

Real Estate Capital Markets Update – March 31, 2004

Volume 6, Number 6

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*...

“Risk Reinforcement”

“Even though the global recovery is no longer questioned, the contours of the new cycle are still to be mapped out clearly. This is true not only in regard to questions regarding job growth, which has still failed to materialize in the otherwise robust U.S. economy, but also in regard to the various stubborn foreign policy issues that only become more confusing during an election season. Unusually rapid increases in commodity prices, the gyrations in the currency markets, the amazing role of China’s boom and the power of Asia’s reserves to keep U.S. rates low - - have become central to the world outlook. We’ve argued that a speculative risk appetite has been rekindled and has become part of this recursive loop. It should be noted that risk models based on standard historical volatility measures tend to be pro-cyclical, reinforcing the low volatility, and thereby creating a virtuous circle. Moreover, based on the widely-used 3-year time frame to estimate risk, risk assessments may still slide significantly as the much higher volatility periods of 2001 are lopped off and more weight is given to the lower volatility of 2003. Both statistically and behaviorally, risk is likely to be mismeasured in what is really an amazingly new business environment.”

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: Terrorism Insurance Update

Expiration of the critical provision of the Terrorism Insurance Risk Act that required insurance companies to make terrorism insurance available on terms and conditions similar to other forms of property and casualty insurance is fast approaching and renewal is required by September 1, 2004 if we are not to see a similar series of disruptions such as those which occurred in the property sale and financing markets in the 2001 to mid-2002 period.

Specifically, the required provision is set to expire at the end of 2004 and it seems logical to believe that if insurance companies are not required to write terrorism insurance policies, they won't, unless there is a

structural change in the premiums paid. It appears that the decision to extend the provision rests solely with the Secretary of the Treasury rather than with Congress.

Readers interested in following this situation should visit The Real Estate Roundtable's Web site at www.rer.org for the most up-to-date information.

Real Estate Capital Markets Scoreboard: Money Rates		March 29, 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 1.04% - 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 1.16000% - 6 months 1.33000% - 1 year
Foreign Prime Rates		Germany – 2.000% Japan – 1.375% Great Britain – 4.000%
U.S. Treasury Securities		3.84% - 10-year

Public Real Estate Securities Capital Markets

Real Estate Capital Markets Scoreboard: Public Securities and Real Estate Performance Indices as of March 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	-2.3%	-0.4%	-2.2%	+2.9%	+9.4%	
*Trailing 12-month period ended December 31, 2003.						

Real estate investment trusts (REITs) continue to outperform everything in sight—the Dow Jones Industrial Average, the Standard & Poor's 500 Stock Index, the NASDAQ Composite Index, and the Russell 2000 Index.

Real Estate Capital Markets Scoreboard: Market Capitalization of REITs (number of shares multiplied by share price in \$ millions) as of March 29, 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	255,250	147	231,588	21	17,986	7	5,625
Source: National Association of Real Estate Investment Trusts (NAREIT).								

And this performance continues unabated (since the fourth quarter of 1999) in the face of high REIT stock valuation multiples, the certainty of future increases in interest rates, and the improving economy's projected impact on corporate earnings (and the resulting attractiveness of corporate equity shares), and a lack of jobs to fill vacant office space and lease vacant apartment units.

As we have noted before, capital continues to conquer fundamentals.

Real Estate Capital Markets Scoreboard: Offerings of Securities by REITs (in \$ millions) as of February 29, 2003				
	2003		2004	
	# of Offerings	\$ Value	# of Offerings	\$ Value
Initial Public Offerings	8	\$2,646	2	\$731
Follow-on offerings-Common Shares	82	5,471	22	2,222
Follow-on Offerings-Preferred Shares	64	5,192	14	1,504
Unsecured Debt	68	10,894	12	1,900
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 29, 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	18,900.0	3,900.0	22,800.0
Source: Commercial Mortgage Alert.			

Trading spreads remain at historical lows.

Delinquency rates—measured on either a “Seasoned” basis or a total outstanding and issued basis, remain modest.

Ample capital is available to potential borrowers for mainstream product at favorable current rates with loan-to-value ratio and debt service coverage requirements based on the application of reasonable underwriting standards.

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	3/24/ 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	+65	-7
AA	+98	+165	+144	+162	+150	+107	+80	+72	-8
A	+112	+190	+164	+177	+175	+122	+87	+79	-8
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.									

	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).

In recent issues of ULI's Real Estate Capital Markets update we have analyzed trends in capitalization rates (declining), transaction activity (improving), and rates of return (increasing), the later based upon using the performance indices of the National Council of Real Estate Investment Fiduciaries as a surrogate for property performance.

But what about investor attitudes?

On a quarterly basis, Real Estate Research Corporation (www.rerc.com) surveys a wide-array of institutional-type participants active in the acquisition and disposition, investment advisory, and management, and capital markets disciplines.

The following summarizes a small portion of the data contained in the most recent RERC survey:

1. Availability of capital remains very high, scoring 8.4 on a 1 to 10 scale.

2. While discipline of capital was unchanged at 5.7 of 10, it has been trending down since the third quarter of 2001, arguing that while the buy-side thinks the “entire market” may be getting ahead of itself, this trend is not stopping anyone from buying property.
3. Respondents were less than enthusiastic regarding whether it is a good time to buy (4.3 of 10), mirroring a trend that has persisted since the fourth quarter 2002. While apparently convinced that now is a good time to sell (7.1 of 10), participants agreed, to a modest extent, that now is also a good time to hold (5.8 of 10).
4. In terms of investment conditions by property sector, all sectors strengthened during the quarter, reflecting we think, investor’s belief in the impact of an improving economy on real estate fundamentals combined with historically low levels of new construction.
5. Investors projected little likelihood of overbuilding with the possible exceptions of the industrial-warehouse (5.1 of 10) and multifamily (5.7 of 10) sectors.
6. Average property sale marketing period was reported at 7.5 months, clearly contradicting anecdotal evidence as well as much of what we read in the popular real estate press.
7. On a property sector basis, there appear to be no “pound the table”, “bet the ranch” type of opinions. We did note a clear buy signal for industrial-warehouse and hotels, a clear sell signal for all type of retail, and a overwhelming hold signal for suburban office, as follows:

	Buy	Sell	Hold
Office-CBD	27%	33%	40%
Office-Suburban	27%	7%	73%
Industrial-Warehouse	43%	14%	43%
Industrial-Research and Development	8%	42%	50%
Retail-Regional Mall	11%	56%	33%
Retail-Neighborhood/Community	17%	42%	42%
Retail-Power Center	11%	56%	33%
Multifamily	33%	47%	20%
Lodging/Hospitality	50%	0%	50%

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%	5.50%	-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									

Capital remains available at extremely competitive rates as Treasury yields remain below 4.00% and defaults of conventional mortgages remain at low levels.

In a recent article entitled "Lender's View: Defaults Stay Low Even As Lending Heats Up" published in the Bank of America Securities Weekly Real Estate Securities Research publication, the head of commercial real estate for Bank of America made the following observations:

1. Loan defaults remain at extremely low levels due to "increased rationality" by lenders during the past 10 years combined with today's low interest rates.
2. The level of loan production has been modest by historical standards with construction lending declining an estimated 20% in 2003, following a 30% decline in 2002.
3. Lenders' requirements for increased "hard dollar" equity investment by borrowers (developers and/or investors) has increased the "integrity of real estate loans".
4. On a cautionary note, it was observed that competition among lenders had begun, in some instances, to negatively effect underwriting standards and discipline.

According to a series of surveys by the American Council of Life Insurers (ACLI), lending by insurers increased 16% last year and delinquency rates declined to a mere 0.18% of outstanding balances (as of September 30, 2003).

Production first. According to its survey, insurance company lenders made \$32.7 billion of mortgage commitments in 2003, an increase of 16% as compared to 2002's \$28.1 billion. Over 90% of the lending activity was in fixed-rate commitments.

The production survey included 27 insurance companies that account for three-quarters of the insurance industry's commercial mortgage holdings.

The following chart summarizes the results of the survey:

Fourth-Quarter 2004 Lending by Life Insurance Companies					
	Average Loan Amount (\$Mil.)	Spread in Basis Points	Debt Service Coverage Ratio	Loan-to-Value Ratio	Average Life (Years)
Multifamily	\$12.4	+166	1.74 x 1	69.1%	6.4
Office	15.7	+180	1.89 x 1	70.1	7.3
Retail	7.8	+168	1.84 x 1	64.3	8.5
Industrial	6.7	+176	1.65 x 1	69.6	6.8
Hotel	20.3	+262	2.40 x 1	62.5	5.6
Mixed-use	43.8	+159	1.78 x 1	53.0	5.5
Other	8.5	+210	1.99 x 1	68.2	7.0
Total	10.9	+178	1.84 x1	67.7	7.2
Source: American Council of Life Insurers.					

The vast majority of loans were committed to the four primary food groups with the office sector accounting for 37.3% of the commitments, followed by the apartment sector (19.8%), the retail sector (17.2%), and the industrial sector (14.3%).

According to a second survey by the ACLI of 73 insurance companies that account for 88% of the insurance industry's total mortgage holdings, delinquency rates for commercial mortgages declined to 0.18% of outstanding balances (of \$200.2 billion) as of the quarter ended September 30, 2003, the industry's most recent reporting period. Delinquencies declined 0.06% as compared to the second quarter's 0.24% of outstanding balances.

Readers who track ACLI's survey will note a downward revision from previously reported delinquencies for the period June 30, 2002 through June 30, 2003 reflecting an instance of double counting in the survey date which has now been corrected.

The following chart tracks commercial mortgage delinquencies as reported by the ACLI from September 30, 2002 through September 30, 2003:

Delinquency Rates by Property Sector (%)					
	9/02	12/02	3/03	6/03	9/03
Multifamily	0.19	0.19	0.14	0.06	0.06
Retail	0.37	0.31	0.20	0.27	0.18
Office	0.21	0.33	0.34	0.32	0.24
Industrial	0.09	0.13	0.17	0.18	0.10
Hotel	0.52	0.43	1.04	0.42	0.57
Other	0.09	0.69	1.08	0.18	0.01
Total	0.23	0.28	0.29	0.24	0.18
Source: American Council of Life Insurers.					