Real Estate Capital Markets Update – April 20, 2007

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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, 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 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

Special Comment: Tax Freedom Day

Tax Freedom Day is the day the average American stops working for the U.S. government and starts working for himself. In 2007, Tax Freedom Day will occur on April 30, two days later than in 2006. The Tax Foundation calculates Tax Freedom Day by dividing total federal, state, and local government taxes paid—estimated at approximately $4 trillion this year by the U.S.'s $12.1 trillion estimated national income. The result—32.7% multiplied by 365 days equals April 30th.

The following are some interesting tax facts and quotable quotes regarding the payment of taxes which appeared in an article entitled "Happy Tax Day" published in the April 16 issue of *Barron's On-Line*:

- "Taxes are the price we pay for a civilized society"—Justice Oliver Wendell Holmes, Jr. in 1904.
- Internal Revenue Service data for 2004, the most recent reporting year, showed that the top 10% of Americans earners made 44.3% of the income and paid 68.1% of all federal income taxes.
    - If this calculation were extended to include the same proportion of state and local taxes, Tax Freedom Day for the top 10% would be deferred until June 7.
- The top 1% of American earners made 19% of the income and paid 36.8% of all federal income tax; their Tax Freedom Day will occur on July 23 this year.

- “When there is an income tax, the just man will pay more and the unjust man will pay less on the same amount of income”—Plato
- “Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes”—Benjamin Franklin in 1789.
- “The difference between death and taxes is death doesn’t get any worse every time Congress meets.”—Will Rogers.

The following table provides a range of estimated Tax Freedom Days for 2007 based on various levels of adjusted gross income:

Adjusted Gross Income	Tax Freedom Day
$50,000	April 30
100,000	June 20
200,000	July 10
500,000	July 26
1 million	August 3
10 million	August 10

Special Comment: Federal Reserve Board Minutes Show [Interest] Rate Rise Still on Table

According to a summary of the Federal Open Market Committee (FOMC) meetings on March 20-21, Federal Reserve Board officials noted that additional interest rate increases might be required to fight inflation but, given an increasing amount of uncertainty about the economy, decided not to cite increased interest rates as their only alternative policy action. Meaning, we have other things—not specified—we can do instead of increasing interest rates.

The statement noted: “[I]n light of the increased uncertainty about the outlook for both growth and inflation, the [Federal Open Market Committee] also agreed that the statement should no longer cite only the possibility of further firming [of interest rates]…[risks to economic growth] had increased in the weeks since the January [FMOC] meeting and the latest information cast some doubt on whether core inflation was on the expected downward path.”

While investors were initially elated at the FOMC’s having removed the possibility of increased interest rates from the economic management bag of tricks, their joy was short lived when Federal Reserve Board Chairman Ben Bernanke said a week later: “I do want to emphasize that we have not shifted away from an inflation bias.” Back to square one.

Special Comment: Federal Reserve Board Chairman Comments on Hedge Fund Regulation

Federal Reserve Board Chairman Bernanke recently defended the "relatively light" level of regulation applied to hedge funds. While acknowledging that hedge funds increasing market share had prompted concerns about potential "systemic risks", he emphasized that these funds are structured to take market risks. "Market discipline does not prevent hedge funds from taking risks, suffering loss, or even failing—nor should it…these funds provide social benefits" such as increasing market liquidity, improved risk sharing, and support for the financial system during periods of disruption. He did suggest that regulators work to ensure that counterparties (financial institutions) in hedge fund transactions take additional precautions against the risk they were taking.

Now that sounds comforting until you recall the disruptions to the debt markets during the fall of 1998 when Long-Term Capital Management "failed" and was rescued by a group of Wall Street firms at the suggestion of the Federal Reserve. Nowadays, here is no assurance that a large enough, privately-sponsored, self-healing rescue plan may work or be feasible next time as the number of hedge funds and private equity funds and their total size is significantly greater than in 1998. The magnitude of the next disruption has the potential to be significantly larger than 1998's and may require a governmental solution. While not a fan of increased regulation, we think some form of increased disclosure could stay within the Federal Reserve Chairman's definition of a "relatively light" level of regulation and allow regulators and "counterparties" to better "understand" the risks hedge funds are taking.

Special Comment: What a Difference a Year Makes

Key Rates			
	April 13, 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	5.36%	5.11%	+0.25%
3-Month Treasury Bills	5.00%	4.74%	+0.24%
10-Year Treasury Bonds	4.76%	4.99%	-0.23%
30-Year Treasury Bonds	4.93%	5.06%	-0.13%

Special Comment: 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 [take] 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."

“Sub-Prime Mortgage Market”

“Bond research firm CreditSights says that the rising defaults on sub-prime mortgages could dump another 500,000 housing units into already overstuffed inventories.”

“Time to Recalibrate?”

“Trouble brewing in Collateralized Debt Obligation (CDO) Land…Bond investors rattled by mounting loses in sub-prime mortgages say trouble is brewing in collateralized debt obligations, the same securities that fueled the boom in leveraged buyouts and cut-rate finance. Managers of CDOs backed by speculative grade loans are borrowing as much as 13 times the amount they raise in equity from investors, up from nine to 10 times as recently as late 2005 according to…41% of the 142 CDOs backed by corporate loans and rated by Moody’s Investors Services last year were set up by first time issuers.”

“Credit Concerns – Realty Programming”

Percent of S & P – Rated Corporate Bonds		
	1980	**2006**
Investment Grade - AAA, AA, A, BBB	68%	**29%**
Below Investment Grade – BB and below	32%	**71%**

“’Defaults are primed for a potentially sharp rise going forward,’ said David Hamilton, Moody’s director of corporate default research in New York. ‘Recent equity market volatility, weakness in sub-prime lending and expectations for slower economic growth all indicate weaker credit conditions’, he said.”

“Real Estate and Construction Outlook”

“With the condo conversion craze across America coming to an end in most markets, multifamily investment is normalizing. Condo converters accounted for $30 billion out of $88 billion in multifamily transactions in 2005, but were down to $9 billion out of $87.4 billion in 2006. Some converted projects are returning to the rental market, and investors are now focused on income, appreciation and improving fundamentals.”

Public Debt Capital Markets

Finally, the credit rating agencies (Standard & Poor’s, Moody’s Investors Service, and Fitch’s Rating) are beginning to talk about and possibly even deal with an issue—the weakening of underwriting standards and “credit culture”—in the commercial mortgage-backed securities (CMBS) business which has been on many people’s minds and discussed fairly openly in the industry’s hallways and around its water fountains.

Among the issues and concerns mentioned by the rating agencies in recent public statements regarding “loose underwriting standards” are the following:

1. Unprecedented high property values combined with high loan-to-value ratios and low to no amortization;
2. CMBS and collateralized debt obligation loans structured on an interest-only for part or all of the loans term;
3. Increased refinancing risk based upon either increases in interest rates and/or property values which do not appreciate as projected;
4. Use of esoteric (non-standard) collateral to secure loans; and
5. Reduced requirements for reserves for capital expenditures.

The following quotes from the news releases from the rating agencies are certainly instructive as to what they are concerned about:

Moody’s: “…ongoing erosion of conduit loan underwriting [standards]”.

Standard & Poor’s: “…[current markets are] characterized by increased liquidity, fierce competition among loan originators, an influx of new buyers and a collateralized debt obligation-focused/short-term mindset…”

Fitch: “Real estate professionals are structuring loans today with the expectation that cash flow will continue to rise in a commercial market that has already experienced dramatic upwards trends. Fitch is seeing the market financing higher values prematurely based on the expectation that it will occur but well before it does, or does not, come to exist.”

In response to issues named and unnamed above, the rating agencies are beginning to take the first small steps by increasing the levels of subordination; the exact amount of increase to be determined by the individual rating agencies. Subordination refers to the amount of the CMBS offering that is junior to, or subordinate, to the tranches with a higher credit rating. For example, if 75% of a CMBS offering is rated triple-A, the triple-A portion has a 25% subordination as 25% of the bonds have a lower credit rating and lower sequential payment priority than the triple-A tranche.

The question is: is this enough? Will it provide the required wake-up call to originators or will they continue with “business as usual”? Interestingly, the head of one CMBS program was recently quoted as follows: “Every day we’re seeing someone break ranks and do something stupid they haven’t done before…There’s nothing left to give borrowers.”

But as we write this update we note that first quarter 2007 numbers are in and the sector had its best first quarter ever with U.S. issuance equaling $61.2 billion, up from $46.5 billion in the comparable period in 2006. Issuance in the international markets was equally vibrant, reaching $20.0 billion as compared to $13.5 billion during the first quarter of 2006. Global issuance totaled $81.2 billion, up approximately one-third from last's $60.0 billion. Global CMBS issuance included offerings from issuers in the U.S., pan-Europe, the United Kingdom, Japan, Canada, South Africa, and Taiwan.

CMBS delinquencies remained at record lows, boosting the popularity of CMBS with fixed-income investors. According to Realpoint, as of February 2007, the overall delinquency rate was 0.33% of bonds outstanding. The universe of CMBS offerings tracked by Realpoint equals $721.1 billion.

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through April 13, 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	65,700.0	22,300.0	88,000.0
Source: *Commercial Mortgage Alert*.			

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)	
	April 11, 2007
10-Year Treasury Bonds	4.76%
AAA	+69
AA	+85
A	+ 98
BBB	+189
BBB-	+229
BB	+290
B	+700
Source: Morgan Stanley; J.P Morgan.	

Private Debt 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
4-12-07	4.65%	1.26%	5.91%	4.74%	1.08%	5.82%
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 (March 29, 2007).