

## Real Estate Capital Markets Update – February 20, 2007

Volume 9, Number 1

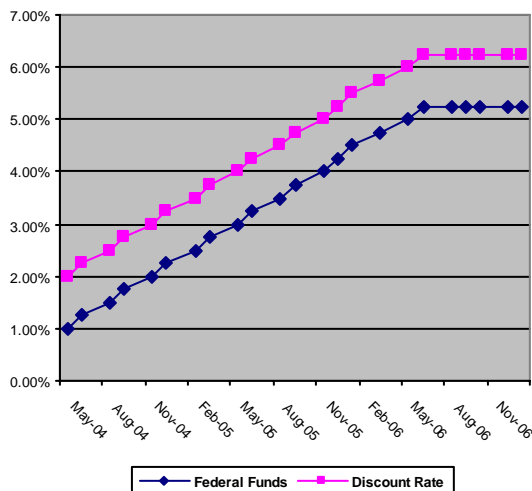
Welcome to the 9<sup>th</sup> year of ULI's Real Estate Capital Markets Update. With the introduction of ULI's Blog, "The Ground Floor", which is available at [www.thegroundfloor.typepad.com](http://www.thegroundfloor.typepad.com), distribution of the results of extensive surveys of ULI members regarding "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)

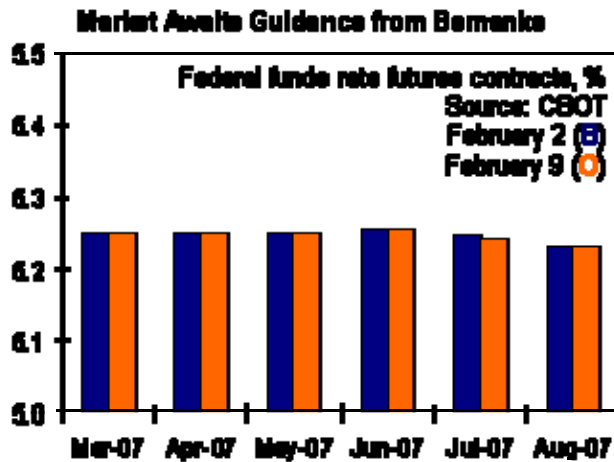
### Special Comment: Federal Reserve Board—No Change in Rates

For the fifth meeting in a row, the Federal Reserve Board voted to leave the Federal Funds Rate and the Discount Rate unchanged at 5.25% and 6.25%, respectively. With gross domestic product projected to grow at a rate of approximately 2.4% and housing the primary drag (at this moment) on the economy, an article in *The Washington Post* noted: "Several analysts said that despite these lingering soft spots, the Fed appears to have achieved the Holy Grail of central banking—a 'soft landing' in which it raised interest rates last year just enough to cool price pressures without triggering a recession".



Trading in the Federal Funds Futures markets indicates more than a 90% probability that the Federal Reserve Board will not change its target Federal Funds Rate at its March 20-21, 2007 meeting; there appears about a 30% probability of a 25 basis point (0.25%) rate cut by the

October meeting. Consensus of analysts recently surveyed—no change in policy for an extended period of time.



**Special Comment: Federal Reserve Board Beige Book**

The Federal Reserve Board’s (FRB) Beige Book economic survey released January 17 appeared “cooler” than the prior survey released at the end of November 2006. Highlights of the survey which expressed little concern about price or wage inflation included the following:

- Retail sales described as “moderately increasing”;
- Tourism spending remained strong;
- Mixed manufacturing activity combined with some slowing reported in the demand for services;
- While housing inventories remain high, some “glimmers” of light were noted as incentives are still being used to promote sales;
- Lending activity was reported as mixed (see Special Comment which follows);
- Single family mortgage delinquencies were noted as rising in certain markets;
- Labor markets continue to tighten; and
- Price increases remain controlled.

**Special Comment: Federal Reserve Board Senior Loan Officer Opinion Survey**

In the Federal Reserve Board’s most recent Senior Loan Officer Survey, the Federal Reserve noted that banks are reporting weakening demand for most types of loans. Further, respondents noted that they anticipated a decline in the [credit] quality of their loans to businesses, whether for commercial real estate or other purposes during 2007.

	Key Rates		
	February 16, 2007	Year Ago	Increase/Decrease
Prime Rate	8.25%	7.50%	+0.75%
Federal Funds Rate	5.25%	4.50%	+.075%
3-Month Libor	5.36%	4.82%	+0.54%
3-Month Treasury Bills	5.16%	4.60%	+0.56%
10-Year Treasury Bonds	4.69%	4.59%	+0.10%
30-Year Treasury Bonds	4.79%	4.54%	+0.25%

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

### “Risk Awakening...”

“News that Ownit Mortgage Solutions, a sub-prime lender, had closed its door on Tuesday evening began to swirl through the markets early Thursday and by the end of the day another sub-prime lender had done the same. While these lenders are very small (Ownit represents only about 1% of the sub-prime business), market sources were worrying about risk for the first time in many, many years”.

### “Key Risks Include...”

“U.S. Housing developments, a move to tighter lending standards, concerns of weaker overseas growth, numerous geopolitical factors...”.

“While the Federal Reserve Board has maintained its inflation concerns and the implicit ‘bias’ toward further firming, the Open Market Committee changed its description (in December) of the state of the economy, elevating the possible economic negatives”.

### “CEO Economic Outlook Index”

“New CEO survey predicts slower growth for first half of 2007; more than half of CEOs say health care is greatest cost pressure.”

Survey Date	CEO Economic Outlook Index
4Q2006	89.9
3Q2006	82.4
1Q2006	98.6
4Q2005	102.2
3Q2005	101.4
2Q2005	95.9
1Q2005	94.3
4Q2004	104.4

Source: Quarterly Business Roundtable CEO Survey.

### “Fed’s Bies Urges Banks to better Manage Their Risky Mortgages...”

Federal Reserve Governor Susan Bies urged U.S. banks to strengthen their mortgage underwriting standards to ensure borrowers increasingly relying on non-traditional loans are shielded against default if the housing market declines. ‘Supervisors are concerned that current risk management practices may not fully address the entire set of risks inherent in non-traditional mortgages—risks that could be heightened by current market conditions,’ Bies

said...Bies, the central bank's lead voice on regulation and bank supervision issues, also pressed banks to improve their disclosure of loan risks to borrowers for non-traditional mortgage products such as interest-only loans. Regulators and economists are concerned about the housing market slump, its impact on the economy, increases in mortgage delinquencies and foreclosure rates, and a growing reliance among borrowers on risky mortgages. Regulators are especially worried about borrowers with adjustable-rate mortgages facing 'payment shock' when the interest rate on their mortgages escalate, resulting in much higher monthly payments."

[Editor's Note: Would we be wrong to ask where these bozos were when these loans were being given out to unqualified borrowers over the past three years?]

### **Public Real Estate Securities Capital Markets**

Raise the flag and declare victory; real estate investment trust (REIT) share performance has reached analysts 2007 entire year consensus forecast of +10% in just one month.

Coming on the heels of 2006's 35.1% performance, January 2007's +8.42% increase in the FTSE/NAREIT Index is...well breathtaking. Cause and effect do not matter anymore as no rational explanation exists for such dazzling numbers. The only irrational explanation we can see is a case of merger mania fuelled by the prospects of a rash of food fights and topping bids similar to the recently ended Blackstone-Vornado quest for Equity Office Properties. As we write, we note that Simon Properties, in joint venture with a hedge fund (which had previously accumulated a large position in Mills) has recently submitted a winning topping bid (to Brookfield Properties') for Mills. One should note that contested takeovers are a new phenomenon in REIT land where gentlemen had been gentlemen. What or who is next is anyone's guess. One thing Equity Office taught us and the entire market is that size is not a barrier as the Equity Office-Blackstone transaction is, for the moment, the largest buyout in history. One wonders if there is any public company (or developing nation) that is too big to be privatized.

What is just as astounding is that the REIT index's average dividend is now 3.4%, approximately 130 basis points below—repeat—below the yield on 10-year Treasury bonds.

The following chart details the performance of the REIT industry by property sector for the month of January 2007 and on a year-to-date basis and includes annual dividend yields as of January 31<sup>st</sup>:

	January	Year-to-Date	Dividend Yield
Office	+9.85%	+ 9.85%	3.08%
Industrial	+5.42%	+ 5.42%	3.01%
Office/Industrial Mix	+6.41%	+ 6.41%	4.27%
Shopping Center	+8.22%	+ 8.22%	3.30%
Regional Mall	+13.44%	+13.44%	3.01%
Freestanding Retail	+3.42%	+3.42%	5.16%
Apartment	+9.61%	+9.61%	3.13%
Manufactured Home	+1.30%	+1.30%	3.12%
Diversified	+2.12%	+2.12%	3.67%
Lodging/Resort	+5.49%	+5.49%	4.14%
Healthcare	+9.33%	+9.33%	4.66%
Self-Storage	+10.66%	+10.66%	2.44%
Specialty	+3.44%	+3.44%	4.10%
<b>Average</b>	<b>+8.42%</b>	<b>+8.42%</b>	<b>3.40%</b>
<b>2006 Average</b>		<b>+35.06%</b>	<b>3.69%</b>
Source: FTSE Group and National Association of Real Estate Investment Trusts			

Public Securities and Real Estate Performance Indices as of February 18, 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	+2.4%	+2.6 %	+3.4 %	+3.9%	+10.6%	+16.6%*
* Trailing 12-months ended December 31, 2006.						

## Private Real Estate Equity Capital Market

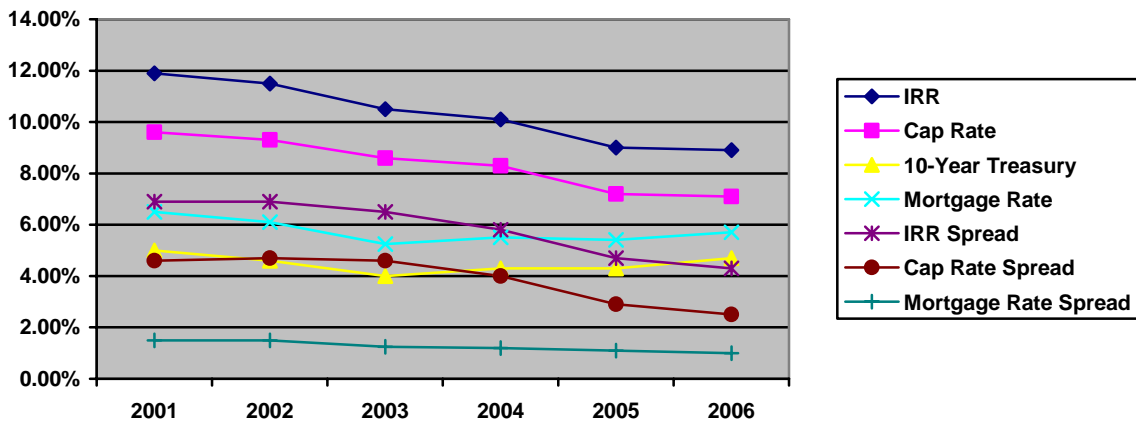
According to a recently released survey by the Association of Foreign Investors in Real Estate (AFIRE), foreign investors in U.S. real estate are expected to increase their investments in higher yielding, non-traditional investment strategies during 2007. Respondents reported that value-added real estate investments would make up 25% of their overall portfolios in 2007, an increase of 6% from 2006's 19% while 30% of survey participants noted that they would be exploring new strategies in 2007. Non-traditional strategies included: secondary and tertiary markets; infrastructure; senior housing; student housing; resort; and self-storage. Many readers will quickly note the similarities between foreign and domestic institutional investment strategies and the increasing convergence among institutional investor attitudes and strategies on a global basis.

AFIRE's members have approximately \$600 billion in global real estate investments of which almost one-third is located in the U.S. According to the survey, 64% of participants said that the U.S. provided the most stable and secure real estate investments, i.e., strongest economy and lowest geopolitical risk.

“An unsustainable trends will not last forever”. So said Herbert Stein, President Nixon's chief economic advisor. Risk premiums ended 2006 at their lowest levels in memory, confirming the “weight of capital” seeking entry into the various real estate sectors. The question on many people's minds is whether current rates of return (or premiums over “safe” rates such as U.S. Treasury bonds) are appropriate given the risks involved in owning and managing real

estate. Are we being compensated correctly? While we certainly are susceptible to the relative value argument wherein real estate's returns (historical and projected) are compared to alternative investments (historical and projected), we continue to wonder if declines in risk premiums of 300 basis points for internal rates of return and 250 basis points for capitalization rates, both in the face of literally no change in the safe rate (10-year bonds down 30 basis points), are really how it should be. It has been a great run, but it is hard not to think that all good things come to an end as we enter a period where the risks are certainly more weighted against us than in our favor.

The following chart, based upon historical survey data from Real Estate Research Corporation's quarterly survey of investor sentiment, helps to define the magnitude of change in risk premiums for a number of measures; as such it reflects the views of a wide array of institutional investors and money managers.

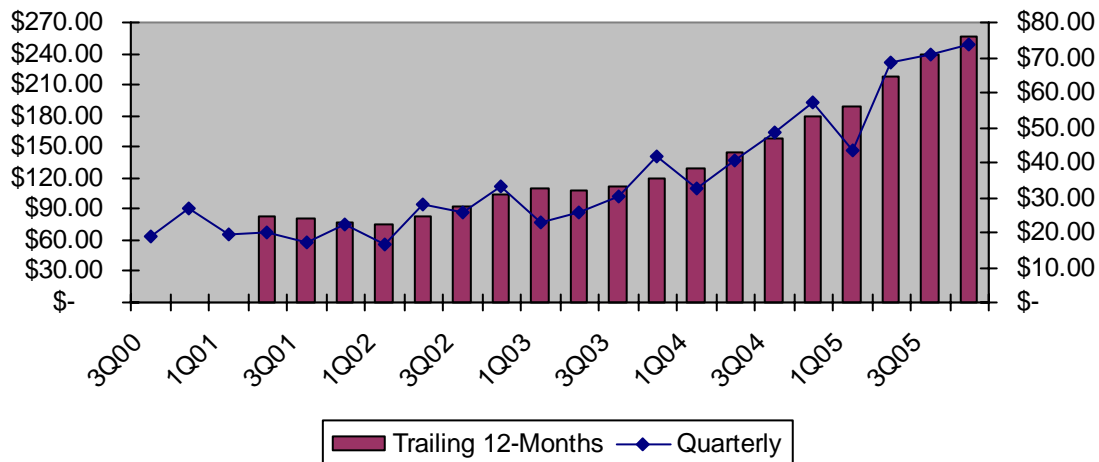


	12/31/2001	12/31/2006	Decrease
IRR	11.90%	8.90%	-3.00%
Cap Rate	9.60%	7.10%	-2.50%
10-Year Bond	5.00%	4.70%	-0.30%
Mortgage Rate	6.50%	5.70%	-0.80%
IRR Spread over 10-Year Bond	6.90%	4.30%	-2.60%
Cap Rate Spread over 10-Year Bond	4.60%	2.50%	-2.10%
Mortgage Spread over 10-Year Bond	1.50%	1.00%	-0.50%

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%
	<b>-0.1%</b>	<b>+0.2%</b>	<b>+0.03%</b>	<b>-0.03%</b>	<b>-0.01%</b>	<b>-0.2%</b>	<b>+0.2%</b>	<b>+0.2%</b>

Source: Real Estate Research Corp. ([www.rerc.com](http://www.rerc.com)).

### Sales of Office, Industrial, Retail, and Apartments (in \$ Billions)



Source: Real Capital Analytics Inc. ([www.realcapitalanalytics.com](http://www.realcapitalanalytics.com))

### Public Real Estate Debt Capital Markets

Issuance of Commercial Mortgage-Backed Securities January 1, 2000 through February 18, 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	12,300.0	2,300.0	14,500.0

Source: *Commercial Mortgage Alert*.

Commercial Mortgage-Backed Securities Trading Spreads above 10-Year Treasury Bonds (in Basis Points)	
February 18, 2007	
10-Year Treasury Bonds	4.69%
AAA	+73
AA	+82
A	+90
BBB	+120
BBB-	+140
BB	+280
B	+700

Source: Morgan Stanley; J.P Morgan.

### 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
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).