

## Real Estate Capital Markets Update – March 6, 2007

Volume 9, Number 2

Welcome to the 9<sup>th</sup> year of ULI's Real Estate Capital Markets Update. With the introduction of ULI's Blog, "The Ground Floor", which is available at [www.thegroundfloor.typepad.com](http://www.thegroundfloor.typepad.com), distribution of the results of extensive surveys of ULI members regarding "just what they wanted" in terms of information, as well as comments from readers, we are making the following changes to our publication:

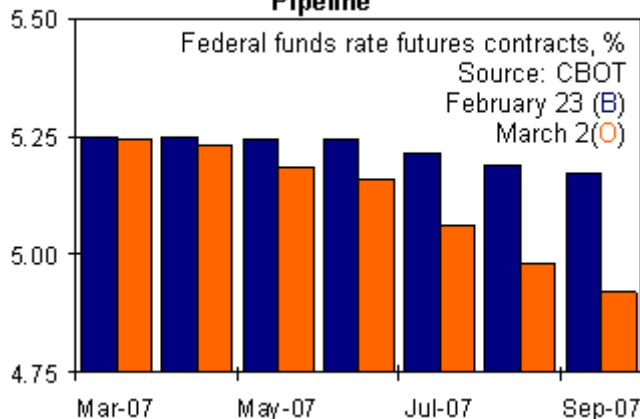
- While maintaining (as best we can) our every other week publishing schedule, we plan to alternatively concentrate the focus of each issue solely on either the equity or debt capital markets; we will, of course, continue to publish terms of indicative transactions (such as mortgage lending spreads) as available.
- Next, we plan to broaden our focus to include new products, such as collateralized debt obligations, new investment strategies (such as Responsible Property Investing and Infrastructure), new private capital sources, and cross-border capital flows. We will continue to report on the progress of the public real estate capital markets.

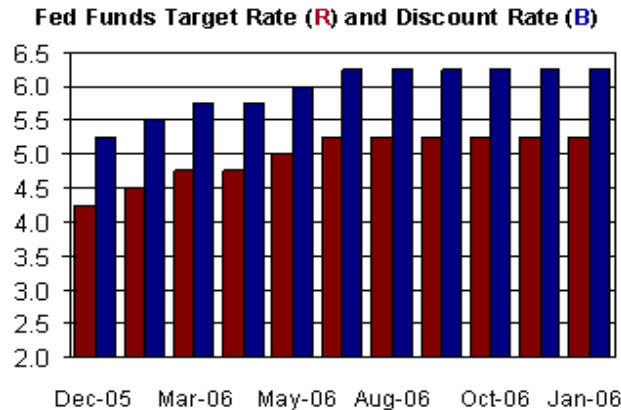
We look forward to your reactions to the above changes and well as suggestions of other areas that we should focus on. Our e-mail address is: [blank@uli.org](mailto:blank@uli.org)

### Special Comment: Federal Reserve Board to Hold Rates Steady

As of the close of trading on March 2, traders had priced in a roughly 90% probability that the Federal Open Market Committee would leave the Federal Funds Rate and the Discount Rate unchanged through its meeting scheduled for March 20-21. As the chart below indicates, the market appears to be pricing in a 25% probability of a rate reduction at the end of the first half of 2007. On the other hand, the majority of traders (75%) feel the potential for a rate cut is more likely during the late summer (August).

**Market Panic Has Investors Betting on a Cut in the Pipeline**





### Special Comment: What a Difference a Year Makes

Key Rates			
	March 2, 2007	Year Ago	Increase/Decrease
Prime Rate	8.25%	7.50%	+0.75%
Federal Funds Rate	5.25%	4.50%	+0.75%
3-Month Libor	5.35%	4.92%	+0.43%
3-Month Treasury Bills	5.12%	4.62%	+0.50%
10-Year Treasury Bonds	4.50%	4.73%	-0.23%
30-Year Treasury Bonds	4.68%	4.75%	-0.08%

### Special Comment: Sub-Prime Single Family Mortgage Upheaval's Impact on Commercial and Multifamily Mortgage Finance

The following comments appeared on ULI's Blog, "The Ground Floor," <http://thegroundfloor.typepad.com>

**What the!@#%& does sub-prime mortgage lending have to do with me? I develop, own, operate, manage, or invest in commercial and multifamily commercial property; I only live in a single family home!**

It's a little bit like what happened in August 1998 when Russia defaulted on its Sovereign debt. The reaction in the capital markets was a flight (to quality and liquidity), that is from all forms of debt investments to U.S. government securities.

From mid-August to December 1998, originators of securitized loans watched inventories build up rather than sell assets at significant losses. Institutional investors did likewise rather than book large losses. At that time, the ability to hedge mortgage positions was not even in the experimental stage so firms just gritted it out and fortunately, the markets returned to normal by the end of the year and a true crisis was averted.

Fast forward to February 2007. Hedging technology is vastly improved and available to institutional investors (pension funds, hedge funds, etc.) who routinely utilize hedges to lock in profits or to create (hopefully) effective stop loss trading strategies. In the sub-

prime lending arena, buyers of sub-prime paper (which produces higher rates of return than other debt products) often seek to hedge their positions by buying or selling (short) the ABX Sub-Prime Index. Which worked fine until the cost of hedging transactions increased substantially in reaction to the havoc which has occurred among sub-prime lenders, including the demise of more than 20 sub-prime lenders. When it became too expensive to use the ABX Sub-Prime Index to hedge positions, bright minds decided to use the triple-B minus CMBS cohort as a surrogate for the ABX Sub-Prime Index and began to short it as a means of hedging their long positions.

OK; great story, but get to the point. The resulting pressure on the triple-B minus bond market caused trading spreads to widen to the point where the pricing of securitized mortgage loans was affected with lenders now quoting deals at spreads that are 4 to 8 basis points wide (that is, more expensive) than they were just a few days ago. Now 4 to 8 basis points may not seem like a lot but we all know that deals are won or lost over much lower amounts.

The real question is where to do we go from here? Do the market normalize with spreads returning to prior levels or does the disconnect increase with spreads continuing to widen (until it “hurts”).

### **Sub-Prime Mortgage Lending: Part II**

Hopefully, this ends here and now...and this will be the last comment and explanation describing the impact of sub-prime mortgage lending on the commercial side of the real estate industry.

As we are well aware, the equity and debt capital markets are oversupplied with capital, and investors, looking for “Alpha” type rates of return, have benefited from making increasingly risky bets on a wide array of strategies and then just sitting back and letting the markets work their magic.

Trying to gauge the magnitude of what happened when the sub-prime lending market hit the wall is difficult at best as many of the investment and hedging strategies as well as much of the vocabulary is so unfamiliar to those in the real estate business. Even persons whose business models straddle both environments—the physical real estate markets and the financial real estate capital markets—have to pause and reflect upon the way government, corporate, and real estate capital markets are today both inter-related and fully integrated and how an issue affecting one segment of the capital stack will impact all segments thereof. No more isolated incidents, quickly forgotten. Anyone who recalls the upheaval created by Russia’s default in August 1998 knows what we mean.

According to an article in the New York Times, the ABX Index “tracks how much it costs to insure a group of BBB-minus bonds based upon sub-prime mortgages. The Index is a derivative which falls in value when the cost of insurance rises, so it can be seen as a proxy for the value of the underlying bonds”.

As the sub-prime market turned sour, more and more highly leveraged, hedge fund type investors sought to hedge (protect the value of) their positions via the ABX Index. But as more and more financial institutions reported increases in delinquency and default rates for sub-prime mortgages, the cost to insure and protect performance and value increased dramatically. In fact, the ABX Index, which had declined approximately 30% since January 1, 2007, fell a whopping 7.4% literally overnight during the height of the crises.

With the ABX Index in “free fall” and incapable of providing a means to hedge existing positions, investors turned to BBB-minus commercial mortgage-backed securities (CMBS) as a surrogate for the ABX. The result: between February 23<sup>rd</sup> and March 1<sup>st</sup>, trading spreads for BBB-minus CMBS widened 27 basis points, from 83 to 110 basis points; parenthetically, spreads for BBB rated CMBS widened 25 basis points, from 65 to 90 basis points. This widening translated into higher borrowing rates in the securitized mortgage market.

While few appear to believe that continued weakness in the sub-prime market will have a long-term impact on the commercial and multifamily side of the real estate capital markets, the recent “upset” should serve to remind us of the interconnection of real estate finance and the capital markets.

### **Special Comment: Notes from “The Punchline...”, a publication of Brookville Capital**

#### **“The Greed-Fear Imbalance”**

“Leverage multiples have reached levels that many banks think excessive. But they are still lending. They are doing so because they have become skilled at passing the hot potato. Banks originate the deals, take fat fees, and then syndicate the loans. At [the World Economic Forum at] Davos, bosses of two big players in the leverage loan business privately boasted of how they had cut their risk exposure in recent years while maintaining, or increasing the amount of new loans they made”.

#### **“2006 Personal Savings Rate Drops to 74-Year Low”**

“People once again spent everything they made and then some last year, pushing the personal savings rate to the lowest level since the Great Depression more than seven decades ago. The Commerce Department (recently reported) that the savings rate for all of 2006 was a negative 1 percent, meaning that not only did people spend all the money they earned, but they also dipped into savings or increased borrowing to finance purchases. 2006 was ...the poorest showing since a negative 1.5 percent in 1933 during the Great depression. For December, consumer spending rose a solid 0.7 percent, the best showing in five months, while increases in incomes rose 0.5 percent, both figures matching Wall Street expectations”.

## “The New Geography of Business”

“Emerging market risk...Against a background of abundant global liquidity, a strengthening of asset prices has been a key feature of emerging market finance over the past few years. Investors searching for yields higher than those available in advanced markets drove up prices of both emerging market bonds and equities in 2006. There was a sharp but swift market correction at mid-year, and by the end of 2006, emerging market equity and bond prices had reached record levels. The IIF (which represents leading banks and other global financial institutions) was unusually explicit this year in pointing out that market participants have continued to price assets ‘as if the Goldilocks global environment will continue undisturbed’. An International Monetary Fund executive noted that global financial markets are currently enjoying a ‘very benign’ environment, which could change at any time. Financial innovation has helped to spread risk in financial markets, but that risk is still present he noted”.

### Public Debt Capital Markets

All’s right with the world of commercial mortgage-backed securities (CMBS) except for a “little” upset to the tummy caused by the upheaval in the sub-prime mortgage market. Originators continued to take applications, subject to some jitters as to pricing. Delinquencies continued to decrease on what is apparently their inexorable path to...none. According to Realpoint, the volume of delinquent CMBS loans fell to \$.2.65 billion (out of a universe of \$716.4 billion) or 0.37% of outstanding balances.

2006 was a record year for issuance of CMBS in the both the U.S. as well as internationally with global issuance just shy of \$300 billion; 2007 looks like more of the same.

Summary of CMBS Issuance (in \$ Billions)		
	U.S.	Non-U.S.
2005	\$169.2	\$69.7
2006	206.0	93.1
2007-Projected	245.0	118.0
Source: Commercial Mortgage Alert		

International issuance of CMBS included offerings of mortgages secured by properties located in the: U.K.; Germany; and on a Pan-European basis; Japan; Canada; Australia, Italy; France; the Netherlands; Oman; Singapore, South Africa; Ireland; and China.

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through March 2, 2007 (in Millions)			
	U.S. Assets	Non-U.S Assets	Total Issuance
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	169,169.5	69,376.1	238,545.6
2006	206,000.0	93,100.0	299,100.0
2007	30,500.0	4,500.0	35,000.0
Source: <i>Commercial Mortgage Alert</i> .			

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)	
February 28, 2007	
10-Year Treasury Bonds	4.64%
AAA	+84
AA	+91
A	+ 99
BBB	+145
BBB-	+165
BB	+280
B	+700
Source: Morgan Stanley; J.P Morgan.	

## Private Debt Capital Markets

Excerpted from the Wall Street Journal On-Line, February 27, 2007:

- **The Issue:** Banks have sharply lowered the level of their reserves set aside to take care of loans that go bad.
- **Background:** Consumers and companies alike are having trouble paying debts, so it may not be a good time to have low reserves.
- **What's Next?:** Will regulators step in? Higher reserves also mean lower bank profits

According to a study by SNL Financial, banks have set aside as loan loss reserves an average of 1.09% of the total value of their loan portfolios as of the end of last year, down from 1.14% in 2005, 1.63% in 1992, and 1.48% in 1990. And the regulators are certainly “trying” to get lenders to beef up their reserves by issuing guidance to banks regarding systemic risk and low levels of reserves.

Notwithstanding the fact that every bank demurs and notes that it has adequate reserves, the level of reserves is at its lowest level since at least 1990, the last year in the SNL study.

Many analysts expect banks to start to increase loan reserves as loan defaults and charge-offs increase in the near future which will in turn have a negative impact on bank earnings. More to follow on this story as the regulators cries become more shrill.

Show me the money—supply! According to an analysis of the Federal Reserve Board’s Flow of Funds data, it continues to be commercial banks followed by conduits originating commercial mortgage-backed loans, followed by everyone else.

Of the \$2.845 trillion in commercial and multifamily mortgages outstanding as of September 30, 2006, \$1.2 trillion, or 44%, was held by commercial banks. CMBS accounted for \$583 billion, or 21% of mortgage outstanding with life insurance companies holding \$279 billion, or 10% and savings and loan associations and government sponsored entities (or GSEs) holding \$212 billion and \$216 billion, or 10%, respectively.

Real Estate Capital Markets Scoreboard: Indicative Commercial Mortgage Pricing for Securitized Financing						
Date	5-Year Treasury Notes	Spread	5-Year Mortgage Rate	10-Year Treasury Notes	Spread	10-Year Mortgage Rate
2-15-07	4.76%	1.18%	5.94%	4.80%	1.01%	5.81%
Source: Cohen Financial L.P.						

Conventional Mortgage Matrix	<65% LTV (in Basis Points over Treasuries)	>65% LTV (in Basis Points over Treasuries)
Multifamily	85-95	95-105
Regional Malls	80-100	95-105
Strip/Power centers	85-105	110-115
Multi-tenant Industrial	90-100	95-105
CBD Office	95-105	105-115
Suburban Office	100-110	110-120
Source: Sonnenblick-Goldman, LLC (February 1, 2007).		