

## **Real Estate Capital Markets Update – May 5, 2008**

### **Volume 10, Number 8**

#### **Federal Reserve Board Cuts Federal Funds and Discount Rates 25 Basis Points (0.25%) Each**

Citing weakness throughout the U.S. economy and continued stress in the financial markets, the Federal Open Market Committee (FOMC) reduced both the Federal Funds Rate from 2.25% to 2.00% and the Discount Rate from 2.50% to 2.25%, bringing them to their lowest rates since late 2004. Major money center banks reduced the Prime Rate to 5.00% from 5.25%.

While noting higher inflation, the FOMC's statement stated that "economic activity was weak" and the business environment was "subdued"; additionally, weakness was noted in consumer spending and a deteriorating labor market. (The later conclusion is reinforced by Friday's -20,000 job number, the fourth monthly loss in jobs in a row).

Obviously, the FOMC stated that the financial markets remain under significant pressure and that the housing crises will continue to negatively impact the economy for a number of months.

Most analysts seem to think that this will be the next to last or last rate cut in this cycle. Moody's Economy.com stated that it "expects the FOMC to keep the Fed Funds Rate target at 2.00% through the summer and start raising rates toward the end of 2008 as the economy improves."

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#### **Federal Reserve Agrees to Accept Everything But the "Kitchen Sink" as Collateral at Term Auction**

Late last week the Fed announced that they will accept bonds backed by auto loans and credit cards at the Term Auction Facility window this week, and it will increase the amount of debt auctioned from \$50 billion to \$75 billion. While the Fed's actions to increase liquidity have begun to show signs of relief in the financial sector and investor confidence is rising, one wonders what it will accept for collateral next week.

#### **Federal Reserve Board Senior Loan Officer Opinion Survey**

The Federal Reserve Board this afternoon released its Senior Loan Officer Opinion Survey detailing...well...senior lending officer's opinions. No surprises—the credit crunch continues unabated under the weight of more stringent lending standards for all types of business and consumer loans. And as you would expect, demand for loans continues to weaken.

The following chart summarizes the results of the survey:

	Net % Domestic Banks Reporting
Tightening for large commercial and industrial borrowers	55.4%
Tightening for small commercial and industrial borrowers	51.8%
Stronger demand from large and medium commercial and industrial borrowers	0.0%
Stronger demand from small commercial and industrial borrowers	-16.1%
Tightening standards for mortgage loans to individuals	
-residential mortgages – Prime	62.3%
-residential mortgages – Sub-prime	77.7%
-residential mortgages – non-traditional	75.6%
Reporting stronger demand for mortgage loans to individuals	
-residential mortgages – Prime	-24.5%
-residential mortgages – Sub-prime	-29.7%
-residential mortgages – non-traditional	-66.6%

The next survey is scheduled to be released on August 13.

### **An Editorial Worth Reading—Actually, Only a Portion of an Editorial But Still Worth Reading**

The following was excerpted from an editorial by Geoffrey Dohrmann, Publisher and Editor-in-Chief, entitled “Break Out the Champagne” which appeared in the April 2008 issue of *The Institutional Real Estate Letter*, a publication of Institutional Real Estate, Inc. in which he noted that many commercial real estate market participants were “in the process of entering the second stage of denial”, which he called “NIMP (standing for “Not in My Portfolio”)”.

“There is absolutely no question, for example, that most if not all of the deals underwritten from 2004 to 2007 were underwritten with very aggressive rental growth assumptions. With the economy slowing, if not already in recession, that kind of rental rate growth just ain't gonna happen. And that means values under which those acquisitions were justified will not be accurate. In other words, write downs are a-commin'—at least for those assets.

Some holders of those assets—particularly those who acquired them with very high short-term leverage in place—may find themselves caught in a liquidity trap, with no option left but to sell those assets (or other assets) to raise cash.

This kind of selling always drives values down. As sold assets create comparables, other assets eventually get marked to the market.

The fact that it hasn't happened on a grand scale doesn't mean it isn't happening or won't start happening on a grand scale”.

**Indicated Spreads for Conventional Commercial Mortgages (as of April 17, 2008)**

	Commercial Mortgage Rate Spreads for 5-10 Year Fixed-Rate Mortgages	
Property Type	<65% LTV	>65% LTV
Multifamily	+230 – 260	+270 – 355
Regional Malls	+225	+250 – 350
Strip/Power Centers	+250 – 300	+250 – 450
Multi-Tenant Industrial	+250 – 300	+300 – 500
CBD Office	+250 – 300	+350 – 500
Suburban Office	+250 – 300	+350 – 500
Full-Service Hotel	+300 – 400	+350 – 500
Limited-Service Hotel	+300 – 400	+400 – 500
	5-Year Treasury – 2.68%; 10-Year Treasury – 3.47%	
Source: Cushman & Wakefield Sonnenblick-Goldman, LLC.		

**Spending on Commercial Property (in Europe) Drops**

According to a recent article on the *Financial Times* web site ([www.ft.com](http://www.ft.com)), the amount “being spent on commercial property in Europe dropped by more than a third in the first quarter of 2008 as continental markets caught up with the problems affecting the United Kingdom”.

According to the article:

- Lower levels of activity were reported across most of Europe with the UK less affected (as it was where the current slowdown began in late 2007); and
- The shortage of (conventional and securitized) debt has had a huge impact on both transaction volume as well as pricing.

**Special Comments: Notes from the “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 Nation in Crisis... Beer Prices on the Rise**

With a shortage of ingredients and higher fuel costs, the price of beer is quickly getting harder to swallow.

## **The Likelihood of Unlikely Events**

**The stimulus package in the US** will have a hard time overcoming the negative impact of rising food and energy prices and the overwhelmingly negative consumer sentiment. As a result, the market seems to be priced for too much of a v-shaped path for Fed funds over the next 12 months...

## **Turnaround Monitor!**

The slowing economy and credit crunch are damping dividend payments, particularly for financial stocks.

The number of companies cutting dividends is the highest since 1991, according to S & P. The Dow Industrials are down 3.1% so far this year.

**If the credit crunch really is close to ending**, as the Citigroup Inc. Chief Executive Officer says, then **why are so many offering below-market terms to rid of its billions in leveraged buyout loans?** Deutsche Bank AG and Royal Bank of Scotland Plc are also offering credit to buyers to help cut their holdings. While the deals helped shrink the global overhang to \$91 billion from \$230 billion, don't expect banks to open their doors to new borrowers anytime soon. That's because the arrangements shift one type of loan for another. Banks escaped about \$65 billion of LBO commitments in the past four months in part by lending money to private equity firms, in part by cancelling some deals. Wall Street is getting rid of the debt individually, in packages or placing it into structures such as collateralized loan obligations, which pool loans and slice them into pieces with various ratings to sell to investors. The rest of the inventory was reduced because acquisitions such as Blackstone's \$6.6 billion of Dallas-based credit card processor Alliance Data Systems Corp. were canceled, eliminating the bank commitments.

## **Realty Check!**

While the decline in the overhang in leverage finance adds to near term optimism in leveraged credit markets, we note most of the decline reflects the addition of financial leverage to create an equity like return, rather than the asset prices themselves falling to an economically attractive level.

## **You Can't Handle the Truth...**

**The blame game...** The "High & Low Finance" column in the NYT by Floyd Norris covers the increasing pressure in Washington, from regulators and legislators, on the rating agencies, which he says are "well on their way to becoming the scapegoat for this disaster, much as securities analysts took much of the blame for the technology stock bubble whose bursting led to the last recession. That the rating process was badly flawed is now clear. But so was much else." What else? Mortgage brokers, Wall Street,

regulators, and legislators, among others, but he claims that "little is being done about most of those sinners."

### **Tripping Covenants: Market Turbulence Boots Risk of Covenant Violations**

Moody's: The ripple effects of the subprime crisis are forcing issuers across the globe to grapple with an issue that was barely on their radar screens a year ago: **the threat of breaching a financial covenant in their loan agreements and not being able to easily obtain a waiver in this environment.**

### **Credit Concerns – Realty Programming**

Many smaller banks moved into unfamiliar markets or products during the boom. Now the slowing economy is exposing blunders, and regulators are bracing for a surge in bank failures.

In the early '90s, only 2% of companies with leveraged debt carried lower-C ratings, which imply greater risk of default. Today, that percentage is at 14%.

### **Real Estate and Construction Outlook**

**Trouble brewing at regional US banks...** Setting aside the 100 largest banks, the share of **commercial real estate loans** in bank loan portfolios nearly doubled over the past 10 years and is approaching 50 percent. The portfolio share at these banks of residential mortgage and other consumer loans, which are more readily securitized, fell by 20 percentage points over the same period.

### **Real Estate Concerns...Watch key issues for non-residential construction markets...**

- faltering domestic profits;
- fallout from residential collapse;
- tighter financing conditions;
- and rising industrial slack