

## Real Estate Capital Markets Update – May 25, 2005

### Volume 7, Number 7

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, that 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](mailto:stephen@uli.org), add your comments, and click "Send".

Key Rates			
	May 17, 2005	Year Ago	Increase/Decrease
Prime Rate	6.00%	4.00%	+2.00%
Federal Funds Rate	3.00%	1.00%	+2.00%
3-Month Libor	3.27%	1.26%	+2.01%
3-Month Treasury Bills	2.80%	1.04%	+1.76%
10-Year Treasury Bonds	4.13%	4.56%	-0.43%
30-Year Treasury Bonds	4.50%	5.42%	-0.92%
Telephone Bonds	6.07%	6.90%	-0.83%
Municipal Bonds	4.44%	5.28%	-0.84%

### Special Comment: Greenspan's Warning

In the May 23, 2005 issue of *Barron's* it was reported that in ...”A recent speech by Federal Reserve Chairman Alan Greenspan, who is known in some circles as ‘Darth Vagueness,’ has left at least two money managers [and probably many more who will not publicly admit it] with nightmares of the Dark Side. So they’ve [the money managers] begun bailing out of stocks and are getting into cash and Treasuries.”

What unnerved the money managers was comments made on May 5, 2005 by the Federal Reserve Chairman regarding the growing risk to banks, individual and institutional investors, and the capital markets, real estate included—remember Russia’s default on its Sovereign debt in August 1998—posed by a possible liquidity crises in the largely unregulated \$22 Trillion derivatives markets.

Without getting too technical, derivatives are synthetically constructed investment vehicles whose investment attributes and performance are anticipated to follow the constructs and constraints of a mathematically model. Unfortunately, our experience has shown that while derivative performance works wells in up-markets, derivatives tend to perform in unpredictable (and therefore riskier) ways in down-markets.

What Chairman Greenspan was alluding to in his remarks was the potential for another “Russia” type event induced by indiscriminate panic selling of derivative positions by hedge funds looking for an exit strategy at literally any price. The result of panic liquidations in the derivative markets would likely depress the price of bonds, thereby increasing yields on debt investments. Equity securities (common stocks) would also be affected because credit based derivatives are often hedged in the equity markets through short sales.

As we (and many more astute observers) have noted, sharply rising interest rates could cause significant losses to non-financial institution risk takers—hedge funds—forcing them to liquidate debt investments (as well as other non-core assets such as real estate investments), thereby driving bond (and real estate) prices down and yields up.

In his remarks Chairman Greenspan warned that derivatives could prove a threat to financial stability and if large dealers were to exit the market after suffering significant losses, a liquidity crises could follow.

Similar concerns have recently been expressed in a number of financial periodicals including *Business Week* in an articles entitled “Taking Risk to Extremes” published in the May 23, 2005 issue, which noted: “Anxiety is high: Big losses in credit derivatives could set off a chain reaction. Banks, insurers, and bond and pension funds, as well as hedge funds, are inextricably linked as issuers, buyers, and traders. An apparently minor problem, such as a flurry of downgrades [think the next Ford-GM type event] could quickly engulf the financial system by sending markets into a tailing spin, wiping out hedge funds, and dragging down banks that lent them money.

If that sounds like a replay of the Long-Term Capital Management hedge-fund meltdown, it is, only worse. In 1998, LTCM borrowed about 100 times its capital to hold derivatives worth some \$1.25 trillion, or 1,000 times the fund’s capital. Today, hedge funds are an industry with \$1 trillion in assets, more than three times the size it was then and [now] trade newfangled derivatives that are vastly more opaque and risky. ‘There’s more borrowing by hedge funds in an untested, illiquid credit market than has historically been the case’ says Peter J. Petas, founder of researcher CreditSights Inc. in New York.”

**Special Comment: John B. Levy, President of John B. Levy & Company, Inc. and author of the monthly *Barron's*/John B. Levy Company, Inc. National Mortgage Survey, to be Guest Speaker on 4th ULI Real Estate Capital Markets Conference Call**

We are pleased to announce that John B. Levy, President of John B. Levy Company, Inc. and author of the *Barron's*/John B. Levy National Mortgage Survey, will be the guest speaker on ULI's Real Estate Capital Markets conference call which will be held on Friday, September 23, 2005 from 11:00 am to Noon, Eastern Standard time.

Given the unique experience, perspective, and knowledge of our guest speaker, the discussion will focus exclusively on the conventional and securitized real estate mortgage capital markets.

If you would like submit a question, please e-mail: [blank@uli.org](mailto:blank@uli.org)

The call-in number will be 1-719-785-9359; the participant pass code will be 508131. The call will be recorded and available for playback for 30 days.

Date	Federal Funds Rate	Increase/Decrease	Discount Rate	Increase/Decrease
May 4, 2004	1.00%	-----	2.00%	-----
June 30, 2004	1.25%	+0.25%	2.25%	+0.25%
August 10, 2004	1.50%	+0.25%	2.50%	+0.25%
September 21, 2004	1.75%	+0.25%	2.75%	+0.25%
November 10, 2004	2.00%	+0.25%	3.00%	+0.25%
December 14, 2004	2.25%	+0.25%	3.25%	+0.25%
February 2, 2005	2.50%	+0.25%	3.50%	+0.25%
March 22, 2005	2.75%	+0.25%	3.75%	+0.25%
May 3, 2005	3.00%	+0.25%	4.00%	+0.25%
June 29, 2005				

**Special Comment: Notes and Quotes from “The PunchLine...”**

“Harsh Reality”

“There are three broad and related themes coming through in this issue. First, more business and market participants are fine-tuning expectations in light of a possible slowdown in business earnings and re-pricing of risk expectations. And unlike 2004, there is a reason to believe that these adjustments are more than tweaking or fine-tuning within the context of a temporary soft patch. The situation is aggravated by disturbing developments in Europe. The European economy, instead of building momentum, appears to be sliding back into stagnation after a short lived growth fillip around the turn of the year. And worse, the EU faces a series of very serious political issues over the next few months, challenges that could even put their new single currency the euro at risk.

Second, company and sector challenges are abounding—whether they are developments surrounding the oil/energy shock, the extraordinary boom in housing and its link to overall consumer expenditures, a slowing in tech, disappointments in pharma or the insurance sector or the ugly GM and Ford stories. Despite impressive earnings across sectors in general in the first quarter, forward guidance is far from spectacular. More and more indicators point to an unhappy combination of subdued growth, but higher inflation. And company differentials are likely on the rise, with the big surprise that some bigger firms are finding it difficult to re-position.

Third, companies, policymakers, and investors will need to face up to the numerous distortions, exaggerations or economic/financial demons that have accumulated in recent years and appear to have no easy resolution. These include the boom in China, the extraordinary low interest rate levels and low credit-risk spreads that have dominated these past few years, the distortions in spending versus savings, and the awkward situation in foreign exchange and commodity markets.”

“Dealmaking”

“Welcome to the silly season. The more competition there is for deals, the sillier it seems to get. Consider some of the numbers making the rounds in the middle market: up to 100 bidders vying for one small company; more than a dozen financial advisors in a bake-off; purchase price-Ebitda [earnings before interest, taxes, depreciation, and amortization] multiples of up to 13 times; debt-to-Ebitda multiples of 6 to 6.5 times. Froth is surfacing. Amid tough competition among strategic buyers in certain areas, financial buyers are coming up short. Return expectations are lower. On the smaller end of the market, beauty contests for intermediaries have turned ugly. The proliferation of investment boutiques has encouraged sellers to tighten terms, putting a squeeze on sell-side advisers and buyers. There’s a darker side too. As companies pile on debt in their capital structure and buyers pay even higher multiples, there is much less room for error if the economy softens.”

### **Update on Status of Terrorism Risk Insurance Act of 2002**

The Terrorism Risk Insurance Act of 2002, which established a three year federal program to share the costs of terrorist acts between the federal government and the insurance industry, is scheduled to expire on December 31, 2005.

A bill proposing the Terrorism Risk Insurance Extension Act of 2005 would extend the federal backstop for an additional two years. Its future is currently uncertain with Treasury Secretary Snow expected to submit a report to Congress assessing the effectiveness of the act and the availability and affordability of terrorism insurance after the expiration of the current legislation.

<b>Real Estate Capital Markets Scoreboard: Money Rates</b>	<b>May 23, 2005</b>
Prime Rate	6.00%
Federal Funds Rate	3.00%
Discount Rate	4.00%
Dealer Commercial Paper	3.10% - 30 days 3.20% - 60 days 3.29% - 90 days
London Inter-bank Offered Rate (LIBOR)	3.09%- 1-month 3.30% - 3-months 3.51% - 6 months 3.76% - 1 year
U.S. Treasury Securities	4.03% - 10-year

### **Public Real Estate Securities Capital Markets**

Real estate investments trusts (REITs) continued to gain ground over the other public securities indices, ending in positive territory after a considerable period of negative returns. There is no cogent explanation for the current behavior of the public securities markets as nothing radical has happened in real estate's space in the past six weeks. Blame it "relative value", how poorly the other indices are performing, the Ford/GM credit debacle, whatever. Hopefully, it will continue.

April was a "big" month for REITs with the National Association of Real Estate Investment Trust's equity market index gaining 5.32%. The following chart details on a property sector basis total returns for the month of April as well as on a year-to-date basis and provides dividend yields as on the end of April:

Property Sector	Total Return		Dividend Yield
	April 2005	Year-to-Date	April 2005
Office	5.07%	1.56%	5.46%
Industrial	4.25%	-6.73%	4.36%
Office/Industrial	1.66%	-8.20%	5.95%
Shopping Center	5.19%	-4.07%	4.93%
Regional Mall	10.53%	2.38%	4.25%
Freestanding retail	1.84%	-2.73%	5.31%
Multifamily	6.13%	-3.66%	5.17%
Manufactured Home	0.78%	-4.50%	5.05%
Diversified	6.64%	-2.19%	5.22%
Lodging/Resort	2.06%	-5.17%	3.52%
Healthcare	7.36%	-4.69%	6.65%
Self-Storage	2.96%	3.81%	3.94%
Specialty	-0.58%	-3.90%	4.87%
<b>Equity REIT Index</b>	<b>5.32%</b>	<b>-2.11%</b>	<b>4.96%</b>

Source: National Association of Real Estate Investment Trusts.

Public Securities and Real Estate Performance Indices as of May 20, 2005						
	Dow Jones Industrial Average	S&P 500 Stock Index	NASDAQ Composite Index	Russell 2000 Index	Morgan Stanley REIT Index	NCREIF All Property Index
2005	-2.89%	-1.87%	-5.93%	-6.47%	+2.94%	+15.55%*

\* Trailing 12-months ended March 31, 2005.

Market Capitalization of REITs (number of shares multiplied by share price in \$ millions) as of May 24, 2005								
	# of REITs	Market Cap	Equity REITs	Market Cap	Mortgage REITs	Market Cap	Hybrid REITs	Market Cap
2005	192	335,312	151	304,504	34	24,707	7	6,106

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

Offerings of Securities by REITs (in \$ millions) as of April 30, 2005				
	2004		2005	
	# of Offerings	\$ Value	# of Offerings	\$ Value
Initial Public Offerings	29	\$8,271	2	\$794
Follow-on offerings-Common Shares	79	7,338	17	1,116
Follow-on Offerings-Preferred Shares	61	5,858	13	1,137
Unsecured Debt	97	17,306	33	5,491
Secured Debt	0	0	2	1,910

Source; National Association of Real Estate Investment Trusts.

### Public Real Estate Debt Capital Markets

According to an analysis of April 2005 remittance reports by Morgan Stanley Fixed Income Research, delinquencies for seasoned commercial mortgage-backed securities (CMBS) equaled 1.59% of outstanding balances, unchanged for March 2005's level.

The property sectors with the highest delinquencies levels were: senior housing, hotel-motel, and multifamily.

The states with the highest levels of delinquencies included: Texas, Illinois, and Florida.

In another study by Morgan Stanley, it was noted that the weighted average loss severity for all liquidated CMBS loans equaled 39% of outstanding balances as compared to 33% for loans originated by life insurance companies. Interestingly, if one excludes senior housing and hotels and motels, property sectors which are clearly not favored by life company lenders, from the CMBS analysis, CMBS loss severity (in the Morgan Stanley analysis) would decline to 34%.

The following chart details weighted average loss severity by property type as well as the average number of months between the time the loan is transferred to the servicer for "resolution" and the loan is finally paid off:

Loss severity and Resolution Time by Property Type		
Property Type	Weighted Average Loss Severity	Average # of Months Between Servicer Transfer and Payoff
Hotel-Motel	43%	20%
Industrial-Warehouse	37%	18%
Multifamily	28%	17%
Mixed-Use	25%	17%
Office	32%	18%
Retail	37%	20%
Senior Housing	79%	40%
<b>Weighted Average All Loans</b>	<b>39%</b>	<b>20%</b>
Source: Morgan Stanley		

Origination volume continues at record levels with capital available at extremely competitive rates and extremely competitive terms.

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through May 20, 2005 (in \$ Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
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	93,838.2	33,746.0	127,584.2
2005	46,100.0	27,100.0	73,200.0
Source: <u>Commercial Mortgage Alert</u> .			

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)			
	12/29/04	5/18/05	Year-to-Date
10-Year Treasury Bonds	4.32%	4.15%	-0.17
AAA	+70	+71	+1
AA	+77	+81	+4
A	+85	+92	+7
BBB	+127	+134	+7
BBB-	+167	+184	+17
BB	+325	+310	-15
B	+770	+750	-20
Source: Morgan Stanley.			

## **Private Real Estate Equity Capital Market**

“Point-Counterpoint”

At the recent Counselors of Real Estate conference in Chicago the following “point-counterpoint” exchange was observed.

On one side was Sam Zell, Chairman of Equity Residential Trust and Equity Office Trust who observed that due to the excessive liquidity available in the real estate industry, low yields (capitalization rates) would be the norm for the foreseeable future (which he noted as up to nine years), thereby continuing the higher and higher prices being paid for real property.

On the other side was Anthony Downs, Senior Fellow of the Brookings Institution, who noted that the current high prices (and low capitalization rates) being paid for income-producing property were vulnerable to rapid increases in interest rates or better performance by investment alternatives such as the stock market, or both.

Other panelists reinforced a series of concerns for investors to consider, including:

1. Investors pricing assets as if fundamentals had completely recovered from their recent bout of underperformance; and
2. The prospect for one or more “Bolts out of the Blue” including: the widening U.S. trade deficit; short and long-term federal budget deficits, geopolitical uncertainty; oil price increases, etc.

According to the first quarter 2005 survey of commercial and multifamily rates of return by the National Council of Real Estate Investment Fiduciaries (NCREIF), real estate returns declined during the quarter as compared to returns achieved during the fourth quarter of 2004. The NCREIF Property Index, which is comprised of approximately 4,225 properties valued at approximately \$159 billion, reported an average total rate of return (income plus appreciation in value) of 3.51% in the first quarter of 2005 as compared to 4.69% in the fourth quarter of 2004. It appears that beanstalk may in fact not reach the sky.

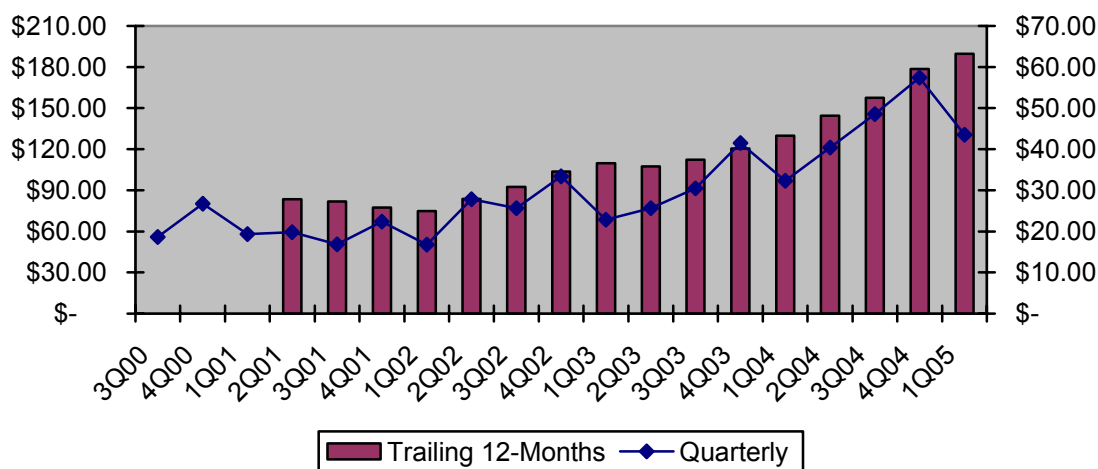
Income reported in the first quarter 2005 was 1.71%, a decline of 0.06% from income reported during the fourth quarter 2004 of 1.77%; appreciation in value reported in the first quarter 2005 was 1.81%, a decline of 1.11% as compared to 2.92% reported during the fourth quarter of 2004.

The following chart compares returns for the first quarter 2005 against the fourth quarter 2004 on a property sector by sector basis:

	Q1/2005 Returns			Q4/2004 Returns		
	Total	Income	Appreciation	Total	Income	Appreciation
Multifamily	3.68%	1.42%	2.26%	4.00%	1.47%	2.53%
Hotel	1.88%	2.03%	-0.15%	3.37%	2.06%	1.31%
Industrial	2.84%	1.85%	0.99%	3.75%	1.83%	1.93%
Office	3.25%	1.78%	1.47%	3.74%	1.81%	1.93%
Retail	4.48%	1.68%	2.79%	7.83%	1.89%	5.94%
<b>Total</b>	<b>3.51%</b>	<b>1.71%</b>	<b>1.81%</b>	<b>4.69%</b>	<b>1.77%</b>	<b>2.92%</b>

As usual, the retail sector was the best performing sector although its returns finally appear to be becoming more “human” in scale.

### Sales of Office, Industrial, Retail, and Apartments (in \$ Billions)



Source: Real Capital Analytics Inc. ([www.realcapitalanalytics.com](http://www.realcapitalanalytics.com)).

Real Estate Capital Markets Scoreboard: Survey of Initial Capitalization Rates								
	Multi-Family	CBD Office	Suburban Office	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%
4Q03	7.6%	8.4%	9.0%	7.9%	8.2%	8.4%	8.4%	9.2%
4Q04	7.2%	8.1%	8.5%	7.6%	7.7%	8.0%	8.0%	8.9%
1Q05	6.9%	7.8%	8.3%	7.3%	7.5%	7.7%	7.8%	8.6%
<b>YTD</b>	<b>-0.3%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>	<b>-0.2%</b>	<b>-0.3%</b>

Source: Real Estate Research Corp. ([www.rrc.com](http://www.rrc.com)).

## Private Real Estate Debt (Mortgage) Capital Markets

The Federal Reserve Board April 2005 survey of Senior Loan Officers reported additional easing in both lending standards as well as loan terms for commercial and industrial loans, including commercial real estate loans.

In summary, the survey noted the following:

1. Easing in loan standards for commercial and industrial loans by both domestic as well as foreign banks;
2. Substantial increase in the percentage of domestic and foreign banks reporting narrower (lending) spreads over their cost of funds;
3. Eased lending standards for commercial real estate loans;
4. Increased competition among capital providers; and
5. Improved (hopefully) risk measurement programs by capital providers.

Real Estate Capital Markets Scoreboard: "Prime" 10-Year Commercial Mortgages						
	12/31/01	12/31/02	12/31/03	12/31/04	5/9/05	Year-to-Date
Prime Mortgages	7.33%	6.05%	5.80%	5.51%	5.41%	-0.10%
10-Year Treasuries	5.05%	3.81%	4.25%	4.22%	4.15%	-0.07%
Spread	2.28%	2.23%	1.65%	1.29%	1.26%	-0.03%
Source: Barron's/John B. Levy and Company Survey.						

Capital remains available in size at competitive rates and upon competitive terms.