Real Estate Capital Markets Update – March 19, 2004

Volume 6, Number 5

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: Food for Thought…from *The PunchLine*…

"Wheel of Fortune"

It is tough to come up with a precedent for the current scene. Among the most striking phenomena of the global financial outlook in 2004-5 will be the sustainability of recycling the unprecedented capital wave from Asian trade surpluses back to markets in the U.S. Issues regarding this recycling of capital have risen recently. Asian dollar buying helps to keep U.S. rates low for longer, that in turn keeps consumers in the U.S. buying products from Asia and helps maintain a seemingly positive tone for U.S. credit markets.

Because currencies in Asia are generally kept steadfastly linked to the declining U.S. currency, movement in residual and freer floating currencies are bearing the brunt of the currency adjustment. In particular, Asia now can make the inroads into Europe with its autos and cameras and other products that it has been pushing for years. The good news is that the sliding dollar translates (at least temporarily) into extended stimulus of the U.S. The evolving pattern of dollar weakness supplies Washington with Asian support for the U.S. Treasury market at the same time that increased competitiveness for U.S. firms against European counterparts.

The prospect of protracted low short-term interest rates—both from the prospective of the Federal Reserve's "patient" policy stance and from extraordinary support from overseas buying—has also helped feed the "high-beta" markets, a speculative rush that has been rekindled over the past year in select market segments ranging from distressed debt, to high-tech, emerging markets, or commodities. Low short-term rates support a steep yield curve, and with increases in Fed funds still only a tease, the yield curve can remain steep for a while. Of course, low short term borrowing rates help make the carry advantage of owning "high-beta" risk attractive. That means that all these are significantly interrelated—the boom in China, the recycling of Asia reserves, the low rates in the U.S. and the rekindled speculative rush in several markets. Beware…

Headlines and data appearing in *The Punchline*, a publication of Brookville Capital Management, come from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and news websites.

Special Comment: As Expected, Federal Reserve Board Leaves Rates Unchanged

As expected, the Federal Reserve Board (FRB), operating through the Federal Open Market Committee (FOMC), left the Federal Funds Rate and the Discount Rate unchanged at 1.00% and 2.00%, respectively.

The FOMC maintained its neutral policy bias, thereby showing that the FRB's assessment of the U.S. economy had remained unchanged from the FOMC's January 2004 meeting. In fact, the language utilized in the FOMC statement to describe economic risks was unchanged from that used in January.

What did change was the wording utilized to describe the labor market situation. In what many would read as a much more downbeat assessment of the labor market, the FOMC replaced January 2004's "Although new hiring remains subdued, others indicators suggest an improvement in the labor market" with "Although job loses have slowed, new hiring has lagged."

Additionally, the FOMC changed its assessment of overall growth from "solid" to "brisk", a difference we recognize, but are not sure we fully comprehend.

At this juncture, the question on everyone's mind should be "what will it take to trigger a tightening of rates by the FOMC and when is it likely that this will happen?" According to Economy.com's analysis of the FRB actions, the two conditions necessary for the FOMC to tighten interest rates are sustained job growth, i.e., job growth in the 150,000 per month range, and evidence that core inflation is no longer decelerating.

Based upon its analysis, Economy.com believes it increasingly likely that monetary tightening will be put off until the fall at the earliest.

Special Comment: Federal Reserve Board Beige Book

The Federal Reserve Board recently released its Beige Book survey of economic activity for the first two months of 2004. As expected by most economists and analysts, the January-February survey period showed a broadening of the U.S.' economic expansion. While the economy clearly remains job challenged, there appears to be more than anecdotal evidence that the recovery is gaining traction.

Real Estate Capital Markets Scoreboard: Money Rates	March 17, 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)	1.09000% - 1-month 1.11000% - 3-months 1.15000% - 6 months 1.28250% - 1 year
Foreign Prime Rates	Germany – 2.000% Japan – 1.375% Great Britain – 4.000%
U.S. Treasury Securities	3.75% - 10-year

The following comments summarize certain portions of the survey:

- Manufacturing activity increased in 11 of 12 districts.
- Employment and wages are increasing…slowly.
- Consumer spending increased in most districts.

- Retail prices remained flat to modestly rising.
- Commodity prices paid by manufactures have risen rapidly, especially for steel and lumber.
- Demand for services has been increasing in all regions and industries.
- Business lending activity was mixed.

Commercial real estate markets were reported largely unchanged with rents continuing to fall, leasing activity remaining soft, and vacancies remaining at high levels. Single-family residential real estate continued its outstanding performance.

The following city-specific comments were included in the survey:

- Boston: Office market remained soft, with little to no leasing activity. CBD-specific comments noted high vacancy rate as well high availability due to sublease activity; suburban markets reported stabilizing conditions.
- New York: Office conditions were reported as improving with declining vacancies and increasing asking rents; property sales were noted as "robust" (which we interpret to mean "pricey").
- Philadelphia: Markets remained weak with declining rental rates combined with slightly higher vacancy rates.
- Cleveland: Commercial builders reported little change from year-end 2003 but expected improvement in market conditions by mid-2004.
- Richmond: Rents were reported as stable with vacancy rates unchanged.
- Atlanta: Commercial real estate market conditions are beginning to show some signs of improvement with vacancy rates declining and leasing activity improving.
- Chicago: Vacancy rates remain at high levels, thereby putting pressure on rental rates.
- St. Louis: Commercial real estate activity continued to lag residential activity.
- Minneapolis: While retail construction activity is expected to be active, industrial activity is projected to be sluggish.
- Kansas City: Commercial markets remained soft with little to no change in vacancy rates and rents.
- Dallas: Office market conditions showed signs of improvement with the decline in rent levels slowing.
- San Francisco: Commercial markets continued to stabilize with improvements noted in office vacancy and lease rates.

The complete text of the FRB's Beige Book report is available at the FRB's website, **www.federalresertve.gov/fomc/beigebook**. The FRB will release the next Beige Book Report on April 21.

Public Real Estate Securities Capital Markets

Real Estate Capital Markets Scoreboard: Public Securities and Real Estate Performance Indices as of March 19, 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	+2.6%	-0.2%	-3.1%	+2.5%	+9.9%	
*Trailing 12-month period ended December 31, 2003.						

It's a REIT-world after all as the globalization of real estate investment trust continues; in fact, it appears to be accelerating.

REIT-type legislation providing for tax transparency and investor level taxation is fast becoming a global phenomena. Jurisdictions that have enacted REIT statutes include:

- North America-U.S., Canada, and Puerto Rico.
- Europe-Belgium, France, Germany, Luxembourg, the Netherlands, Spain, and Turkey.
- Asia-Japan, Singapore, Korea, Malaysia, and Taiwan.

Additionally, a number of jurisdictions including Hong Kong, the United Kingdom, and the European Union (for a pan-European REIT structure) have actively joined the debate and are expected to enact enabling legislation in the near future.

Real Estate Capital Markets Scoreboard: Market Capitalization of REITs (number of shares multiplied by share price in $ millions) as of March 18, 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	256,361	147	232,502	21	18,196	7	5,662
Source: National Association of Real Estate Investment Trusts (NAREIT).								

Is there another REIT initial public offering boom on the way? Hard to say, but there is clearly lots of talk going on among underwriters about a wide array of business models and their sustainability in the public market.

Recently filed transactions include Capital Lease Funding, which describes itself as “a fully-integrated specialty finance company currently focused primarily on the business of originating and selling commercial mortgage loans secured by properties net leased to credit tenants”. Capital Lease Funding anticipates raising $200 million.

The company’s current portfolio included: existing commercial mortgage loans; certain bonds comprised of commercial mortgage-backed securities (CMBS) from prior securitizations; and other CMBS. The aggregate principal value of the company’s portfolio exceeds $125 million.

In addition to originating commercial mortgage loans, the company expects to directly acquire newly developed as well as existing property net leased to corporate tenants.

(Capital Lease Funding priced after the close of the New York Stock Exchange on March 18, 2004. The company sold 20 million shares at $10.50, thereby raising $210 million. The company’s ticker symbol is: LSE.

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.				

Public Real Estate Debt Capital Markets

Issuance of Commercial Mortgage-Backed Securities January 1, 1995 through March 15, 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	14,100	3,200.0	17,300.0
Source: Commercial Mortgage Alert.			

Spreads remain at historical lows, year-to-date volume has skyrocketed, and real estate fundamentals remain unchanged and unlikely to change—positively—for some time.

A quick review of the chart which follows confirms that trading spreads (and therefore rates charged borrowers) for commercial mortgage-backed securities (CMBS) and CMBS mortgage loans remain at their lowest levels since the second quarter of 2003. While the industry is not experiencing a food fight similar to what occurred in pre-Russia default 1998—where certain lenders were lending solely to gain market share—pricing is highly competitive, to say the least.

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	3/17/ 2004	YTD +/-
10-Yr. Treas. Bonds	5.50%	4.87%	6.44%	5.11%	5.05%	3.81%	4.25%	3.71%	-0.54
AAA	+86	+140	+124	+147	+130	+ 93	+72	+66	-6
AA	+98	+165	+144	+162	+150	+107	+80	+78	-2
A	+112	+190	+164	+177	+175	+122	+87	+81	-6
BBB	+150	+270	+210	+235	+225	+183	+134	+117	-17
BBB-	+200	+350	+295	+280	+265	+224	+182	+157	-25
BB	+275	+575	+525	+525	+575	+450	+425	+415	-10
B	+450	+825	+800	+815	+1000	+950	+950	+950	0
Source: Morgan Stanley.									

And through March 15th, U.S. CMBS issuance volume had reached $14.1 billion as compared to $9.1 billion during the same period in 2003, a year-over-year increase of 55%. In the international markets, the story is similar as issuance through March 15th equaled $3.2 billion as compared to $1.9 billion last year, an increase of 68%.

Usually, increased supply leads to wider spreads as investor's require increasing yields as they absorb excess product in the market. But not today, as demand for asset-based, high relative yield-producing investments is apparently boundless.

Part of the increase in demand can be explained by the benign state of CMBS delinquencies, which as of February 29, equaled 1.59% of outstanding balances. The delinquency rate for "seasoned" collateral, i.e., CMBS outstanding or "aged" more than one year, was 2.57% of current balances.

As of the February 2004 remittance reports, the property sectors with the highest percentage delinquencies were: senior housing (6.31%); hotel-motel (5.41%); and multifamily (1.70%).

The property sectors with the lowest percentage delinquencies were: self-storage (0.28%); mobile home (0.66%); and retail (1.11%).

The states with the highest percentage delinquencies were: Illinois (2.94%); Pennsylvania (2.67%); and Texas (2.64%). The states with the lowest percentage delinquencies were: California (0.52%); New York (0.61%); and New Jersey (1.06%).

	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%
February	1.59%	1.03%	0.56%
Source: Morgan Stanley *CMBS Perspectives*.			

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%
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).								

According to the most recent Real Estate Research Corporation survey of institutional investors, capitalization rates for the majority of property types continued to decline during the fourth quarter of 2003, which was to be expected as they were sort of "baked into the cake already". The litmus test as to whether the perfect storm is finally over, or still raging, will be the results of the next survey measuring the first quarter 2004.

Overall, average capitalization rates now stand at 8.50%, a decrease of 0.20% from the third quarter of 2003. Individual sector results were as follows: multifamily (unchanged); CBD office (decreased 0.10%); suburban office (unchanged); regional malls (decreased 0.10%); neighborhood retail

(decreased 0.10%); power centers (decreased 0.20%); and industrial-warehouse and research and development (unchanged). The lodging component, which no one can decide whether its real estate or a real estate-based business, decreased 0.30%.

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.				

Velocity, in terms of the number of transactions completed, appears to have finally picked-up, although simple division shows that average deal size has declined quite a bit. Transaction volume, in terms of dollar value, remains about 12% lower that the benchmark period.

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%	5.50%	-0.30%
10-Year Treasuries	5.50%	4.87%	6.52%	5.11%	5.05%	3.81%	4.25%	4.01%	-0.24%
Spread	1.32%	2.13%	1.93%	2.24%	2.28%	2.23%	1.65%	1.49%	-0.16%
Source: Barron's/John B. Levy and Company Survey									

"Not All Seasoned Loans Are Created Equal"

In a recent issue of *TWR About Real Estate*, a weekly publication of Torto Wheaton Research, the authors clearly expressed what many in the real estate industry are thinking—that commercial and multifamily mortgage loans originated in the past four or five years may have great difficulty in being refinance due to the precipitous decline in rents and occupancies the real estate industry has recently experienced.

The author noted that "in comparing seasoned loans by the year they were originated, two pieces of conventional wisdom regarding real estate appear to be converging. The first suggests that default risk rises during the first four years or so of a loan's life and then declines. The second suggests that any loan made during the [recent] bubble [period] could be in trouble today, as rents have fallen so dramatically that [any] turnover could seriously hurt collateral value".

The author's first "piece of common wisdom"—the danger of the first four years of loan life—is based upon studies of loan performance over long time frames and appears intuitively explained by the fact that

little positive has changed to the value of the average property in such a short time period and that a small negative change in the property's operating profile can have a major impact on its ability to service debt.

The second piece of wisdom is based upon "the dramatic declines in rents in many markets. As rents have fallen…any rollover in the collateral, whether through normal lease expiration or [tenant] bankruptcy, now presents a serious threat to gross property income [as well as income available for debt service]".

At point, as rents peaked in 1999 or 2000, today we have crossed, or are about to cross, the four year barrier and 2004 may be a time of some opportunity for those investors who can move quickly to take advantage of owner's distress.