

2005 Borrower Trends Survey: A Special Research Report

Insatiable Appetite For Debt Financing

Even in a rising interest rate environment, borrowers appear undaunted in their quest for capital.

The prospect of higher interest rates shows no sign of dampening borrower demand for commercial real estate debt, according to an exclusive survey of more than 400 developers and owners conducted by **National Real Estate Investor**. More than half of respondents (52%) expect total debt in their commercial real estate portfolios to increase during 2005, while only 14% expect their debt levels to decrease.

That's sweet music to the ears of lenders and mortgage bankers. "The pipeline that we have is very strong going into 2005. We expect a very robust first quarter that is equal to or better than last year," says John Fowler, executive managing director at Holliday Fenoglio Fowler,

a Boston-based investment banking firm. HFF arranged more than \$14.3 billion in real estate debt financing in 2004, up 24% from the \$11.53 billion the firm placed in 2003.

Mortgage loan originations industry wide were expected to set a new record in 2004. Commercial mortgage bankers originated \$88.2 billion during the first three quarters of 2004 — up 12.9% compared to the \$78.1 billion originated during the same period in 2003, according to the Mortgage Bankers Association (MBA). At that pace, originations will likely surpass the \$116 billion record set in 2003.

To gain more insight into borrowers' debt financing plans for 2005, *NREI* conducted an exclusive mail survey in November and e

Debt Sources
Commercial banks remain a dominant force p. 3

Mortgage Rates
Most respondents expect a 1% to 2% hike p. 4

Fixed vs. Floating Rates
Borrowers with long hold periods prefer fixed rates p. 5

Refinancing Activity
In this climate, volume is likely to remain strong p. 6

Borrower Needs
Ease of loan process ranks atop list p. 7

Survey Methodology

Data for the 2005 Borrower Trends Survey, an exclusive research report conducted by *National Real Estate Investor*, was collected between Nov. 5 and Dec. 7, 2004. Surveys were mailed to 1,500 domestic subscribers of *NREI*, selected on a random basis from the magazine's circulation list of commercial real estate owners and developers. The total number of completed surveys was 442, for a response rate of approximately 30%.

The purpose of the study was threefold: (1) to measure the volume of capital that respondents borrow annually; (2) to quantify borrowers' level of satisfaction with the overall commercial real estate loan process; and (3) to determine the qualities that respondents look for when working with direct lenders and financial intermediaries.

In addition to appearing in the February 2005 issue of *NREI*, this special finance report can also be viewed online at www.nreionline.com. Questions pertaining to the survey can be directed to Editor Matt Valley.

NREI covers trends in commercial real estate with an emphasis on finance. Approximately 40% of the publication's 35,210 qualified readers are developers, owners and managers. Lenders, corporate users and brokers make up the balance of the readership.



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December 2004. The 400-plus respondents reported a median \$9.4 million in commercial real estate assets. A majority of respondents (70%) own or develop multiple property types, though the largest group of respondents (43%) is active in apartments, followed by office (42%) and retail (41%) [Figures 1 and 2]. What follows are some of the study's key findings:

- Some 16% of respondents expect the total debt in their portfolios to increase significantly in 2005, while another 36% expect their total debt to increase somewhat. Nearly one-third of respondents (31%) expect their debt level to remain the same [Figure 3].

- Over the past year, respondents have borrowed a median of \$4.8 million, which represents a median of 15% of their total assets [Figures 4 and 5].

- An overwhelming majority (83%) of respondents have borrowed from commercial banks and savings institutions over the past year. Private investors are the next most frequently cited source of debt financing (27%) [Figure 6].

- The largest group of respondents (31%) indicate that that mortgage rates on 10-year loans would have to rise to more than 7.5% — about 200 basis points from current levels — before their borrowing decisions would be affected [Figure 7].

- In the next 12 months, 42% of respondents expect their use of long-term, fixed-rate debt to increase, while 33% expect their use of short-term rates to increase. Only 13% of respondents expect their use of short-term debt to decrease, and 8% anticipate a decrease in their use of long-term debt [Figure 8].

- When selecting a loan officer, overall ease of the borrowing process ranks as the most important factor, earning a score of 5.5 out of a possible 6, followed by lowest interest rate (5.3), and speed with which loans are closed (5.2).

- Although the speed with which loans are closed, low fees and flexibility of loan terms are three areas that rate relatively high in importance, they score relatively low in satisfaction, pinpointing possible areas of improvement for direct lenders and financial intermediaries to address.

FIGURE 1. RESPONDENTS ARE MOST LIKELY TO OWN OR DEVELOP APARTMENTS FOLLOWED BY OFFICE SPACE

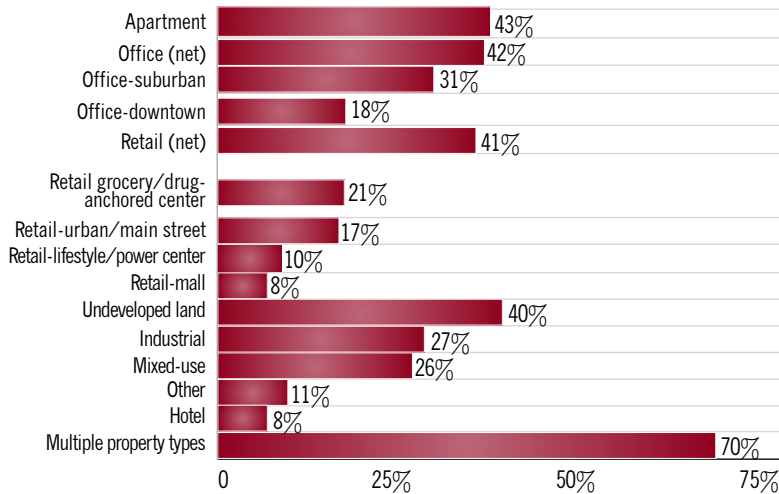


FIGURE 2. THE MEDIAN VALUE OF RESPONDENTS' COMMERCIAL REAL ESTATE ASSETS IS \$9.4 MILLION

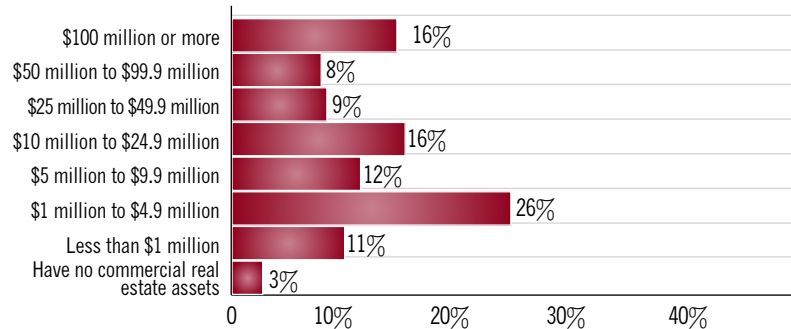
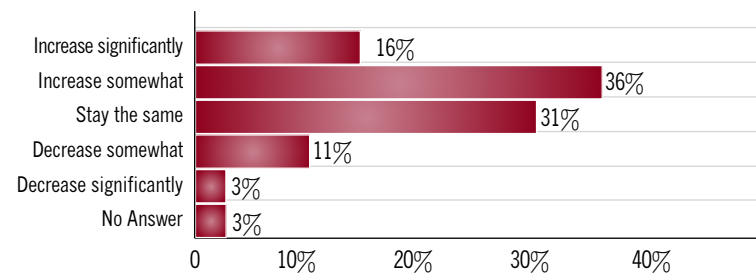


FIGURE 3. A MAJORITY OF RESPONDENTS EXPECT THE DEBT LEVEL IN THEIR PORTFOLIOS TO INCREASE



- The study found that borrowers are actively pursuing capital for a variety of reasons, including acquisitions, development and renovation of commercial properties, with the greatest number of respondents (39%) citing development.

The Miller-Valentine Group of Dayton, Ohio, is a fitting example. The company borrowed more than \$200 million in 2004, and the developer expects to meet or exceed that level in 2005 thanks to a major project in the pipeline.

Miller-Valentine is moving forward with the \$150 million third phase of Rookwood, a mixed-use development in Cincinnati that Miller-Valentine is developing in partnership with Cincinnati-based Anderson Real Estate Group.

"The market is very liquid right now. All lenders are looking for quality product with quality borrowers," says Sharon Pennell, partner and director of finance at Miller-Valentine. "They are not doing crazy deals. But they are trying to be a little bit more aggressive on price and flexibility."

Commercial banks riding high

Among the myriad debt sources available today, borrowers' most frequently cite use of commercial banks and savings institutions. Some 83% of respondents indicate they've borrowed funds from these two capital sources in the past 12 months.

One reason that banks are a top pick in the current market is incredibly low short-term rates. Banks are traditionally a more active player in providing short-term debt such as construction loans, interim financing and lines of credit, while other lenders, such as conduits and life companies, tend to specialize in originating permanent financing. Cleveland-based KeyBank Real Estate Capital, for example, closed approximately \$8 billion in construction and interim loans in 2004, a 60% spike from \$5 billion in 2003.

A good chunk of KeyBank's increase in interim lending was due to existing borrowers taking out 2- to 5-year floating-rate loans. "Part of that has to do with the fact that LIBOR (London Interbank Offered Rate)

FIGURE 4. RESPONDENTS HAVE BORROWED A MEDIAN OF \$4.8 MILLION IN THE PAST 12 MONTHS

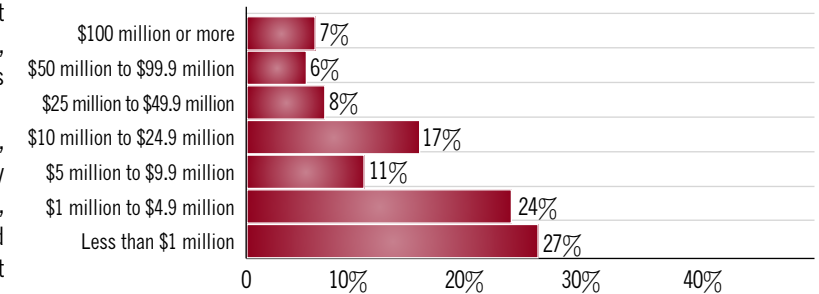
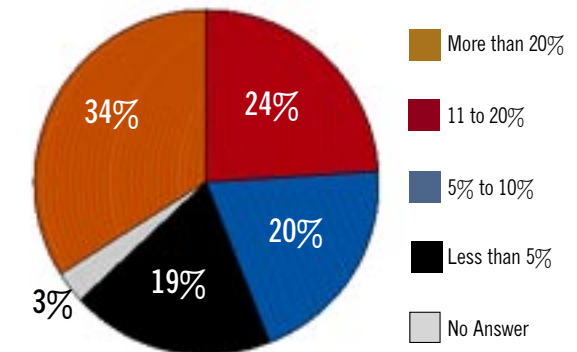


FIGURE 5. RESPONDENTS INDICATE THE AMOUNT BORROWED REPRESENTS A MEDIAN OF 15% OF TOTAL ASSETS. THE LARGEST GROUP SAYS THE AMOUNT IS ABOVE 20% OF ASSETS.



for 2004 has been at an incredibly low rate," says E.J. Burke, an executive vice president at KeyBank Real Estate Capital. The 3-month LIBOR ended the year at 2.56%, which is still incredibly low compared to historical levels. In 2000, for example, the 3-month LIBOR averaged 6.5%.

Another reason banks score high among borrowers is that they offer a variety of loan products. In addition to its interim loan products, KeyBank offers its clients a full menu of financing products such as mezzanine debt, private equity investment and permanent loans — including arranging financing via conduits, life companies, Freddie Mac and Fannie Mae. Banks also cater to smaller borrowers, while conduits

and life companies tend to pursue larger transactions. The average loan transaction by banks during the third quarter of 2004 was \$6.5 million compared with \$11.9 million for conduits and \$11.7 million for life companies, according to MBA.

Opus Northwest, based in Minnetonka, Minn., borrowed \$500 million from banks in 2004, and the group expects to borrow as much or more in 2005. "Bank flexibility has not changed a lot, but there is a lot of capital on the debt and equity side for developers of strong projects," says Becky Finnigan, vice president of finance for Opus Northwest, a division of Opus Corp.

Banks are attracted to well-located projects with solid anchors, such as the

FIGURE 6. A MAJORITY OF RESPONDENTS USED COMMERCIAL BANKS AS A DEBT SOURCE IN 2004

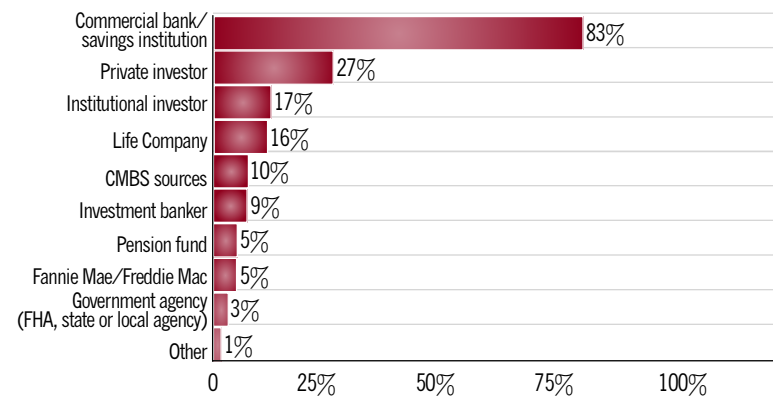


FIGURE 7. BORROWER DECISIONS WOULD BE MOST GREATLY AFFECTED IF 10-YEAR MORTGAGE RATES EXCEED 7.5%

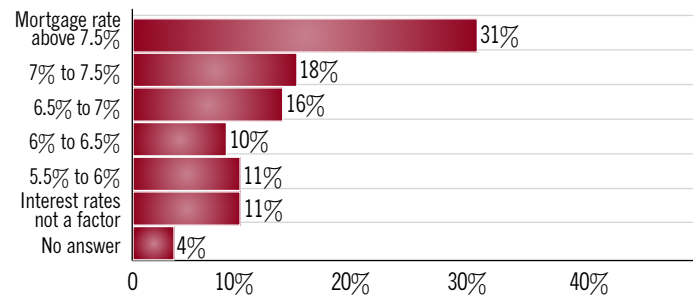
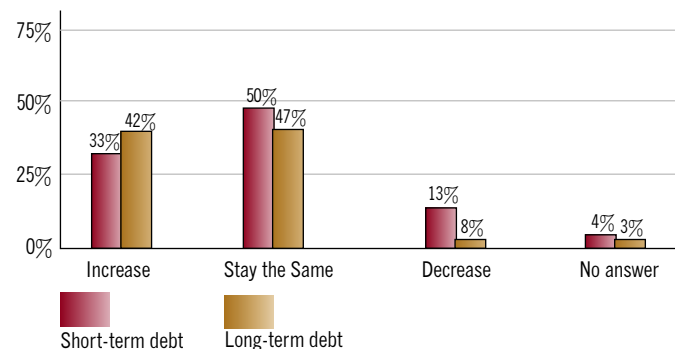


FIGURE 8. ONE-THIRD OF RESPONDENTS EXPECT THEIR USE OF SHORT-TERM DEBT TO INCREASE



Shoppes at Arbor Lakes in Maple Grove, Minn. Opus Northwest built the 411,000 sq. ft. lifestyle center in conjunction with Kansas City-based Red Development. The project, which opened in 2004, features tenants such as Williams Sonoma, Pottery Barn, Talbot's and P.F. Chang's.

The 1,260 loans originated by commercial banks during the third quarter of 2004 easily surpassed the 758 loans originated by conduits, according to the MBA. Commercial mortgage-backed securities, or CMBS, accounted for the highest dollar volume in originations during the third quarter. CMBS transactions totaled \$9.4 billion compared with \$8.2 billion for commercial banks, and \$5.9 billion for life companies.

"The whole CMBS market right now is very profitable," says Ed Padilla, CEO of NorthMarq Capital based in Bloomington, Minn. That's partly due to overwhelming demand. "There doesn't seem to be any shortage of customer for what they are creating. Pools are selling out, and there doesn't seem to be any end in sight," he says.

Borrowers brace for higher rates

Respondents are highly confident that interest rates will continue to rise. Specifically, 84% expect higher long-term rates, while 77% anticipate higher short-term rates [Figure 9]. But how high, and how quickly those rates rise could impact not only the amount of dollars borrowed, but also decisions to refinance and whether to pursue floating-rate or fixed-rate financing.

The largest percentage of respondents (55%) expects long-term mortgage rates to rise between 1% and 2% in 2005 [Figure 10]. Under that scenario, the 10-year Treasury yield — which as of mid-January hovered around 4.25% — would rise to 5.25%. Industry experts emphasize that by historical standards, 5.25% is still relatively low. In 1981, for example, the 10-year Treasury yield averaged nearly 14%.

HFF's Fowler, a 36-year veteran of real

estate finance, does not expect a dramatic shift in borrowing activity, but there is one caveat: If rates were to spike a full percentage point over a period of several weeks rather than several months that could put a damper on lending activity. "If there were a 100-basis point jump in treasuries or LIBOR, owners wouldn't know whether to sell, finance or hold," Fowler says. "Big spikes in interest rates have a way of paralyzing people's actions. Gradual rises don't paralyze anyone. People just get used to it."

The Federal Reserve Board raised the fed funds rate one-quarter point to 2.25% in December, the fifth increase in 2004. But while short-term rates took a leap, long-term rates have been slow to follow. Case in point: The 3-month LIBOR began the year at 1.13% but rose 143 basis points to end the year at 2.56%. Meanwhile, the 10-year Treasury began 2004 at 4.15% and increased just 10 basis points to reach 4.25% as of Dec. 31.

The "disconnect" between short-term and long-term rates is driven by expectations, says Lawrence Hadley, president of Hadley & Associates, a commercial mortgage banker in Novi, Mich. The short-term market anticipates more rate hikes by the Fed. But the bond market does not anticipate long-term rates to rise largely because there are still concerns about the outlook for economic growth in the U.S. Additionally, there is an expectation that inflation will be contained over the long term.

But that's not to say long-term rates won't rise in 2005, Hadley emphasizes. "Both short- and long-term rates will likely continue to rise over the next year, with the gap between the two likely to narrow further somewhat," says Hadley.

Vehicle of choice: long-term debt

Despite relatively low short-term rates, most borrowers prefer to go the safe route and lock in long-term debt. Respondents indicate that on average 68% of their debt is structured as long-term, fixed-rate financing while 32% is short-term, adjustable-rate debt [Figure 11]. Fixed-rate financing is prevalent among owners planning to hold

FIGURE 9. A CLEAR MAJORITY OF RESPONDENTS EXPECT SHORT-TERM AND LONG-TERM MORTGAGE RATES TO RISE

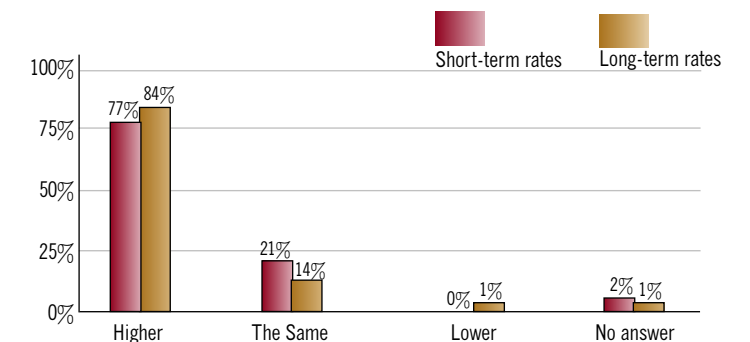
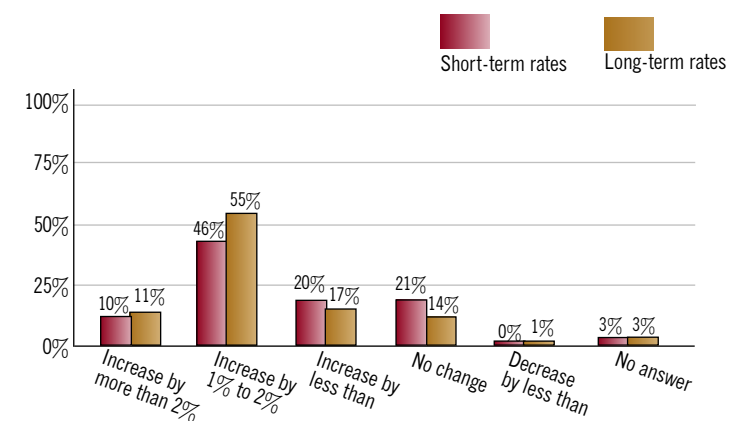


FIGURE 10. THE LARGEST PERCENTAGE OF RESPONDENTS EXPECTS MORTGAGE RATES TO RISE BETWEEN 1% AND 2%



assets for five years or longer. Those owners thinking about selling a property within the next three years typically opt for floating-rate loans, which offer more flexibility for paying off the loan when selling a property compared to the stiff pre-payment penalties on permanent loans.

Miller-Valentine prefers to borrow in the permanent market and lock into long-term, fixed-rate loans. "It's our goal to build the project, get it stabilized and then take it to the permanent market," Pennell says. As a result, Miller-Valentine primarily pursues life companies and pension funds for its commercial developments, while turning to conduits or perhaps a Fannie Mae lender for larger deals such as a major multifamily project. Typically, Miller-Valentine carries

about 25% of its portfolio in floating debt, which consists largely of construction loans. "We take our projects to the permanent market at any point we can," Pennell says.

The fact that respondents indicate that floating-rate debt accounts for one-third of all their debt is significant, according to industry experts. It's no surprise given the incredibly low short-term rates.

"In the history of our company, we have never done so many floating-rate transactions," Padilla says. "The floating rates have been so compelling, that it has allowed a lot of investors to buy properties at extremely aggressive cap rates. So we have been extremely active in the marketplace."

But that is likely to change in 2005. Rising rates will push even more debt into

long-term loans. The fact that short term rates are moving up, while the 5- and 10-year Treasuries are holding relatively steady, is causing real estate owners to evaluate whether they will maintain floating debt or convert to fixed. In the next 12 months, 42% of respondents expect their use of long-term, fixed-rate debt to increase.

Although the 10-year rate has not moved significantly in the past year, eventually it will follow the short-term rates and climb higher. The common thinking is that the Fed will raise rates at least another 100 basis points in 2005, Padilla notes. In theory, that should spark additional financing activity in the coming months as owners shift from floating to fixed debt. "The question for borrowers is when to pull the trigger," he adds.

Still, the spigot for short-term money is

not going to shut off completely, say industry experts. The relatively low short-term rates will continue to entice some borrowers, and the active investment market will motivate other borrowers to stick with the more flexible short-term loans.

Hot Refinancing Market

Rising interest rates will likely contribute to more refinancing activity in 2005 as owners shift from short-term to long-term debt. Overall, 70% of respondents borrowed money in the last 12 months, with more than one-third borrowing to refinance [Figure 12]. Only new development eclipsed refinancing. Another factor that could encourage that shift is a move by permanent lenders — particularly life

insurance companies — to incorporate pre-payment flexibility into their permanent loan products, which would make permanent financing options more attractive.

The big hurdle for many is that LIBOR has been so extremely low that there is a sizable and painful leap between a short-term construction loan and a 10-year permanent loan. If an owner has \$50 million in floating-rate debt that is financed at 100 basis points over the 3-month LIBOR, the loan rate would be about 3.5%. Converting that debt to a 10-year fixed mortgage at 100 points over the 10-year Treasury yield would translate into a rate of 5.25%. That's a difference of 1.75%, which would add more than \$800,000 in debt service just for the first year.

The cost of capital for servicing that debt comes out of the owner's net operating income, which is a direct hit to its projected return. "There is still a bit of pain in converting, but now you're locked in for 10 years. So if the LIBOR keeps going up, you've made a smart call," Padilla says. However, borrowers that hold onto floating-rate debt may see the short-term rate climb to a point where it is equal to or higher than the fixed rate, he adds.

Many owners have been reluctant to make that jump. But with the gap between short-term rates and long-term rates narrowing, owners are beginning to wonder if now is the time to "bite the bullet" and convert, Padilla notes. "If they don't convert now, and the long-term rate starts increasing, they will have missed the boat," he adds.

Glimcher Realty Trust, a Columbus, Ohio-based shopping center REIT, has been busy converting its floating-rate debt to long-term, fixed-rate financing. Although Glimcher did not borrow any money to finance new acquisitions in 2004, the firm did conduct about \$231 million in new debt financing as it continued to restructure its debt. "We made an effort to refinance a lot of maturing debt in the 2002-2003 time period, and we did more of that refinancing in the first half of 2004," says William Cornely, COO and treasurer for Glimcher.

Currently, only about 10% of Glimcher's debt load is in floating-rate loans compared with 45% about four years ago. Typically, the company's target is to have 10% to 20% of its debt in floating-rate loans. "Over the last 36 months, we felt comfortable having more than our target in floating-rate (debt), but we also wanted to get that reduced this year due to our belief that interest rates were on the rise," Cornely says.

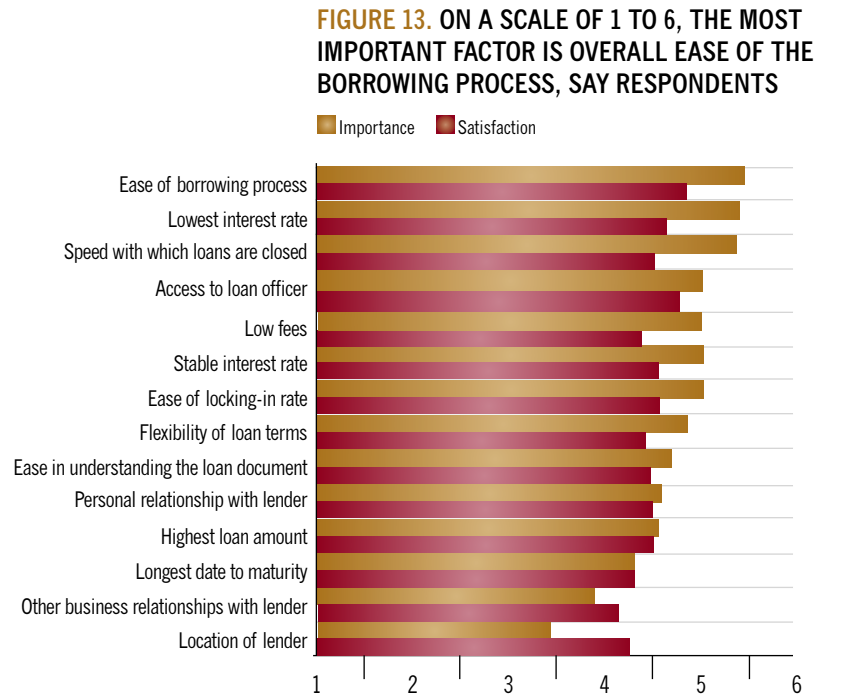
Loan terms trump relationships

Given the heightened competition, lenders recognize that they need to do all they can to meet and exceed borrower expectations. "The pendulum is well in the borrower's corner. Everyone has to be a little more aggressive," says Tom MacManus, CEO of North American operations for Horsham, Pa.-based GMAC Commercial Mortgage Corp. Lenders are competing not only on rates, but also on the speed in which loans close and flexibility of loan terms.

Borrowers indicate that securing the lowest rate is not the most important factor when it comes to choosing a lender. Respondents ranked ease of the borrowing process as the most important factor when working with a loan officer [Figure 13]. On a scale of 1 to 6, with 6 being very important, ease of the borrowing process scored 5.5.

Although most permanent loans require a minimum of 30 to 45 days to close, some deals are closing in less than 30 days. In addition, lenders are willing to be more flexible in areas such as escrow terms and prepayment penalties than they were a couple of years ago. "There are things (lenders) can do on the flexibility side that can win the day for them, and the more creative lenders are doing that," says HFF's Fowler.

Miller-Valentine's top priority in choosing a lender is the flexible terms followed by the rate. "On the commercial side of the business, we don't do a lot of CMBS borrowing because we need flexibility with our lender," Pennell says. "Typically, we choose a life company that we know and have flexibility with so when we need to change something in the deal, the life



company is willing to hear our story and willing to let us do what we need to do." After a CMBS deal goes through, it can be difficult to even get someone on the phone to discuss it, says Pennell.

Although CMBS terms are notoriously inflexible, they generate the highest dollar volume because the rates are so competitive and have the ability to fund large deals. "The mall sector has been a fairly significant player in the CMBS business because our transaction size tends to be fairly large," Cornely says. Over the years, Glimcher has turned to conduits for several loans that ranged between \$100 million and \$150 million. In addition to competing on price, the CMBS lenders are very efficient and offer good execution, he adds.

In a business where relationships are often touted as a key to deal making, respondents ranked the importance of personal relationships with lenders a mediocre 4.7 on a scale of 1 to 6. Yet invariably, relationships are still a key part of the equation for some borrowers. "My peers and I disagree, but we look for somebody that wants to be the debt partner in our deal. So we look very much for a good relationship," says Finnigan of Opus Northwest.

Larger projects in particular, such as the development of a retail lifestyle center,

often take two to three years to build and can require changes to the loan structure during project construction and lease-up. "You need a (lending) partner that has confidence in you as a developer and will work with you as things come up," Finnigan says. For example, if a project performs better than expected, Opus can ask the lender for a lower equity requirement because the lender's risk is lower. Or a project may encounter bumps along the way, such as a major tenant backing out of a project where it needs to work with the lender to make an adjustment on the structure of a loan.

Certainty of execution is important, which is where relationships come into play. Yet knowledgeable capital users want to know what kind of premium they are paying for that relationship. "First and foremost, you have to get the borrower the dollars they want," Hadley says. Although Hadley has one or two capital sources that he prefers to work with, he typically shops the deals to anywhere from three to six lenders.

The second priority is pricing and terms of the structure, and the third criteria is the lender's ability to deliver. "You try to get the most dollars and best pricing out of the lender that you think is going to be the most deliverable," explains Hadley, "and that's where it comes down to the relationship."

FIGURE 11. RESPONDENTS SAY MORE THAN TWO-THIRDS OF THEIR DEBT IS LONG-TERM, FIXED-RATE FINANCING

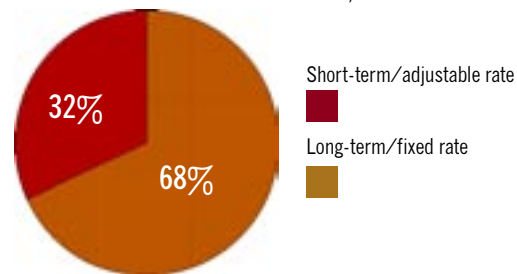


FIGURE 12. THE LARGEST GROUP OF RESPONDENTS HAS BORROWED FUNDS FOR NEW DEVELOPMENT

