Presentation to: ULI 2007 South Florida Economic & Development Outlook Conference

Real Estate Industry and Capital Markets Trends

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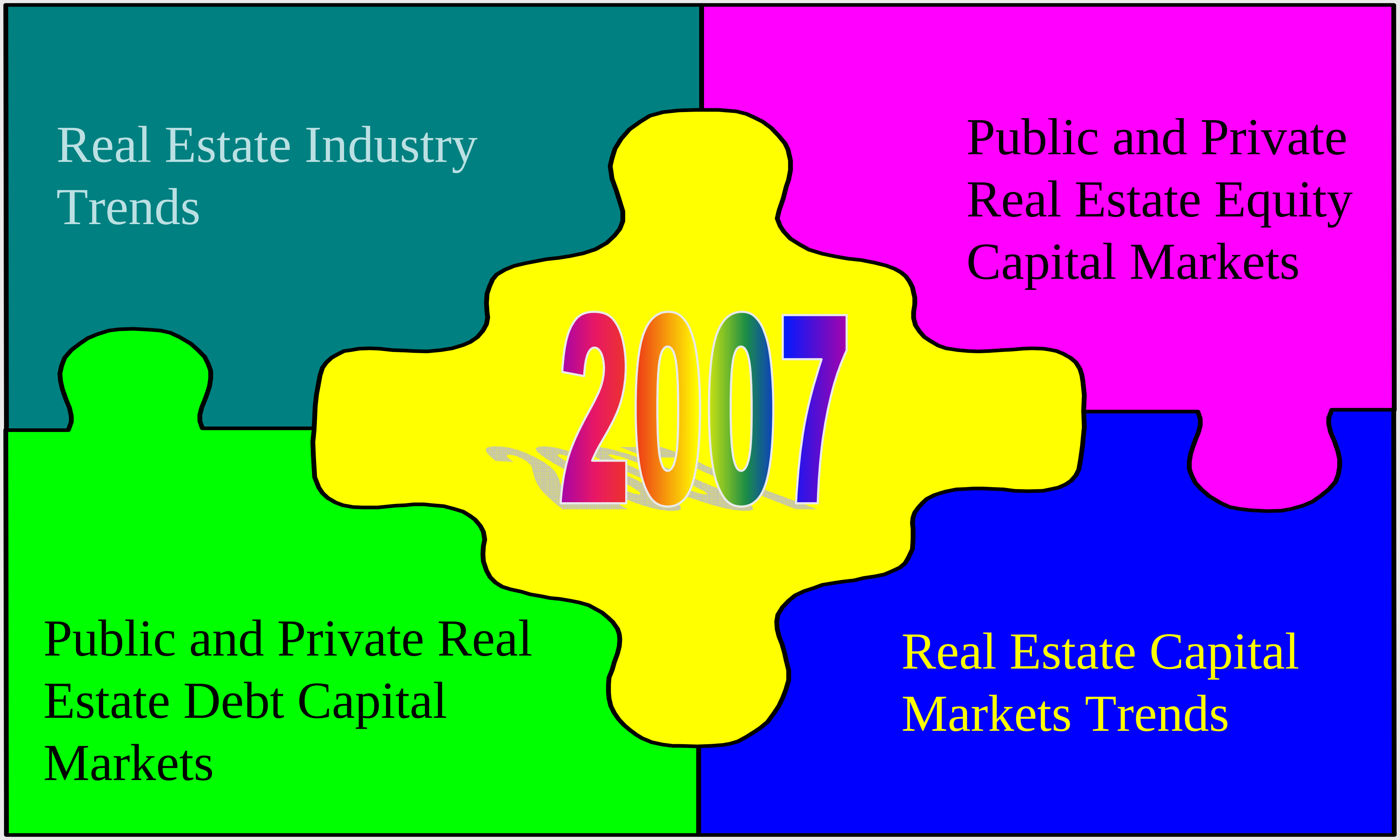
Agenda: Real Estate Industry and Real Estate Capital Markets Trends




THE SPHINX SPEAKS
You can't please everyone, so you've gotta please yourself.
Real estate is the best hedge against inflation.
Twenty minutes of an aerobic activity three times a week is all you need.
R. Chast

Why Study Real Estate Industry and Capital Markets Trends?

- "If you come to a fork in the road, take it."

  Yogi Berra

- "Successful investing [involves] anticipating the anticipations of others"

  John Maynard Keynes

- "The view never changes unless you're the lead dog."

  Anon

Viewing the Future Requires a 21st Century Vocabulary

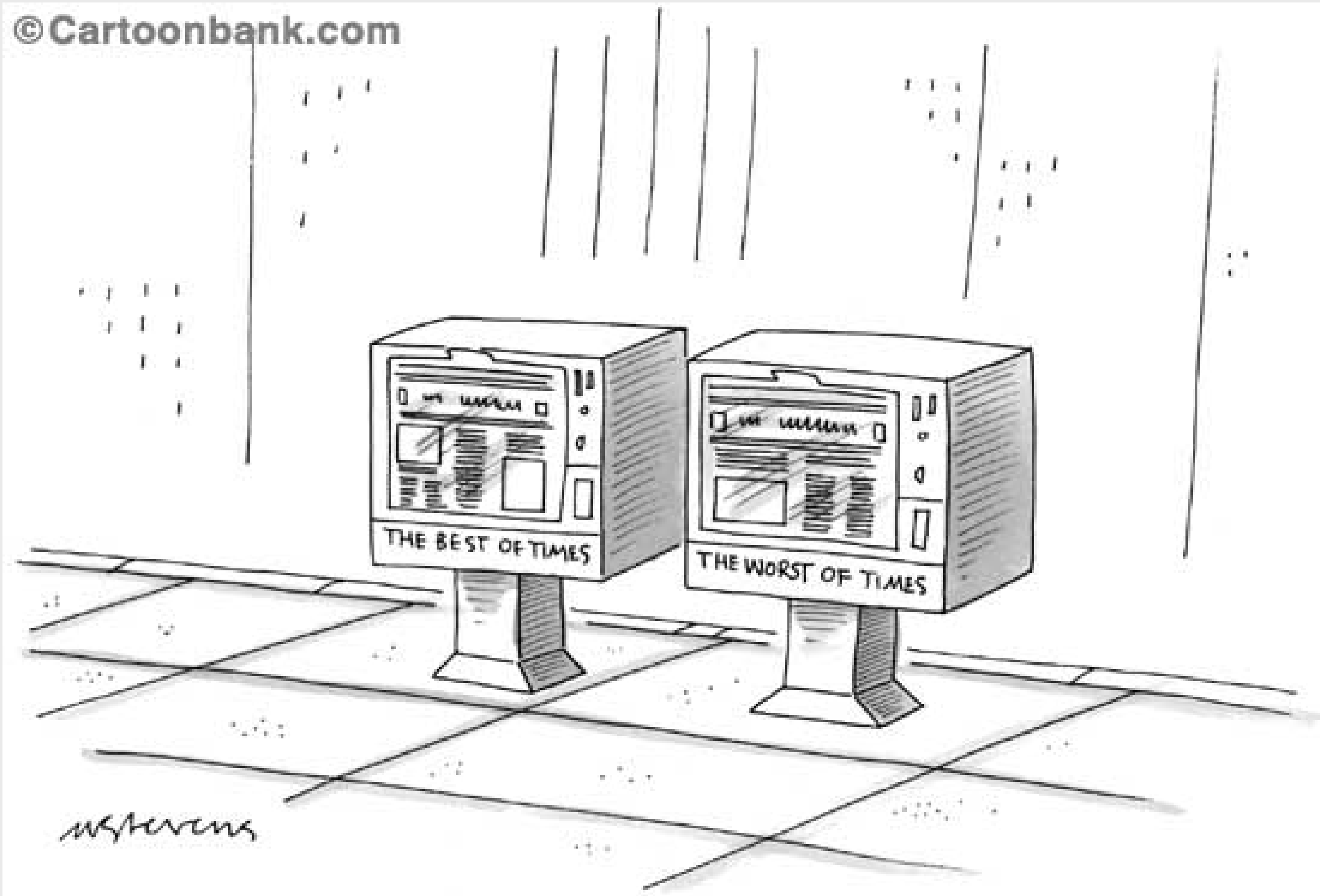
- **BABOONS –** “Baby Boomers” with no savings
- **SITCOM** – Single income, two children, oppressive mortgage
- **SHAKE-UP CALL –** A wake-up call to the 10th power; the difference between heartburn and a heart attack
- **YOGURT CITIES** – Places with active cultures and access to the arts, music, education, etc. Retiring “Baby Boomers” will move to “Yogurt Cities”, not retirement communities

Viewing the Future Also Requires a New Real Estate Vocabulary

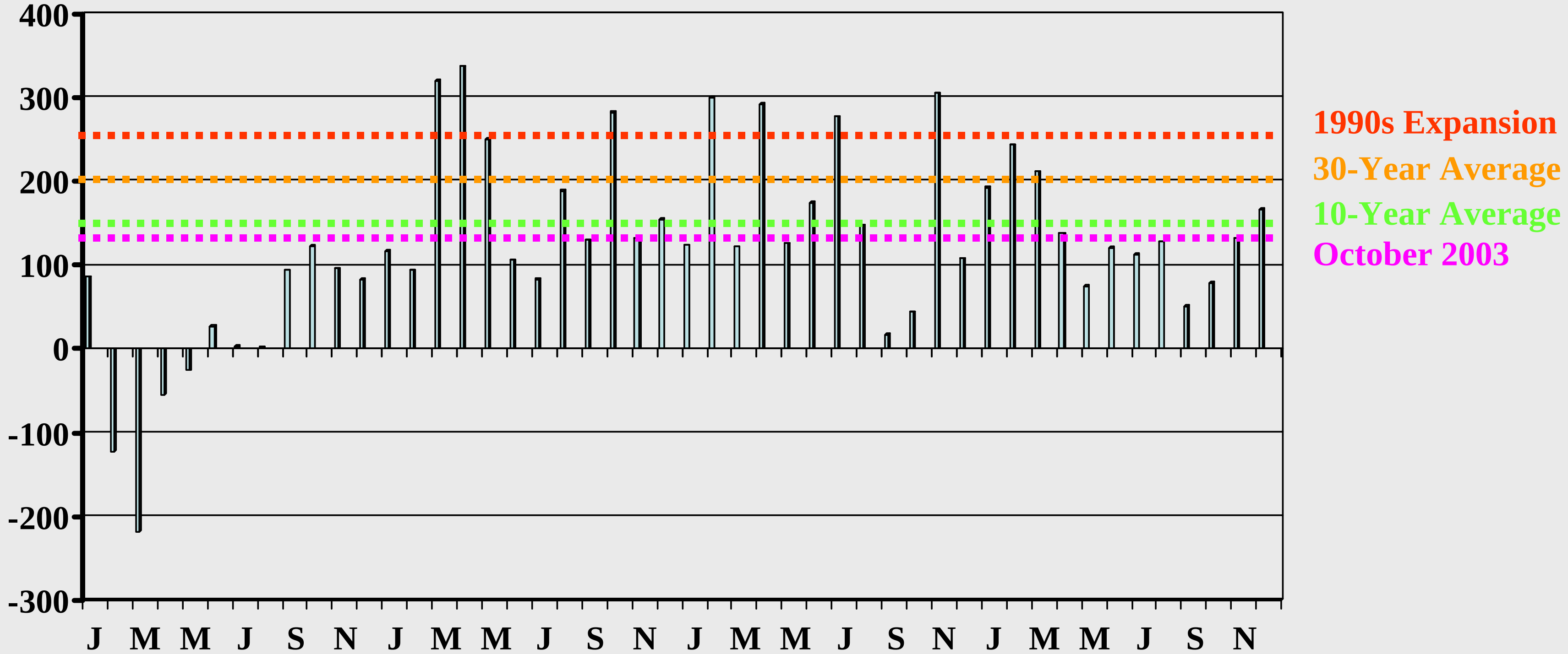
- **TOAD**—Temporary, Obsolete, Abandoned, or Derelict
- **LITTER ON A STICK**—Billboards
- **GROUND COVER**—Easily bulldozed buildings
- **ALLIGATOR**—real estate scheme that has gone belly up
- **ZOOMBURB**—a city in the suburbs growing faster than a “boomburb”
- **LULU**—Locally Unwanted Land Use
- **BANANA**—Build Absolutely Nothing Anywhere Near
- **NOPE**—Not on Planet Earth

“If all the economists were laid end to end, they would never reach a conclusion”

(George Bernard Shaw)



Job Growth Drives the Real Estate Economy - Monthly Employment Growth



Source: Bureau of Labor Statistics (in 000s)

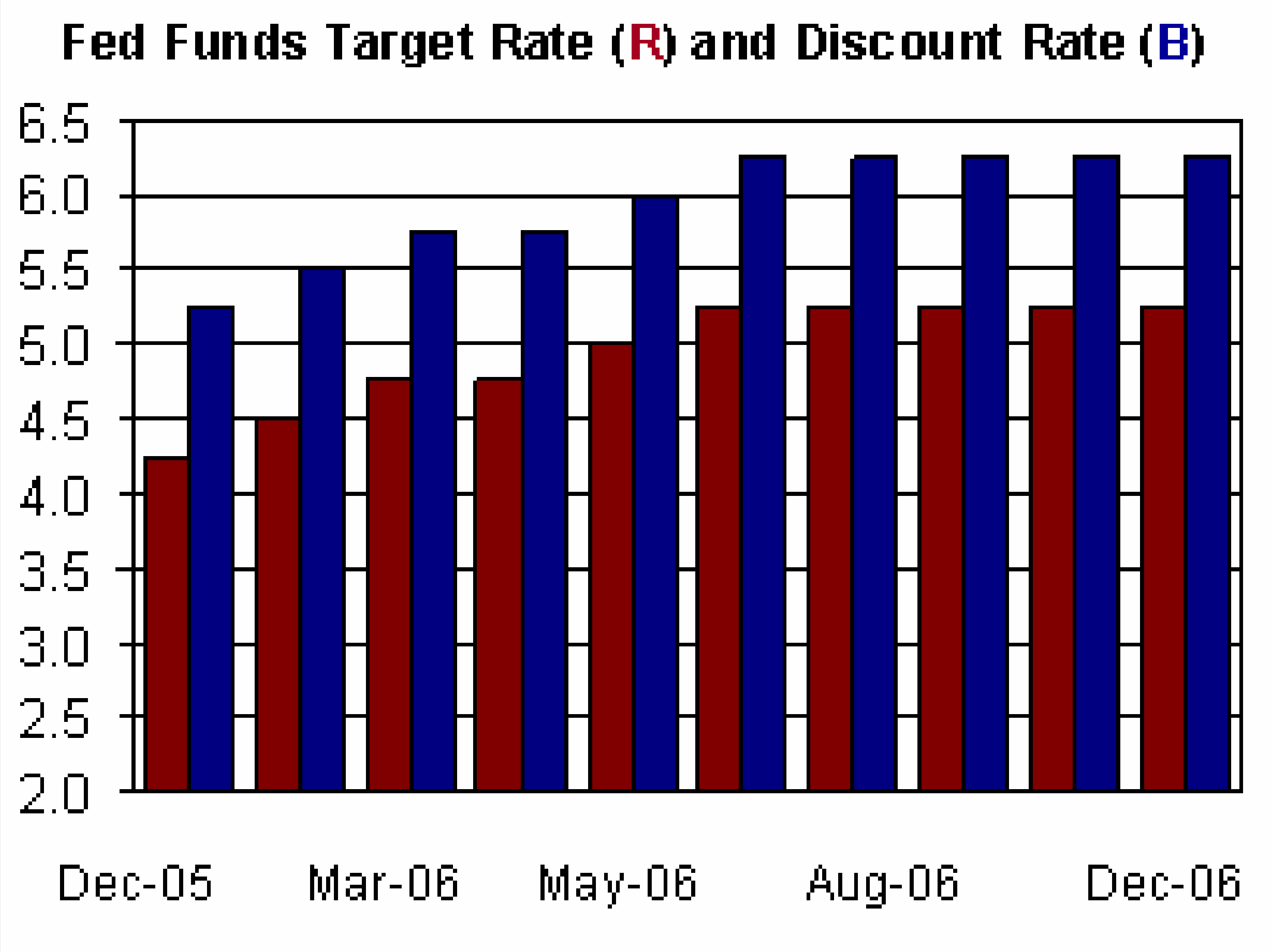
Interest Rates

"I'm just glad we got out before interest rates went up again."

Key Interest Rates

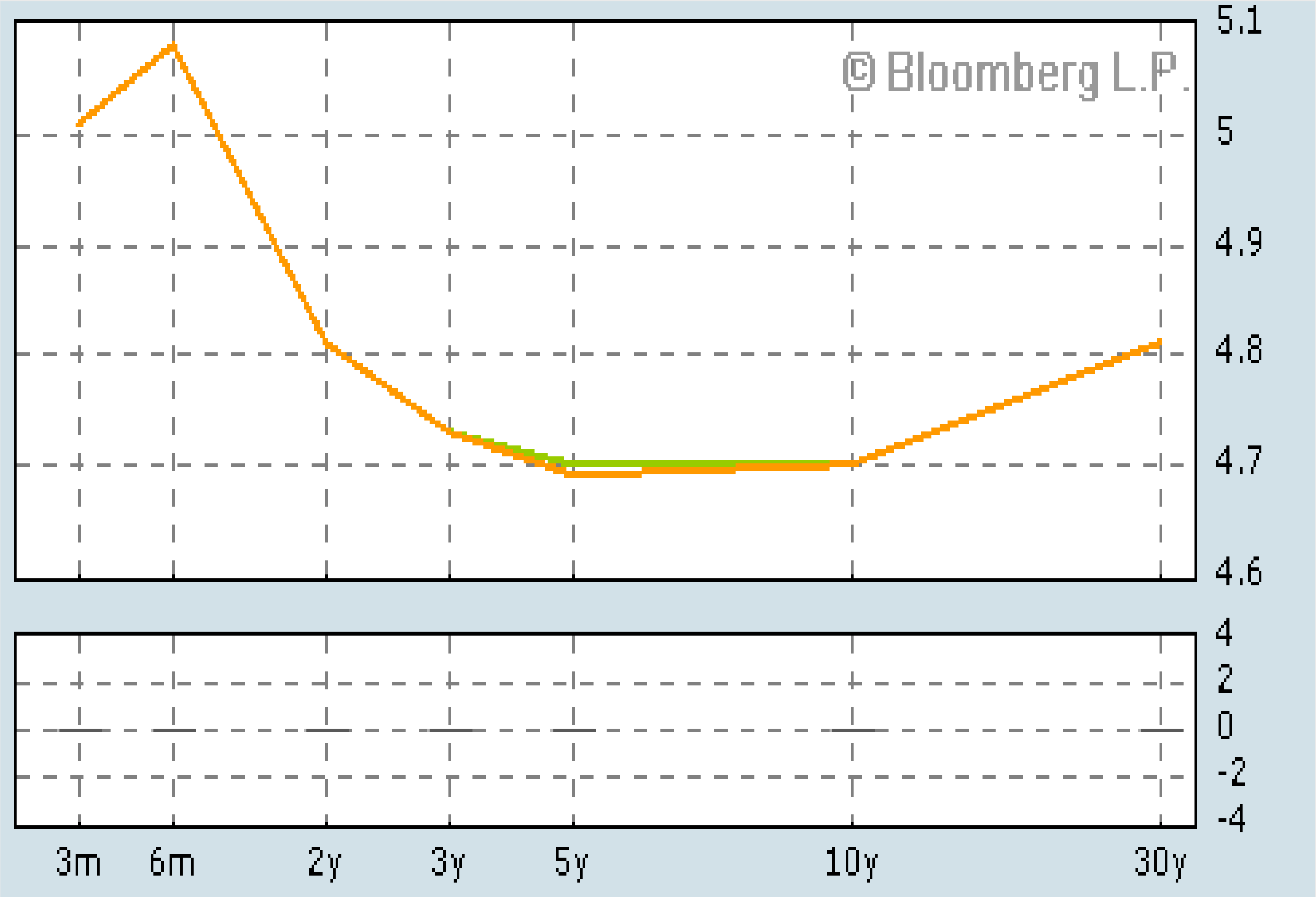
	December 29, 2006	One Year Ago	Increase/ Decrease
Prime Rate	8.25%	7.25%	+1.00%
Federal Funds Rate	5.25%	4.25%	+1.00%
3-Month Libor	5.36%	4.53%	+0.83%
3-Month T-Bills	4.88%	4.07%	+0.81%
10-Year T-Bonds	4.70%	4.39%	+0.31%
30-Year T-Bonds	4.81%	4.79%	+0.02%

Federal Funds Rate and Discount Rate



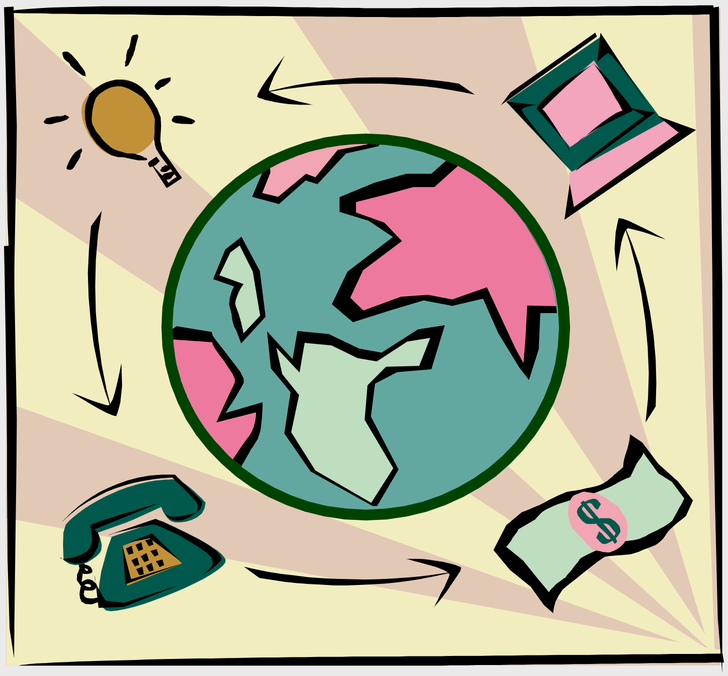
Source: Moody’s Economy.com Dismal Scientist.

Yield Curve at December 29, 2006

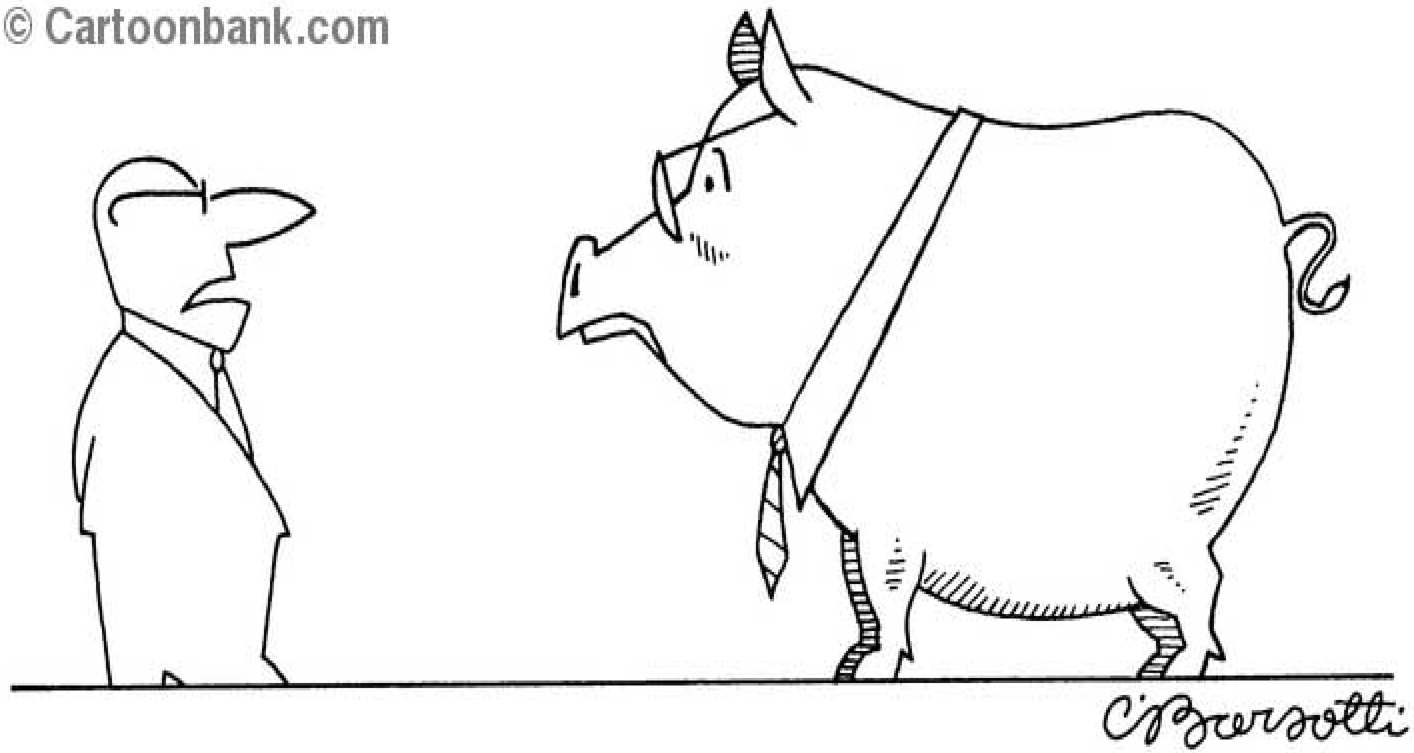


"Sir, the following paradigm shifts occurred while you were out."

The World of "Paradigm Shifts"

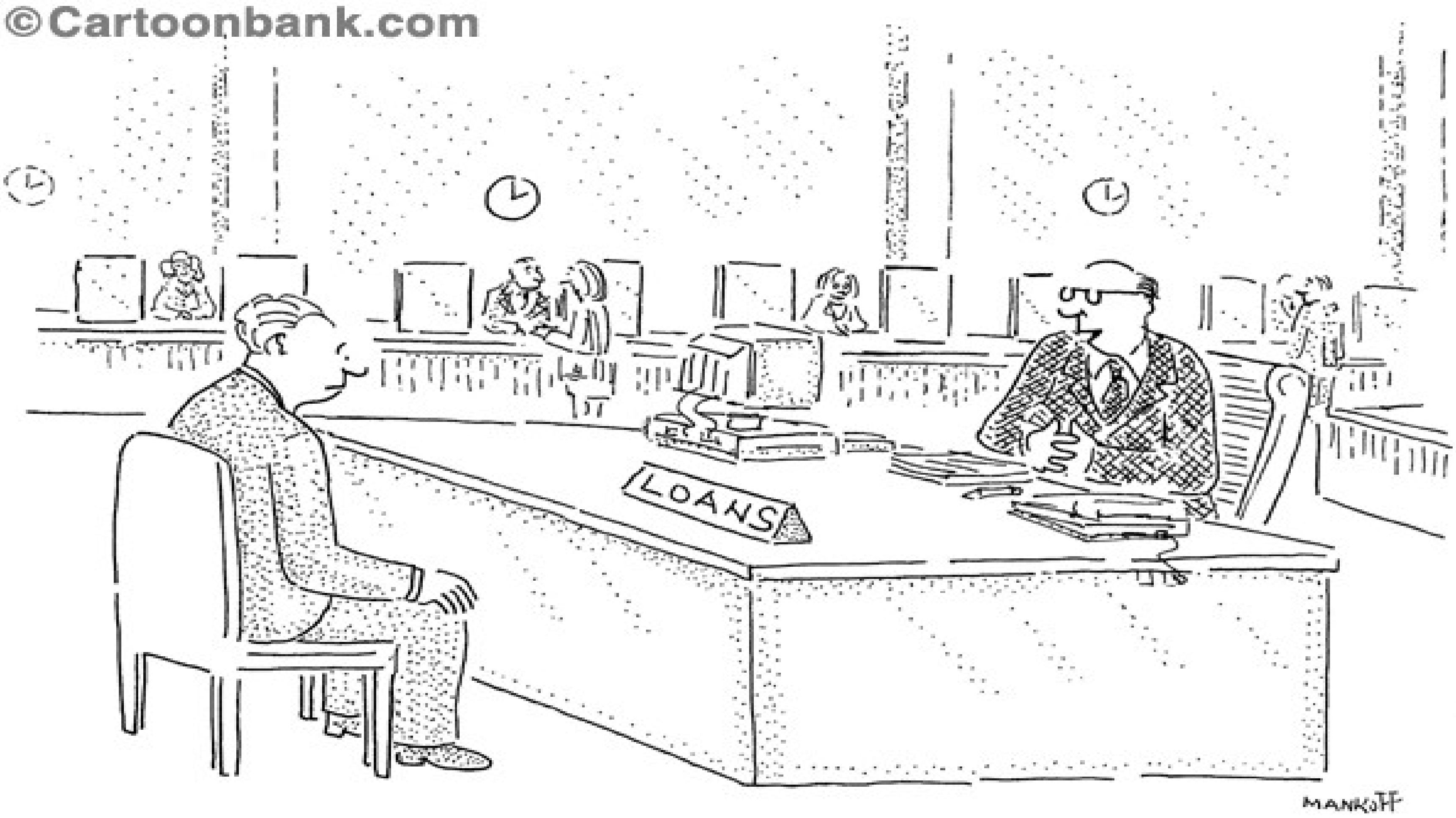


- Securitization
- Consolidation
- Globalization
- Technology
- Resiliency

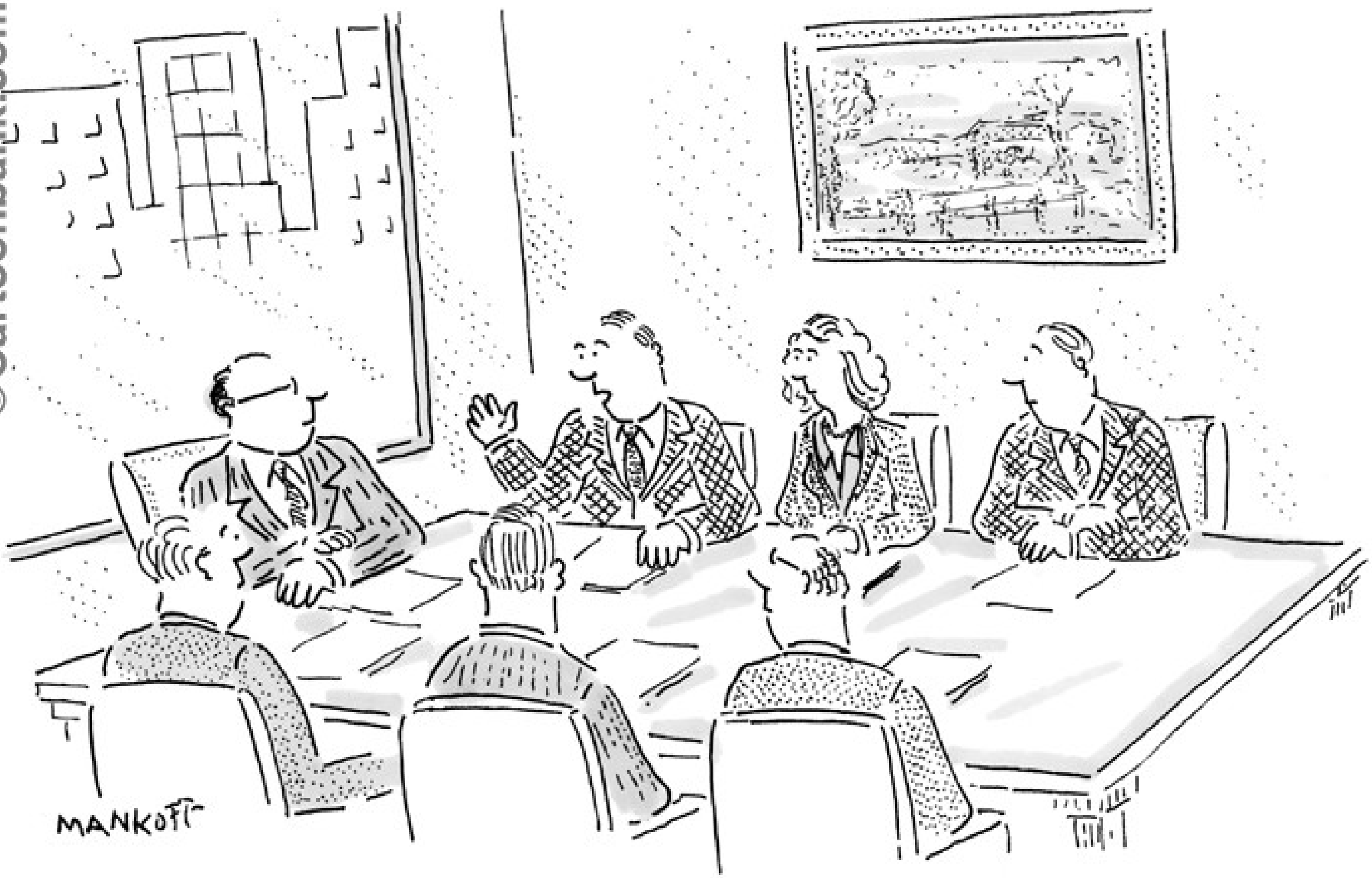


"Basic economics—sometimes the parts are worth more than the whole."

"Someday I hope to have a whole complex of caves."

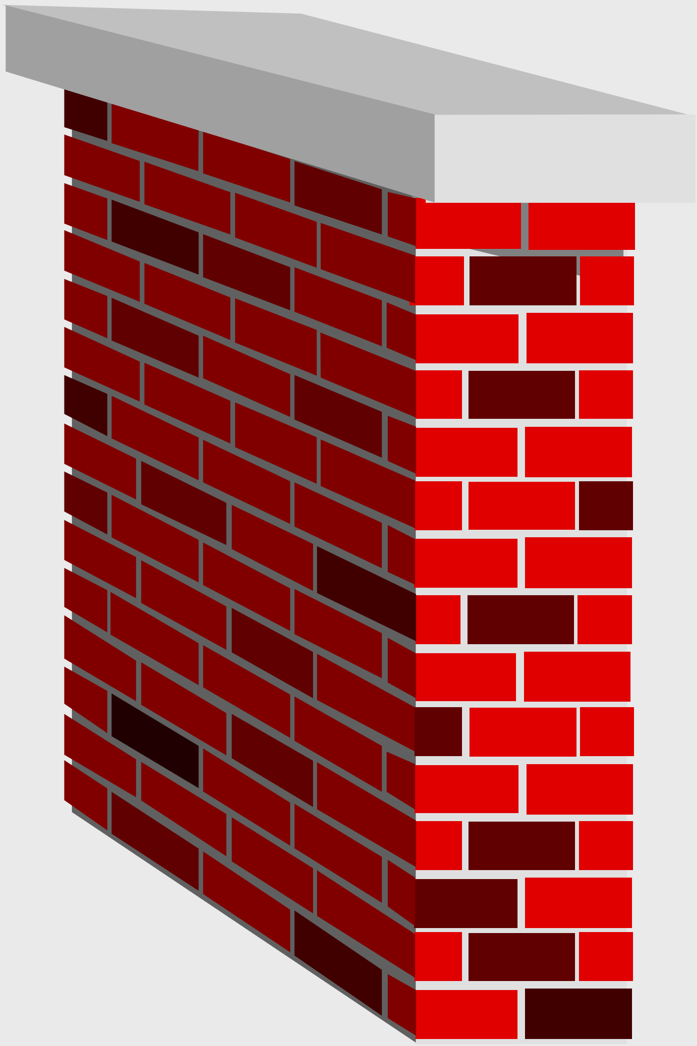


"Of course, you could try another bank, if there <u>*were*</u> *any other banks."*

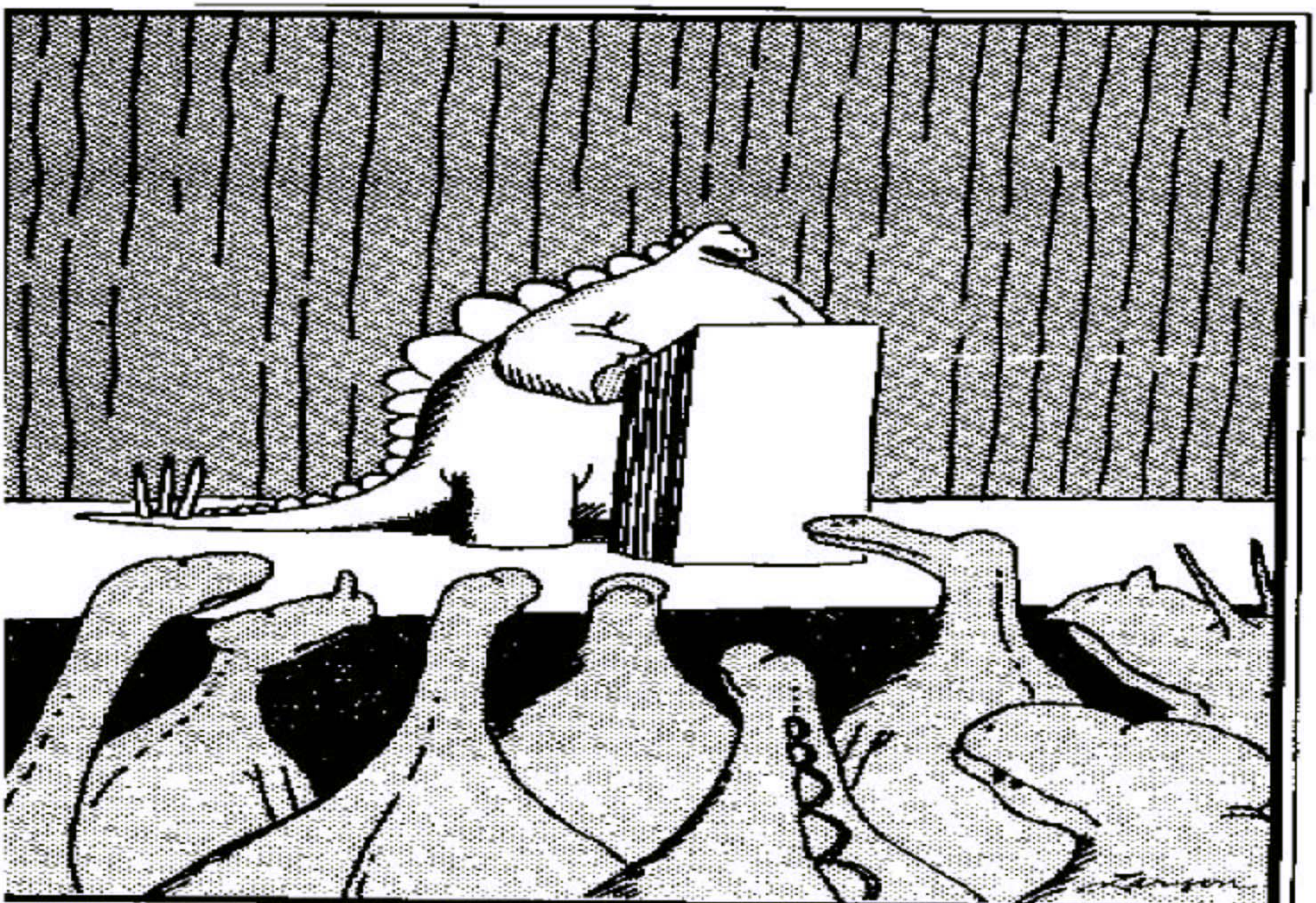


"On the one hand, eliminating the middleman would result in lower costs, increased sales, and greater consumer satisfaction; on the other hand, we're the middleman."

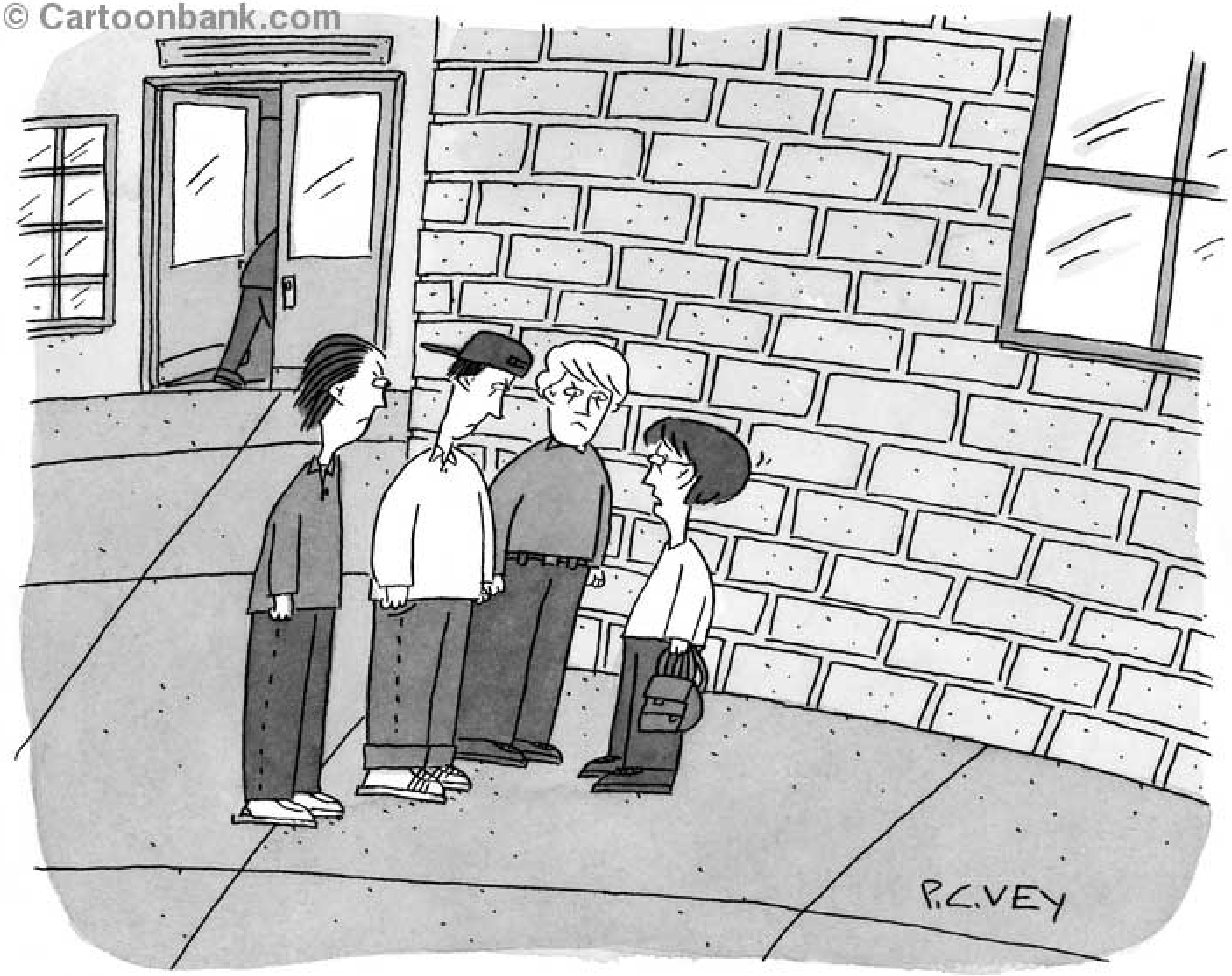
Resiliency



- Prisms to measure real estate's resiliency by:
  - 1998: Russia defaults on its sovereign debt
  - 2001: September 11th
  - Continuing resiliency to global economic and geo-political uncertainty



"The picture's pretty bleak, gentlemen. ... The world's climates are changing, the mammals are taking over, and we all have a brain about the size of a walnut."

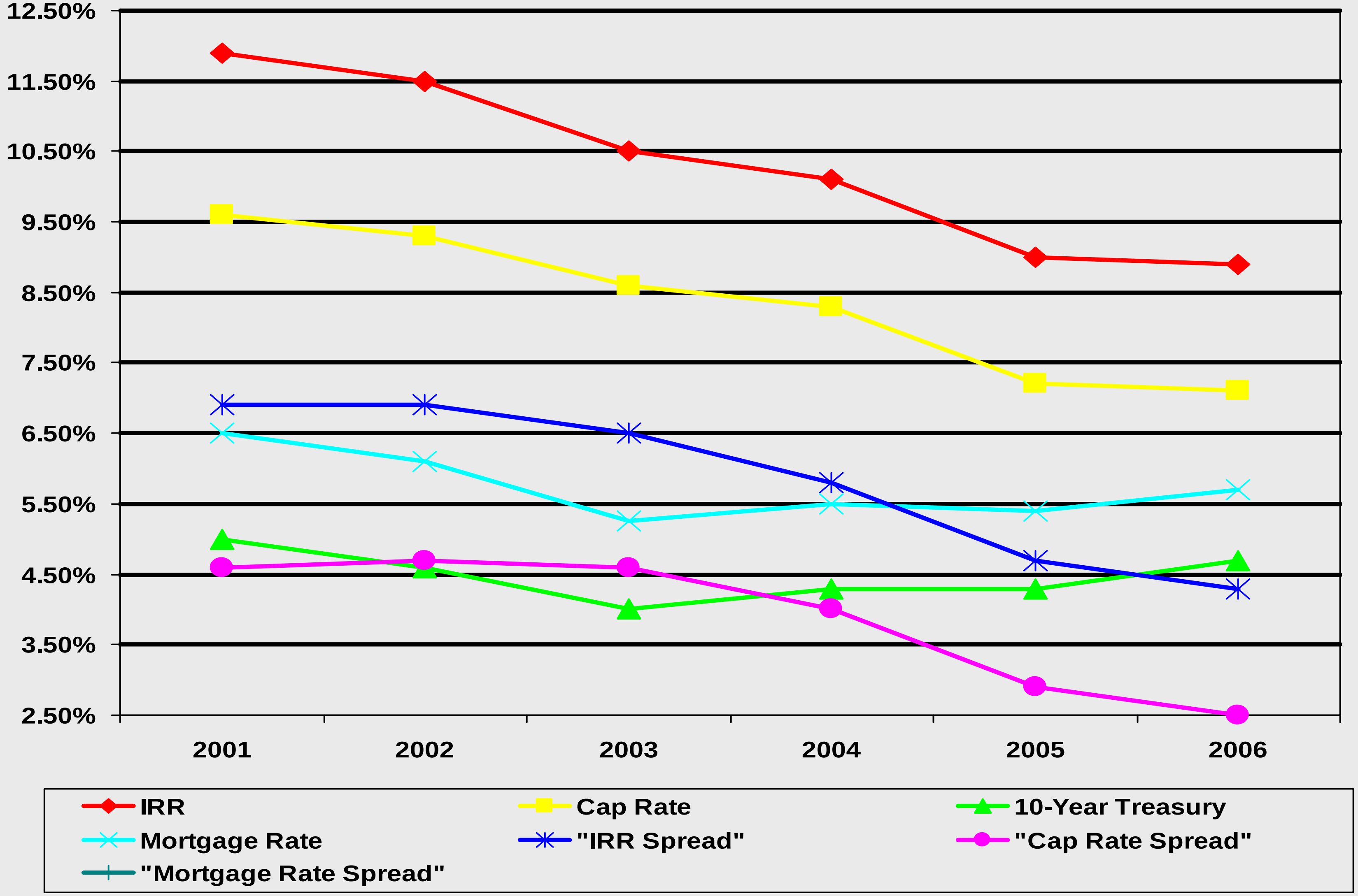


"All my lunch money's in real estate."

“History has not dealt kindly with protracted periods of low risk premiums”

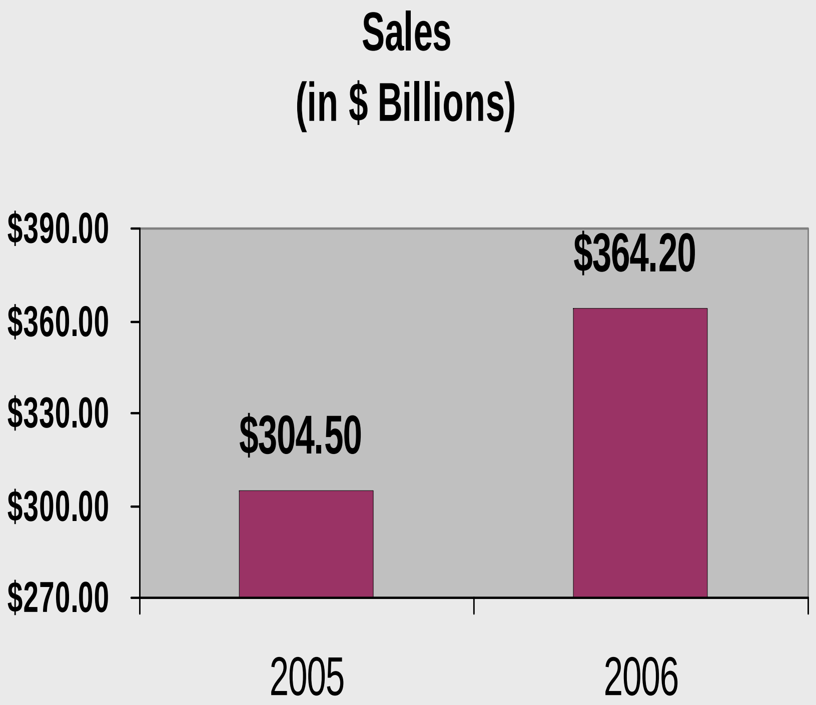
- Historic global liquidity + insatiable appetite for yield = “irrational exuberance” applied to real estate
  - No distinction as to quality, quantity, or durability of income
  - Increased competition has led to lower underwriting standards
  - Increase in proprietary risk takers active in the real estate investment and capital markets, many of whom could be characterized as “inexperienced”
  - Low interest rates are driving many investment, operating, and financing strategies
  - Record year for everything-property sales, conventional/securitized debt financing

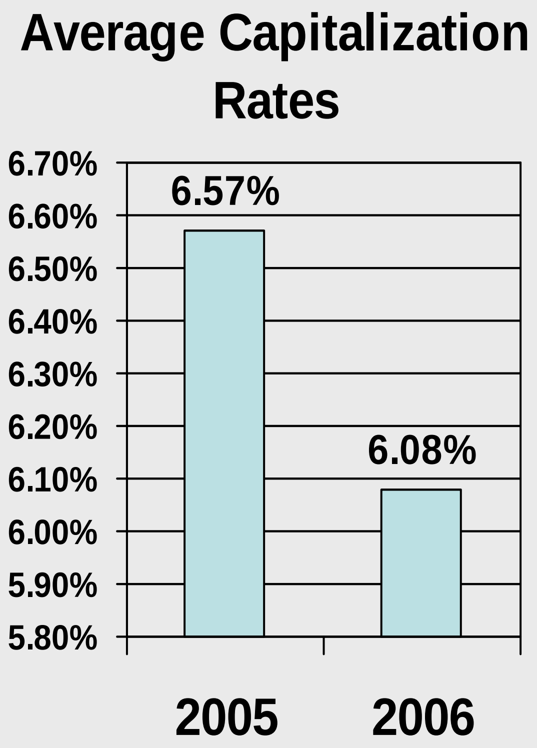
"An unsustainable trends will not last forever"



Source: Real Estate Research Corporation.

Sales of Office, Industrial, Retail, and Multifamily (in $ Billions)

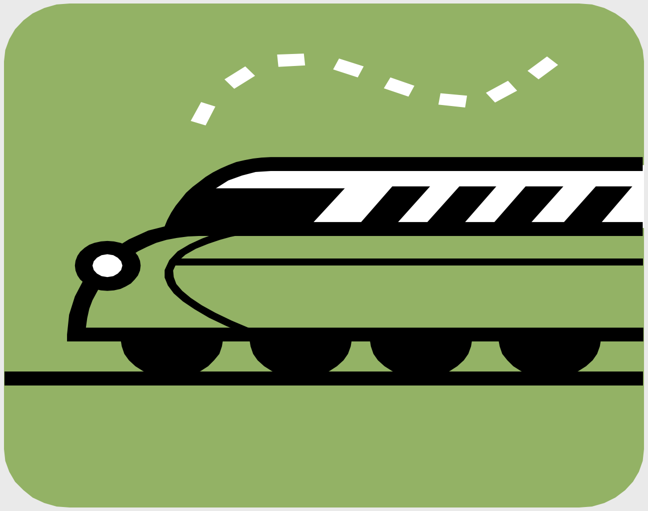




Source: Real Capital Analytics Inc.

2004

2005



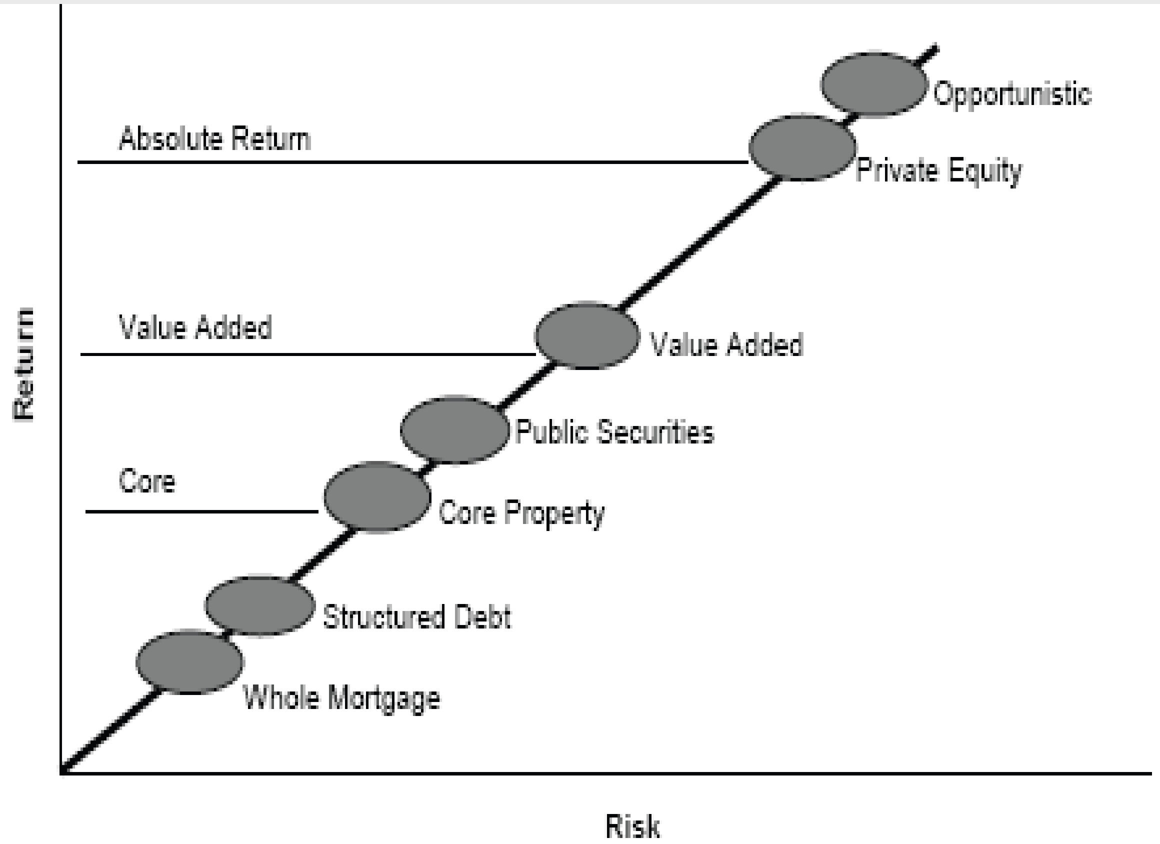
2006

2007

“Today…a deployment problem; tomorrow…a performance problem”

- Perfect alignment of the stars due to investment income requirements of a wide array of investors
  - Baby boomers seeking low-risk, income-oriented investments
  - Institutional investors seeking income-producing investments to fund distributions to retirees
  - Offshore investors seeking higher yields and geopolitical safety of U.S. real estate
- No longer a decision of whether to own real estate or not
  - Now it’s how (to structure) and where (geographically) to own it

An Ever Widening Array of Investment Strategies for Commercial Real Estate



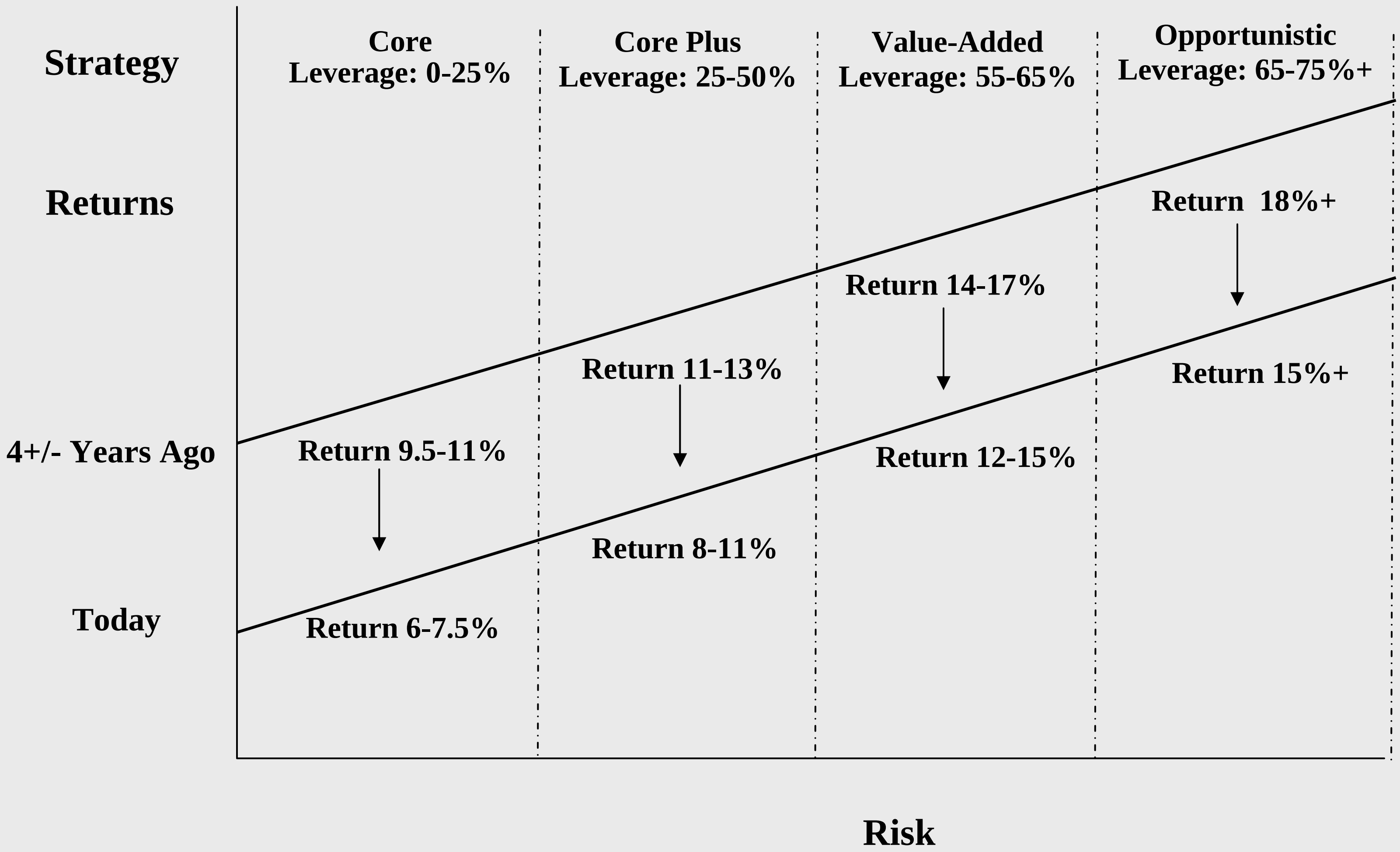
Source: Prudential Real Estate Investors

Growing Appetite for Higher Yielding, Non-Traditional, Investment Strategies

- Demographically-driven investment strategies
  - Senior Housing
  - Student Housing
  - Medical Office Buildings
  - Resorts and destination hotels
  - Second home communities
  - Single family
  - Condominium conversions
- Development, re-development, rehabilitation, renovation, re-leasing and re-positioning

- Offshore investing
  - Equity and debt in securitized format
  - Direct investment via pooled funds and joint ventures
- Fixed-income oriented investments
  - Investment grade securities to B-pieces
  - Non-investment grade/non-rated securities
  - Mezzanine debt
  - Structured debt (CDOs, CLOs)
- Other alternative investment strategies/structures
  - Real estate securities hedge funds
  - Real estate derivatives
  - Infrastructure (toll roads, bridges, tunnels, etc.)

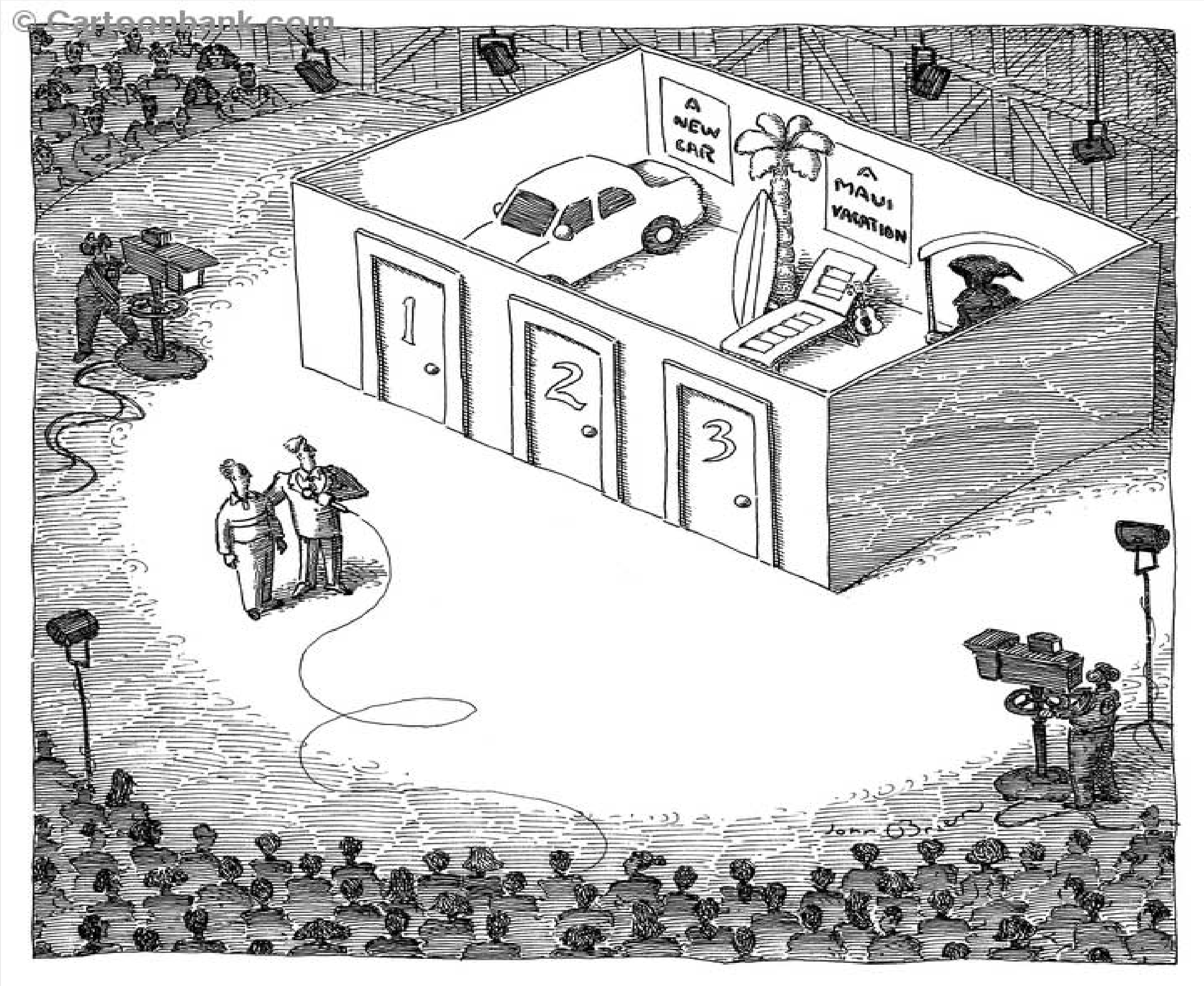
“We are at the stage where investors are paying up to put money out”



Rapidly Changing Real Estate Capital Markets

- Excess global liquidity in both the public and private real estate equity and debt capital markets
  - Increased globalization of owners, developers, investors, investment funds, lenders, and service providers
  - Compressed capitalization rates and risk premiums, all in the face of volatile interest rates and an uncertain economy
  - New players (hedge funds), new investment strategies and alternatives (demographics plays and infrastructure), new financial instruments (collateralized debt obligations and real estate derivatives)

What's Behind Door Number 3?



“Bubble Trouble?”

- Characteristics of a bubble
  - Belief in new “paradigms”
    - 1980s—junk bonds
    - 1990s—day traders and the Internet
    - 2000s—day traders of homes and condos
  - Long uninterrupted period of prosperity
  - Increased investment allocations to prosperous sectors
  - Equity and debt capital is cheap and plentiful
  - Asset values appear destined to increase forever

2007: Themes and Trends

- When interest and capitalization rates increase, industry will learn if recent decline in capitalization rates was cyclical or secular
  - Cyclical argues for reversion to historical mean
  - Secular argues that risk premium and required investment yields have decreased permanently
    - Has the risk-return metric for real estate equity and debt changed?
    - Does current margin of returns in excess of risk-free rates provide adequate risk-adjusted rates of return?

2007: Themes and Trends…(continued)

- “Weight of capital” has compressed real estate’s historical yield premium as compared to other asset classes
  - Will this lead to decrease in investment flows as momentum-driven and tactical investors rotate away from real estate
- Future real estate performance will be driven by growth in NOI, not capitalization rate compression
  - Rates of returns continue to revert to single-digits
- Optimism tempered by potential for one or more “Bolts out of the Blue”
  - Interest rate spike; premature new construction; slowdown in the economy; high levels of financial leverage; acts of terrorism; etc.

2007: Themes and Trends…(continued)

- Increases in interest rates will squeeze positive leverage and cash flows
  - New mantra—“The deal will cash flow in 2008!”
- Leverage is at historical high as government (3 deficits), business (derivatives), and consumers (mortgage and credit card debt) “pile” it on
- As interest rates increase, refinancing risk will increase
- Some buyers are incorporating lots of recovery in their pricing with little discrimination as to asset quality
  - Everyone is betting a future buyer (or lender) will take them out

2007: Themes and Trends…(continued)

- Crises, when it comes, will be liquidity driven due to withdrawal of equity, mezzanine capital, and/or mortgage capital from the real estate industry
- Industry faces unaccustomed pressure of new capital sources such as mezzanine investors and hedge funds
  - While better able to analyze, segment, and price risk, many current real estate industry and capital markets participants have never endured “rough seas”
- Hopefully, the real estate capital markets continue to function as a “governor” and “allocater” of capital

“Things Have a Habit of Ending Badly”

- Today’s commercial/multifamily real estate investment markets have been powered by a combination of
  - Belief in a long-term, uninterrupted economic boom
  - Assumption of continued availability of equity and debt capital
- But “things” have a habit of ending badly
  - More serious housing decline leads to consumer driven global economic downturn
  - Continuing decline in U.S. dollar lowers purchasing power while defending the dollar raises interest rates

“Things Have a Habit of Ending Badly” …(continued)

- Collapse of a hedge fund or private equity fund similar to Long-Term Capital Management’s (in 1998)
- Unexpected event affecting the global economy such as oil price and/or interest rate spike or oil flow disruption
- Abundance of new development causing real estate industry fundamentals to weaken
- Major collapse in housing prices in one or more large markets
- Economic recession

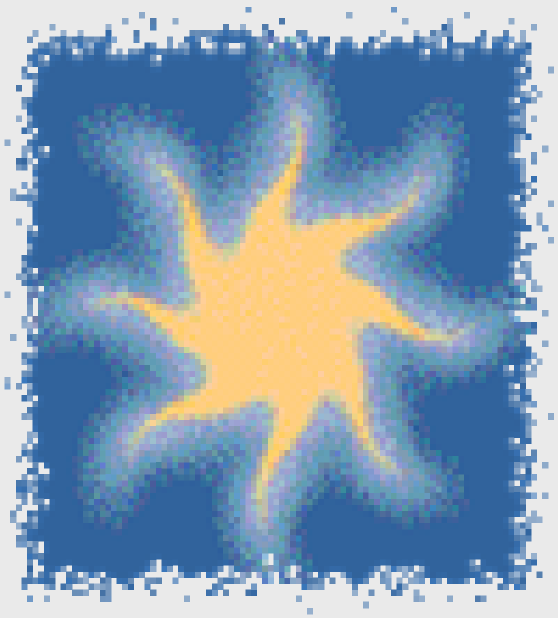
“Things Have a Habit of Ending Badly” ….(continued)

- Foreign trade initiatives, i.e., protectionism and tariffs, reduce confidence in the capital markets
- Uncertainty regarding international geopolitical event risk reduces confidence in the capital markets
- Uncertainty regarding the potential for a terrorist “event” leads to a loss of confidence and the closing— figurative or literal—of the capital markets
- Failure of a major transaction to close leads to a loss of confidence and the closing of the bridge equity or bridge loan markets

“Things Have a Habit of Ending Badly” …(concluded)

- “Deal Making^3” (to the third power”)
  - How risky is this generation of leveraged buyouts?
  - How has the emergence of hedge funds, CDOs, and CLOs as “lenders” altered the landscape?
  - What implications does the recent trend toward “covenant-lite” and “covenant-loose” lending have for future restructurings?
  - What impact will structured second lien lending have on leveraged finance?

“Perfect Beach Day”…or “Perfect Storm”?



“Perfect Beach Day”…or “Perfect Storm”?

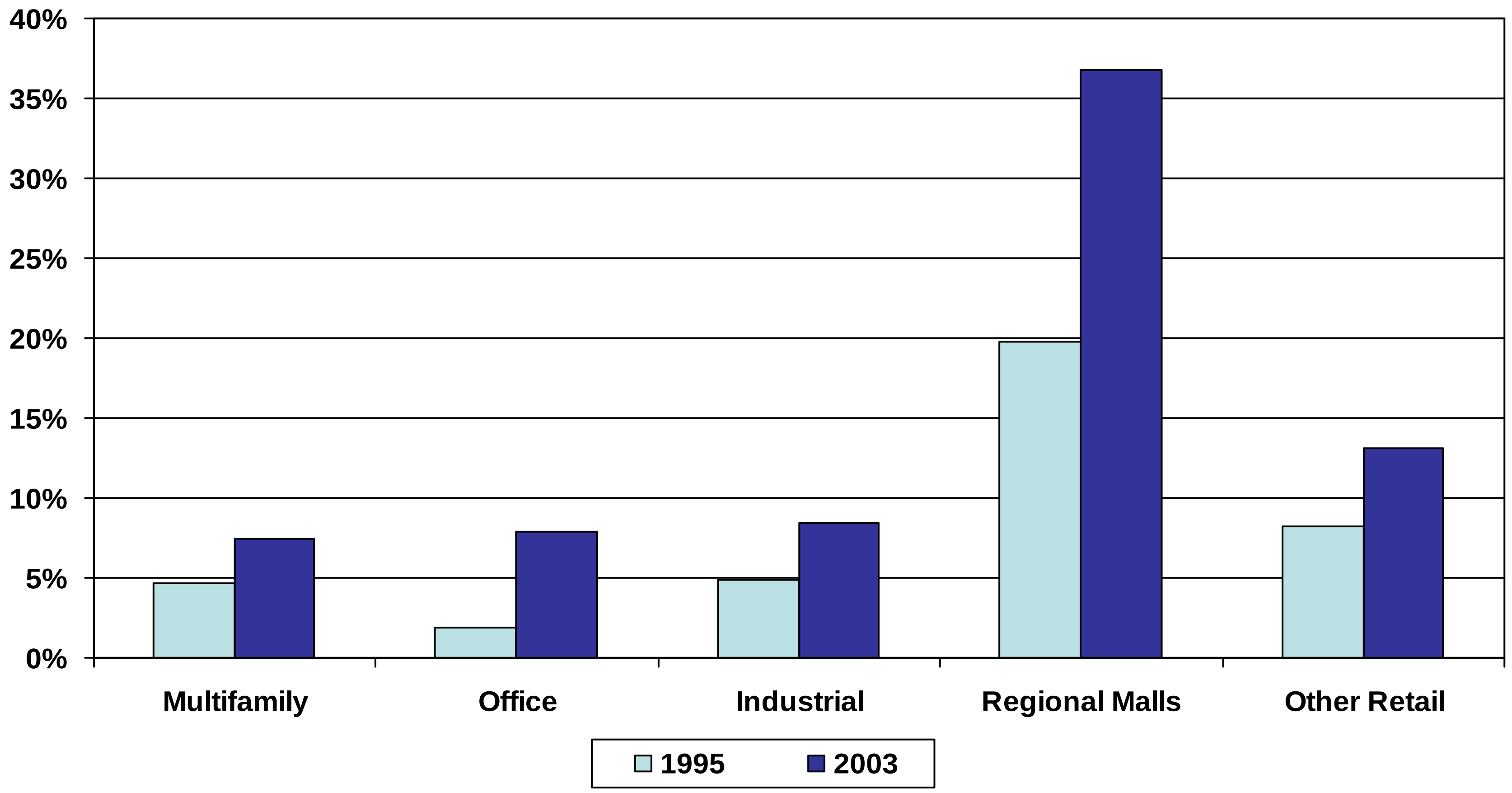
- Historically low interest rates and low credit spreads
- Oversupply of equity and debt capital
- Competition to invest as well as lend at historical peak
- Sellers and borrowers, rather than buyers and lenders, have pricing power
- Buyers justifying paying more by borrowing more at low interest rates
- Confluence of investors (baby boomers, pension funds, and foreign investors) with shared yield objective has sustained excess investment demand


BUYER'S REMORSE

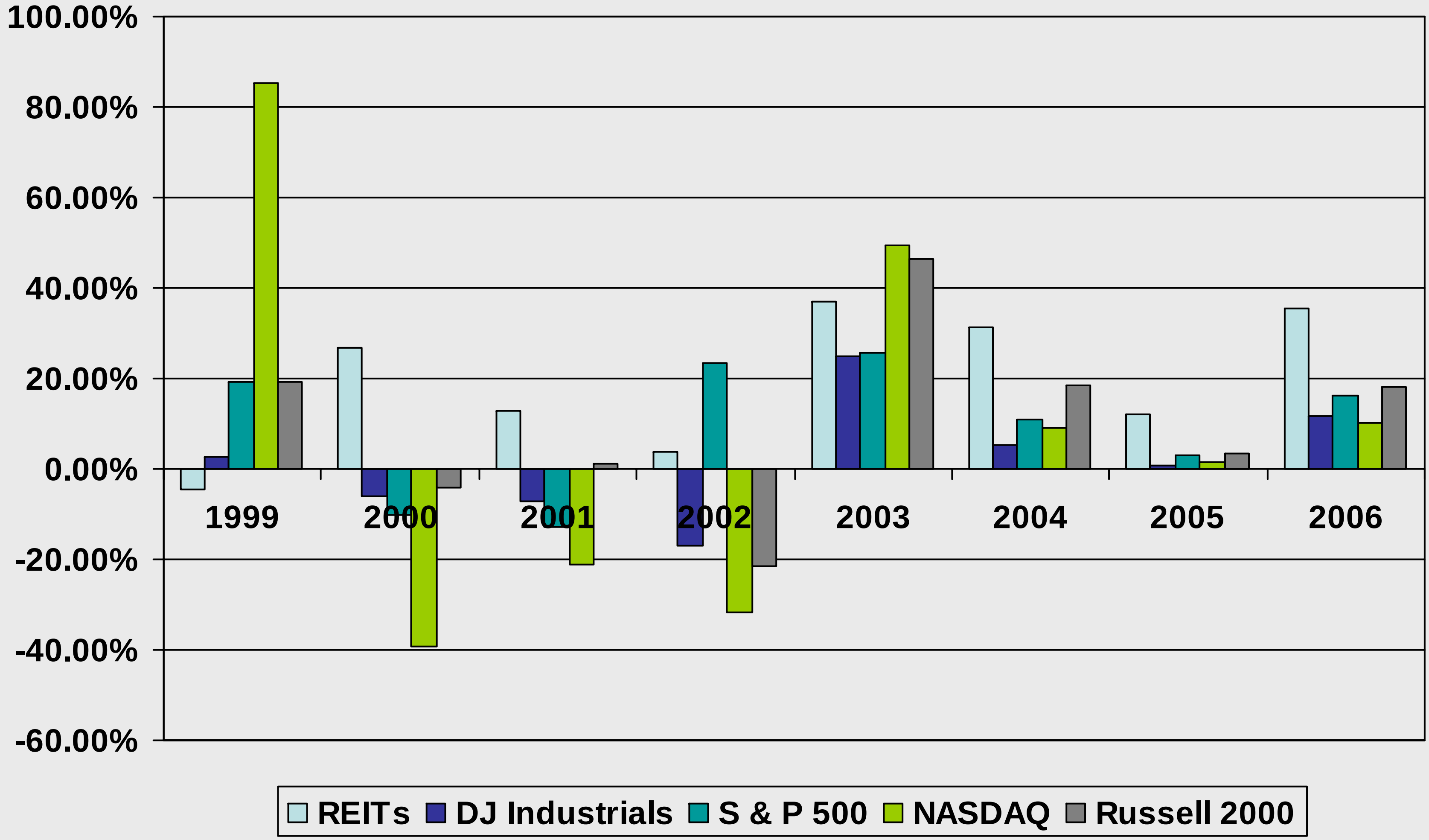
RL ST
WALL ST
S.GROSS

"The little pig with the portfolio of straw and the little pig with the portfolio of sticks were swallowed up, but the little pig with the portfolio of bricks withstood the dip in the market."

Increasing Penetration of Public Company Ownership of Real Estate



REIT Performance



For REITs…It's Different This Time

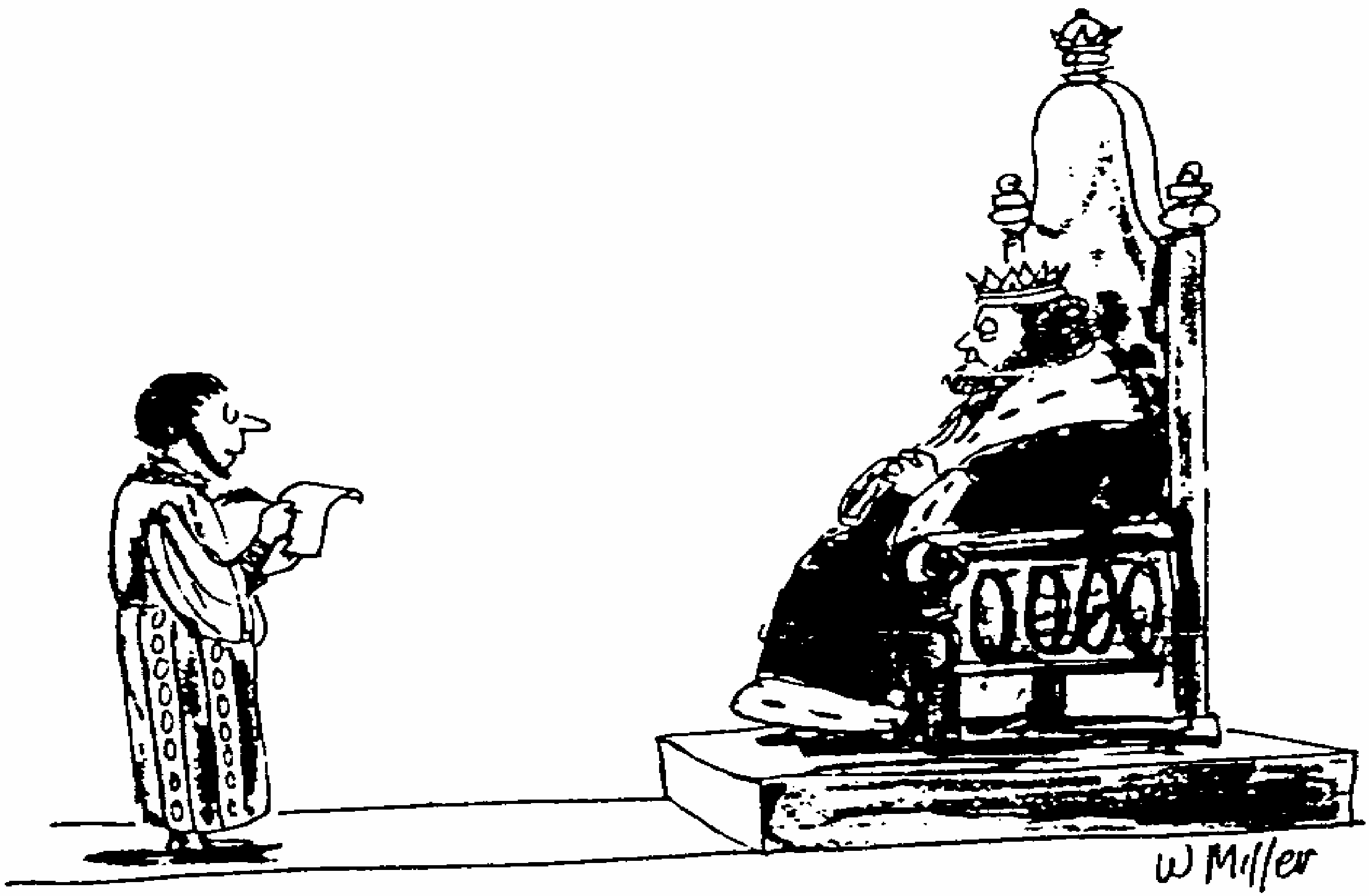
- Have proven themselves to be cycle-tested and user-friendly
- Demonstrated ability to provide portfolio diversification
- Liquidity available in size as average daily trading volumes increase
- Abundant transparency and availability of information as well as critical analysis from numerous independent sources
- Proven relative value performance versus wide array of publicly-traded alternative equity investments

It’s Different This Time But...

- What trading values are “sustainable”?
  - Prices should correlate to “something”
  - Earnings are growing, but are they growing fast enough to support current valuations?
- Has low interest rate environment been the real driver of performance?
  - Correlation between interest rates and REIT prices seems to exist
- Accelerating number of joint venture transactions
- REITs “poking their noses” in operating company M & A/ restructuring-type transactions
- Benefiting from high global inflows of investment funds
  - Risk of sector rotation by various investor constituencies

What’s Driving Recent REIT Merger and Acquisition Activity?

- Recent REIT merger and acquisition activity driven by private funds backed by institutional investors
  - Public market pricing attractive relative to private market prices
  - Availability of capital is no longer a constraint
- “Horizontal” transactions allow institutional investors to acquire both “size” and vertically-integrated operating platforms
  - Willingness to pay portfolio premium for “size”
  - Operate differently-sell assets, increase leverage, etc.



" 'War is the highest form of the real-estate business.' May I quote you?"

Private Equity Capital Markets Circa 2007

- Historically, it is in the later stages of the cycle that the biggest mistakes are made
- Buyers will begin to awaken from “dream-like” state
  - Capital can no longer ignore fundamentals
  - If interest rates increase, capital flows could become more subdued
  - If interest rates increase, so will capitalization rates
- Allocations to real estate could decrease if investors decide to rotate to alternative investments in search of better “relative” value

Private Equity Capital Markets Circa 2007…(continued)

- Institutional investors will continue to dominate the private capital markets
- Foreign investors, driven by geo-political concerns, the weak dollar, and higher yields, continue to find the U.S. attractive
- Opportunistic and valued-added investors will continue to focus on M & A/LBOs and offshore investing
- Wild cards: continued investment by high net worth individual investors, TICs, 1031 exchange investors, private REITs, and hedge funds

"By God, gentlemen, I believe we've found it—the Fountain of Funding!"

Three Strikes and You're Out?

- 2005—regulatory agencies issued "guidance" regarding underwriting practices in home-equity lending and risks of "exotic" home mortgage financing
- 2006—federal regulators issued for comment guidelines regarding risks associated with concentrations [of loans] in commercial real estate
  - December 7, 2006—federal regulators proposed guidelines on the amount of commercial real estate loans banks can hold before drawing further oversight
    - Regulators noted that "banks hold more real estate now than during the market decline in the 1980s"

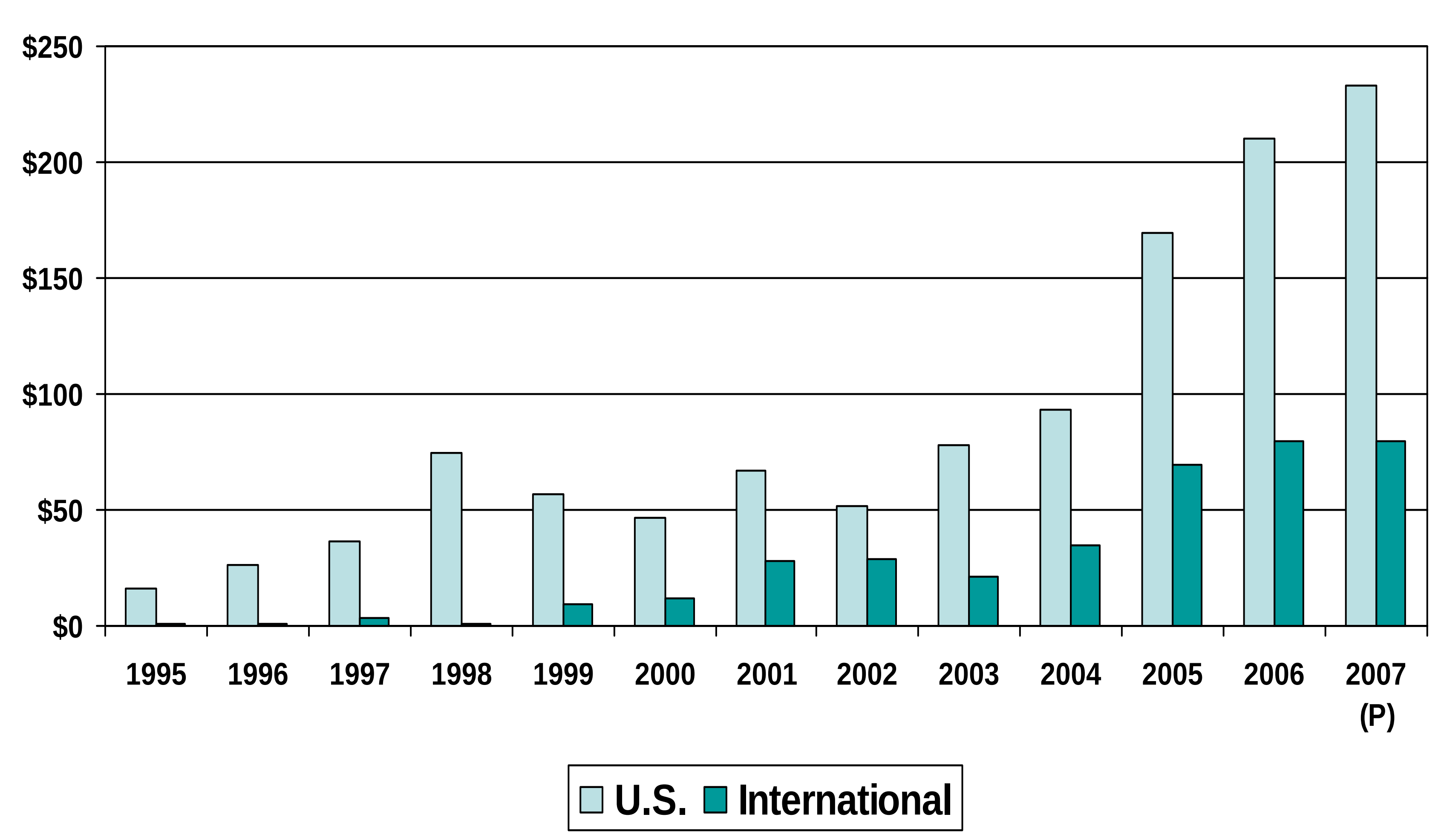
Private Debt Capital Markets Circa 2007

- 2007 may finally test industry's underwriting practices
  - While securitized and conventional delinquencies remain far below industry "high-water" levels, recent increase in interest-only loans is increasing risk
- Underwriting standards should "tighten" as regulators and management recognize recent weakening of the credit culture
- Continued decline in balance sheet lenders in favor of warehouse-securitized origination/distribution strategies and clubs, participations, and syndications
- Foreign banks remain active in selected markets
- Overall, adequate capital will be available from both conventional as well well securitized lenders

Commercial Mortgage-Backed Securities

- Remain positioned to outperform comparable debt investments based on relative value, credit performance, and structural characteristics
  - Delinquencies on seasoned transactions at lowest level since September 2001
    - Well below 1.54% industry “lifetime” average
  - Foreclosure loss severity improved to 28% of principal versus 35% long-term average
  - 8-to-1 credit ratings upgrade/downgrade ratio; best performance since 2001

Growth in Issuance of Commercial Mortgage-Backed Securities



CMBS Issues and Concerns : Have Underwriting Standards Deteriorated?

- Continued investor demand for yield combined with intense competition between originators
  - Underwriting will not improve dramatically if at all
- Wall Street conduits “need to feed” their underwriting and issuance machine
  - Lender’s are pushing underwriting boundaries
  - “Amortization…covenants...how retro!”
- Will rising tide of improving fundamentals offset risk of aggressive underwriting?
  - Volume of Interest-only/partial interest-only loans continue to increase
  - DSCR/LTVs continue to “deteriorate”
  - Subordination levels continue to decline

In conclusion…

- Return expectations continue to decline for all asset classes
- Real estate returns continue to offer positive spreads relative to alternatives
- Spreads over Treasury yields and inflation remain positive
- Real estate remains "the least vertically challenged" in relative value comparisons
  - But…as risk premium compression continues, investors may start to look elsewhere

In conclusion…really!

- Real estate is in driver ‘s seat…for now
- Capital flows from individual and institutional investors will continue to grow…for now
- Capital flows to global property investment markets will continue…for now
- Drivers today are external to real estate markets
  - Domestic and off-shore individual and institutional investors have become “income-seeking missiles”
- Once again, it’s ours to blow

ULI's Real Estate Capital Markets Web Site

- At www.uli.org, click on "Research" on the navigation bar, then click on "Trends" to view the most recent issue of ULI's Real Estate Capital Markets Update
- Web site also contains
  - Archives of prior updates
  - FAQs
  - E-mail subscription form

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