A Conversation with the Chairman

MASSEY KNAKAL
Realty Services

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Dear Friends,

This month we sat down with Massey Knakal Chairman Robert Knakal to discuss a year end synopsis of the New York City building sales market and insights into his outlook for 2008. This is the first in a two-part series that we hope you find insightful and informative.

Q Subprime lending problems have had a tremendous impact on the national housing market, the economy and our local real estate market. How has this issue affected our local market?

A The subprime lending issue has been a significant one for the economy and for the country. It is the American dream to own a home and liberal lending practices have helped millions of Americans realize the dream of homeownership. But, unfortunately, 1.8 million of those individuals are now at risk of losing their homes. Lack of prudent underwriting criteria and falling prices in the national housing market have exacerbated the subprime problems and have led to uncertainty across all capital markets. This issue has not been as prevalent in New York City as it has been for the rest of the nation as the dominant form of home ownership in NYC is through owning cooperative shares. Coops have much more stringent borrowing guidelines than banks; consequently, the NYC market has been more resilient to the housing downturn than the rest of the country. The effect on the credit markets in general has been the major local impact on our building sales market.

Q Please share your thoughts about President Bush's subprime bail-out plan.

A Well, it's really not President Bush's plan, it's Treasury Secretary Paulson's and HUD Secretary Jackson's plan. That being said, I don't think there is a perfect solution to this problem. But the plan that has been laid out is a great first step in the process. The HOPE NOW Alliance is a private sector initiative which could help 2/3 of the 1.8 million Americans at risk of losing their homes. There have been three key steps towards progress that have been achieved. The first is the launching of a new initiative at the Federal Housing Administration (FHA) called FHAsecure. This program will give FHA expanded abilities to offer flexible refinancing to homeowners with good credit. Secondly, Secretaries Paulson and Jackson have assembled the private sector HOPE NOW Alliance which will provide significant assistance to at-risk borrowers. Thirdly, the Federal Government is taking several regulatory actions to make the mortgage industry more transparent, reliable and fair. If members of Congress are serious about responding to the challenges in the housing market, they can start with several steps of their own. The House has passed many of these reforms but Congress needs to pass legislation to modernize the FHA. Congress needs to temporarily reform the tax code to help homeowners refinance and they also need to funding to support mortgage counseling for those who are unaware of programs available to them. Congress also needs to pass legislation to reform Government Sponsored Enterprises (GSEs) like Freddie Mac and Fannie Mae.

Q As 2007 nears its end, the biggest real estate issue is the state of the credit market. What are your thoughts on how the current credit market has affected building values in New York City?

A Clearly the market can be bifurcated into two segments. Transactions over $100 million dollars are much more challenging to finance now than they were previously. In the market under $100 million dollars there is plenty of debt available for these transactions. That debt, however, is requiring more equity and the debt is more expensive. With more equity being required it is important to note that equity is more expensive than debt, so intuitively this will put downward pressure on pricing. However, we have not seen prices falling thus far. The only softening in values we have observed are for development or redevelopment opportunities in fringe locations. For these projects lenders are underwriting much more conservatively and we have seen an adverse effect on values in the 5-10% range. Income producing properties have not yet been affected.

Q The general sentiment is that the credit crisis will put downward pressure on prices. Isn't this inevitable?

A The interesting thing about this question is that the state of the credit markets is putting upward pressure on capitalization rates. Upward pressure on capitalization rates leads to lower relative pricing. However, given the tremendous increase we have seen in rental rates over the past year or two, even slightly higher cap rates of 25-50 basis points are still yielding ever increasing prices per square foot. In fact, our survey of the building sales market in 2007, which was done in conjunction with the appraisal firm Miller Cicero, shows that in Manhattan, for example, average prices per square foot exceeded the $500 dollar level for the first time in history. These rental fundamentals have been a significant factor in keeping values where they are. The lending markets, in general, have changed as 1) spreads have increased; 2) debt service coverage has increased; 3) amortization is now a component of all mortgages (which was not the case 6 months ago); and 4) loan-to-value ratios are decreasing.

In Manhattan,
average prices per sqaure foot exceeded the $500 level for the first time in history

2H02	1H03	2H03	1H04	2H04	1H05	2H05	1H06	2H06	1H07
$215		$385	$329	$374	$418	$469		$469	$508
$254		$414	$314	$256	$331	$407		$449	$517
$349		$385	$540	$549	$535	$874		$940	$906

Source: Miller Cicero

Q You always integrate macroeconomics into your "Message from the Chairman" articles. Is this because of your Wharton School background?

A I have always been very interested how macroeconomic issues impact our local real estate market. The ties and connections now are more important and more significant than ever as globalization of the real estate market has become a reality. Although economic indicators do not provide a crystal ball into the future, they do provide some sense of where markets are headed. Having this information, we hope, can lead clients towards making more informationally based and fundamentally sound decisions.

Q The U.S. economy is growing slowly. How will this affect the 2008 building sales market?

A It is true that the economy is growing very slowly and, in fact, in the 4th quarter of 2007 the annualized growth rate of GDP is running at only 1%. This 1% growth is due mainly to the tremendous increase in exports that the country has experienced. Given the relative weak dollar, our exports are up significantly and our imports are down. This is stimulating our economy by some estimates to the tune of about 1% growth in GDP, meaning there is nominal growth in the rest of our economy. The slowing economy has several affects on our local market primarily due to its affect on interest rates. We have to monitor the economic indicators closely including inflation and employment which are the two indicators having the most profound effect on the direction of interest rates.

Q You have been quoted as stating that that the national economic slow down has been beneficial to the New York City building sales market. Can you explain this further?

A I think I have been misquoted. I stated the national economic slow down has to been "to some degree" beneficial to our building sales market. Fed Chairman Bernanke and Fed Vice Chairman Kohn have been extremely concerned about balancing growth and inflation. One of the major things the Fed does to effectuate this balance is to set interest rates. Given the slowdown in the economy, the Fed has been reducing rates and we expected another reduction of 25 basis points in the December 11th session. This has helped our local market as falling rates are stimulus to activity. Lower interest rates do not mean that banks have to lend money but it clearly creates at least one of two potential positives. If the federal funds rate gets lowered, mortgage rates may lower. Or mortgage rates are not lowered but this will further increase spreads creating tangible motivation for banks to push money into the market. Either way, this is very positive for us.

Q In 2007, the building sales market will see approximately $50 billion in aggregate transactions. This is up from approximately $35 billion in 2006. Will volume continue to rise in 2008?

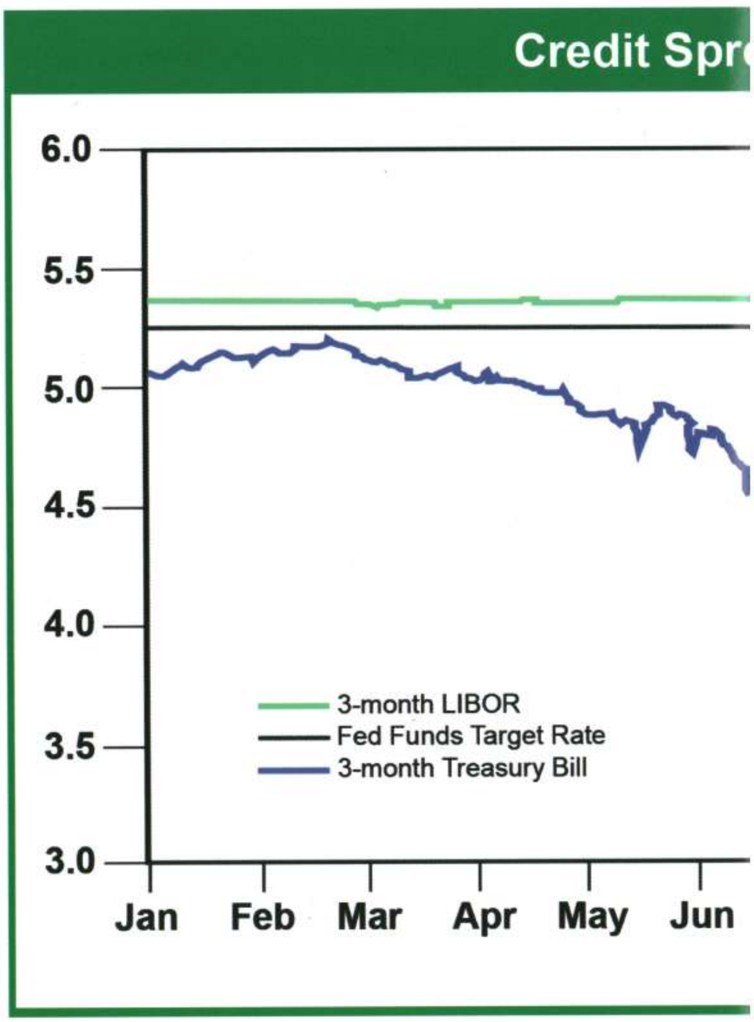
A The issue of volume is a very interesting and important topic. We focus on the number of transactions as opposed to the aggregate dollar volume. We believe that although the volume dollar of sales grew in 2007, the actual number of transactions was down from 2006. Increased rent levels, leading to higher prices, and more large assets being sold have been key factors in the $50 billion dollars of sales figures. That being said, during the last four months, we have seen a slow down in the number of contracts executed of approximately 20%. In the first half of the year Massey Knakal was signing approximately 50 contracts each month and for the past several months, we have been signing about 40 contracts. The volume of sales for Manhattan in the first half of the year was 1.7% of the total stock of buildings, or 3.4% annuallized. The 20% reduction in the second half of the year will lead to an overall market turnover of approximately 3.1% of the total stock of buildings. We anticipate the volume of sales to diminish in 2008 to 2.75-3% of the total stock of buildings. This is not necessarily a negative thing as we must realize that this is a very healthy volume of sales. Equilibrium seems to be at a volume of 2.5% of the total stock of buildings which has been the market average throughout most of the 1990's and into the present decade.

Q **It is thought that with a more challenging selling environment and reduced volume, marginal brokers will disappear from the market. Do you anticipate this?**

A That's an interesting question. As we saw volume fall off the table in the early 90's, clearly many brokerages downsized their operations or disappeared from the business completely. I would agree that selling buildings as a broker was not extremely difficult over the past several years. It is thought that now, with more challenging times, the skills, capabilities and effort displayed by brokers will be more important in the equation of whether that broker is successful or not. That being said, the significant volume of transactions that we do expect in 2008 should provide a significant pool of potential transactions for brokers. There are many fine brokers and brokerage companies that will continue to prosper even with a slight reduction in volume.

Q **You always discuss the direction of interest rates. Where are they headed?**

A I wish I knew. There is no way to know. All indications are that the economy will continue on its sluggish pace with low GDP growth, upward pressure on unemployment and inflation in check. These factors should continue to place downward pressure on rates. A bigger question,



because most economists believe rates will begin to fall throughout at least the first two quarters of 2008, is what will happen to margins? The last two rate drops (in the federal funds rate) have shown little effect on lending rates as margins have widened. Presently, the movement of margins and lender's willingness to lend are more important than the movement of interest rates.

Q **A lot has been written about the strength of the hotel market. There are, however, concerns that there may be overbuilding in this sector. What are your thoughts?**

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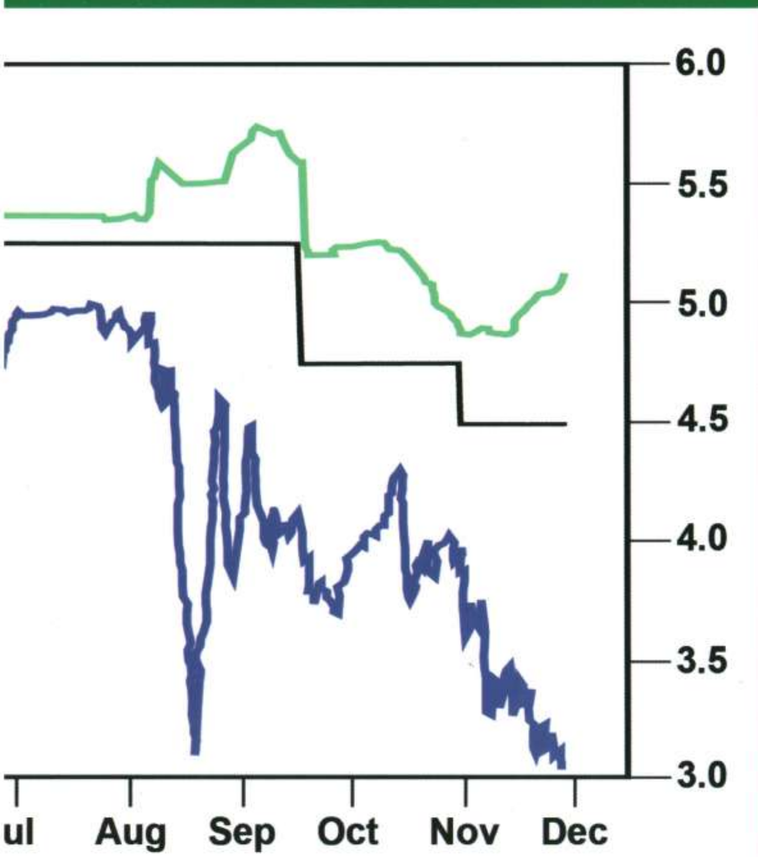

Source: Federal Reserve Board. Financial Times.

A Depending upon which report you read, there are anywhere from 15-20,000 new hotel units either under construction or in the planning stages. This may seem like a large number but let's not forget that for the past two years we have had record growth in room rates coupled with cyclically high occupancy rates. There is no doubt that hotels have been performing better than they ever had in history. We also went through a period over the last three years where the overwhelming strength of the condominium market led to the elimination of some 8-9,000 hotel rooms to make way for conversion to condominium ownership. So, even if we assume the high end of the range of 20,000 is accurate, this is really adding a net of 11-12,000 new rooms to our stock. As a percentage of the total stock of hotel rooms in the city, which is about 75,000 rooms, this is not a disasterous addition to the stock. We also must take into consideration that the strength of the office building market may cause a shift in some plans to change sites planned for hotels to office developments. We must also consider the fact that this segment is buoyed by the tremendous tourism numbers that the city has experienced. In 2007, 44 million visitors will have visited New York City. It is anticipated that 47 million will visit the city in 2008. The weak U.S. dollar has had a two fold impact on this. Firstly, international travelers find New York City a relative bargain and secondly, domestic travelers find it more expensive to travel internationally and are looking for domestic destinations upon which to spend their vacation dollars, NYC is a primary choice. We have benefited significantly from both of these factors. I think the outlook for the hotel market is terrific.

Q What is the current status of the multi-family market in New York City?

A With a vacancy rate of less than 1% how can you say that the market is not fantastic? The appetite of investors for multi-family product has never been higher. These buildings are easiest to finance. Private investors, institutional investors and foreign investors are attracted to the artificially low rents created by rent regulation. We have seen cap rates stay well below borrowing rates for years now with no sign of a change in this dynamic. We have tremendous activity on all of the multi-family portfolios and all of the multi-family properties that we are marketing today and these assets are viewed as the most risk free assets in the marketplace. So risk free in fact, that their cap rates are sometimes lower than U.S. Treasuries. Demand seems insatiable and the outlook is great.

Q With regard to the office building market, people point to Harry Macklowe's acquisition of the EOP portfolio as a litmus test for the future. Any thoughts?

A The institutional office building market is not a focus of ours. However, in that market as well, vacancy rates are very low and rents have seen tremendous growth over the last year or two. As long as companies believe that New York City is a safe place to do business and is the financial capital of the world, this sector of the market will continue to be very strong. If you look at NYC compared to other leading international cities, we are relatively inexpensive, even with our triple digit rents in class "A" buildings. In terms of Harry's acquisition, I am confident that it will result in a very successful investment for him. Harry has tremendous vision and will figure out the best way to maximize the value of those properties.

Q Why are so many investors seeking retail properties today?

A Well, it goes without saying that retailers want to be in New York City. NYC is the most under-retailed city, on a per capita basis, in the United States. The average major U.S. city has 22 square feet of retail space per person. NYC has six! The buying appetite, particularly in emerging areas in the boroughs, is just tremendous. Investors simply love this product type. For example, the number of investors that are on our investor database that are now interested in purchasing commercial condominiums has more than tripled in the past two years.

Q The tremendous international demand for real estate in New York City is attributed to the weak U.S. dollar that you mentioned earlier. In a recent speech you gave at Columbia University, you disagreed with this. Please explain.

A The weak dollar is an interesting thing to look at. It is important to realize that from the perspective of a foreign buyer buying a building, which is income-producing, because of the weak dollar, they are going to receive their cash flow in that weak dollar and will receive their profits on resale of the assets based on that weak dollar. The only way the weak dollar is beneficial to the investor is if the dollar gains relative strength over the life of that investment. Where the weak dollar is beneficial is for the international buyer that is buying a co-op or a condominium here. In that instance, the weak dollar does have a direct benefit to the foreign buyer. Therefore, if we're talking about income-producing properties, the weak dollar is much less of a factor than it is for the coop or condominium market. The international demand is directly related to the perception that NYC is a safe city in which to invest with sound fundamentals. This is, in many ways, thanks to Mayors Giuliani and Bloomberg and highlights the importance of the next mayoral race.

Q What is the origin of the most prominent foreign investors today?

A We are now in a unique economic period globally with economies expanding all over the world. People are making tremendous amounts of cash in foreign countries and much of that capital is seeking U.S.-based investments. Of this appetite, a significant percentage is focused on New York City real estate. Interestingly, with the growth we have seen in exports, due mainly to the weakened dollar, the buyers we have seen entering the market are from some of the same countries that are our major export partners. These countries include Canada, Japan, China, The U.K, Germany, South Korea, Brazil, Venezuela and Ireland. While exports might not seem like an important part of the U.S. economy, in absolute dollar terms our exports in 2006 were higher than those of China.

Q What is the most important economic indicator we should be watching for in 2008?

A Interest rates and spreads are always significantly important and should always be watched. But I think an indicator that needs to be looked at very closely is employment data. For much of the past 18 months unemployment was at a cyclical low, running at about 4.5-4.6%. Over the past several months it has been inching up and is currently at 4.7%. A recent study by Goldman Sachs shows that unemployment is projected to reach 5.5% by the middle of 2008. This would have significant implications for our building sales market. As jobless benefit claims rise it will exacerbate the reduction in consumer confidence and consumer spending. If unemployment rises and layoffs continue to pick up, spending and confidence will continue to be reduced, the foreclosure rate will increase and office space needs will be reduced. We will be keeping a close eye on the employment data.

Q Finally, where do you see building sales prices going in 2008?

A As we stated before, we remain very bullish on the building sales market. New York City

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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is as highly sought after as it ever has been and the fundamentals in the market remain excellent. We have a miniscule vacancy rate in residential, very low vacancy in office buildings with relatively little speculative construction on the horizon. There remains tremendous demand from both local, domestic and international sources and we have to realize that billions of dollars of wealth have been created with the surge in building sales prices over the last six or seven years. I believe that the continued malaise in the national economy will keep downward pressure on interest rates, which should keep debt flowing into our markets. We are looking forward to a very solid year in 2008.

If you would like additional market information or would like to sell your property, please give us a call:

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