

Real Estate Capital Markets Update – April 2, 2007

Volume 9, Number 3

Welcome to the 9th year of ULI's Real Estate Capital Markets Update. With the introduction of ULI's Blog, "The Ground Floor", which is available at www.uli.org/blog, 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 a frequent 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.
- And lastly, we plan to take full advantage of ULI's Blog as a means of communicating both faster and more frequently with readers.

We look forward to your reactions as well suggestions of other areas that we should focus on. Our e-mail address is: blank@uli.org

Lloyd's "Wall of Worry"—"It's the counterintuitive indicator: many worries, buy; few worries, sell"

"Long a part of Wall Street lore, Lloyd's Wall of Worry (a trademark of Khaner Capital Management) is a quick, handy way to gauge the emotions of investors. As interpreted by money manager Lloyd Khaner, a low wall, with seven or fewer blocks, indicates a complacent, even overconfident market: Time to take profits. A high all, with 15 or more blocks, suggests a squeamish market: Look to buy at bargain prices. In the middle range, reading the wall gets tricky; knowing not only where the wall stands but whether it's headed up or down is the key."

"Nothing to fear but... Wintertime, and the livin's is easy. Valuations are high, the bulk of earnings season is behind us, and hope for the new year remains strong. At seven worries, we are officially in the complacency zone. The stock market is interpreting all news as good news. If by rare chance a stock's price drops too low, not to fear: It will be acquired faster than you can say "LBO". Not surprisingly, cheap stocks are getting hard to find, so patience is required. Looking ahead, several potentially market-disturbing issues are gathering force: the threat of policy change in China, which rocked markets in Shanghai and around the world; simultaneous escalation of war in Iraq and Afghanistan; an increasing number of delinquencies in the sub-prime mortgage market; and hearty Russian chest pounding, to post a few".

The building "Blocks":

U.S. Economy: Too fast or too slow? The Flying Wallendas economy is perilously walking a tightrope—without a net.

Interest Rates: It's official—one third of investors think rates are going up, one third think they're going down, and one third think they are staying flat. In other words, confusion reigns.

Inflation: Guessing the monthly core rate is more difficult than nailing jelly to the wall. And thanks to the Fed's quasi-inflation targeting—less than 2 percent good, more than 2 percent bad—"I'm developing a nervous tic".

Oil Prices: down from the point-of-no-return zone, but still a good Tiger Woods par-5 tee shot away from SUV-friendly territory.

Consumer Spending: For now, most Americans are bingeing with the appetite of a giddy tourist at a Las Vegas buffet. But there's a chance that consumers won't feel so well afterwards and might not go back for more. In the meantime, bring on the breaded shrimp.

Housing Prices: Gently falling from their peak, like snowflakes drifting down from the summit of Everest—this trip is gonna take a while.

Iran: The U.S. deciders are working to make a case that Iran is the real enemy, and unsurprisingly, their target is not backing away from the change. One dangerous game of chicken.

Special Comment: Notable and Quotable

"The longer it lasts, the worse it will be when it ends."

William Conway, Co-founder of the Carlyle Group, in an internal memo warning colleagues that an era of cheap debt has caused private equity firms—including his own—to make "risky credit decisions" that could come back to haunt them when the markets shift.

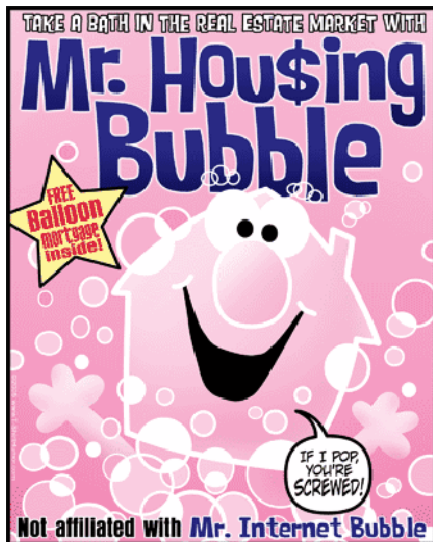
Special Comment: Federal Reserve Board Beige Book

The Federal Reserve Board's (FRB) Beige Book economic survey released in mid-March indicated some signs of slowing in the economy. Highlights of the survey included the following:

- Retail sales continued to increase with the exception of housing related items; overall, service industries continued to expand;
- The economic slowdown so far appears confined to the housing and auto sector;
- Single family mortgage lending was noted as considerably weaker while commercial and industrial lending was characterized as "increased or remaining solid";

Overall, the report was about as good as it gets given the weakness noted in the housing and auto sectors.

Key Rates			
	March 31, 2007	Year Ago	Increase/Decrease
Prime Rate	8.25%	7.75%	+0.50%
Federal Funds Rate	5.25%	4.75%	+0.50%
3-Month Libor	5.35%	5.00%	+0.35%
3-Month Treasury Bills	5.02%	4.63%	+0.39%
10-Year Treasury Bonds	4.55%	4.85%	-0.30%
30-Year Treasury Bonds	4.70%	4.89%	-0.19%



Special Comments: Notes from “The PunchLine...”, a publication of Brookville Capital

“Flood of Capital – Funds Seek Risk Game”

“A wave of new ‘best ideas’ hedge funds are looking to meet demand from wealthy investors for highly concentrated investments that provide the potential for high returns but also greater risk. Backers of these concentrated funds, some of which hold as few as six holdings, say they are keen to take on more risk as volatility of almost every asset class has been driven to record or near record lows by a flood of liquidity.”

“Some Questions”

“New Fitch credit study discusses the following key considerations:

- The days of easy money may have peaked;
- Corporate credit quality is expected to modestly deteriorate going forward as profit growth slows and debt rises;
- Aggressive new issuance and high concentration of low-rated issues continue to put upward pressure on default risk—a spike in the default rate is a possibility;
- Recovery rates have soared as prospects for future recoveries may have weakened;
- The sustainability of foreign and hedge fund demand for U.S. fixed income securities is a wildcard.

So while U.S. defaults shrank in 2006, corporate debt is expanding at the fastest pace in 5 years. The very low default rate experienced in 2006 is not sustainable given expectations of slower profit growth, rising debt and an environment of more discriminating lenders/investors focusing more intently on risk/reward attributes in a maturing credit cycle. In addition, the increasingly aggressive profile of deals coming to the market in the speculative grade loan and bond markets continues to put upward pressure on default rates. Fitch believes there will be a meaningful increase in defaults in 2008.”

“Weary Households”

“The Federal Reserve said that the delinquency rate on banks’ residential real-estate loans climbed last quarter to the highest level in four years. The share of loans on which payments were at least 30 days overdue rose to 2.11%, the highest since the fourth quarter of 2002, and from 1.72% the previous three months, according to data posted on the Fed’s web site. The data isn’t adjusted for seasonal patterns. The deterioration in credit quality comes in a period of sustained gains in employment and incomes, a sign that weaker underwriting standards, not economic stress, may be to blame.”

Credit Concerns – Realty Programming”

“Loose covenants...looming risk. One of the driving forces behind the private equity boom is the continued availability of cheap debt financing at favorable terms. For instance, Henry Sender in the Wall Street Journal notes that the rise of so-called “PIK toggle” securities that provide private equity borrowers some additional flexibility to defer interest payments in light of a cash flow crunch. This is also helping boost bid values.”

Public Real Estate Securities Capital Markets

The following chart details the performance of the REIT industry by property sector for calendar year 2006, March 2007 and on a year-to-date basis and includes annual dividend yields as of March 31st:

Property Sector/Sub-sector	Total Return			Dividend
	2006	March	Year to Date	Yield
FTSE NAREIT Equity REIT Index	35.06	-2.39	3.46	3.73
Industrial/Office	39.39	-3.58	2.15	3.66
Industrial	28.92	-1.57	4.35	3.29
Office	45.22	-4.86	0.82	3.67
Mixed	28.27	-2.21	3.99	4.41
Retail	29.01	-0.97	9.80	3.39
Shopping Centers	34.87	-1.92	6.41	3.51
Regional Malls	23.83	-0.45	13.85	3.14
Free Standing	30.74	1.46	1.77	4.78
Residential	38.93	-3.95	-2.36	3.61
Apartments	39.95	-4.01	-2.40	3.61
Manufactured Homes	15.34	-2.11	-1.19	3.55
Diversified	38.03	-3.71	-0.76	3.77
Lodging/Resorts	28.17	2.76	7.74	4.25
Health Care	44.55	-3.44	0.09	5.41
Self Storage	40.95	-5.53	-1.73	2.76
Specialty	23.56	-1.11	4.47	4.23

Source: NAREIT.

All in all, March was not a good month for REITs. Every sector, except lodging/resorts, ended up in the “red”; on year-to-date basis, returns for most sectors remained positive. Our sense is that the market is treading water, waiting for some event such as another blockbuster merger transaction to give it direction. In a few weeks REITs will begin releasing the results of operations for the first quarter 2007 as well as earnings guidance for the balance of 2007; this may prove the directional event.

Public Securities and Real Estate Performance Indices as of March 31, 2007						
	Dow Jones Industrial Average	S&P 500 Stock Index	NASDAQ Composite Index	Russell 2000 Index	Morgan Stanley REIT Index	NCREIF All Property Index
2007	-0.9%	+0.2 %	+0.3 %	+1.6%	+2.6%	+16.6%*
* Trailing 12-months ended December 31, 2006.						

Private Real Estate Equity Capital Market

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%
4Q05	6.3%	6.9%	7.5%	7.3%	6.8%	7.0%	6.9%	7.8%
1Q06	6.6%	7.1%	7.4%	7.2%	7.0%	7.0%	7.1%	7.8%
2Q06	6.4%	7.2%	7.5%	7.3%	7.2%	7.2%	7.3%	7.9%
3Q06	6.3%	6.8%	7.3%	7.0%	6.9%	7.0%	6.9%	7.4%
4Q06	6.2%	7.0%	7.6%	6.7%	6.8%	6.8%	7.1%	7.6%
1Q07	5.9%	6.5%	7.0%	6.7%	6.6%	6.6%	6.7%	7.4%
	-0.3%	-0.5%	-0.6%	0.0%	-0.2%	-0.2%	-0.4%	-0.2%

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

As the above survey from Real Estate Research Corporation indicates, capitalization rates fell for the umpteenth quarter in a row. While many are starting to talk about appreciation slowing, and some are even willing to talk about it publicly, one is hard pressed to find any instances where “pushing back” is actually occurring.

Interestingly, in a recent survey of pension funds and endowments by Institutional Real Estate, Inc. and Kingsley Associates, institutional investors said they were planning to reduce the amount invested in real estate in 2007 (from \$59 billion in 2006 to \$46 billion this year), not because of pricing or projected return on investment but solely due to the fact their real estate holdings were finally in line with previously approved real estate allocations, i.e., they were fully invested and no longer had to play catch-up. In fact, when asked to predict expected rate of return, portfolio managers surveyed remain optimistic, expecting real estate returns of 9.3% in 2007, up from the 8.1% predicted for 2006.

Public Real Estate Debt Capital Markets

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through March 30, 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	185,700.0	81,100.0	266,800.0
2007	56,900.0	11,600.0	68,500.0

Source: *Commercial Mortgage Alert*.

Commercial Mortgage-Backed Securities Trading Spreads To U.S. Treasury Bonds (in Basis Points)		
Rating	Term	Spread
AAA	5 years	+71 basis points
AAA	10 years	+85 basis points
AA	10 years	+98 basis points
A	10 years	+106 basis points
BBB	10 years	+174 basis points
BBB-	10 years	+219 basis points

Private Real Estate Debt (Mortgage) Capital Markets

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
3-15-07	4.48%	1.24%	5.72%	4.53%	1.07%	5.60%

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	100-115
Multi-tenant Industrial	90-100	95-105
CBD Office	95-105	105-115
Suburban Office	100-110	110-120

Source: Sonnenblick-Goldman, LLC (March 1, 2007).