

2006 Borrower Trends Survey: A Special Research Report

The Lure of Low Rates

A favorable interest-rate climate fuels record demand for debt financing, but for how long?

Despite more than a dozen hikes in the federal funds rate in the past 18 months and consensus among industry experts that the 10-year Treasury yield is poised to climb, borrower attitudes reveal an unflappable demand for commercial real estate debt. While four out of five respondents (81%) in National Real Estate Investor's 2006 Borrower Trends Survey indicate that both short-term and long-term interest rates will climb in 2006, 51% expect the total commercial debt in their portfolios to rise over the next year.

The strong appetite for debt financing is largely the result of highly favorable long-term interest rates that have refused to budge, say industry experts. While the Fed's actions have pushed short-term rates

up about 200 basis points in the past year, long-term rates have barely moved. The flat — and now inverted — yield curve has created a very attractive borrowing environment. The 3-month London Interbank Offering Rate (LIBOR) registered 4.57% as of Jan. 10 compared to the 10-year Treasury yield of 4.36%.

"I think borrowers and bond investors have been lulled into a false sense of security by the narrow trading range that long-term yields have found themselves in recently," says Scott Anderson, a senior economist at Minneapolis-based Wells Fargo & Co.

A variety of factors are to blame for the lagging 10-year yield. The severe imbalance in global trade has helped generate a glut of



\$2.5 Trillion And Counting

Level of debt outstanding continues to soar. p. 2

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Survey Methodology

Data for the 2006 Borrower Trends Survey, an exclusive research report conducted by *National Real Estate Investor*, was collected between Nov. 4 and Dec. 14, 2005. 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 354, for a response rate of approximately 23.7%.

The purpose of the study was threefold: (1) to measure the volume of capital that respondents borrow annually; (2) to assess their views on how interest rates will climb in the year ahead; 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 2006 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 35% of the publication's 36,235 qualified readers are developers, owners and managers. Lenders, corporate users and brokers make up the balance of the readership.



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U.S. dollars overseas, driving up foreign demand for longer-term U.S. Treasuries and keeping long-term yields relatively contained. "It is also partly a reflection of the low global inflationary environment and poor returns elsewhere that allow bond investors to settle for what historically has been considered paltry returns," Anderson says.

Debt outstanding still climbing

Overall, the level of U.S. commercial/multifamily mortgage debt outstanding grew by a record \$83.8 billion in the third quarter of 2005 to reach \$2.5 trillion, according to the Federal Reserve Board of Governors. The increase represented a 13.6% spike over the \$2.25 trillion in mortgage debt in the third quarter of 2004.

The favorable interest-rate climate coupled with the continued flow of capital into the commercial real estate sector is expected to boost debt financing in the coming year.

"Higher interest rates and a further compression of cap rates could have an impact, but we still expect 2006 to be a very active year," says Todd Everett, managing director, head of real estate fixed income at Principal Real Estate Investors, which arranges both debt and equity financing for clients, including its own affiliate Principal Life Insurance Co.

Principal arranged about \$5 billion in financing in 2005. That volume is up about 14% compared to 2004, and Principal is anticipating that volume will reach about \$5.5 billion in 2006.

The fact that many economists are predicting moderate short- and long-term interest rate increases for 2006 also bodes well for a continuation of that borrowing boom. Economists at Wells Fargo expect the Federal Reserve Board to introduce only two quarter-point hikes in early 2006. Those increases would be sufficient to douse any fears of inflation that were sparked by high energy prices, Anderson notes.

"Looking ahead in the coming year, we see the Fed winning its war on inflation," Anderson says. In fact, there

FIGURE 1. RESPONDENTS HAVE A MEDIAN \$9.8 MILLION IN COMMERCIAL REAL ESTATE ASSETS

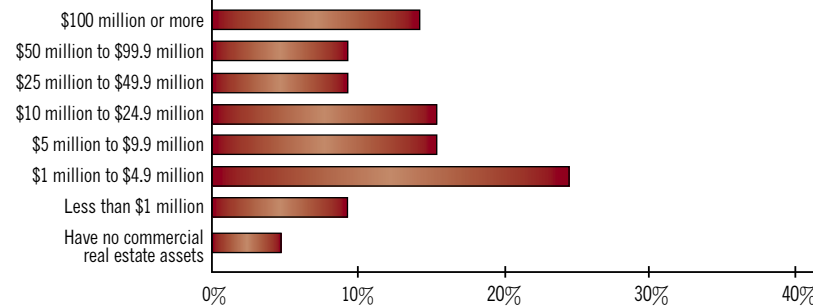


FIGURE 2. SEVEN OUT OF 10 RESPONDENTS ARE ACTIVE IN MULTIPLE PROPERTY TYPES

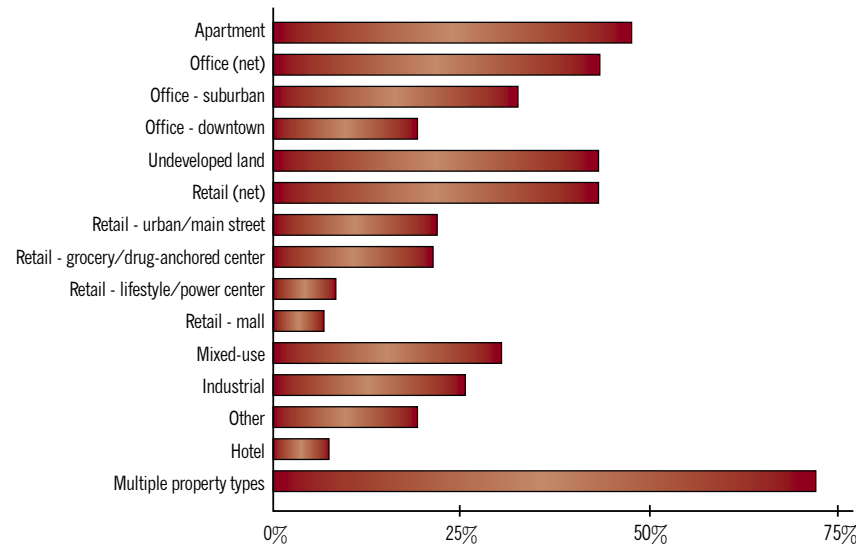
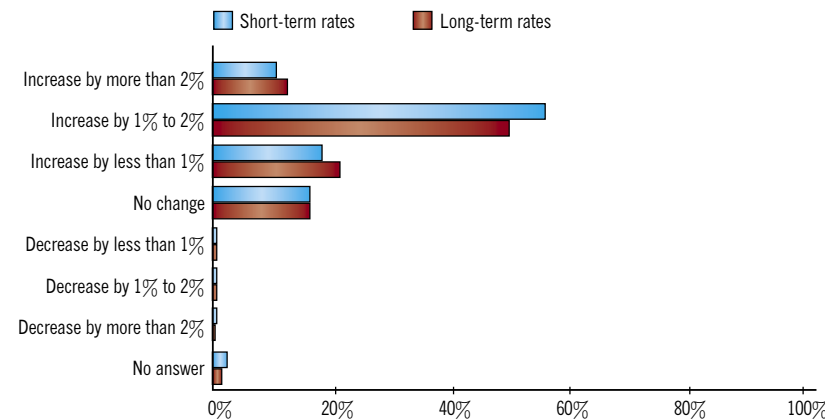


FIGURE 3. FOUR OF FIVE RESPONDENTS EXPECT LONG-TERM INTEREST RATES TO INCREASE. MOST EXPECT RATES TO CLIMB BETWEEN 1% AND 2%



are already signs that the Fed is getting a grip on inflation. For example, consumer inflation expectations have dropped by 1 percentage point since last fall. Inflation is currently growing at an annualized rate of 3.5%, and Anderson expects that rate to decrease to 2.5% by the fourth quarter of 2006.

To better gauge borrower attitudes, National Real Estate Investor conducted a mail survey of commercial and multifamily owners and developers in late 2005 that yielded 354 responses. Respondents reported a median \$9.8 million in commercial real estate assets [Figure 1]. The majority of respondents (71%) are active in multiple property types and 70% have borrowed funds in the past 12 months.

Among the study's major findings:

- The largest group of respondents (46%) own or develop apartments, while office properties, retail properties and undeveloped land are each owned or developed by 42% of respondents [Figure 2].

- Two-thirds (67%) of borrowers' debt is long-term, fixed-rate financing while 33% is short-term, variable-rate debt. In addition, 27% of respondents indicate that all of their debt is long-term compared to only 10% who say all of their debt is short-term.

- Overall, four out of five respondents expect interest rates to increase over the next year. A clear majority expect interest rates to rise between 1% and 2%. Still, 15% anticipate no change in either short-term or long-term rates [Figure 3].

- Overall, 42% of respondents indicate the 10-year Treasury yield would need to climb above 6% before their use of fixed-rate, long-term debt would be negatively affected.

- Despite rising rates, 38% of respondents expect the total commercial debt in their portfolios to increase somewhat, 13% believe debt will increase significantly and 32% say debt will remain the same. Among those predicting that their total debt level will decrease, 12% say their debt will decrease somewhat and only 3% expect debt to decrease

FIGURE 4. THE MAJORITY OF RESPONDENTS EXPECT THEIR DEBT LEVEL TO INCREASE OVER THE NEXT YEAR

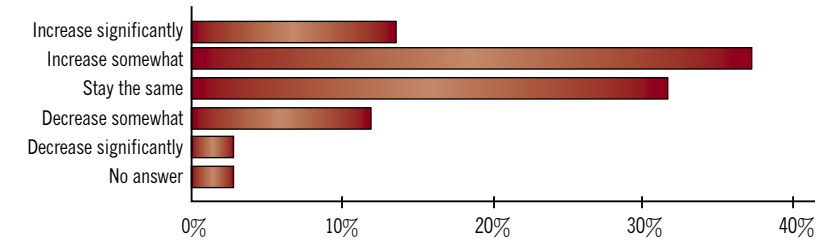
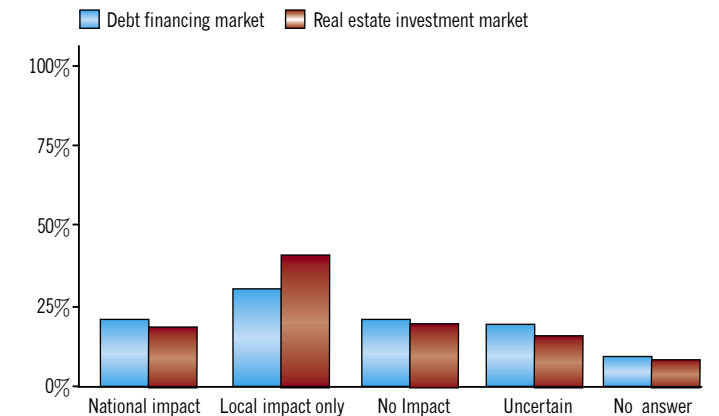


FIGURE 5. ONE IN FIVE EXPECTS THE HURRICANES OF 2005 TO HAVE A NATIONAL IMPACT ON THE DEBT FINANCING AND COMMERCIAL REAL ESTATE INVESTMENT MARKETS



significantly [Figure 4].

- Borrowers offer mixed views on what impact the massive hurricane destruction in Louisiana, Mississippi and Florida will have on debt financing and real estate investment markets in 2006. While 21% of respondents anticipate the aftermath of the 2005 hurricanes to impact the debt financings market nationally, 30% expect only a local impact. And 18% believe there will be a national impact on the real estate investment market vs. 40% who anticipate a local impact only [Figure 5].

Monetary policy post-Greenspan

When new Federal Reserve Chairman Ben Bernanke replaces the retiring Alan Greenspan this month, it will undoubt-

edly add a layer of uncertainty to the economy. The change could result in more volatility in the stock market; higher risk spreads on corporate bonds and perhaps some higher yields in the bond market. "[Bernanke] has to prove that he will not be soft on inflation. So, he will have to raise rates in March to prove that he wants to keep inflation in check," Anderson says.

Respondents are mixed in their views of how Greenspan's departure will impact rates. Although 33% expect the change to impact interest rates, 40% anticipate no impact on interest rates and 27% indicate they were uncertain or had no answer [Figure 6]. The incoming Bernanke is a former Princeton University economics professor and chairman of the President's

Council of Economic Advisors.

"I am concerned that, even if the economy doesn't warrant it, Bernanke will continue to raise short-term interest rates by a quarter point for the next six to eight meetings in order to show that he is an inflation hawk like his predecessors," says Andrew Stewart, chief operating officer at David Cronheim Mortgage Corp. in Chatham, N.J.

However unlikely, if the Fed does continue to raise short-term rates to 6% to 7%, at some point long-term rates will tag along. "If that does occur, commercial real estate will hurt in a big way," he adds. "Many of the properties that sold at 6% cap rates are going to be worth significantly less if that occurs."

Respondents vary in their views of how high the 10-year Treasury yield would need to climb before it negatively affects borrower's use of fixed-rate, long-term debt. In fact, the largest percentage of respondents (32%) say they were uncertain of what point the 10-year Treasury would start to negatively impact their use of long-term debt.

Seventeen percent of respondents say the 10-year Treasury yield would need to reach 6% to 6.4% before they would be negatively impacted; 14% don't expect a negative impact unless it climbs above 7% [Figure 7].

Impact of inverted yield curve

The inverted yield curve has raised speculation about a potential recession. Historically, a yield curve inversion has spelled trouble for the U.S. economy. However, the yield curve is only one of many indicators used to determine if a recession is imminent. What's more, lower jobless claims and an increase in new factory orders suggest a stronger economy, notes Anderson of Wells Fargo.

"I do believe the bond market is trying to tell us something with the inverted yield curve — probably that we are headed for slower economic growth," he says. The GDP grew at an annual-

FIGURE 6. ONE-THIRD OF RESPONDENTS EXPECT ALAN GREENSPAN'S RETIREMENT AS FEDERAL RESERVE CHAIRMAN TO AFFECT INTEREST RATES

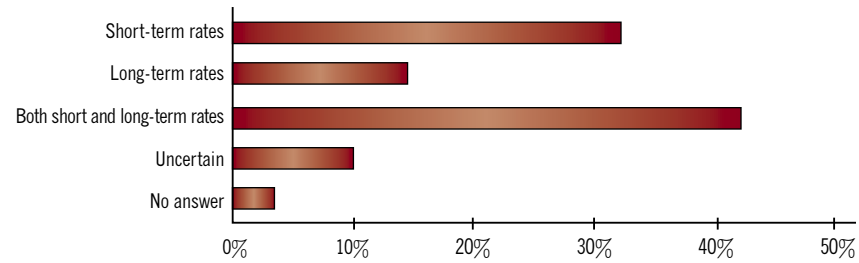


FIGURE 7. SOME 14% OF RESPONDENTS DON'T EXPECT ANY NEGATIVE IMPACT ON BORROWING UNTIL THE 10-YEAR TREASURY YIELD REACHES 7%.

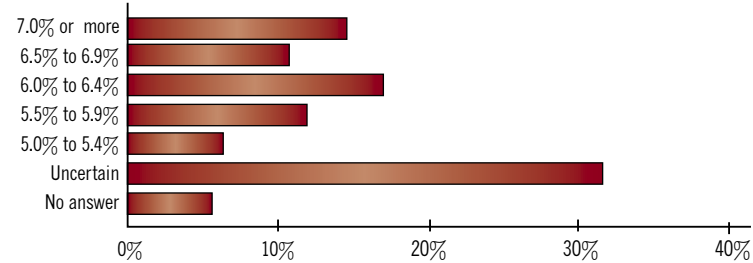
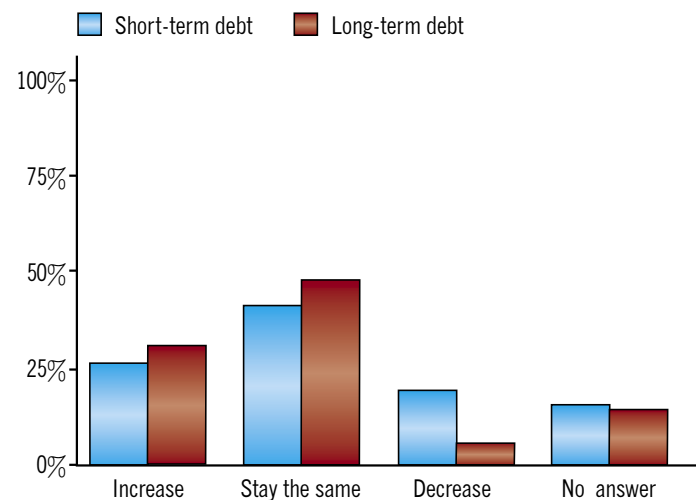


FIGURE 8. ONE-FOURTH OF RESPONDENTS EXPECT THEIR USE OF SHORT-TERM DEBT TO INCREASE



ized rate of 3.7% in 2005. Anderson expects the GDP growth to hover closer to a 3.5% growth rate in 2006.

Borrowers have been steadily shifting debt from short- to long-term loans along with the climbing 3-month LIBOR, and that trend is likely to continue into 2006. Thirty-five percent of respondents expect their use of long-term debt to increase in the next year compared to 26% who anticipate an increase in their use of short-term debt [Figure 8].

Fewer borrowers anticipate an increase in long-term debt compared to last year's survey results, perhaps because much of that debt has already shifted away from short-term debt. In last year's survey, 42% of respondents expected long-term debt to increase vs. 33% who predicted an increase in short-term debt.

Acquisitions fuel demand

Lenders who are hoping for another 13.6% spike in the level of U.S. commercial mortgage debt in 2006 may get their wish. One of the key drivers of that record lending volume has been the tremendous demand for commercial real estate, and that trend is expected to continue. More than \$249 billion in commercial and multifamily properties changed hands in 2005 — a 35% increase compared to the \$185 billion in transactions recorded last year, according to New York-based Real Capital Analytics. RCA tracks deals in excess of \$5 million.

Improving real estate fundamentals across most property types also are likely to boost deal flow in 2006. A surge in construction financing, not to mention a growing inventory of commercial real estate that will be bought, sold and financed, will have a significant impact on lending activity.

Rising occupancies and rents are already beginning to spark a wave of new construction. In the multifamily sector, for example, 31.5 million sq. ft.

FIGURE 9. THE LARGEST PERCENTAGE OF RESPONDENTS (41%) HAS BORROWED FUNDS FOR NEW DEVELOPMENT OVER THE PAST 12 MONTHS

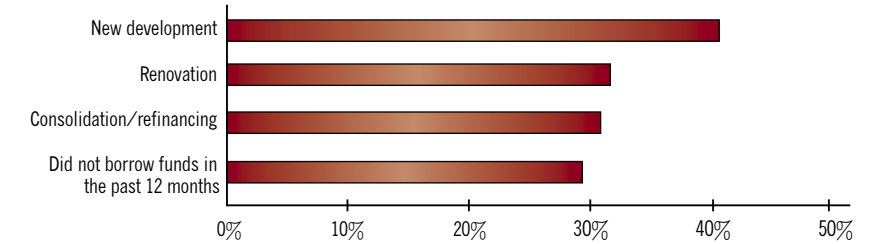
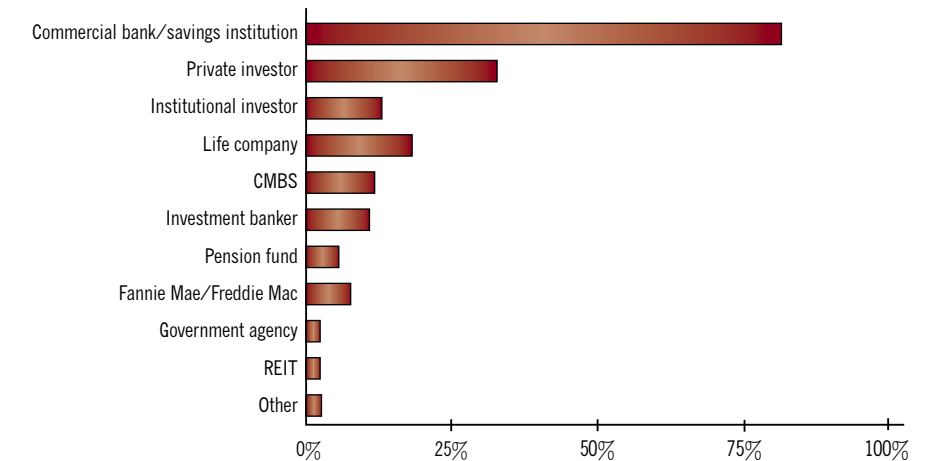


FIGURE 10. FOUR IN FIVE RESPONDENTS HAVE BORROWED FUNDS FROM COMMERCIAL BANKS/SAVINGS INSTITUTIONS DURING THE PAST 12 MONTHS



of new space was built in 2005 with an additional 37.1 million on tap for 2006. That volume of new space exceeds that of recent years by 5 million to 12 million sq. ft., according to data research firm Reis Inc.

Overall, 70% of respondents have borrowed funds in the past year. Specifically, 41% have borrowed money for new development; 32% for renovation; and 31% for debt consolidation/refinancing [Figure 9]. Those totals are very similar to last year's survey.

"I think 2006 will be a stronger development year for us," predicts Richard

Gatto, an executive vice president at The Alter Group in Skokie, Ill. The private company, which specializes in build-to-suits, built approximately \$380 million in new office, medical office and industrial buildings in 2005. That translates into nearly \$320 million in short-term construction loans. Gatto expects the firm's construction activity to increase by 15% to 20% in 2006 as The Alter Group takes advantage of niche office development opportunities.

The Alter Group has 1.3 million sq. ft. of office space under construction, and an additional four office build-

ings on the drawing board that will total about 500,000 sq. ft. One planned project is a 100,000 sq. ft. office building in Fort Lauderdale for Kaplan Inc., a national provider of online higher education learning. “We will see some of the office market starting to improve with increasing occupancy and rent levels, which will foster new development,” Gatto predicts. Nationally, office vacancies dropped to 14.4% in the third quarter of 2005, down nearly 200 basis points from 16.3% a year ago, according to CB Richard Ellis.

The industrial sector appears to be maintaining its momentum. The trend of importing goods through California and moving inventory to large warehouses across the country seems to have no end, Gatto says.

Industrial vacancy rates declined to 10% during the third quarter, which represents the eighth straight quarter of decreasing vacancies and marks the lowest level since the fourth quarter of 2001, reports CB Richard Ellis. At the same time, new construction during the third quarter totaled 38.4 million sq. ft. — more than double the amount of space built in the second quarter.

Although concerns are rising about overbuilding in the condo sector, apartment fundamentals continue to improve. National apartment vacancies dropped 60 basis points to 5.8% in the

third quarter of 2005. During the same period, effective rents grew by 1.2% — the highest quarterly jump recorded since early 2001, according to Reis.

The retail sector may see some flat growth due to anticipated weakening in consumer confidence. Economists are predicting that consumer spending growth will rise 3% in 2006 compared with nearly 4% in 2005. Nationally, vacancies at community and neighborhood centers declined a nominal 10 basis points during the third quarter while effective triple net rents rose 0.9% to \$16.61 per sq. ft., according to Reis.

“Clearly we’re watching consumer spending and anticipating that we might not see the continuation of the strength that we have seen in the retail sector in recent years,” Everett says. Although the outlook for the retail sector is still positive, Everett expects the “soft landing” in the housing market to curb some of the retail growth in the coming months. Retail accounted for a large chunk of Principal’s financing volume in 2005 — about 38% or \$1.9 billion in financing.

Banks are main capital source

When asked what debt sources they have used over the past 12 months for real estate ventures, 80% of respondents cite commercial banks and savings institutions [Figure 10]. After banks,

respondents most frequently cite private investors as debt sources (32%), life companies (17%), and institutional investors (13%).

Those findings are consistent with industry statistics. As of the third quarter of 2005, commercial banks held the largest share of commercial/multifamily mortgages with \$1.1 trillion, or 43% of the total. CMBS ranked second at \$499 billion or 20%, while life insurance companies accounted for 10% of the total with \$261 billion. Government-sponsored enterprises (GSEs) and federally related mortgage pools including Fannie Mae, Freddie Mac and Ginnie Mae hold \$128 billion in multifamily loans and an additional \$65 billion “whole” loans for a total share of 8%.

One of the reasons banks grab such a large piece of the pie is that they dominate construction lending. Banks are the clear choice for construction loans because they possess sophistication and an appetite for the business, Gatto notes. The Alter Group works exclusively with banks for its mortgage needs.

Banks also offer a myriad of financing options. “Heading into 2006, we expect domestic CMBS volume to be flat to slightly higher year-over-year, but we will see growth from our recent expansion into the European CMBS market, and continued growth in our Fannie Mae, Freddie Mac and FHA originations,” says Brett Smith, managing director of real estate capital markets for Wachovia, based in Charlotte, N.C.

Wachovia also is building a portfolio of mezzanine and equity investments in Asia, with an eye toward entering Asia’s CMBS market.

Borrower expectations

Similar to last year’s survey, the majority of investors prefer long-term, fixed-rate debt (67%), despite the low interest rates [Figure 11]. Borrowers are concerned with more than locking in

the lowest fixed rate, however. In fact, borrowers rank ease of the lending process as the most important quality they look for in a loan officer. On a scale of 1 to 6, ease of the borrowing process scored 5.5. The next two most frequently cited qualities — interest rates and the speed at which loans are closed — scored 5.2 [Figure 12].

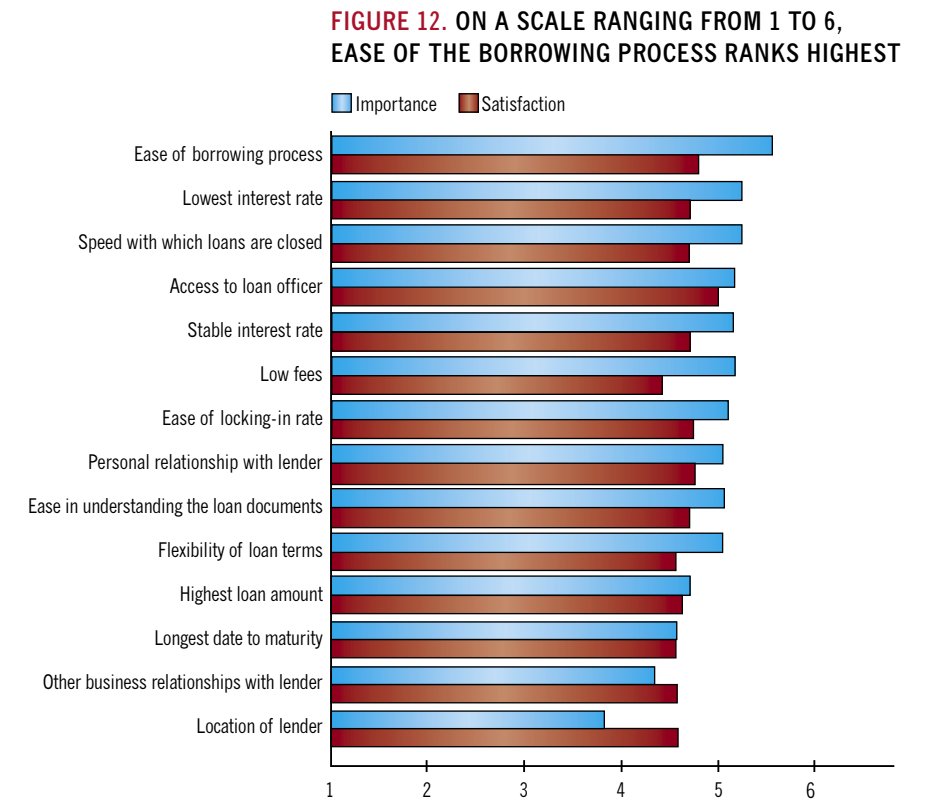
A top priority for borrowers such as San Francisco-based AMB Property Corp. is cultivating strong relationships. On its U.S. debt, AMB works exclusively with five to seven different life companies. Strong relationships are vital in securing the ease in servicing existing loans that most borrowers value.

For example, if AMB wants to tear down an existing property and rebuild or needs flexibility in relocating a tenant, it is much easier to do that when there is a relationship with the lender, emphasizes Gayle Starr, AMB’s senior vice president of capital markets. AMB secured about \$160 million in new U.S. financing in 2005.

“We tend to shy away from CMBS because flexibility is a big factor for us, and we don’t find that as readily in the CMBS market,” Starr says. Flexibility can be essential in successfully executing an exit strategy. “If we’re planning to sell a property as a course of business, we don’t want the debt to chill the sale,” Starr says. As a result, AMB is seeking terms that will give the giant REIT flexibility, such as the ability to pre-pay portions of the loan at par or with prepayment penalties with a declining balance structure.

Has lending volume peaked?

The momentum of commercial/multifamily originations has already spilled over into 2006, giving lenders confidence that deal flow will continue strong at least through mid-year — and hopefully beyond. “I would expect our volume to be a little lower in 2006. However, our current pipeline would belie that statement,” Stewart says.



Cronheim Mortgage already has \$275 million in deals lined up to close in January and February, which is ahead of last year’s pace.

“Everybody expects rising rates to eventually impact originations. That said, people were making the same predictions in 2005, and even as far back as mid-2004,” Smith says. Wachovia generated \$78.6 million in commercial and multifamily loans in 2005 — up 34% compared to the \$58.5 billion in 2004. Smith expects another strong year in 2006. “We see no slowdown in originations in the first quarter, and in fact our forward pipeline is larger now than it was in the first quarter last year.”

Higher property values combined with a flat yield curve have spurred more refinancing than anyone could possibly have imagined. Some borrowers are refinancing as early as three years into a 10-year loan in order to take advantage of their ability to pull more money out of properties as values continue to rise. The refinancing

wave from CMBS loans originated in the mid-1990s also is expected to continue in 2006. “There is a huge pipeline of securitized mortgages that needs to be refinanced, in effect creating some pent-up demand,” Smith says.

Ultimately, the economic fundamentals appear fairly solid for 2006 with continued expansion in the economy and job growth that should bode well for the commercial real estate sector — particularly the recovering office sector. However, the high real estate values are certainly cause for concern, especially in an environment where long-term rates are likely to rise, notes Wells Fargo’s Anderson.

Anderson expects mortgage originations in 2006 to continue a pace of very slow growth in the low single digits. “I’m cautiously optimistic on lending activity in 2006, but I think we will see some of that investment activity cooling down in the coming year.”

FIGURE 11. ONE-THIRD OF BORROWERS’ DEBT IS SHORT-TERM, ADJUSTABLE-RATE FINANCING

