

Real Estate Capital Markets Update – October 5, 2007

Volume 9, Number 9

Special Comment: Federal Reserve Board (FRB) Lowers Federal Funds Rate and Discount Rate 50 Basis Points Respectively

Here's an example of how fast sentiment changes. On June 28th we wrote the following comment (note the final paragraph) regarding the FRB's decision to leave interest rates unchanged (at 5.25% for the Federal Funds rate and 6.25% for the Discount Rate).

“The Federal Reserve Board kept the Federal Funds Rate at 5.25%, expressing a positive view toward lower inflation and economic growth.

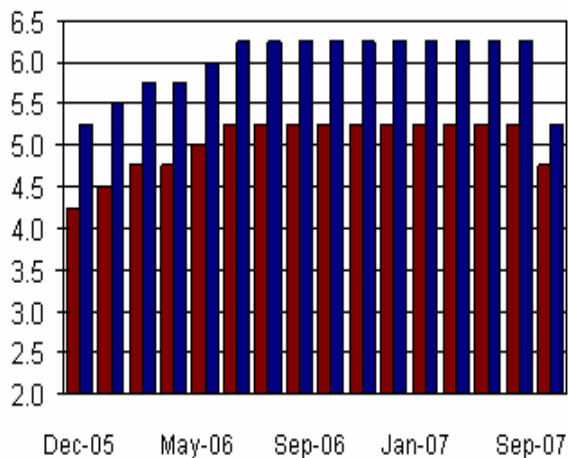
Inflation appears a principal concern as expressed in its statement where the Federal Open Market Committee noted that its greatest concern was that inflation would not moderate as expected.

There appears near universal agreement that rates will remain unchanged through the summer and possibly through yearend.”

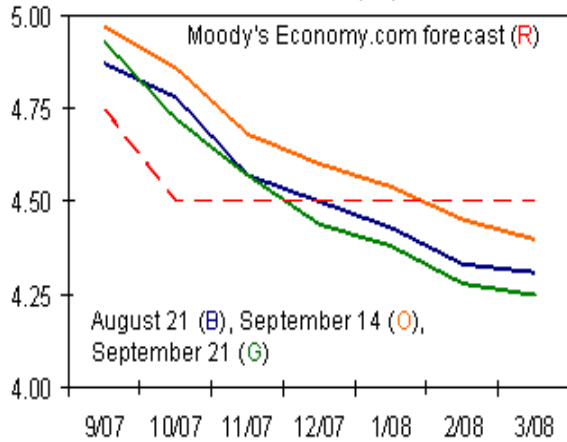
Not exactly. With the clarity of hindsight, we—and seemingly everyone else—missed any number of clues that more stressful times were ahead for everybody in the housing industry including owners, builders, and lenders and the FRB, in response, would lower interest rates (which they did on September 18th).

The Federal Open Market Committee, in its statement accompanying the rate decrease, noted that while inflation remained a primary concern, tighter credit market conditions were weighing on the economy in general, and the housing markets directly, and they needed to take some positive action to “calm” the markets.

Fed Funds Target Rate (R) and Discount Rate (B)



**Markets Believe Fed Still Has More Work to Do
Federal funds futures contracts, %, Source: CBOT**

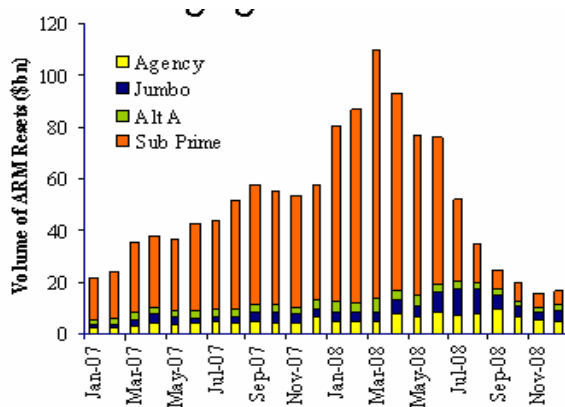


Not to be caught short this time, trading in the Federal Funds Rate futures market indicates a roughly 40% chance of an additional rate cut by Halloween (the FRB meets on October 31) and a 30% chance of another 25 basis point decrease by December 2007, thereby bringing the Federal Funds Rate at yearend 2007 to 4.25%.

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.)

A very Worrisome Picture: Single Family Mortgage Payment Re-Set Schedule



Credit Concerns – Reality Programming

- The unpalatable truth is that almost every bubble has been accompanied by a belief that innovation has changed the rules.
- Standard & Poor’s butchered the ratings of \$3.2 billion in debt from structured investment vehicles spawned by Solent Capital Partners LLP in London and

Avendis Group in Geneva. About \$254 million was slashed from the top triple-A grade to triple-C+ and triple-C, slices of 16 and 17 levels, triggered by their investment in [presumably sub-prime single family] mortgage-backed securities.

- Too late...Moody's Investors Services said on August 16 that it had downgraded 691 mortgage-backed securities because of "dramatically poor overall performance". These residential mortgage securities were originated in 2006 and backed by closed end second lien home loans, Moody's said. The downgraded securities had an original face value to \$19.4 billion, representing 74% of the dollar volume of securities rated by Moody's in 2006 that were backed by sub-prime closed end second lien loans..."The actions reflect the extremely poor performance of closed end second lien loans in 2006," Moody's said. "These loans are defaulting at a rate dramatically higher than original expectations."

Fat Tails: Easy Money was the Culprit! How Can it be the Solution?

- The \$300 billion elephant in the room....As banks return from summer mode, a big [and continuing] question [was and still] is whether they will find buyers for their huge leveraged loan commitments.
- Can a still more serious downturn be avoided? Together with financial market developments, one soon will have to worry about higher default rates. Moody's most recent default report, released in September, highlighted that the agency continues to become more negative on default rates, their forecast for the speculative default rate in August 2008 shifting upward to 4.1%. Moody's also specifically mentions diminished liquidity as one of the factors putting distressed issuers at increased risk of default.

Weary Households

- Top 5 States for [Single Family] Foreclosures in August, 2007
 - Nevada—1 in 165 homes
 - California—1 in 224 homes
 - Florida—1 in 224 homes
 - Georgia—1 in 271 homes
 - Ohio—1 in 281 homes

The DNA of Business

CEO Economic Outlook Index	
Period	Outlook Index
2007 Q3	77.4
2007 Q2	81.9
2007 Q1	84.9

Credit Concerns – Reality Programming

- Federal Reserve Governor Randall Kroszner: A crises in credit markets, triggered by a jump in delinquencies among adjustable rate sub-prime mortgages, shows that some investors failed to exercise adequate due diligence about the securities they were buying, the Fed governor said.
- Still, having a banking parent in the U.S. comes with benefits, especially in a credit crunch. Retail deposits give banks a source of cheap funding whereas Wall Street firms typically rely completely on borrowed money, which is more expensive and can dry up in a crises. Nor do brokerage houses have a lender of last resort, the role the Federal Reserve plays for banks. Bank accounting rules for loans are also more flexible. Banks have the option of holding them at their original value. Investment banks must mark their holdings to the market value daily. This isn't a problems as long as they can repackage them and sell them to other investors quickly. With that business at a standstill, investment banks are stuck with billion of dollars of commitments that, in many instances, are worth less than face value.

Real Estate and Construction Outlook

- Fitch Sees Rising Shakiness in Commercial Mortgage Arena: In a recent report, Fitch Ratings said the fervid lending conditions from 2005 to early this year allowed landlords and real estate developers to load up on interest-only loans and loans with high loan-to-value ratios that were underwritten with expectations for rent increases that appear “unrealistic”. While commercial rents are rising at the fastest level in many years—especially in some of the strongest commercial markets, including New York and Washington—Fitch said owners have “overly optimistic expectations of future rental rates, sales growth and market growth.”
- Commentary surrounding U.S. commercial property activity has turned more cautious during recent management presentations. U.S. commercial real estate prices may fall as much as 15% over the next year in the broadest decline since the 2001 recession as rising borrowing costs force property owners to accept less or postpone sales. Investors in July [2007] bought the fewest commercial properties since August 2006 and apartment acquisitions were down 50% from June data compiled by industry consultants Real Capital Analytics Inc. show. “People aren't doing deals right now” said Howard Michaels, the Chairman of Carlton Advisory Services Inc.,...”The expectation is that prices will come down.”

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."

As of September 17, 2007:

"It was darkness at noon in mid-August until the equity markets found some light in the form of massive cash injections for the world's central banks. Still, Tough Love Ben Bernanke has sent a message that the salad days of yesteryear (1987 – 2006) are over and that financial pain will be evenly spread between Wall Street and Main Street. The wall adds a worry (to August's): the panic has passed, but longer-term concerns are rising. Keep an eye on auto sales. Then there's the checkered history of stocks in September and October. So we may just get another, bigger, buying opportunity, should rates be cut. Refresh your wish list, gird yourself for volatility and chant: "Don't fight the Fed."

Interest Rates: All bets, hopes, and prayers are on a 50 basis point cut in the Fed Funds rate sooner rather than later [which occurred].

Consumer Spending: Black or blue? With the critical Christmas season coming, now is the time for all good men and women to come to the aid of the economy—and keep on buying.

Mergers & Acquisitions: MDEs (market disrupting events) that close the CDO, CLO, and ABCP playgrounds are not a LOL situation.

Unemployment: For now, it's just the mortgage industry taking it on the chin. For now.

Inflation: How can things get more expensive when banks have tightened credit and the economy is slowing? Wikipedia the 1970s for the definition of stagflation.

Oil Prices: Up is still bad and down is still good—unless they drop to far down, potentially signaling a recession. This is going to get more confusing, not less.

Housing Prices: The time draws near when people will be bragging about how much their home used to be worth, much the way they once boasted of the erstwhile value of their bubble-market stock portfolios.

China: Sure was sweet interrupting the halcyon nanoseconds of my August vacation to rip potentially lethal toys out of the hands of my children.

U.S. Mortgagee: Sharing. The American way. Turns out we've been packaging and selling the nastiest of our mortgages to many of our worldwide financial buddies. As if we weren't popular enough already.

Liquidity: Cash is not only King; it's Emperor, Czar, Premier, Dalai Lama, and Grand Poobah. All hail Mr. Buffet and his \$50 billion cash hoard.

U.S. Economy: Sublimely walking between the raindrops. The current housing downturn will be the acid test of whether a recession is in the offing in 2008.

Hedge Funds: While everyone waits for the big one, the likelihood is that a bunch of smaller firms will fail, leaving a multi-billion dollar tale of woe but perhaps not the anticipated value

Carry Trade: Now you see it, now you don't; now you see it, now you don't; now you see it, now you don't.

Private Real Estate Equity

The data is in and it's not encouraging. According to a recent report from Real Capital Analytics, the pace of sales has weakened measurably with indications that September "will be one of the slowest months in years."

The following chart says it all:

Property Type	August 2007 Sales (in \$ billions)	Average Per Month Sales for Period January 2007 to July 2007
Office	\$13.1	\$22.5
Multifamily	\$5.1	\$6.4
Retail	\$3.4	\$6.9
Industrial	\$2.8	\$4.7

Why you wonder? A substantial amount of the fall-off in sales is attributable to the combination of the significantly higher cost of commercial real estate mortgages whose cost has increased by as much as 125 basis points in recent months and the application of more stringent underwriting standards including lower loan-to-values and higher debts service coverage ratios. Expected decline in pricing of commercial real estate. Most probable number on everyone's lips seems to be a "hopeful" 10% to a "maybe" 15%.

And as if that wasn't enough bad news, "broken deal" volume has increased. According to an analysis published by Citigroup Global Markets' Real Estate Research Group, the volume of busted deals on a trailing 12-month (TTM) basis increased to \$10.8 billion in September, more than twice the levels of earlier in 2007. [On a trailing 12-month basis, the January through June period averaged less than \$6 billion, July's number was slightly above \$6 billion, and August's was slightly over \$8 billion.]

Caution—Attitudinal Change Occurring

According to the Summer 2007 survey of institutional investor attitudes and opinions by Real Estate Research Corporation (RERC), things are starting to change. While it still is too early to see much of a difference in capitalization rates as precious little time has elapsed between the start of the current capital markets crises and today, anecdotal evidence—deals re-traded, deals not closing, and deals withdrawn from the market

clearly shows that things are changing and attitudes are shifting. See the following three charts from RERC's Summer 2007 Survey:

	2Q2007	1Q2007
Availability of Capital	8.2	8.7
Discipline of Capital	5.2	4.7
Scale: 1 (lowest) to 10 (highest).		

Our take: a little less capital and a little less unruly mob investing it. This trend will continue—for some time.

	2Q2007	1Q2007
Buy	4.0	4.7
Sell	7.9	7.3
Hold	6.3	6.1
Scale: 1 (lowest) to 10 (highest).		

Our take: a little less enthusiasm on the buy side, a realization by some that a top was near or occurring, and an increase in those caught like deer in the headlights.

	3Q2007	2Q2007	3Q2006	3Q2005	3Q2004	3Q2003
Real Estate Yield	8.1%	8.1%	8.9%	8.9%	10.1%	10.6%
10-Year Treasuries	4.8%	4.8%	5.0%	4.3%	4.4%	4.1%
Spread	3.3%	3.3%	3.9%	4.6%	5.7%	6.5%
Source: Real Estate Research Corporation.						

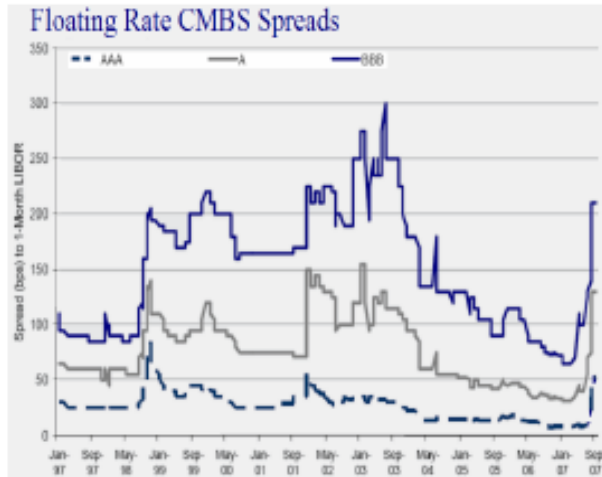
Our take: we've entered the transition period; required rates of return (as measured by internal rates of return) will be seen as "firming", i.e., no longer declining. By the end of the year, investors should clearly be requiring more bang for their buck.

	2Q2007	3Q2007	Increase/Decrease
All Property	6.47%	6.51%	+0.04%
Office-CBD	6.0%	6.0%	0.00%
Office-Suburban	6.6%	6.5%	-0.10%
Industrial-Warehouse	6.4%	6.3%	-0.10%
Industrial-R & D	7.0%	6.8%	-0.20%
Industrial-Flex	7.0%	6.9%	-0.10%
Regional Malls	6.6%	6.6%	0.00%
Neighborhood Centers	6.5%	6.5%	0.00%
Power Centers	6.5%	6.5%	0.00%
Multifamily	5.7%	5.8%	+0.10%
Source: Real Estate Research Corporation.			

Our take: a little change—at the margins; wait for the fourth quarter data and watch for anecdotal evidence of changes in cap rates.

Conventional and Securitized Mortgages

You tell me spreads have widened and that’s why the cost of a conduit mortgage has gone through the roof; well...show me. The following chart details changes in spreads over 1-month LIBOR for floating rate triple-A, single-A, and triple-B commercial mortgage-backed securities during the period January 1997 to September 2007—not a pretty picture and ample evidence of how wide spreads have become. It does not take much imagination to translate these spreads into the increased cost of securitized mortgages in the table which follows the chart.



Anecdotal evidence: The following summarizes conversations we have had in the past few weeks with a wide array of conventional and securitized lending sources:

Mortgage Source	Spread over 10-Year Treasuries at June 30	Spread over 10-Year Treasuries at September 30
Securitized	+125 – 150	+175 – 225
Conventional	+105 - 125	+175 – 200

The following survey was published in the October 1st issue of “Real Estate Finance and Investment”:

Senior Mortgage Matrix (as of September 26, 2007) 5 to 10 Year, Fixed-Rate Mortgages		
Property Type	<65% Loan-to-Value	>65% Loan-to-Value
Multifamily	165 – 185	190 – 200
Regional Malls	165 – 185	190 – 200
Strip and Power Centers	170 – 190	190 – 205
Multi-Tenant Industrial	180 – 195	200 – 210
Office-CBD	170 – 190	195 – 205
Office-Suburban	180 -200	205 - 215

Source: Cushman & Wakefield Sonnenblick-Goldman, LLC