said, it is thought that this plan will provide liquidity to the credit markets from which the real estate market would benefit.

**Q Do you think the plan will succeed?**

A Well, the question is which objectives the plan will succeed in achieving. Strengthening balance sheets of financial institutions holding toxic assets will be achieved, but will it solve the credit crisis? I am not convinced. That being said, the plan may not be perfect but it was absolutely necessary. The Treasury department will, likely, move quickly to start buying distressed assets from struggling financial institutions although the impact of these acquisitions with respect to enhancing liquidity may not be felt for some time. There are still many details of the plan which are unclear such as who will oversee the program, how it will be administered and, most importantly, what the government will pay for these distressed assets. Some economists have indicated that the taxpayers could actually make a profit on these "investments." That will all be a function of what is paid for the securities.

**Q What is the process that will be used to acquire the securities?**

A It appears that a reverse auction mechanism will be implemented to determine who the government will buy from and what they will pay. In this scenario the government sets a price they are prepared to pay for certain securities and firms will continue to underbid until no one will go lower. These institutions will essentially be competing to sell the assets. Among the biggest issues the Treasury will have to deal with is to determine which assets to buy and how to determine the quality of the collateral for those particular assets. It will be an interesting process for them to determine where to set the initial pricing bar.

**Q How will this plan affect our real estate market?**

A Well, the hope is that this plan will restore the free flow of credit into the marketplace. We have a significant credit problem in which banks have been put in the position of hoarding cash and essentially not trusting each other. This 700 billion dollars is not a solution to our economic woes and is not a solution to the liquidity crisis but it is a step in the right direction. It is a component part of a solution but not a solution in and of itself. Banks' lack of willingness to lend to each other was illustrated very clearly last Tuesday when the Libor rate went from approximately 2.2% to 6.88% in one day. This is the overnight lending rate in the U.K. Short term money markets where companies raise money to advance their operations remain distressed. Financial firms went to the Fed for over 400 billion dollars in emergency overnight loans last week. This was a record amount caused by the windows being closed at many sources. In order for our real estate markets to function efficiently we need capital to flow freely.

**Q Is the volume of building sales negatively impacted by this lack of credit?**

A It really depends on what segments of the market you're addressing. All segments have been affected, but to varying degrees. The market for properties over $50 million in value has been much more adversely affected than the market for properties under $50 million. Portfolio lenders have stepped in to provide debt in the under $50 million dollar market. The banking industry has been a huge beneficiary of the current marketplace in that if they have capital to lend, and that is a very big if today, they can put money on the street which is ten times as profitable as it was 18 months ago because spreads have widened from approximately 40 basis points over treasuries to approximately 400 over. While these loans are more profitable, the risk associated with these investments is much lower because loan to value ratios have been reduced to 60-65% from 75-85%. If a bank has capital to lend, they will do extremely well today.

**Q What types of sales volumes have you seen?**

A In our marketplace, the turn over of sales has been approximately 2.2% of the total stock of buildings. This turnover ratio is 31% lower than the turnover we saw in the first half of 2007 which by all accounts was the top of the market. In the over $100 million market, volume is off 70-85% depending upon which report you read. Our volume at 2.2% is still about 27% above the market baseline of 1.6% which is the level of turnover the market sees when there are only sellers who have no choice but to sell.

**Q How have prices held up?**

**A** Again, it depends what segment of the market you are addressing. Investment properties under $50 million in value have seen prices fall only 5-10% from their peak. Larger institutional properties have seen price reductions of 25-30%. We have not seen a significant number of trades of larger buildings recently so there are not enough data points to determine how recent activity has affected that market. With respect to the mid-market, it appears that properties have not been adversely affected in a significant way. We are in the market with several income producing assets and had very active bidding last week, signed 4 contracts and closed 5 sales. All of this activity was on assets in the under $25 million category.

**Q It appears we're heading into a recession. What are the implications of this on the real estate market?**

**A** There is no doubt we are in a recession and have been for a while. While the economy may not meet the technical definition to officially call what we are in a recession, if it were not for government spending, it would be broadly acknowledged that we are in a recession. Consumer spending is down and consumer confidence is as low as it has been in recent memory. These metrics are indicative of a consumer's ability and willingness to spend money. Corporate profits are down and this is evidenced by the big increases in unemployment we have seen recently. With any growth phase interruption you get a corresponding re-pricing of assets, so we will see building prices fall. The question is to what degree. During the recession in 2001-2003, building prices were affected only slightly in every sector.

**Q In your 2007 year-end interview, you indicated that unemployment was a key economic factor to watch. Why do you think it is so important?**

**A** Unemployment is the most important economic indicator which affects the fundamentals of the real estate market. Unemployment has been increasing and as of the end of September sat at 6.1%. The interesting thing is that our economy has lost jobs for each of the last nine months and in September alone we lost 159,000 jobs. The unemployment rate at the end of August was also 6.1%. With the unemployment rate unchanged after the losses in September, this is indicative of the fact that a number of people have dropped out of the job market altogether and are no longer looking for work. Thus far the country has lost nearly 800,000 jobs in 2008 and last month job losses were at the fastest pace in 5 years. The weakness in the job market spread from the manufacturing industry into services and even to the public sector. There were only minor gains in education and healthcare services. The job market is just not good at the moment. We're going through the painful adjustment of clearing out enormous excesses in housing and finance. Now that the financial crisis has become more and more severe, it is clearly spilling over into other sectors of the economy.

**Q With the trouble on Wall Street and Lehman Brothers going out of business and other financial institutions merging or being propped up by the government, what is the outlook for New York City's job market?**

**A** Economists have predicted that the city will lose as many as 90,000 jobs during this downturn. That is a significant number particularly given most of these cuts will be in financial services where the average employee earns about $350,000 a year. This is more than 5 times the average of the rest of the citizens in the city. If you think about the services that these employees require and the businesses that they support, the ripple effect could be considerable. This has tremendous impact on our real estate market. As I think I said before, our real estate fundamentals coming into this downturn were very strong. That is one of the biggest differences between us entering this downturn and our condition in the early '90s. During the recession in the early '90s unemployment hit 7.8%. Today most economists believe that we will hit 7% and I was not surprised to see that last week Goldman Sachs forecast an unemployment rate of 8%. For every job lost, the demand for office space will shrink by about 200 square feet. Clearly this affects the value of office buildings. People who are out of work or even fear that they may lose a job will not rent larger apartments and are less likely to purchase a co-op or condo. Therefore, the effect on our residential market could be significant as well.

**Q If you indicate that the Paulson plan is only part of the solution, what else needs to be done?**

A We got into this crisis through the housing market and it is through the housing market that we will emerge from it.

**Q That is an interesting comment, can you expand on it?**

A A successful plan to stabilize the U.S. economy and prevent a deep global recession must do more than buy back toxic debt from financial institutions. It must address the fundamental cause of the crisis which is the downward spiral of house prices that devastates household wealth and destroys the capital of financial institutions that hold the mortgages, mortgage backed securities and the various derivative instruments tied to the housing market. Housing has fallen approximately 20% in value during the last year and today there are approximately 10 million homes with mortgages that exceed the value of the house. Approximately 5 million homeowners are now delinquent or are in foreclosure. Because residential mortgages are effectively non-recourse, it is very tempting for people who have negative equity in their home to just walk away. The prospect of a downward spiral of house prices depresses the values of the mortgage backed securities and therefore the capital and liquidity of financial institutions. Experts indicate that an additional 10-15% decline in house prices is needed to get back to the pre-bubble level and to the point where the buy vs. rent equation is in equilibrium. This would double the number of homes with negative equity, raising the total to approximately 40% of all homes with mortgages. If you think about this it is devastating. The impaired assets are not just mortgages but the complex derivatives based on those mortgages, the collateralized debt obligations and the various risk slices of those CDO's which, even if rated AAA, often have market prices close to 15% of their notional value. In addition, hundreds of billions of dollars of credit default swaps "guarantee" the value of these mortgage backed securities. Until house prices stop declining, determining the true value of these assets tied to housing will be difficult. The $700 billion plan does not really address the housing downturn directly.

**Q What will happen with interest rates?**

A Three months ago it was widely thought that the next Fed move would be to tighten monetary policy by raising rates. Given what has happened in the last couple of weeks, there is now nearly an 80% chance that the Fed will cut rates by 50 basis points at or before their next meeting on October 19th. The $700 billion plan theoretically increases liquidity but while cleaning up their balance sheets; it doesn't mean the banks will actually begin to loosen credit. It is the proverbial - leading the horse to water but you can't make it drink.

**Q Have you seen the foreign buyers coming in to the marketplace in increasing numbers?**

A The thing we must keep in mind with foreign buyers is that there will always be economies that are expanding and much of the capital created in those economies will seek investments in stable areas. The biggest reason that New York has benefited from foreign capital is because of the political stability of the United States and New York is viewed as the financial capital of the U.S. That being said, much of the world economy is suffering today. The U.S. contributes 25% to global GDP and when we sneeze the world catches a cold. The U.K. is headed into a recession, Japan is already in a recession and the Euro zone is in recession as well. Thirteen foreign banks have either failed or been nationalized and foreign governments are taking unprecedented steps. Following the lead of the U.S., they are infusing massive amounts of capital into their banking systems. In Ireland, for instance, not only have banks been nationalized but the government is now guaranteeing 100% of all bank deposits with no limitations for their six largest banks. This is creating a problem in that depositors in neighboring countries are withdrawing money and are putting it in banks with national guarantees. I would not be surprised if other governments follow Ireland's lead. Given the globalized nature of financial systems, it is very clear that the rest of the world has a extraordinary stake in our financial success and they are dependent upon it.

**Q In one of your recent weekly commentaries, you mention how our building sales market needed to go through a massive deleveraging. Can you expand on that?**

A The deleveraging that our market needs to experience has already begun to occur. The impact has occurred mainly from 2005 and 2006 vintage loans which now need to be refinanced. Unfortunately, the amounts of refinancing proceeds that are available do not meet the amount of existing debt on the property. Often the property owner does not have a capital to make up the difference. The owners have a couple of choices: 1) To bring in preferred equity in order to retain a piece of the property or 2) Sell the building and, based on the modest declines in pricing to date, they can probably make the lender whole, although much of their equity will evaporate. In addition to the deleveraging of the real estate market, banks needs to deleverage as well. In this environment raising capital is difficult and costly and the way the banking system deleverages is by lending less money. That's a big part of the problem we have been dealing with right now.

**Q During the 3rd quarter, oil prices peaked. How is that effecting building sales?**

A In mid-July oil hit an all time high of \$147.00 per barrel. I have to hand it to the Saudis who were the only OPEC nation that did not want to see oil get above \$100.00 a barrel. The repercussions from the large run up in prices is that it focused the attention of the suffering American consumer on the energy issue. Now the wave of sentiment to free ourselves of dependency on foreign oil has never been greater. Even environmentalists now are endorsing more drilling and alternative sources of energy like natural gas, clean coal, wind and nuclear. Reductions in U.S. demand have helped reduce oil prices to about \$100 today. The increase in oil prices has raised #2 heating oil up to \$3.38 a gallon and at this level, heating bills for multi-family properties have increased from a low of \$2.50 a square foot up to as much as \$3.75 per square foot which can be nearly triple what these bills were just a few years ago.

**Q So are investors still interested in multi-family buildings?**

A Don't get me wrong, multi-family buildings are still the most highly sought after product type in New York City, particularly those with very high levels of rent regulated tenants. These have always been a very attractive segment of the marketplace and will continue to be so.

**Q How has the New York City hotel market been holding up?**

A The U.S. dollar had it strongest run in quite a while last week relative to the Euro and the stronger dollar means that it is less attractive for international tourists to come to New York. That being said, the dollar is still relatively weak and it is expected that tourism will remain fairly healthy. Occupancy rates remain high and room rates have been strong. Caution in this sector is highlighted by economies across the globe which are suffering. This will potentially affect international travel. With the dollar getting stronger, commodity prices have been falling, sharply in some cases. I am hopeful that the decrease in commodity prices will mean the cost of construction goes down.

**Q What types of properties are most highly sought after today?**

A As we discussed multi-family properties are always in high demand. Retail condominiums and retail properties are also in extraordinarily high demand. New York is so under retailed on a per capita basis that it is anticipated that even though retailers might suffer in the short-term, investments in retail space is a very good long-term play. Consumer spending has been decreasing and consumer confidence is very low. This will put stress on retail stores to find ways to increase revenue. Just the consolidation in the banking industry alone will put some downward pressure on retail rents. But as I said, over the long-term, retail is a very sound investment.

**Q What caused the financial crisis?**

A Essentially two things. The first was the collapse of the housing bubble and the second was the mispricing of risk. Problems became evident with troubles in the subprime mortgage area and spread to housing. Housing continues to contribute to our financial crisis. This is reducing the supply of credit which is needed to sustain economic activity. Wall Street shouldn't be blamed exclusively for this. Congress through various programs like The Community Reinvestment Act and The Taxpayer Relief Act of 1997 created incentives for people who really couldn't afford houses to buy them. The government urged Fannie Mae and Freddie Mac to purchase loans made to borrowers with incomes below the medium in their area and these targets continued to increase almost on a yearly basis. The Fed did its part also. In 2003 the Federal Funds rate hit a 40-year low of 1.25% that puts the rates on adjustable loans to historical lows, helping to fuel the housing bubble. The result was that from 1997–2005 the average price of a house in the U.S. more than doubled. It wasn't merely a speculative bubble. Much of the rise in housing prices was the result of public policies that increased the demand for housing. Without the surge in rising prices, the sub-prime market would never have taken off. Basically, political agendas created a push of home ownership rates to historic highs from 64% in 1994 to 69% in 2004 and this was mostly the result of loans to low income, higher risk borrowers. As they say, beware of trying to do good with other people's money. Unfortunately, that strategy remains at the heart of the political proces, and is part of the proposed solutions to this crisis.

**Q Won't the bail out package increase banks lending?**

A Strong balance sheets breed confidence, it is not the other way around. That is why the plan by itself isn't likely to get banks and debt investors to immediately lend freely. Confidence has to be restored to the marketplace.

**Q How long do you think this crisis will last?**

A Nobody knows the answer to that question. Financial institutions need to be stabilized and this process has begun. Housing prices need to bottom out and the hangover of inventory must be absorbed. The banking system needs to be recapitalized and banks need to regain their appetite to lend money. While we don't know how long it will last, there are indicators we are looking at which can indicate we are hitting the bottom of the cycle. The first will be when we see two or three quarters go by when banks are not forced to raise capital. The second will be watching leveraged loan spreads. These spreads are extraordinarily high and are indicative of banks' willingness to make loans. When they

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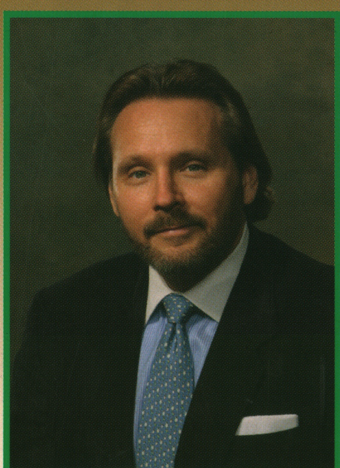
start to moderate, it will be a good sign. The third item are credit default swap premiums. These premiums have also been extraordinarily high and are indicative of the confidence that the marketplace has in financial institutions. When these premiums start to moderate, it will be a good indication that things will be turning around.



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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 $5.0 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.

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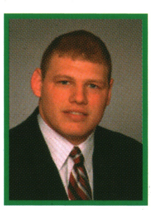

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