

## Real Estate Capital Markets Update – May 31, 2008

### Volume 10, Number 10

#### Liquidity Update

Maybe...just maybe, things are starting to get to the point where they can really get to the point where they will be better and more debt capital will be available to the real estate industry. Recently, some small, immature, baby-like steps have been taken via a rally in the commercial mortgage-backed securities (CMBS) markets that is leading some to believe that the light at the end of the tunnel is not a train.

The recent rally in CMBS yield spreads has lowered the weighted average cost of capital and breakeven calculations to the point that conduits, if they can mobilize capital, i.e., get their parent company's to open up their warehouse lines again, could be getting near the point where they might be able to compete with portfolio lenders. Don't jump up and high-five the person next to just yet and don't start singing "happy days are here again" on your way home tonight.

Lots of road blocks remain to be overcome such as: the already mentioned need to re-capitalize the conduit lenders; the remaining "hung" inventory that needs to be "resolved"; the B-piece market needs to be re-established with either the historic buyers "re-awakening" and/or new players entering the market as liquidity for the lowest rated tranches is a must; and institutional investors need to end their "buyer's strike".

We remain clearly in two steps forward, one step back territory for now. More to follow as we hear of or observe changes in conditions.

**Cap Rates Up Moderately on Low Volumes (Transaction Volume Down Almost 80% Since Peak in Apr'07)** read the headline in a recent Citigroup real estate research report.

The report, which combined an analysis of recently released data from Real Capital Analytics with internally generated information, noted the following:

- Capitalization rate increases on a sector-by-sector basis since their most recent troughs:
  - CBD Office - +96 basis points since November 2007
  - Suburban office - +41 basis points since June 2007
  - Industrial - +53 basis points since August 2007
  - Retail - +56 basis points since April 2007
  - Multifamily - +18 basis points since April 2007
  
- Transaction volume is down significantly; April 2008's transaction volume was down 79% year-over-year and down 47% from March 2008's.

## Indicated Spreads for Conventional Commercial Mortgages (as of May 23, 2008)

According to the most recent survey of indicated spreads for conventional commercial mortgage loans by Cushman & Wakefield Sonnenblick Goldman, spreads remained generally unchanged. Borrowers in the market are benefitting from lower yields on benchmark Treasury bonds.

	Commercial Mortgage Rate Spreads for 5-10 Year Fixed-Rate Mortgages	
Property Type	<65% LTV	>65% LTV
Multifamily	+200 – 240	+250 – 300
Regional Malls	+225 – 250	+250 – 350
Strip/Power Centers	+250 – 300	+300 – 450
Multi-Tenant Industrial	+250 – 300	+300 – 500
CBD Office	+225 – 325	+300 – 450
Suburban Office	+250 – 350	+350 – 500
Full-Service Hotel	+300 – 400	+350 – 500
Limited-Service Hotel	+300 – 450	+400 – 500
	5-Year Treasury – 3.02%; 10-Year Treasury – 3.78%	
Source: Cushman & Wakefield Sonnenblick-Goldman, LLC.		

**Lloyd's Wall of Worry: It's the counterintuitive indicator: many worries, but; few worries, sell.**

### May 13, 2008: May Flowers?

Hope springs eternal now that April showered us with a much-needed rally. Whether we are in a recession or not, the market is treating the economy gingerly while looking ahead six to nine months for signs of recovery. The Wall gets a little less crowded as daily headline fears recede. Potential worries: The rebate checks are saved, not spent, and China's economic growth drops into single digits. Fingers crossed that oil prices drop, the dollar firms and credit starts flowing. Sounds like a lot to wish for, but stranger things have happened—and we could end up with a surprise summer rally.

Housing prices—worse comes to worst, we just require everyone to pull their houses off the market...forever...and never move...ever.

Inflation—The imminent minimum-wage hike will not help the situation.

Oil prices—Where's ol' Beverly Hillbilly Jed Clampett and his oil-sniffing, black-gold-prospecting, Texas-tea-locating savvy?

U.S. mortgages—The good news: we found the weapons of mass destruction. The bad news: they were in the U.S. all along.

European economies—Still drinking the “our economy is decoupled from the U.S. economy” Kool-Aid. Enjoy the sugar high while it lasts.

Stagflation—Why all the fretting? The recession will pull us out of this quagmire. Unless, as in the 1980s, it doesn't.

Credit crises—Marginally better, but the credit markets aren't going back to the good old days of 2003-2006 during my lifetime. I'm 43, so you do the math.

Interest rates—here's how it's supposed to work: Fed cuts rates—check. Yield curves steepens—check. Lending increase—no check.

Unemployment—The razor-slim silver lining of this mushroom cloud? The default servicing companies are hiring at breakneck speed.

U.S. dollar—The Group of Seven nations come out swinging in their battle to fight off the speculators and shore up the American buck.

Consumer spending—So much for living the dream. Now can we save the dream from bankruptcy?

U.S. economy—Dazed and confused and in need of some serious rehab.

Commodities—With the price of eggs, milk, flour, rice and everything organic basically doubling, I don't know whether to eat the food in the pantry or put it in the safe-deposit box.

**Special Comments: Notes from the May 16, 2008 issue of “The Punch Line...”, published by Abraham Gulkowitz**

*Headlines and data appearing in The Punch Line came from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and news websites.*

**No Sweat!?:** During the last several weeks, some better than expected earnings, a strong equity rebound, a perceived “safety net” or “firewall” provided by the Fed, huge fund raising by the financial sector, and strong technical support in the markets have combined to provide a necessary psychological lift and help drive debt and equity markets to the best levels in quite a while. Indeed, the severe downward momentum that appeared in place in the early months of the year appears to have moderated, with a long string of arguments that the worst is probably behind us, and, with a wink, there is some belief that the Fed really cannot stomach more surprises. Here, several reality checks deserve more attention, however. First, the slide in the household and business sectors has more to go. And more fundamentally, the support that both the consumer and business sectors received from “easy money” can just not be recreated, nor should it be. The obvious example is in the tragic state of the housing markets – and also becoming evident in the

auto industry. But also a consideration is what happened in business finance. Take just one example. There will be new rating criteria for all sorts of structured products. If so, consider CDOs. Given that the explosion in single tranche CDO issuance was an important driver in credit spread tightening during the credit boom in recent years, shouldn't this lessen the demand from what had been an important bid for credit risk? Another important point - there are now more signs that global growth is slowing. It is evident in India, in the UK, in Spain and will become even more evident over the next 12 months. Awkward developments in the commodity and currency markets should also not be ignored. These are always ripe for surprises. The number of distortions, exaggerations, or awkward configurations that have developed in the world economic and financial situation will take still more time to play out...

**Acute tightening...** In the April survey, domestic and foreign financial institutions reported having further tightened their lending standards and terms on a broad range of loan categories over the previous three months. The net fractions of domestic banks reporting tighter lending standards were close to, or above, historical highs for nearly all loan categories in the survey. One should view the report as further evidence that the recent credit squeeze in capital markets is feeding through to the non-financial sector, and **is likely to retrain economic activity over the coming quarters.**

**Federal Reserve Chairman Ben Bernanke** said Thursday that U.S. financial markets are riding out the recent financial market storm, amid ongoing concerns about liquidity and credit risk. Financial firms have been "hunkering down" as they try to replace losses with new capital, Bernanke said, taking questions from a Chicago Fed conference on banking. As a result, they're being conservative about new lending and also watching liquidity risk closely.

**Credit standards for small business loans suggest a worse environment than anything in recent past.** Large businesses always have more degrees of freedom. The conditions for smaller businesspeople seems to be more dire than in past recessions, underscoring a concern that a too much reliance on public company balance sheet strength misses the point of potentially weaker private company smaller business trends.

**Defaults Gather Pace:** The number of companies defaulting on junk rated debt and filing for bankruptcy in North America is running at its fastest rate in five years.

**Federal Reserve Chairman Ben Bernanke admitted** that the mortgage market is still struggling, while the overall economy remains vulnerable to housing market woes.

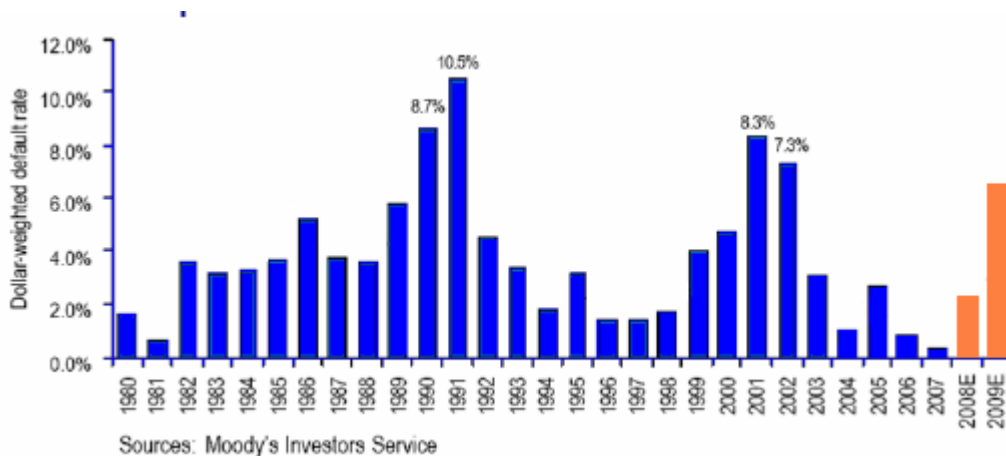
**...just because we haven't had any "nasty new surprises" in the economic news as of late, we're not out of the woods yet.** There are four key indicators to watch: housing, corporate profits, jobs, and pay. **Whether this is a recession may only be a question of semantics.**

**Fed Survey: Reduced tolerance for risk** Substantial majorities of domestic and foreign respondents pointed to a less favorable or more uncertain economic outlook and to a

worsening of industry-specific problems as reasons for tightening their lending standards and terms on C&I loans over the past three months. In addition, significant majorities of respondents cited their banks' reduced tolerance for risk and decreased liquidity in the secondary market for these loans.

**The Survey Says:** How harmful is the present credit crisis? A small majority—55 percent—of executives at the top 50 U.S. banks and credit card issuers say the crunch is a “manageable setback,” according to the recent survey, conducted by TowerGroup for Fair Isaac Corp. But a third of the participants portrayed the credit contraction as “systemic threat or a severe challenge to their institutions,” notes a press release from Fair Isaac. “No one doubts the seriousness of the current credit crisis, but it’s noteworthy that the largest financial institutions are more likely than others to characterize its impact as severe or worse.” Fifty-seven percent of the survey’s participants point to “increased credit delinquencies as their biggest challenge for the next two years,” it states.

**Credit Concerns – Reality Programming:** Corporate Default Rates



**Fault Lines – Too Many Wildcards:** The Federal Reserve's direct loans of cash to commercial banks climbed to the highest level on record in the past week, a sign of continued stress in financial markets that threatens to curtail credit for households and companies. **The increase indicates financial firms' emergency needs for cash haven't receded.** Funds provided through the so-called discount window for banks rose by \$2.8 billion to a daily average of \$14.4 billion in the week to May 14, the central bank said today in Washington.

**Real Estate and Construction Outlook:** Sales of U.S. offices, shopping centers and other commercial properties dropped by almost half in the first quarter as pension funds refused to lower asking prices to complete transactions, a real estate index showed. The volume of completed transactions in the first quarter fell 47 percent from the previous quarter, according to an index produced by the Massachusetts Institute of Technology Center for Real Estate. Prices for completed deals rose 2.1 percent, ending two quarters of declines. Property owners raised asking prices and investors dropped their offer prices, creating the widest gap between buyers and sellers since 1991, the center said. The

supply and demand sides of the market are ``diverging from each other," Henry Pollakowski, co-director of the center's Commercial Real Estate Data Laboratory, said in an interview.

**Real estate Concerns...**Tightening credit availability, which started in the residential mortgage market and spread to commercial real estate, has slashed sales of office buildings, retail properties and other commercial real estate.