



INSIGHTS

Urban Land Institute (ULI) Opinion of the State of the Real Estate Industry

Notes from Third Quarter 2010 Conference

According to ULI, the leading real estate industry research organization, there is a glimmer of hope on the horizon for the real estate industry. Many industry owners, investors and lenders are mildly optimistic. However, extreme caution prevails. Below are notes from the conference that we hope you will find interesting.

For tenants, superior opportunities remain for renegotiating leases in this temporarily soft market. Cash strapped owners everywhere will do almost anything to keep existing tenants, particularly those that require little to no capital improvements. Concessions are coming in the form of significantly reduced rent, give-backs of excess space and extended rent abatement periods. Tenants with good to great credit remain extraordinary desirable and have maximum leverage. While long term decisions can be difficult to make in this environment, firms that take advantage of the unique opportunity to cut operating costs on an extended basis will prove to be highly valuable once the economy recovers and businesses are growing once again.

Economy:

- The markets are slightly better, but the U.S. is not out of the woods yet - at least not for the next couple of years (economy needs jobs, jobs and more jobs).
- Property types are at the following points in their respective cycles: apartments are emerging out of their down cycle, condominiums are at the bottom of their cycle, industrial is emerging out of its cycle, office is at the bottom of its cycle and it's expected to stay there for a long time.
- Interest rates are expected to remain low for next 12-18 months. They will increase with inflation which won't move until job creation occurs.
- Most ULI participants feel interest rates will be noticeably higher within 5 years and that the asset financing owners fix now may be their most valuable asset. This inflation will also result in higher cap rates in the future which should be considered on today's acquisitions.
- Projection for a stabilized economy is 2013.
- Global economies are considered "linked" with capital and commodities that greatly impact one country sending effects through all countries.
- An ongoing trend of reduction homeowner ration from near 70% to the historical norm of 60% was an ongoing theme.
- The weak U.S. dollar is another influence on investor appetite for U.S. core real estate. Foreign investors, already used to lower returns, are more likely to bid on US core real estate when the dollar is weak.

Capital Markets:

- Spreads are holding at their wider levels for now but gross note rates remain relatively flat.
- Life companies expected to dominate permanent lending markets as CMBS still being defined and Banks remain cautious with strong recourse requirements.

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- A managing partner (GP) of a key principal group should have at least 10% of the equity in the deal (Fannie & Freddie guideline).
- In lieu of lowering underwriting floors, Fannie is now reducing the DCR (gets you to the same place). The MBS market is ok with such metrics as they will look to the actual DCR.
- Comparable investment notes: Johnson and Johnson issued a 7 year bond at 3%; IBM issued a 3 year bond at 0.88%. Relative to low corporate bonds, real estate is an attractive investment to achieve higher returns.
- A note on opportunistic return expectations: "15% is the New 20%" - the low cost of capital and lack of quality product is causing high yield investors to re-think their ability to invest capital and underwrite to 20+% as they have in the past.
- Hedge funds have become active bidders in core real estate and they have a competitive advantage over private equity funds: they aren't required to pay a preferred return to their investors. They typically make a fee of 20% over any yield exceeding 0%.

Government Policies:

- Industry participants identified a need for a national housing policy; should the Government participate as the driving force? This is an ongoing debate spilling into the need for the GSEs.
- Federal and local governments need to help families by providing or fostering housing options near public transportation nodes as a method of sustaining the economy. Thus, some type of FNMA and Freddie Mac support will continue to be available to offer affordability and market liquidity. There is an Affordability gap - nearly 20 million families spending more than 50% on housing, while about half the population spends more than 50% on housing AND transportation.
- Decreased housing values have helped to make housing more affordable, but lenders need to start loosening mortgage restrictions as well, which is slowly occurring. Using the "old rule of thumb- 30% of salary should be housing costs- should be effective in realistically underwriting borrower's ability to pay their mortgages.
- Debate continues on private markets replacing government markets - transparency is the key and private sector must retain some portion of risk in funding pool to assure more disciplined / prudent underwriting.
- The bank system is healing: more banks failures, but fewer losses due to smaller banks.
- FDIC wants to see banks use more Interest rate risk management, stressing loans several hundred basis points (e.g., 300 to 500 bps), in anticipation of asset recovery in a rising interest rate environment.
- Loss mitigation - is main goal of workout loan plan for banks vs. foreclosure if the economics are failing.
- Banks weigh the decision on whether to foreclose and sell or work out based on sponsor actions and NPV of future cash flows in each scenario.
- Federal government policy - fairly significant resets plus loan performance.
- The FDIC noted there is a need for diversity in bank size to maintain a strong banking system.
- The FDIC noted they want to avoid the "too big to fail" scenario from occurring again. They will want higher capital reserves to be achieved by downsizing bank portfolios, tapping into retained earnings, and reducing salaries and overhead to increase capital requirements.
- There was a concern over the US education system and how it positions the US globally.
- Three regions, based on migration patterns, are emerging as important: New Sun Belt, Melting Pot and Heartland (this compares to the four regions of US based on location).

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- The US population will increase 85MM to 2015 and the immigration pattern is expected to remain the same. The Northeast will be a net loser of population growth despite its Gateway Cities.
- FASB 13 long term lease accounting proposal expected to take effect in 2014 is a concern by lenders and owners.

Supply and Demand:

- Commercial properties are recovering anemically, most urban infill retail, parking, etc.
- Industrial markets spotty demand.
- 24 to 36 months “window of new construction” as for apartments as markets remain tight.
- Population growth is the saving grace for many of the markets, with 2 to 3% per year translating to about 300,000/yr. rental units needed on a national basis.
- Investors want a “plain vanilla” market and Washington needs provide clear directions and rule book without various federal-agency overlap.
- Other than population growth, demand generators don’t exist except in select areas.
- For most product types, especially office and multifamily, “Green is a Given.” Product not developed to some level of LEED certification will be viewed as inferior in the market.
- U.S. Gateway Cities are like the “New Gold” there is much demand for New York, Washington D.C., San Francisco and Los Angeles core properties.
- Eco-boomers emerging as a demand generator (75MM Americans born 1975-1995)
- There is still a large and pervasive “bid-ask gap” for distressed real estate. There are some, but a few deals being consummated.

ULI, the Urban Land Institute, is a 501(c) (3) nonprofit research and education organization supported by its members.

Founded in 1936, the Institute now has members in 95 countries worldwide, representing the entire spectrum of land use and real estate development disciplines working in private enterprise and public service.

As the preeminent, multidisciplinary real estate forum, ULI facilitates an open exchange of ideas, information, and experience among local, national, and international industry leaders and policy makers dedicated to creating better places.

Members say ULI provides information they can trust and is a place where leaders come to grow professionally and personally through sharing, mentoring, and problem solving. With pride, ULI members commit to the best in land use policy and practice.

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