

Real Estate Capital Markets Update – February 27, 2004

Volume 6, Number 4

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. [Click here for links to other Web sites.](#)

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, [click here.](#)

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, [click here.](#)

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".

Special Comment: California State Public Employees Retirement System Real Estate Investments Outperform Benchmarks

In a recent press release, the California Public Employees Retirement System (CalPERS) reported that its "investments in real estate, which are largely office, retail, apartment, and industrial assets, gained 8.5% [in calendar year 2003]. The systems investments in [single-family] housing, timber, and other specialized real estate assets earned 20.4%. Both portfolios exceeded the NCREIF [National Council of Real Estate Investment Fiduciaries] Property Index that returned 7.8% [in 2003].

As of December 31, 2003, CalPERS' assets totaled \$161.1 billion, allocated 60% to equities, 25% to bonds and other fixed income investments, and 7% (\$11.3 billion) to real estate.

Special Comment: Real Estate's Popularity Continues Unabated

Notwithstanding the state of underlying real estate industry fundamentals, real estate's popularity continues unabated.

According to a recent UBS / Gallup survey of individual investors, 46% of the respondents expect to invest in real estate securities in 2004, an increase of 4% from last year's survey's results, and up 6% from three years ago.

What could this mean? UBS estimates that a 2% increase in funds allocated to real estate could translate into \$20+ billion in demand for publicly-traded real estate securities, an amount that is equal to 10% of the current market capitalization of the entire publicly-traded real estate investment trust industry.

Additionally, 56% of the respondents to the North American portion of a Frank Russell Company / Goldman Sachs survey on alternative investments said they had invested in real estate, noting that they believed real estate had provided 9% to 10% annual returns for the past 10 years. Further, the respondents stated that they believed real estate would continue to provide similar returns on a going-forward basis.

Special Comment: Basel Committee Continues to Respond to Concerns Expressed Over New Capital Requirements

According to an analysis by the Real Estate Roundtable (www.rer.org) of the most recent revisions to the proposed Basel II Capital Accord which is to go into effect on January 1, 2007, serious concerns remain regarding the potential impact of the proposals upon the treatment of commercial bank's securitization-related exposure. Specifically, the Real Estate Roundtable's analysis noted that the proposals, as presently constructed, could increase banks' cost of owning commercial mortgage-backed securities as well as providing certain real estate acquisition, construction, and development loans, thereby reducing the amount of credit available to the real estate sector.

Readers should expect to see increasing attention paid to the proposed Basel II Capital Accords as 2004 progresses.

Real Estate Capital Markets Scoreboard: Money Rates	February 27, 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)	0.98% - 30 days 0.99% - 60 days 1.00% - 90 days
London Inter-bank Offered Rate (LIBOR) (Rate on deposit-based transactions between banks in the Eurocurrency market)	1.1000% - 1-month 1.1200% - 3-months 1.1700% - 6 months 1.3675% - 1 year
Foreign Prime Rates	Germany – 2.000% Japan – 1.375% Great Britain – 4.000%
U.S. Treasury Securities	4.01% - 10-year

Just How Competitive Were Real Estate's Rates of Return in 2003?

First, we need a benchmark or two for comparison purposes. For real estate, we suggest one of two measures—the rate of return for the Morgan Stanley Real Estate Investment Trust (REIT) Index and the All-Property Index of the National Council of Real Estate Investment Fiduciaries (NCREIF). For calendar year 2003, the Morgan Stanley REIT Index was up 36.9% and the NCREIF All-Property Index was up 9.0% on a free and clear basis.

Second, we need a series of benchmarks to act as surrogates for the publicly-traded world. Fortunately, each year Callan Associates (www.callan.com) publishes “The Callan Periodic Table of Investment Returns” which details investment returns for an array of investment styles (growth versus value), capitalization (large cap versus small cap), and markets (U.S. versus international).

The Callan Table shows the investment returns for eight key indices on a 20-year basis (1984 to 2003) which when viewed as an entirety, makes a strong case for diversification across investment strategies as a very wise and insightfully decision. The eight indices included in the Callan “Table” are the:

- S & P 500 Index—large capitalization U.S. common stocks.
- S & P/Barra 500 Growth and S & P/Barra 500 Value Indices—growth and value styles of investing in large capitalization U.S. common stocks.
- Russell 2000 Index—small capitalization U.S. stocks.
- Russell 2000 Value and Russell 2000 Growth Indices—growth and value styles of investing in small capitalization common stocks.

- Morgan Stanley Capital International (MSCI) Europe, Australia, and Far East (EAFE)—developed stock markets of Europe, Australia, and the Far East.
- Lehman Brothers (LB) Aggregate—bond index comprised of U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

As the following comparison indicates, real estate in 2003 fared well on a comparative basis with an investment in the Morgan Stanley REIT index placing fifth and the investment in unleveraged real estate placing ninth.

1. Russell 2000 Growth - +48.54%
2. Russell 2000 - +47.25%
3. Russell 2000 Value - +46.03%
4. MSCI EAFE - +38.59%
5. Morgan Stanley REIT - +36.96%
6. S & P / Barra 500 Value - +31.79%
7. S & P 500 Index - +28.68%
8. S & P / Barra 500 Growth - +25.66%
9. NCREIF All-Property - +9.00% (which we estimate to be equivalent to 14.5% annual rates of return on a leveraged basis)
10. Lehman Brothers Bonds - +4.10%

Special Comment: Foreign Investment in U.S. Real Estate Projected to Increase in 2004

Just what we need—more investors! As if there weren't enough investors already in or entering the real estate arena, the Association of Foreign Investors in Real Estate (www.afire.org) reported in a recent survey that foreign investors expect to invest more than 50% of their 2004 real estate allocation to cross-border transactions involving U.S. real estate.

The survey noted that the top five cities on foreign investors' lists included: Washington, DC; New York; Los Angeles; San Francisco; and Chicago.

And notwithstanding worldwide geo-political uncertainty and rhetoric, as well as the state of the U.S. economy in general and the real estate economy specifically, 60% of survey participants regard the U.S. as “the most stable and secure country for real estate investment” and 54% believe the U.S. has “the best opportunity for capital appreciation”.

Specific property preferences mentioned in the survey (in order of attractiveness) include: retail, up from fourth place one year ago; multifamily, down from first place last year; hotels (which had consistently ranked last since the mid-1990's); industrial (which ranked fourth); and office, which currently accounts for about one-half of foreign investor's current portfolio, is now ranked fifth.

Special Comment: Some Quotes from the ULI Mid-Winter Trustee's Meeting

The following attempts to faithfully and accurately capture some of the comments made by participants in the real estate capital markets panel at the recent ULI Trustee's Meeting held in early February:

- “You make money in real estate when rents go up; you can only trade or refinance so much”.
- “Breathtaking and discomfoting”—two words used to describe the unprecedented capital flow into real estate from a wide array of individual and institutional investors.
- “We are in the midst of a significant bubble; unless interest rates increase and let some air out of the bubble slowly, we are going to have trouble”.
- “Sort of like being between a dog and a fire hydrant”.
- “Many real estate investors are looking at the investment world through the rear view mirror”.

- “You can drive a truck through historical value relationships”.

Public Real Estate Securities Capital Markets

Real Estate Capital Markets Scoreboard: Public Securities and Real Estate Performance Indices as of February 27, 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	+1.2%	+3.0%	+1.3%	+5.1%	+6.1%	

*Trailing 12-month period ended December 31, 2003.

As the chart above indicates, real estate investment trusts (REITs) continue to out perform all of the widely followed public market indices including the Dow Jones Industrial Average, the S & P 500 Stock Index, the NASDAQ Composite Index, and the Russell 2000.

Real Estate Capital Markets Scoreboard: Market Capitalization of REITs (number of shares multiplied by share price in \$ millions) as of February 27, 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	175	252,353	147	228,949	21	17,727	7	5,677

Source: National Association of Real Estate Investment Trusts (NAREIT).

As we have mentioned in prior issues of ULI’s Real Estate Capital Markets Update, there exists a wide disparity among real estate securities analysts estimates for overall REIT industry investment performance in 2004. While each of the analysts whose research we have the opportunity to read clearly has company-specific recommendations, the industry-wide picture is less than clear, as illustrated by the following:

Analyst	Projected 2004 Total Rate of Return*
“A”	+7% to +10%
“B”	+5% to +15%
“C”	+5%
“D”	-5% to -10%
“E”	-10%
“F”	-11%

* Including average dividend of 6% per annum.

With a majority of REITs having reported fourth quarter 2003 (as well as calendar year) earnings, it is time to revisit Morgan Stanley’s Real Estate Industry Weekly Insights’ “Earnings Report Card” which noted the following:

- “[REITs] reported results are largely meeting or beating consensus estimates”.
- “Multifamily [REITs] are conspicuous with roughly two-thirds of the companies that have reported having missed consensus expectations”.
- “Mall [REITs] continued their winning streak with all of the companies that have reported so far having beaten consensus estimates”.
- “Hotel REITs have uniformly missed analyst’s expectations”.
- “None of the commercial (office and industrial) or retail (mall or strip) REITs have missed their estimates for the fourth quarter 2003”.

All in all, the dialing down of earnings estimates by company management's and analysts throughout the year appears to have lead to an environment with fewer surprises and increased reliability in projections and earnings estimates.

Real Estate Capital Markets Scoreboard: Offerings of Securities by REITs (in \$ millions) as of January 31, 2003				
	2003		2004	
	# of Offerings	\$ Value	# of Offerings	\$ Value
Initial Public Offerings	6	\$2,201	1	\$193
Follow-on offerings-Common Shares	76	5,083	9	914
Follow-on Offerings-Preferred Shares	57	4,417	6	812
Unsecured Debt	63	10,069	10	1,700
Secured Debt	6	1,358	0	0

Source: NAREIT REITWatch On-line.

Last, for readers who actively follow and/or invest in publicly-traded REITs and real estate operating companies (REOCs), REIT University (www.reitu.com), which is sponsored by Real Stock Review, has recently updated its profiles of individual REITs and REOCs. Additionally, REIT-U anticipates updating its extensive analysis and profiles of real estate mutual funds, real estate closed-end funds, and exchange-traded real estate funds in the near future.

Public Real Estate Debt Capital Markets

Issuance of Commercial Mortgage-Backed Securities January 1, 1995 through February 27, 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	9,600.0	2,200.0	11,800.0

Source: Commercial Mortgage Alert.

Commercial mortgage-backed securities trading spreads remain at their lowest levels since July 1998 and delinquencies for all CMBS declined 6 basis points (0.006%) during January 2004 and are now equal to 1.56% of outstanding balances.

	Total CMBS Delinquencies	30/60/90+ Days Delinquent	Foreclosure/Real Estate Owned
January-2003	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%
January-2004	1.56%	1.08%	0.48%

Source: Morgan Stanley *CMBS Perspectives*.

As of January 2004 remittance reports, the property sectors with the highest percentage of delinquencies were: hotel-motel (5.53%); senior housing (5.03%); and industrial-warehouse (1.54%). The property sectors with the lowest percentage of delinquencies were: self-storage (0.26%); manufactured housing (0.70%); and retail (1.09%).

The states with the highest percentage of delinquencies were: Texas (2.66%); Pennsylvania (2.46%); and Florida (2.37%). The states with the lowest percentage of delinquencies were: Maryland (0.22%); New York (0.51%); and California (0.58%).

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	2/25/ 2004	YTD +/-
10-Yr. Treas. Bonds	5.50%	4.87%	6.44%	5.11%	5.05%	3.81%	4.25%	4.01%	-0.24%
AAA	+86	+140	+124	+147	+130	+93	+72	+72	0
AA	+98	+165	+144	+162	+150	+107	+80	+79	-1
A	+112	+190	+164	+177	+175	+122	+87	+88	1
BBB	+150	+270	+210	+235	+225	+183	+134	+120	-14
BBB-	+200	+350	+295	+280	+265	+224	+182	+160	-22
BB	+275	+575	+525	+525	+575	+450	+425	+415	-10
B	+450	+825	+800	+815	+1000	+950	+950	+950	0

Source: Morgan Stanley.

What is loss severity? Loss severity is the term used to describe the amount of principal lost when a loan is foreclosed upon and the collateral securing (or underlying) the loan is liquidated by the lender (or the lender's representative, usually the Special Servicer).

Base upon a recently analysis of 582 loans by Morgan Stanley's CMBS Research Group, the weighted average loss severity was 43%, meaning that 43% of the original principal amount of the loan was not recovered during the foreclosure and liquidation process.

The following was the loss severities reported in the study for the major property types:

Property Type	Weighted Average Loss Severity
Hotel-Motel	55%
Industrial-Warehouse	31%
Multifamily	26%
Mixed-Use	27%
Office	40%
Retail	40%
Senior Housing	89%
Average Loss Severity for 582 Loan Survey	43%

Private Real Estate Equity Capital Market

The National Council of Real Estate Investment Fiduciaries (NCREIF at www.ncreif.org) recently released the results of performance of its Property Index for the fourth quarter 2003 as well as for the 12-months ended December 31, 2003. The NCREIF Indices are comprised of 4,060 properties valued in excess of \$132 billion owned by various categories of tax-exempt institutional investors. The Index is reported as an

entirety as well as on a regional and property sector basis and divides reported performance data into two components—income and capital appreciation or depreciation (i.e., loss in value).

For the fourth quarter 2003, the NCREIF All-Property Index reported an average total return of 2.76% as compared to 1.97% during the third quarter 2003. The income component of the return—1.90% for the fourth quarter—was the same as reported in the prior quarter while the appreciation component—0.86% increased significantly as compared to the 0.07% achieved in the prior quarter.

The following chart details the results of the All-Property and property-type sub-indices for the third and fourth quarters of 2003:

NCREIF Property Index – Property-Type Sub-indices						
Property Sub-Index	4Q03 Returns			3Q03 Returns		
	Total Rate of Return	Income Component	Appreciation Component	Total Rate of Return	Income Component	Appreciation Component
Apartments	2.04%	1.54%	0.50%	2.03%	1.49%	0.53%
Industrial	2.35%	1.98%	0.38%	2.26%	2.06%	0.20%
Office	1.63%	1.96%	-0.32%	1.25%	1.96%	-0.71%
Retail	6.29%	2.10%	4.19%	3.04%	2.02%	1.02%
Total	2.76%	1.90%	0.86%	1.97%	1.90%	0.07%

Source: National Council of Real Estate Investment Fiduciaries.

In analyzing the results on a quarter-over-quarter basis we note the following:

- The retail sector continues to seriously outperform all other property sectors, returning a 6.29% total rate of return for the fourth quarter 2003.
- As one would expect, the office sector was the weakest sector, showing a total rates of return equal to 1.63% comprised of 1.96% income less 0.32% depreciation in asset value.
- The total rates of return for the industrial sector (2.35%) and the apartment sector (2.04%) were relatively unchanged from those achieved in the third quarter 2003.

NCREIF Property Index – All-Property		
Property Sub-Index	12-Months Ended December 31, 2003	12-Months Ended September 30, 2003
Apartments	8.90%	8.87%
Industrial	8.23%	8.23%
Office	5.67%	4.19%
Retail	17.15%	15.28%
Total	9.00%	7.84%

Source: National Council of Real Estate Investment Fiduciaries.

On a trailing 12-month basis, the office and retail sub-indices improved as compared to the prior period while the apartment and industrial sectors were basically unchanged.

To many, the positive results of the NCREIF Indices seem counter-intuitive as real estate fundamentals, with the exception of the retail sector, remain weakened, with little to no improvement in rental rates, occupancies, and expenses foreseen for the foreseeable future, until the economy gains traction and serious job creation begins.

True, but the NCREIF Indices measure property performance on an appraisal basis and therefore reflect the increasing prices investors appear willing to pay (and the decreasing yields they appear willing to accept) in the face of weak property level performance and industry-wide fundamentals, with the exception of the retail component.

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%
4Q03	7.6%	8.4%	9.0%	7.9%	8.2%	8.4%	8.4%	9.2%

Source: Real Estate Research Corp. (www.rerc.com).

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%
01/01/03 – 12/31/03	1,678	+29.78%	\$68.40	+20.85%

*Benchmark period equals first six months of 1998, annualized.
Source: Institutional Real Estate, Inc.

Private Real Estate Debt (Mortgage) Capital Markets

Real Estate Capital Markets Scorecard: "Prime" 10-Year Commercial Mortgages Versus Treasuries Yields as of February 29, 2004									
	7/31/1998	12/31/1998	12/31/1999	12/31/2000	12/31/2001	12/31/2002	12/31/2003	2/29/2004	YTD
Prime Mortgages	6.82%	7.00%	8.45%	7.35%	7.33%	6.05%	5.80%	5.75%	-0.05%
10-Year Treasuries	5.50%	4.87%	6.52%	5.11%	5.05%	3.81%	4.25%	4.00%	-0.25%
Spread	1.32%	2.13%	1.93%	2.24%	2.28%	2.23%	1.65%	1.75%	+0.10%

Source: Barron's/John B. Levy and Company Survey

Sources indicate ample capital remains available at very competitive rates.