disciplined markets foster ample liquidity, which buffers performance and helps ensure continued equilibrium. Sounds good, but does the new real estate world really work that way? Have public market governors helped to straightjacket imprudent investing by using new sources of real-time market information to spotlight potential dislocations?

Performance and equilibrium may be tested in 2002. But so far, real estate appears well positioned to escape significant damage from an economic decline. The capital markets have indeed embraced greater discipline and managed to sustain ready access to capital. Lenders closed shop temporarily after September 11, but a “no panic” mentality prevailed as the market digested the horrendous events.

In fact, the real estate capital markets have behaved rather impressively, pulling an about-face from a decade earlier when gross overindulgence by investors, lenders, and developers led to a collapse and long-lasting liquidity crisis.

The industry seems to have learned from its hard lessons:

- Throughout the recovery and upswing most construction lenders insisted on large-percentage equity contributions from developers and stiff preleasing requirements before funding major office projects. Now, as fundamentals weaken, development capital is drying up.

- Buyers contributed to the restraint, backing away from overheating office and hotel markets well before the sublease flood.

- Dealmakers refused to calculate frothy rental rates into pricing assumptions, holding closer to replacement cost numbers and maintaining rational expectations.
CMBS lenders, banks, and insurers, meanwhile, provided ample market liquidity for refinancing in the comfortable low-interest-rate environment. Equilibrium in the space markets and record-low delinquency and default rates gave them the necessary security.

As a result, most owners are well capitalized and most lenders are well insulated. It’s a powerful combination that should help us weather a wheezing economy and listless demand for space.

Emerging Trends interviewees see lending sources becoming more conservative as markets soften further into early 2002. But they expect gridlocked equity investors to come off the sidelines once they’re confident that markets have reached bottom. In short, capital will be available, but more limited in the debt markets and more opportunistic in the equity markets. Considerable attention will be focused on how CMBS markets handle the inevitable defaults and foreclosures, and whether pension funds beef up their real estate allocations once the dust settles.

### THE POWER OF THE PUBLIC DEBT MARKETS

“In real estate everybody focuses on equity, but debt is where the action is,” an interviewee points out. The mortgage markets—private and public—are more than four times the size of equity markets, and the growing influence of public mortgage markets over the past decade has had an exponential impact on real estate markets. “REITs get all the hype, but CMBS have made the difference.”

### THE GREAT REGULATOR

“CMBS is now the great regulator of the real estate markets.” Rating agencies and the small group of B-piece bond buyers known as “the Cartel” scrutinize offerings and kick out questionable loans. They feed off market data now readily available over the Internet and react quickly to changing trends. “Rating agencies and the Cartel supply enough discipline to counter Wall Street’s penchant for making as much money as they can.”

### CONCLUSION TO VAST FIXED-INCOME FLOWS

CMBS now link the real estate markets to the trillions of dollars worldwide that are seeking fixed-income investments. Bonds are constantly being repaid and investors need to replenish their portfolios. Securitized mortgages tap into this huge appetite and attract a ready source of liquidity for the commercial real estate markets—one that never existed before.

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**EXHIBIT 3-1 Availability of Capital**

| Source: Emerging Trends in Real Estate 2002 interviews |
|---|---|---|
| 2002 Estimated | 2001 Forecast |
| **Pension Funds** | 6.3 | 5.8 |
| **Life Insurance Companies** | 5.8 | 5.7 |
| **Commercial Banks** | 5.7 | 5.5 |
| **Entrepreneurial Capital** | 6.3 | 6.1 |
| **CMBS** | 6.2 | 6.1 |
| **Wall Street** | 5.7 | 5.5 |
| **Foreign Investors** | 5.7 | 5.4 |
| **REITs** | 5.2 | 4.5 |
| **Overall** | 6.1 | 5.7 |

*0 5 10*  

*Decrease  Stable  Increase*
Capital Sources: The Flow of Funds
As of September 15, 2001

TOTAL U.S. REAL ESTATE: $4.6 TRILLION

Total Equity: $372.7 Billion
Total Debt: $1,676 Billion

Non-institutional: $2.53 Trillion
Institutional: $2.05 Trillion

Foreign Investors
$39.2B–10.5%

REITs
$146.6B–39.3%

Pension Funds
$144B–38.6%

Non-Govt. CMBS Issuers
$247.8B–14.8%

Commercial Banks
$146.8B–8.5%

Federally Funded Mortgage Pools
$69.3B–4.1%

Other
$55.6B–3.3%

Pension Funds
$37.6B–2.2%

REITs
$8.6B–0.5%

Commercial Banks
$704B–42%

Sources: Rosen Consulting Group, Lend Lease Real Estate Investments
PRIVATE MORTGAGE MARKETS BENEFIT

Life insurers and banks now readily securitize parts of their whole-loan portfolios, and they’re emulating conduit practices for pricing, sizing of loans, and lockout periods. No longer confined to lend-and-hold strategies, these originators have greater flexibility and can provide more liquidity through the private markets. Overall, the mortgage markets have become more efficient and standardized.

EVERYONE KNOWS

If B-piece buyers or rating agencies reject loans in offerings, “everyone knows about it.” Securitizations are fodder for the Internet; the lending process has become more of an open book and defaults are public spectacles. “Information about borrowers, tenants, locations is 110% accessible. It’s all there. Anyone who ignores the signals is crazy.” Private lenders who stray from course leave themselves exposed to questions and greater scrutiny from industry regulators and analysts. REIT investors and private equity players pick up the data streams. Real-time information works to discipline expectations, stymie wayward lending, and regulate overall capital flows in both the debt and equity markets. “Everything is too transparent to do something stupid.”

From nowhere ten years ago, CMBS now command nearly 15% of the commercial mortgage market, producing new domestic offerings at a $1-billion-a-week clip. The small “hodgepodge” of B-piece buyers keys the securitization process and effectively caps the market appetite at about $60-$65 billion annually. Comprising “maybe 12” large financial companies, opportunity funds, and private syndicators, they price and buy up the higher-risk tranches in each offering, providing “the grease for the deal’s success.” CMBS share growth will hinge in part on increasing this thin B-piece buyer universe, which could be a perfect use for opportunity fund dollars.

CMBS MARKETS FACE FIRST MARKET DOWNTURN

In fall 1998, CMBS markets survived the consequences of a worldwide capital-markets crisis with a few major casualties—issuers who got caught warehousing leveraged loans as spreads widened dramatically. Buy-and-hold investors escaped damage, as markets normalized within months. Unlike the ’98 situation, issuers were not overleveraged when the U.S. terrorist attacks touched off an “event crisis.” Lenders and investors could sit back and wait for market confidence to return without suffering losses. But in 2002, CMBS investors confront their first down market: “1998 was the liquidity test; 2002 will be the credit test.” Avoiding too much turmoil if defaults and delinquencies surge will be crucial for sustaining growth in this influential capital channel.

Interviewees seem reasonably sanguine about CMBS prospects, predicting overall delinquency and foreclosure rates to increase to around 2% (the historic average) or worst case, 3%, which is still within a manageable range. “Don’t expect widespread defaults”—the industry is too well capitalized and markets have been in good balance. “There won’t be blanket pain.”
Here’s the *Emerging Trends* consensus view about the vulnerability of CMBS owners:

- **Triple-A through triple-B investors will all get paid and are well protected.** “No sweat here, the pools are too well diversified and borrowers have too much equity in these deals.”

- **If defaults rise, most losses will be confined to unrated buyers.** “If ‘unrateds’ have been investing for three years or more, the worst case is they are even up. To date, they’ve made a fortune.”

- **“All eyes will be on what happens to the B buyers.”** If single-B buyers get paid or come through the market okay, “the market will be in great shape” for the future. “But if B buyers start taking it in the shorts, then the industry will have to convince investment-grade bond holders not to panic.” Obviously, if an already limited group of B buyers is depleted, the CMBS market could be crippled. The odds of B pieces failing “are fairly long.” But the stakes are high.

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“Hotels are another turnoff.” Issuers view lodging properties more like businesses, not real estate.

Fannie Mae and Freddie Mac dominate multifamily lending, using originator intermediaries and then securitizing pools. Constrained markets and housing shortages promise to keep lender capital flowing to apartment owners and developers.

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**BANKS AND OTHER PRIVATE LENDERS**

**BANKS STAY DISCIPLINED**

For all the considerable and deserved attention paid to CMBS, it’s banks that continue to furnish the “lion’s share” of real estate debt—about 40% of the market, including construction loans. In 2002 “banks will be very cautious, sticking to formulas and major relationships until they see the markets in a definite upswing.” Most importantly, development capital is shriveling, tempering new construction.

Keeping bank lending in check:

- **Institutional memories from the early-'90s nightmare linger on.** “The guys who made the bad loans ten years ago now sit at the head of the credit committees, and they don’t want to get burned again.”

- **Wall Street analysts and major shareholders join regulators in scrutinizing lending practices of the large money center banks, which are publicly held.** Share-price pressures keep loan officers in line.

- **In turn, banks reduce their balance sheet exposure through securitizations and syndications.** They need to meet rating-agency and B-piece standards or undergo review from industry brethren, who are steeped in their own institutional horror stories.

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**2002 LENDING OUTLOOK**

Softened markets will challenge CMBS and other lenders in 2002. Volumes could fall off and refinancing could become harder to obtain. “Every deal is tough, because there’s not the upside from tenant and rent growth to bail you out,” says a conduit executive. “What was prudent in ’97 or ’98 is stupid today. Lenders will need to protect themselves more from downside risk.”

Spreads on investment-grade should tighten, if investors escape unscathed from default episodes. Non-investment-grade will reflect individual debt risk more closely. Hot-button turnoffs for B-piece buyers are clearly defined: single-tenant buildings, weak tenant credit, outlying markets, and bad borrower history. Retail gets a bad rap—everyone is concerned about the credit of retail tenants. “At best it’s BB.”

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CMBS investors confront their first down market: “1998 was the liquidity test; 2002 will be the credit test.”
Smaller regional banks made some unwise bets on speculative development, mostly in suburban markets in hot growth areas. They may take some haircuts.

DO LIFE INSURERS AND WHOLE LOANS HAVE A FUTURE TOGETHER?

Expect life insurers to continue expanding CMBS holdings at the expense of their once prodigious whole-loan portfolios. Fewer new insurance policies and investment offerings match up to traditional whole loans. Also, risk-based capital provisions penalize whole loans on insurers’ books, while CMBS are treated like lower-risk corporate bonds. As more mutual life insurers go public, company honchos confront analyst scorn for large mortgage portfolios, and mortgage investment departments increasingly look like costly overhead.

For now, most insurers will try to have the best of both worlds—originating whole loans, keeping some on their books, securitizing others, and investing directly in CMBS. Combinations of CMBS and whole loans can optimize their portfolio risks. Once the primary source of $100-million-plus loans on single-asset trophy buildings, insurers have abandoned megalending territory to Wall Street securitizers; chief investment officers fear there’s too much risk tied into such single-asset loans. Instead, the life companies focus mostly on the $50-million-to-$100-million spectrum, where they can cherry pick among borrowers desirous of personalized attention. “Insurers get origination fees and command premium returns for structuring non-cookie-cutter loans that work for the borrower’s specific needs.”

But the trend lines seem obvious: over time, more insurers will curtail whole-loan lending, or drop it entirely, and concentrate on CMBS. “Ten years from now, you’ll see a lot less whole lending.”

FOREIGN LENDERS EXPAND

The rise of global capital markets has solidified lending by offshore banks, particularly German institutions and to a lesser degree Swiss and Dutch. “The borders are coming down and these players are here to stay.” Germans have been more active than some domestic banks. European investors have reaped significantly higher yields in the U.S. than they have back home, even when adjusted for currency.
Over time, more insurers will curtail whole-loan lending, or drop it entirely, and concentrate on CMBS.

fluctuations. The Europeans have built up a generally good reputation, concentrating on larger properties in top-tier markets. “They haven’t been reckless—it’s not dumb money.” In fact, “there’s a lot of brain damage in getting financing from them—it’s a difficult process.” Asian banks, notably Japanese, are scarce—too many troubles back home and too many past losses here.

MEZZANINE DEBT—A LOOSE CANNON

Various financial institutions and Wall Street players have been raising money for mezzanine debt funds that take quasi-equity stakes in development projects or refinance up to 80% of properties’ values. For some borrowers, mezz debt “can be as good as a sale. It’s almost like equity—if things go bad, they can walk away.” That may not be good for mezz debt investors if the markets deteriorate. Far from being market makers, some mezz funds could catch a case of bad market timing. It all depends on the overall level of leverage and the underlying property value used at the time of underwriting.

THE EQUITY MARKETS

PENSION FUNDS: WHAT WILL THEY DO COMING OUT OF THE DOWNTURN?

Pension real estate portfolio allocations shot up past targets in 2001 as Wall Street’s bear market savaged plan sponsor stock holdings. Many funds pulled back from new real estate investing and moved to rebalance by selling some property holdings. Industry advisers hoped that glowing property performance and newfound market discipline would encourage a different approach. Now they wonder whether plan sponsors will ever raise their allocation targets and pour more money into the asset class.

Given the recent weakening in real estate’s market profile, pension fund reluctance to increase property investing appears well timed. Says one pension portfolio manager: “If I had a lot more dollars now, I don’t know what I’d do with them. Buy just anything in a declining market and there go your returns. I’ve been there before, and don’t want to go back.”

Returns must hold up Market performance in the cyclical downturn will be important in convincing pension executives to reevaluate real estate strategies. If total core returns can be sustained close to traditional strong investment income levels, as most observers expect, then real estate should get an important boost in credibility. But if depreciation eats into income returns significantly, poor total performance could reinforce pension fund doubts about whether real estate adds enough value to diversified portfolios to be worth the effort. The decision on which road to take will probably be made in 2002.

Plan sponsors need more income Unquestionably, pension funds will need more income-based returns by the end of the decade as the ranks of Baby Boomer retirees start collecting
benefits. Core real estate and its steady high-single-digit income returns would be attractive, especially if markets stay in equilibrium and add a dependable though modest appreciation kicker. Some combination of equity real estate and REITs could gain favor.

**Wait and see** Most pension funds are taking a wait-and-see approach; for now they’re sticking to allocation targets that average out to less than 3%, where they’ve been stuck for most of the past decade. A persistent impediment is staff time—managing lumpy real estate holdings from long distance is much harder than monitoring stock portfolios on your laptop. “Real estate doesn’t have a real benchmark and is still a leap of faith for most chief investment officers—they don’t get paid to be mavericks.” Influential pension consultants also resist real estate because of performance history (the early 1990s primarily), transparency and liquidity issues, absence of consistent reporting standards, and questions about the valuation process. Still, the strength of recent property returns, plus future needs to match assets and liabilities, argue for an adjustment in modeling.

**No land rush predicted** “Any change is going to take time and be a slow process,” says an interviewee. “Six months ago nothing was going on—but big public funds are beginning to push for allocation studies, and they could lead the way.” If it happens, they’ll raise allocation targets more toward 5%-7%, using both private equity and REITs.

**401k conundrum** Private real estate also confounds easy packaging into 401k and defined contribution retirement plans, which are the future growth vehicles for pensions as traditional defined-benefit plans continue to lose adherents. How do you create a workable private real estate vehicle that delivers credible, daily-valued returns in a liquid format? So far, the conundrum hasn’t been solved exactly, despite valiant attempts. REIT mutual funds are a ready alternative, but these stocks only command a $150 million capitalization.

“They can’t easily absorb the billions of dollars potentially out there.”

**Limited equity flows** The debate may be somewhat academic. “Real estate is a small sector on the equity side and doesn’t need huge capital flows,” says an interviewee. “As long as real estate supply stays in check, returns can roll along. When too much money floods the market, we get ourselves in trouble. Real estate is going mainstream through the debt markets and CMBS, not so much the equity side.”

Just the same, the equity markets need increased levels of participation from pension funds to provide liquidity and grow values.

**REITS: NET ASSET VALUES KEY GROWTH PLANS**

Since their 1998 market correction, most REITs have been unwilling to raise new capital through securities offerings because their stock-price levels
have stayed well under net asset values. Total capitalization for the group began leveling off in 1997 after a rapid growth spurt, and it hasn’t climbed above the current $150 billion plateau ($260 billion including leverage). Again, 2002 could be a pivotal year. If these stocks don’t decline because of investor sell-offs prompted by real estate market concerns and maintain values close to NAVs, then REIT offerings could look attractive as real estate prospects improve later in the year. But if REIT pricing takes a tumble, management plans would suffer setbacks.

PLENTY OF OPPORTUNITY
CAPITAL IS READY TO POUNCE

With increased buying power from possible secondary offerings, REITs would be in the thick of the move to lead equity investors out of the doldrums, joining opportunity players in the hunt for distressed assets at bargain pricing. Opportunity funds have raised significant monies from pension funds and high-net-worth individuals, who hope recent past performance can be replicated in the next market cycle. That may be difficult, since most markets aren’t expected to stray too far from equilibrium and distressed sellers may be in shorter supply than they were at steeper cyclical nadirs. For outsized returns, opportunity investors will need to look overseas, where risk increases dramatically. A severe U.S. economic downturn, however, would position opportunity war chests perfectly. Be careful what you hope for.

OFFSHORE BUYERS

Foreign investors remain a mixed bag—“there’s no dominant force.” Through most of 2001, the high dollar was an impediment to stepped-up investment, though German institutions and syndicates had returned gingerly to major office markets, dominating spotty deal-making activity in New York and Washington, D.C. As for Middle Eastern countries, “their currencies are tied to the dollar and they have no domestic real estate market.” These investors concentrate on enhanced yields from apartments and industrials. Money was available before September 11, but time will tell.

Asia has been a dry hole.