

Real Estate Capital Markets Update – May 4, 2004

Volume 6, Number 8

“1Q04”

The “Q” series is designed to provide a concise statistical, graphic and textual review of the activities of the real estate capital markets during the most recent calendar quarter.

Reminder Notice: First ULI-Sponsored Real Estate Capital Markets Conference Calls Scheduled for June 28, 2004

Michael Fascitelli, President, Vornado Realty Trust, to be Guest Speaker

We are pleased to announce that Michael Fascitelli, President of Vornado Realty Trust, has agreed to be our guest speaker on ULI’s inaugural Real Estate Capital Markets Conference.

The call will take place on Monday, June 28, 2004, from 11:00 am to 11:30 am, Eastern Standard Time.

Due to the anticipated number of participants, the call will be set-up as a dial-in, listen-only call and will feature a discussion between Mr. Fascitelli and Stephen Blank, ULI’s Senior Fellow, Finance. Participants will be able to pose questions to the participants in advance by e-mailing their questions to blank@uli.org.

The discussion will focus on immediate as well as future real estate industry and real estate capital markets conditions—what is happening today, what is likely to happen tomorrow—information that participants can use immediately.

Logistical information such as registration, dial-in numbers, participant codes, etc. will be published in future issues of ULI’s Real Estate Capital Markets Update.

We have maintained a list of all readers who responded to our Reader Survey published in the January 23, 2004 issues of ULI’s Real Estate Capital Markets Update and will send each person a reminder notice before the call.

Questions, suggestions...? Please e-mail blank@uli.org

Special Comment: Federal Reserve Board Leaves Federal Funds Rate Unchanged at 1.0%...for Now

The Federal Reserve Board (FRB), acting through the Federal Open Market Committee (FOMC), may have left the Federal Funds Rate and the Discount Rate unchanged for now, but it provided any number of verbal clues that it will be increasing rates sooner rather than later, with sooner being defined as the FOMC meeting scheduled for August 6th.

There were at least three changes of note evident in the wording of the policy statement released after the conclusion of today’s meeting. First, the FOMC adopted a “neutral” bias toward inflation, noting that “although incoming inflation data [has] moved somewhat higher, long-term inflation expectations appear to have remained well contained”, thereby moderating the formerly more concerned view.

Second, the statement acknowledged that the economy’s performance continued to improve and “hiring appears to have picked up”.

Third, the FOMC stated that it believes “that policy accommodation can be removed at a pace that is likely to be measured” as compared to prior statements wherein the FOMC stated that it could be “patient” in [not] removing “policy accommodation”.

Public Real Estate Equity Capital Markets

| | 1Q04 | Year-to-Date |
|---------------------|-------|--------------|
| Dow Jones Average | -2.3% | -2.3% |
| Standard & Poor’s | -0.4% | -0.4% |
| NASDAQ Composite | -2.2% | -2.2% |
| Russell 2000 | -2.9% | -2.9% |
| Morgan Stanley REIT | +9.4% | +9.4% |

Although real estate investments trusts (REITs) had an excellent first quarter 2004 as compared to an array of common stock indices including the Dow Jones Industrial Average, the Standard & Poor’s 500 Stock Index, the NASDAQ Composite Index, and the Russell 2000, they have been subject to a serious price correction since March 31st, ending on April 30th down 4.56% on a year-to-date basis. This equates to a performance—total valuation “adjustment” of negative 14.0% in just one month!

While the first quarter’s results clearly evidenced continued demand by investors for income-producing, income-denominated investments such as REITs, nothing prepared the industry for the sharp decline experienced in April, especially in light of four years of exceptional performance in the face of deteriorating industry fundamentals. Did the entire REIT investment industry suddenly wake-up and realize in unison that real estate investment fundamentals are less than robust and REITs can not avoid the laws of nature, gravity, or poor business fundamentals.

Lots of reasons abound; none are dispositive. Clearly, REITs had become “pricey”, selling at premiums to net asset values that may have been a little too generous. Also, on a historical basis, multiples of Funds from Operations and Adjusted Funds from Operations—REIT-speak for earnings—were “out-of-line” and so the recent correction put some rationality back into the investment metrics for REITs. Also, we suspect that the recent increase in interest rates (10-year Treasury bond yields have increased 50 basis points, or 0.50% in the past few weeks), combined with the fear and/or expectation of higher interest rates, has taken its toll.

We do not, however, view the recent softness as the start of anything like a bear market for REIT shares. A necessary breather, but not a bear market.

The following chart details the performance of REITs on a total return (dividends plus or minus change in share price) for the 3-month period ending March 31, 2004 as well as property sector dividend yields as of the end of the first quarter:

| Property Sector/ Sub-Sector | Year-to-Date Total Return | Dividend Yield (at 3/31/04) |
|--|------------------------------|--------------------------------|
| Office/Industrial | | |
| Office | 9.04% | 5.83% |
| Industrial | 12.41% | 4.43% |
| Mixed | 14.50% | 5.29% |
| Retail | | |
| Shopping Centers | 15.52% | 4.65% |
| Regional Malls | 22.70% | 4.22% |
| Free Standing Retail | 13.90% | 5.01% |
| Residential | | |
| Multifamily | 4.29% | 5.99% |
| Manufactured Homes | 11.40% | 3.27% |
| Other | | |
| Diversified | 10.26% | 5.49% |
| Hospitality | 6.84% | 2.51% |
| Health Care | 16.62% | 5.85% |
| Self-Storage | 12.02% | 4.21% |
| Specialty | 8.11% | 8.11% |
| NAREIT Equity REIT Index | 12.02% | 5.01% |
| Source: National Association of Real Estate Investment Trusts (www.nareit.com). | | |

Public Real Estate Debt Capital Markets

Issuance of commercial mortgage-backed securities in the U.S. capital markets during the first quarter 2004 equaled almost \$19.0 billion as compared to approximately \$15.0 billion in the same period last year, an increase of 27%. Issuance in the international capital markets increased to \$6.4 billion during 1Q04 as compared to approximately \$2.0 billion in 1Q03, an increase of 226%. On a global basis, issuance increased approximately 50%, marking the first quarter of 2004 as the most (issuance) productive in history.

As the following chart indicates, trading spreads declined across the board, aided by a combination of institutional investor demand for income-denominated investments combined with an approximately 50 basis point (0.50%) decrease in 10-year Treasury bond yields.

And the lower required investment yields translated into the lowest borrowing costs in memory, completing the virtuous circle.

| Commercial Mortgage-Backed Securities Increase/Decrease in Trading Spreads in Basis Points over 10-Year Treasury Bonds | | | | |
|--|----------|---------|--|------------------|
| | 12/31/03 | 3/24/04 | Quarter-over-Quarter Change in Basis Points | Year-to- Date |
| AAA | 72 | 65 | -7 | -7 |
| AA | 80 | 72 | -8 | -8 |
| A | 87 | 79 | -8 | -8 |
| BBB | 134 | 117 | -17 | -17 |
| BBB- | 182 | 157 | -25 | -25 |
| BB | 450 | 415 | -10 | -10 |
| B | 950 | 950 | 0 | 0 |
| 10-Year Treasury | 4.25% | 3.71% | -0.54% | -0.54% |
| Source: Morgan Stanley; Bloomberg LLP | | | | |

During the quarter, overall CMBS delinquencies declined 13 basis points (0.13%), from 1.62% of outstanding balances to 1.49% with 30/60/90 day delinquencies declining 15 basis points (0.15%) from 1.11% to 0.96% and foreclosures increasing 2 basis points (0.02%) from 0.15% to 0.53%.

The CMBS markets strength and depth is clearly evident from the pricing on April 30th of a \$2.6 billion offering, the largest (by far) offering in recent history. While some had questioned the size of the offering, it appears that the various tranches were placed in record time.

Private Real Estate Equity Capital Markets

| Capitalization Rates by Property Segment | | | |
|--|------------|-------|--------------|
| | 12/31/2003 | 1Q04 | Year-to-Date |
| All Property | 8.50% | 8.44% | -0.06% |
| Multifamily | 7.60% | 7.40% | -0.20% |
| Office-CBD | 8.40% | 8.30% | -0.10% |
| Office-Suburban | 9.00% | 8.80% | -0.20% |
| Retail-Mall | 7.90% | 7.70% | -0.20% |
| Retail-Neighborhood | 8.20% | 7.90% | -0.30% |
| Retail-Power | 8.40% | 8.30% | -0.10% |
| Industrial-Warehouse | 8.40% | 8.10% | -0.30% |
| Industrial-R & D | 9.20% | 9.00% | -0.20% |

Source: Real Estate Research Corporation (www.lerc.com).

Required real estate yields, as measured by indicated initial capitalization rates (see chart above), continued to decline during the first quarter. Overall required rates of return were also reported to have declined from an industry-wide average 10.5% to 10.3% during the period.

Given the near certainty of an increasing interest rate environment, many suspect that these trends will be reversed when the results of the second quarter of 2004 are considered. Interestingly, average marketing periods were reported to have increased from 7.5 months to 7.6 months during the first quarter.

According to surveys of institutional investors, investment conditions were perceived to have deteriorated for all property sectors during the quarter, as follows:

| Investment Conditions by Property Segment | | | |
|---|------------|------|--------------|
| | 12/31/2003 | 1Q04 | Year-to-Date |
| Multifamily | 5.8 | 5.6 | -0.2 |
| Office-CBD | 5.8 | 5.6 | -0.2 |
| Office-Suburban | 5.2 | 4.2 | -1.0 |
| Retail-Mall | 6.7 | 6.4 | -0.2 |
| Retail-Neighborhood | 7.0 | 6.8 | -0.2 |
| Retail-Power | 6.9 | 6.7 | -0.2 |
| Industrial-Warehouse | 6.3 | 6.1 | -0.2 |
| Industrial-R & D | 4.7 | 4.2 | -0.5 |

Scale: 1 (poor), 10 (excellent)

Source: Real Estate Research Corporation (www.lerc.com).

The most significant declines in investment conditions were noted in the suburban office sector (-1.0 or 10% on a scale of 1 to 10) and the industrial-research and development (-0.5 or 5%) categories; all other sectors were noted to have declined a modest 0.2 (or 2%).

| Performance of National Council of Real Estate Investment Fiduciaries Property Indices | | | | |
|---|--------------------------------------|-------------------------------------|----------------------------------|--|
| | Trailing 12-months ended 12/31/03 | Trailing 12-months ended 3/31/04 | Trailing 12- Months Income | Trailing 12-Months Appreciation/ Depreciation in Value |
| All Property | 9.00% | 9.72% | 7.85% | 1.77% |
| Office | 5.67% | 6.73% | 8.17% | -1.36% |
| Retail | 17.15% | 17.30% | 8.28% | 8.51% |
| Industrial | 8.23% | 8.54% | 8.29% | 0.24% |
| Multifamily | 8.90% | 9.70% | 6.27% | 3.28% |
| Source: National Council of Real Estate Investment Fiduciaries (NCREIF). | | | | |

As of March 31, 2004, the National Council of Real Estate Investment Fiduciaries (NCREIF at www.ncreif.org) Property Index was comprised of 4,042 commercial and multifamily properties owned by institutional investors having an estimated market value of approximately \$136 billion.

As the chart above indicates, performance for all property sectors continued to increase on a trailing 12-month basis as compared to the prior 12-month period. Remarkably, retail showed a 17.3% one-year return comprised of almost equal parts income and appreciation. For all other sectors, 12-month returns were comprised substantially (two-thirds or more) of income. In the office sector, properties were reported to have depreciated in value reflecting recent increases in vacancy rates and operating expenses combined with lower rental rates and the necessity of concessions in many markets.

Private Real Estate Debt Capital Market

| 10-Year Prime Commercial Mortgages | | | | |
|---------------------------------------|----------|--------|--------------------------|------------------|
| | 12/31/03 | 4/3/04 | Quarter-over- Quarter | Year-to- Date |
| Midpoint of Range | 5.80% | 5.30% | -0.40% | -0.40% |
| Spread over 10-Year Treasury Bonds | 1.65% | 1.16% | -0.49% | -0.49% |
| Source: Barron's/John B. Levy Company | | | | |

During the first quarter, prime (and every other) conventional mortgage rate continued to decline in response to serious compression in lender required spreads combined with a modest decrease in yields on 10-year Treasury securities. The environment remains highly competitive, benefiting the borrowing community.

As of December 31, 2003 (the most recently available reporting period), conventional commercial mortgage delinquencies, as reported by the American Council of Life Insurers (whose reporting members represent 75% of all commercial mortgage loan originations), were 0.12% of outstanding balances, down from 0.18% as of the quarter ended September 30, 2003. For comparison purposes, readers should note that the delinquency high-water mark is 7.5% of outstanding balances which was recorded in June 1992.