

## Real Estate Capital Markets Update – August 27, 2007

Volume 9, Number 8

**Editor's Note: Apologies to our readers for the length of time between issues of ULI's Real Estate Capital Markets Update. No excuses but...between one-on-one (many in the middle of the night) interviews, editorial and other responsibilities associated with the publication of the Asia/Pacific edition of Emerging Trends in Real Estate 2008 (in late September) as well as the planning of a multi-city Asian road show combined with similar responsibilities for the U.S. edition of Emerging Trends in Real Estate 2008 (one-on-one interviews, editorial support, and road show) further combined with trying to understand and comment on the current state of the global corporate and real estate capital markets together seem to have subsumed all other activities for the past two months. We are actively taking steps to improve the "currency" of our performance in the future.**

**So, this issue will be our catch-up, take to the beach or the mountains for the Labor Weekend, issue; future issues will focus on analysis of "current events".**

### **Special Comment: Debt Issue Tops Economists' Fear**

The National Association of Business Economics reported on August 27 that almost one-third of its survey respondent's listed debt-related problems are their top worry. Other issues of concern included: defense concerns and impact of a terrorist event (20%); sub-prime loan defaults (18%); excessive household or corporate debt (14%); and energy prices (13%).

**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." Source: Institutional Investor magazine, August 2007.

### **August 2007's Wall: Midsummer's Fright**

July 2007 can claim Dow 14,000 as its own, but the good times didn't last. The ride is getting bumpy: mortgage woes won't subside, and a spluttering U.S. economy is placing more of the growth burden on our trading partners on the other side of the big blue marble. The wall moves up to 12 [blocks] and seems to be rising. High on the list of things to fret about during your peaceful August are the myriad of esoteric financial instruments like leveraged loans, bridge loans and covenant-lite loans. Their demise might shake-up the markets a bit while offering some buying opportunities we haven't seen in a while.

Inflation: Dutiful Fed governors are feverishly turning over every rock and bramble to locate it. My guess is they'll find the mother lode when they stop to buy a cup of coffee.

U.S. Economy: Forget Goldilocks. This is a Sleeping Beauty economy. Just when it looks like it's all over, a bit of economic magic shows up (currently an inventory re-build), and she's back on her feet.

Hedge Funds: When the all-natural means of putting up stellar numbers falters, there are always performance enhancing products like sub-prime mortgages...until the day they cease to work and leave a blazing trail of synthetic catastrophe. Give Barry Bonds, Jose Canseco and Mark McGwire a call in about 10 years for a detailed explanation.

Ten-Year Treasury: Plenty of money is hunkering down in this flight-to-safety investment vehicle rather than jumping into the U.S. equity pool. C'mon in! The water's fine.

U.S. Mortgages: Right on cue, banks and other lenders tighten standards after writing mountains of disastrous loans—just when people need to borrow money most. Nothing like slamming the barn door shut after the horse is half a mile down the road.

Oil Prices: \$70+ per barrel is the new \$60+ per barrel and economies around the world are digesting it without a hiccup. Going to be interesting if \$80+ becomes the new norm.

Interest Rates: If the Fed raises rates, it'll put people out of their homes. A rate cut could send inflation spiraling upward. Solution: follow Congress's lead and take the month of August off.

Iran: Let's hope that as we get closer to the Iraq pullout, we don't move closer to an Iran push-in.

Housing Prices: Listing your house is scarier than waking up with a horse's head in your bed. But the house may be harder to get rid of.

Carry Trade: The Bank of Japan will be more closely watched by Wall Street than August's Annual PGA Championship golf tourney, as the central bank decides whether to raise interest rates from wonderfully accommodative yen-crippling levels.

Consumer Spending: Feeling a pinch at the three Rs; retail, restaurants, and recreation. But low unemployment and a freshly minted minimum-wage increase should keep most of the registers ringing.

Liquidity: Shut down the supermarkets, the hypermarkets and the flea markets, but, for the financial system's sake, not the debt markets.

### **“What a (Little) Difference a Year Makes”**

Key Rates			
	August 27, 2007	Year Ago	Increase/Decrease
Prime Rate	8.25%	8.25%	0.00%
Federal Funds Rate	5.25%	5.25%	0.00%
3-Month Libor	5.51%	5.39%	+0.12%
3-Month Treasury Bills	4.56%	4.95%	-0.39%
10-Year Treasury Bonds	4.59%	4.80%	-0.21%
30-Year Treasury Bonds	4.86%	4.86%	0.00%

## **Special Comments: Notes from “The Punch Line...” published by Abraham Gulkowitz**

(Headlines and data in The Punch Line come from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and websites.)

Wall Street mis-priced risk for quite a while and now many are getting burned

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A range of factors have now combined to threaten the U.S. economy. Is the world economy at risk?

- Financial market turmoil, threatening not only specific sectors (eg, private equity deals and hedge funds) but also real economy effects in housing and international credit markets;
- Global inflationary pressures remain stubborn, led by record dollar oil prices and farm prices;
- A sharp drop in the value of the dollar that could both drive domestic inflation and undermine foreign investor confidence before significant benefits accrue from the long-term trade improvement; and
- Federal budget and balance-of-payment deficits that threaten the sustainability of fiscal policy and macro-economic stability.

Most ominously, an awkward patten of macro-economic dependence on consumption in the U.S. suggests that the chance recession has increased. Only growth in private domestic consumption ensured positive growth in real GDP for three successive quarters, from the third quarter 2006, through the first quarter of this year.

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How big a credit problem?...Those required to ascribe a market value to these securities are faced with what some describe as a version of the prisoner’s dilemma. Everybody would be better off if nobody traded, so that there would be no need to recognize lower prices. But if everybody is planning to sell, those who trade first will have an advantage.

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If globalization has weakened the hand of central banks, so has financial innovation. The growth of derivatives, for example, has made it harder for central banks to control the supply of money and credit. According to the International Bank for Settlements, the face value of outstanding derivative positions on over-the-counter markets is some \$400 trillion. These instruments give investors a claim on a large chunk of assets, with only a small downpayment. When asset prices rise, speculators can borrow against their increased wealth, helping to drive prices even higher.

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The unsold home inventory is now at its highest level since June 1992, but the pile up of excess units on the block for sale—that aren’t selling—has not risen this fast since June 1990, and it took a good year and one-half for the residential real estate market to work off the backlog and carve out a fundamental bottom. The unsold inventory in the condo market did improve in June to 9.2 months’ supply from 9.8 months in May, but this is still nosebleed territory—tied for the third highest on record, not to mention 18% above a year ago.

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A New Record for Real Estate: Global investment in real estate surged during the first half of 2007, led by building purchases in the U.S. Investment in the second half is expected to slow, but the year is still on track to hit a new record high.

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Mortgage Fallout – The Truth Hurts – Bond Risk Rises Worldwide with Fund Losses: The perceived risk of owning corporate bonds soared worldwide on concerns over losses at hedge funds. If Merrill Lynch manages to sell off its giant load of collateralized debt obligations (tied to two collapsing Bear Stearns hedge funds) that would mean Wall Street would finally have to face the real price of its shaky mortgage securities. And that discovery—which many expect would be painful—could trigger a very scary chain reaction.

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The question of Pricing Collateralized Debt Obligations-“If every [CDO] manager was forced to mark-to-market their sub-prime holdings, it would be—well, I can’t think of a strong enough word to describe what it would be,” an unnamed U.S. policymaker told the Financial Times.

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Credit Risk...A Warning: A Bank of France Governor noted: “Still, it is not clear today—in a world of abundant liquidity, low interest rates, and historically low spreads—that markets are correctly evaluating the risks linked to the explosion of derivatives and leveraged operations over the last five years...The risk of default somewhere in the chain of borrowers is always possible, especially if the cost of liquidity rises...The evaluation of certain categories of risk may seem exaggeratedly optimistic since compressed spreads oblige investors in search of high returns to accept mediocre security...Banks should learn a preventive lesson from [the] rise of default risk seen in the U.S. sub-prime category.”

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Beware the carry-trade: Fed Board member Yellen also pointed to the global carry trade phenomenon, whereby low-yielding currencies are borrowed to buy higher yielding assets in other countries, as evidence of low risk premiums. But she warned some carry trades may be un-hedged and investors may not be fully appreciative of the potential for a reversal of currency markets.

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RealtyTrac reported that the number of foreclosures filings in July 2007 was 93% greater than in July 2006 (179,599 versus 92,845)—the national foreclosure rate is now 1 per 693 households.

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CEO Business Confidence (as reported by the Conference Board):

2004				2005				2006				2007	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
73	70	63	61	62	55	50	56	57	50	44	50	53	45

...Expectations of CEOs for their own industry over the next six months dropped 13 points to the lowest level since the 4<sup>th</sup> quarter of 2000 and only 22% expected profits to increase.

### Public Real Estate Equity and Debt Capital Markets

The equity real estate investment trust (REIT) index continued to decline, falling 7.80% in July; on a year-to-date basis; REITs are down 13.23%:

Property Sector	Total Return		Dividend Yield
	July 2007	Year-to-Date	July 30, 2007
Industrial	-0.90%	-7.95%	3.90%
Office	-7.99%	-14.31%	4.39%
Office/Industrial	-11.86%	-19.87%	5.92%
Shopping Centers	-6.40%	-15.46%	4.47%
Regional Malls	-8.39%	-11.21%	4.11%
Freestanding Retail	-5.19%	-11.03%	5.73%
Multifamily	-10.34%	-15.07%	4.21%
Manufactured Homes	-10.93%	-14.36%	4.12%
Diversified	+4.02%	-10.03%	4.29%
Hospitality	-8.71%	-6.00%	5.11%
Healthcare	-10.18%	-21.74%	7.09%
Self-Storage	-9.49%	-26.46%	3.73%
Specialty	-7.44%	-1.31%	4.45%
<b>NAREIT Equity Index</b>	<b>-7.80%</b>	<b>-13.23%</b>	<b>4.56%</b>
Source: FTSE Group and National Association of Real Estate Investment Trusts.			

It would appear that REITs will remain out of fashion, regardless of real estate industry fundamentals, partially due to the “meltdown” in the debt capital markets; partially due to questions relating to REIT valuations based on earnings multiples and recent discussions of increases in capitalization rates; partially due to the combined perception as well as demonstrated potential for overbuilding in some markets and sectors; and partially due to the relatively greater attractiveness of other markets and sectors.

While the commercial mortgage-backed securities (CMBS) market set issuance records across the board during the first six months of 2007, it is anyone’s guess when liquidity will return to the market during the balance of 2007. Sources we have spoken to are all over the lot, ranging from “everyone will get serious after Labor Day or the end of the U.S. (tennis) Open” to “don’t expect much to happen for a few months”.

During the first half of 2007, issuance equaled approximately \$137 billion, an increase of 54% from the approximately \$89 billion issued during the comparable period in 2006. Non-U.S. issuance also grew substantially during the first six months of 2007, increasing 75% to approximately \$55 billion from 2006’s approximately \$31.5 billion.

Delinquencies remain “benign”. According to Realpoint, delinquencies measured \$2.27 billion as of June 30<sup>th</sup>, or 0.28% of the approximately \$800 billion in CMBS which the company tracks.

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through June 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	136,991.2	54,990.7	191,981.9

Source: *Commercial Mortgage Alert*.

Commercial Mortgage-Backed Securities Trading Spreads To U.S. Treasury Bonds (in Basis Points)		
Rating	Term	Spread
AAA	5 years	+143 basis points
AAA	10 years	+143 basis points
AA	10 years	+205 basis points
A	10 years	+250 basis points
BBB	10 years	+395 basis points
BBB-	10 years	+470 basis points
BB	10 years	+465 basis points
B	10 years	+850 basis points

### Private Real Estate Equity and Debt (Mortgage) Capital Markets

The National Council of Real Estate Investment Fiduciaries (NCREIF) recently released its “Snapshot” of the performance of its Property Index for the 2<sup>nd</sup> quarter 2007 as a well as on a trailing 12-month basis (from July 1, 2006 through June 30, 2007). The NCREIF Property Index is comprised of 5,563 properties having an estimated market value of approximately \$280 billion.

The following chart summarizes the indices returns for the quarters ending March 31 and June 30 as well as on a trailing 12-month basis.

		2 <sup>nd</sup> Quarter 2007	1 <sup>st</sup> Quarter 2007	Trailing 12- months
Total Index	Total	4.59%	3.62%	17.3%
	Income	1.38%	1.40%	5.9%
	Appreciation	3.21%	2.22%	10.9%
Multifamily	Total	3.26%	2.87%	13.3%
	Income	1.16%	1.18%	5.0%
	Appreciation	2.10%	1.69%	8.0%
Industrial	Total	5.14%	3.22%	16.9%
	Income	1.56%	1.55%	6.4%
	Appreciation	3.59%	1.67%	10.0%
Office	Total	5.93%	4.60%	22.1%
	Income	1.40%	1.43%	6.0%
	Appreciation	4.53%	3.17%	15.3%
Retail	Total	3.42%	3.14%	13.6%
	Income	1.39%	1.46%	6.0%
	Appreciation	20.3%	1.69%	7.2%

All-in-all, pretty heady numbers with trailing 12-month overall returns of 17.3% comprised of 5.9% income and 10.9% appreciation in value.

And just as “heady” as the NCREIF returns is Real Capital Analytics report on property sales which reported sales volume for core property types increasing 80% to over \$230 billion during the first half of 2007.

What these returns and volume statistics will look like at the end of the third and fourth quarters is anyone’s guess as it is hard to predict the level of impact of the current dearth of debt capital on the transaction markets and property pricing. Further, if the credit crises widens and deepens, in turn leading to an overall economic slowdown...

Risk premiums continued to narrow during the second quarter 2007 as real estate investors’ expected (or maybe it’s required) rates of return continued to decline. The following table tracks investor’s required yield spreads (i.e., risk premiums) as reported by Real Estate Research Corporation in its most recent quarterly survey of institutional investors and capital sources:

	2Q 2007	1Q 2007	2Q 2006	2Q 2005	2Q 2004	2Q 2003
Real Estate Yield	8.3%	8.4%	9.1%	9.4%	10.3%	11.0%
10-Year Treasuries	4.8%	4.7%	5.0%	4.3%	4.4%	3.7%
Yield Spread	3.5%	3.7%	4.1%	5.1%	5.9%	7.3%

Source: Real Estate Research Corporation.

And while we are on the subject of declines in rates of return, Real Estate Research Corporation’s second quarter survey showed the continued decrease in initial capitalization rates we have come to expect, as follows:

	CBD Office	Suburban Office	Warehouse	R&D	Flex	Regional Mall	Neighborhood Center	Power Center	Multifamily
1Q07	6.5%	7.0%	6.7%	7.4%	7.3%	6.7%	6.6%	6.7%	5.9%
2Q07	6.0%	6.8%	6.6%	7.1%	7.1%	6.7%	6.6%	6.7%	5.7%
	-0.5%	-0.2%	-.01%	-.03%	-.02%	---	---	---	-0.2%

We suspect that when we next report the results of these surveys for the third quarter 2007 we are going to see a re-pricing of risk, either in terms of required initial capitalization rate, or spread above Treasuries, or both. Based on the current standstill in the corporate and real estate capital markets, change is in the wind.

While the recent and continuing turmoil in the corporate and real estate capital markets, including the CMBS market which is suffering through a major back-up in transactions, has made it easier for life insurance companies to compete for mortgage loans, our conversations with persons active in the public and private mortgage markets indicate, regardless of source, an overall tightening of underwriting standards including lower loan-to-value ratios, higher debt service coverage ratios, “re-covenanting” of loans, interest-only periods not to exceed two years, projections based upon current market indicators, etc., all combined with a widening of spreads on the order of 175 to 225 basis points over 10-year Treasury bonds. Fortunately for the real estate industry, the 10-year bond has been more than cooperative, closing recently at 4.59%.