Real Estate Capital Markets Update – February 12, 2004

Volume 6, Number 3

Welcome to the update of ULI's Real Estate Capital Markets Web site. Updates are divided into four sections: public real estate securities markets, public real estate debt markets, private real estate equity markets, and private real estate debt (mortgage) markets. In each section, we feature Real Estate Capital Markets Scoreboards detailing selected performance indices for each of the real estate capital markets.

To expand site users' knowledge and understanding of the real estate capital markets, we will publish "knowledge" papers describing underlying market mechanics. In addition, we have provided links to other Web sites that provide related and relevant information. <u>Click here for links to other Web sites</u>.

Frequently Asked Questions (FAQs): In addition to knowledge papers, we have published answers to FAQs about the real estate capital markets. To go to FAQs, <u>click here</u>.

Glossaries of frequently used terms are available for readers' use. To go to the glossary section, which includes selected Web sites that provide glossaries and/or real estate term search engines, <u>click here</u>.

We want this site to be both useful and responsive to users, and we encourage you to e-mail comments and suggestions. If you want to send me an e-mail, click stephen@uli.org, add your comments, and click "Send".

Food for Thought from "The PunchLine", Volume 3-1 (January 12, 2004)

"Recovery Unleashed"

The business recovery led by the US should become increasingly entrenched in 2004. Business risk should therefore continue to decline on the back of the strengthening economic picture, improved earnings and only a gradual turn in interest rates. The bottom line is that the earnings equation for 2004-5 is much improved as firms are de-leveraging, refocusing and restructuring business plans, selling assets and clawing back to profitability via an unprecedented cost retrenchment. At the end, earnings prospects may be less a function of classical cyclical recovery patterns and more a function of extensive business transformations. Of course, that argues for the outlook being much more complex than the euphoria in the markets would have one believe. Risk considerations include the gradual ending of the huge doses of government stimulus, a weary consumer sector waiting for significant pickup in job prospects, issues regarding the cascading US dollar, accelerating competitive pressures across numerous sectors, some very stubborn costs (energy, for one) and a lingering threat of terrorism. Another factor that is becoming difficult to gauge is the gnawing indication that investors are chasing the "risk frontiers" of 2003's 50% run in the tech sectors, some even larger returns in emerging markets and select commodity sectors.

"The PunchLine" is published by Brookville Capital (www.brookvillecap.com)

Special Comment: Federal Open Market Committee Holds Monetary Policy Unchanged

The Federal Reserve Board (FRB), operating through the Federal Open Market Committee (FOMC), held monetary policy unchanged at it meeting held on January 27 and 28. And while the FOMC maintained its neutral policy "bias", the statement released by the Committee omitted the words "considerable time" from its lexicon. Instead, the FOMC noted that it could "be patient in removing its policy accommodation." Translators of Fed-speak interpreted the FOMC's remarks to mean that the FRB had moved one step closer toward the eventual tightening of monetary policy and the increase of the Federal Funds Rate. The equity markets did not digest the news too well!

Real Estate Capital Markets Scoreboard: Money Rates	February 7, 2004
Prime Rate (Base rate on corporate loans posted by the largest commercial banks)	4.00%
Federal Funds Rate (Rate banks charge other banks for overnight loans)	1.00%
Discount Rate (Rate charged banks who borrow overnight from the Federal Reserve)	2.00%
Dealer Commercial Paper (Rate for high grade unsecured notes sold by major corporations)	1.02% - 30 days 1.03% - 60 days 1.05% - 90 days
London Inter-bank Offered Rate (LIBOR) (Rate on deposit-based transactions between banks in the Eurocurrency market)	1.10000% - 1-month 1.13000% - 3-months 1.22000% - 6 months 1.48375% - 1 year
Foreign Prime Rates	Germany – 2.000% Japan – 1.375% Great Britain – 4.000%
U.S. Treasury Securities	4.08% - 10-year

It appears that the consensus of leading thinkers believes that the tightening of FRB policy will not occur before the summer, and will depend upon and reflect what is going on in the job market. Job creation is a precondition to tightening of monetary policy; weakness in the job markets will most likely delay any action by the FRB.

Special Comment: Federal Reserve Board's Beige Book Shows Signs of Improving Economy

According to the FRB's Beige Book survey, the U.S.'s economy continued to improve through the end of the year. The following is a summary of selected portions of the survey. The survey may be viewed in its entirety by visiting the FRB's web site at **www.federalreserve.gov/FOMC/Beigebook**. The next FRB Beige Book will be released on March 3, 2004.

- Nearly all districts reported improvement in the manufacturing sector;
- Consumer spending through the end of the holiday season was reported as solid in most districts;
- Travel and tourism is being assisted by the low value of the dollar;
- Commercial real estate remain soft in most district:
  - A few districts, such as Atlanta, Dallas, and Richmond reported either increased activity or an improvement in expectations;
  - The Chicago and Cleveland districts reported weak commercial real estate markets with little expectation of firming in the near term.

Public Real Estate Securities Capital Markets

One merger, one initial public offering. Not bad for a January. And real estate investment trust shares continue to increase in value.

First, the initial public offering. On January 27, 2004, Government Properties Trust, a real estate investment trust that will focus on acquiring single-tenant properties subject to long-term leases to agencies of federal, state, and local governments, completed its initial public offering, raising approximately $180 million in total net proceeds. The company's shares will trade on the New York Stock Exchange under the symbol "GPP".

At the time of the offering, GPP owned five properties totaling approximately 250,000 square feet and had commitments to acquire an additional eight properties totaling approximately 500,000. Tenants include entities such as the Department of Justice, Drug Enforcement Administration, FBI, Social Security Administration, U.S. Border Patrol, U.S. Immigration and Naturalization Service, Veterans Administration, U.S. Bureau of the Public Debt, Department of Labor.

GPP has a huge market available to it as according to the 2002 Federal Real Property profile published by the General Services Administration, the Federal government alone occupies in total approximately 885 million square feet of office space of which it leases approximately 192 million (23%). Add to this the assets of state and municipal governments and …

Real Estate Capital Markets Scoreboard: Public Securities and Real Estate Performance Indices as of February 6, 2004						
	Dow Jones Industrial Average	S&P 500 Stock Index	NASDAQ Composite Index	Russell 2000 Index	Morgan Stanley REIT Index	NCREIF All Property Index
2003	+24.8%	+25.8%	+49.5%	+46.3%	+36.9%	+9.0%*
2004	+1.3%	+2.8%	+3.0%	+4.9%	+6.0%	
*Trailing 12-month period ended December 31, 2003.						

Next, the merger. On January 22, 2004, Great Lakes REIT (ticker symbol: GL) announced that it had signed a definitive merger agreement to be acquired by Aslan Realty Partners II, L.P., an affiliate of Transwestern Investment Company, L.L.C.

As part of the overall transaction, GL has entered into definitive agreement to separately sell certain assets consisting of medical office buildings and two buildings located in Minnesota to two institutional investors.

Based upon the assumed net proceeds of the asset sales, combined with the consideration to be paid by Aslan Realty Partners, GL shareholders will receive approximately $15.50 per share.

Real Estate Capital Markets Scoreboard: Market Capitalization of REITs (number of shares multiplied by share price in $ millions) as of February 6, 2004								
	Number of REITs	Market Cap	Equity REITs	Market Cap	Mortgage REITs	Market Cap	Hybrid REITs	Market Cap
2003	171	224,729	144	204,801	20	14,703	7	5,225
2004	173	244,467	146	223,112	20	15,943	7	5,413
Source: National Association of Real Estate Investment Trusts (NAREIT).								

REITs continued to outperform the stock market indices, ending February 6, 2004 up 6.0% for the year versus 1.3% for the Dow Jones Industrial Average, 2.8% for the S & P 500 Stock Index, 3.0% for the NASDAQ Composite Index, and 4.9% for the Russell 2000.

Real Estate Capital Markets Scoreboard: Offerings of Securities by REITs (in $ millions) as of December 31, 2003				
	2003		2004	
	# of Offerings	$ Value	# of Offerings	$ Value
Initial Public Offerings	6	$2,201	0	0
Follow-on offerings-Common Shares	76	5,083	0	0
Follow-on Offerings-Preferred Shares	57	4,417	0	0
Unsecured Debt	63	10,069	0	0
Secured Debt	6	1,358	0	0
Source: NAREIT REITWatch On-line.				

How long will capital continue to conquer fundamentals is anyone’s guess. The amount of capital entering the real estate space from all sources is nothing short of “breathtaking” and “discomforting” given the state of industry fundamentals.

Public Real Estate Debt Capital Markets

Issuance of Commercial Mortgage-Backed Securities January 1, 1995 through February 6, 2004 (in $ Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
1995	$15,749.7	$1,050.9	$16,800.6
1996	26,365.3	930.3	27,295.6
1997	36,797.7	3,557.0	40,354.7
1998	74,331.7	628.8	74,960.5
1999	56,571.1	9,085.0	65,656.1
2000	46,849.4	12,116.4	59,010.8
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	4,300.0	600.0	4,900.0
Source: Commercial Mortgage Alert.			

	Total CMBS Delinquencies	30/60/90+ Days Delinquent	Foreclosure/Real Estate Owned
January	1.42%	0.95%	0.47%
February	1.39%	0.94%	0.45%
March	1.37%	0.92%	0.45%
April	1.54%	0.99%	0.54%
May	1.49%	1.00%	0.49%
June	1.50%	1.00%	0.50%
July	1.55%	1.05%	0.49%
August	1.58%	1.06%	0.52%
September	1.54%	1.07%	0.50%
October	1.70%	1.20%	0.50%
November	1.55%	1.04%	0.51%
December	1.62%	1.11%	0.51%
Source: Morgan Stanley *CMBS Perspectives*.			

Commercial mortgage-backed securities (CMBS) trading spreads remain at their lowest levels since July 1998, leading to a highly competitive lending environment. And while we concur with Herbert Stein, President Nixon's economic advisor who said, "An unsustainable trend will not last forever", the trend in CMBS trading spreads has sure lasted for a very long time given the state of real estate industry fundamentals.

Real Estate Capital Markets Scoreboard: Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)									
	7/31/ 1998	12/31/ 1998	12/31/ 1999	12/31/ 2000	12/31/ 2001	12/31/ /2002	12/31/ 2003	2/4/ 2004	YTD +/-
10-Yr. Treas. Bonds	5.50%	4.87%	6.44%	5.11%	5.05%	3.81%	4.25%	4.12%	-0.13%
AAA	+86	+140	+124	+147	+130	+ 93	+72	+68	-4
AA	+98	+165	+144	+162	+150	+107	+80	+75	-5
A	+112	+190	+164	+177	+175	+122	+87	+82	-5
BBB	+150	+270	+210	+235	+225	+183	+134	+124	-10
BBB-	+200	+350	+295	+280	+265	+224	+182	+164	-18
BB	+275	+575	+525	+525	+575	+450	+425	+415	-10
B	+450	+825	+800	+815	+1000	+950	+950	+950	0
Source: Morgan Stanley.									

Private Real Estate Equity Capital Market

Real Estate Capital Markets Scoreboard: Survey of Initial Capitalization Rates								
	Multi-Family	Office-CDB	Office-Suburban	Retail-Mall	Retail-Neighborhood	Retail-Power	Industrial-Warehouse	Industrial-R & D
2Q98	8.5%	8.5%	8.6%	8.3%	9.1%	9.2%	8.7%	8.8%
4Q98	8.8%	8.7%	8.9%	8.6%	9.5%	9.6%	8.9%	9.1%
4Q99	8.8%	8.9%	9.0%	8.5%	9.2%	9.6%	9.0%	9.3%
4Q00	8.7%	8.6%	9.3%	8.9%	9.4%	10.1%	8.9%	9.3%
4Q01	8.6%	9.2%	9.8%	8.9%	9.5%	10.2%	9.1%	9.7%
4Q02	8.0%	9.0%	9.7%	8.7%	9.2%	9.5%	8.9%	9.7%
1Q03	8.1%	8.9%	9.5%	8.8%	8.9%	9.3%	8.7%	9.5%
2Q03	7.8%	8.7%	9.2%	8.4%	8.6%	9.0%	8.5%	9.4%
3Q03	7.6%	8.5%	9.0%	8.0%	8.3%	8.6%	8.3%	9.2%
Source: Real Estate Research Corp. (www.rerc.com).								

The *Emerging Trends in Real Estate 2004* report, considered the most comprehensive annual forecast available on all categories of the commercial real estate industry, was released at the 2003 ULI Fall Meeting. Published jointly by ULI and PricewaterhouseCoopers, *Emerging Trends* findings are based on interviews with leading real estate authorities.

If you are interested in ordering a copy of the full report, please visit the ULI bookstore at www.uli.org, then click on "Bookstore" on the navigation line.

The following is a summary of the highlights section contained in *Emerging Trends in Real Estate 2004*:

- Today's weak fundamentals will improve… slowly.
- Office markets will erode further before recovering.
- Corporate outsourcing and reliance on productivity gains to increase profits continues to restrain job growth.
- As always, it's the economy, stupid!
- Interest rates will rise as will capitalization rates.
- Capital flows into real estate equity and debt will lessen, but remain more than adequate.
- Rates of return for core investments will be in the mid-to-high single digits, reverting to the mean.
- Delinquencies, defaults, workouts, and foreclosures will increase modestly but remain manageable.
- Real estate's recovery will be muted as current returns, enhanced by low interest rates and huge capital inflows, are "borrowing" from future performance.
- Development activity will be limited…very limited, but opportunities can be found in urban/suburban infill.
- Washington, DC, Southern California and New York are the best metro markets for investment.
- By property sector, investors favor grocery-anchored retail, warehouse, and apartments are favored by investors.

The following is a summary of the "Best Bets 2004" section contained in *Emerging Trends in Real Estate 2004*:

- Sell into "hordes of cash".
- Buy credit and term office (i.e., avoid rollovers in the next five years and leverage up using low cost, fixed-rate debt).
- "Dare to be boring"—buy industrial properties.
- Borrow now—"It's today's best opportunistic-oriented return".

- Be patient and husband resources—distress, if any, will unfold later in the year.
- Identify vanguard markets that will lead the recovery.
- Bide your time on apartments—wait for mortgage rates to increase with conviction.
- Expect real estate investment trusts to trade in a narrow range as earnings could be flat or down.

Real Estate Capital Markets Scoreboard: Transaction Volume and Investment Activity ($ billions)				
Period	Total Number of Transactions	% Increase/ Decrease	$ Value of Transactions	% Increase/ Decrease
Benchmark Period *	1,470		$77.40	
01/01/98 – 12/31/98	1,189	-19.12%	$62.10	-19.77%
01/01/99 – 12/31/99	1,061	-10.77%	$50.80	-18.2%
01/01/00 – 12/31/00	745	-29.78%	$42.40	-16.54%
01/01/01 – 12/31/01	940	+26.17%	$46.60	+9.91%
01/01/02 – 12/31/02	1,293	+37.55%	$56.60	+21.46%
07/01/20 – 06/30/03	1,604	+24.05%	$59.11	+4.43%
*Benchmark period equals first six months of 1998, annualized.				
Source: Institutional Real Estate, Inc.				

Summary of the "Best Bets 2004", continued:

- Prune grocery-anchored retail—sell into the demand curve.
- Sell B-malls and B-power centers.
- Consider buying full service hotels—the worst could be behind us?
- Examine second-tier markets.
- Look at affordable housing—both development and redevelopment.
- Develop/redevelop warm-weather waterfront condominiums and mountain resort hideaways to satisfy the incredible demand of affluent baby boomers preparing for retirement.
- Focus on infill redevelopment.
- Office tenants—relocate and upgrade your surroundings.

Private Real Estate Debt (Mortgage) Capital Markets

Hot, hot, hot! What else describes the mortgage market today? At 5.7%, overall rates are low, spreads (as measured by the Barron's/John B. Levy and Company Survey of Prime 10-Year Commercial Mortgages) of 1.55% over 10-year Treasury bonds, are at lows not seen since July 1998, and by all reports, money is plentiful and lenders are eager to loan it.

Real Estate Capital Markets Scorecard: "Prime" 10-Year Commercial Mortgages Versus Treasuries Yields as of January 31, 2004									
	7/31/ 1998	12/31/ 1998	12/31/ 1999	12/31/ 2000	12/31/ 2001	12/31/ 2002	12/31 2003	1/31/ 2004	YTD
Prime Mortgages	6.82%	7.00%	8.45%	7.35%	7.33%	6.05%	5.80%	5.70%	-0.10%
10-Year Treasuries	5.50%	4.87%	6.52%	5.11%	5.05%	3.81%	4.25%	4.15%	-0.10%
Spread	1.32%	2.13%	1.93%	2.24%	2.28%	2.23%	1.65%	1.55%	-0.10%
Source: Barron's/John B. Levy and Company Survey									

According to the Federal Reserve Board's most recent Senior Loan Officer Opinion Survey of approximately 60 large domestic banks and 24 U.S. branches and agencies of foreign banks operating in the U.S., banking lending standards and lending terms for commercial and industrial loans continued to ease during the fourth quarter of 2003.

According to the survey, a net 17.9% of the financial institutions reported easing standards and terms for loans to larger commercial and industrial borrowers; importantly, this is the fourth consecutive time standards for commercial and industrial borrowers have eased.

The survey noted that loan demand during the fourth quarter of 2003 continued to increase with a net 10.7% of the banking institutions reported a strengthening in demand from large and medium sized firms.

While banks reported a strengthening in the demand for commercial real estate loans, a net percentage of banks reported weakening demand for residential mortgage loans.