



Capital Metes and Bounds

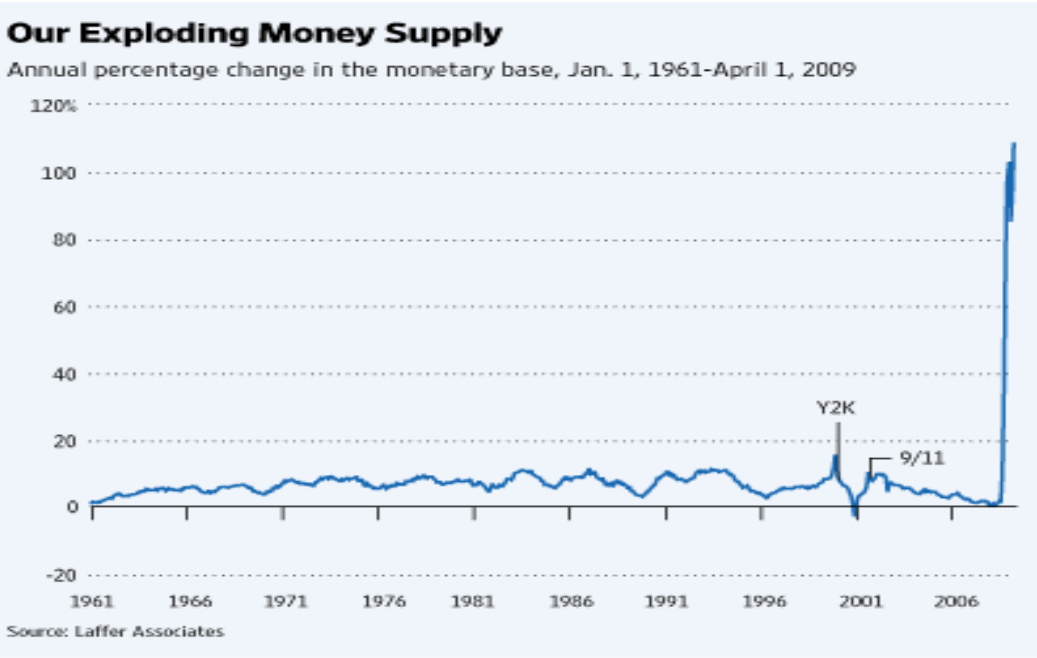
By James M. Murphy, CMB, CRI

In the past few years, this newsletter has focused on three basic tenets that dramatically affect the commercial real estate market: the underlying economy, the capital markets and demand for space. Each has its own implication for short and long term success in our business. The most obvious of the three is the economy and its ability to create jobs. Jobs create demand for office space. Jobs make people secure and security leads to apartment and single family housing occupancy which leads to buying by the consumer, which leads to demand for goods that need to be warehoused. The end result is increased demand for office, homes, apartments, retail goods and warehouse space. Let us take a look at the three tenets today in the context of opportunity to find value in commercial real estate. While the tone may seem negative, transactions are beginning to occur and capital is available at rates in the 7% range for quality real estate that is conservatively leveraged.

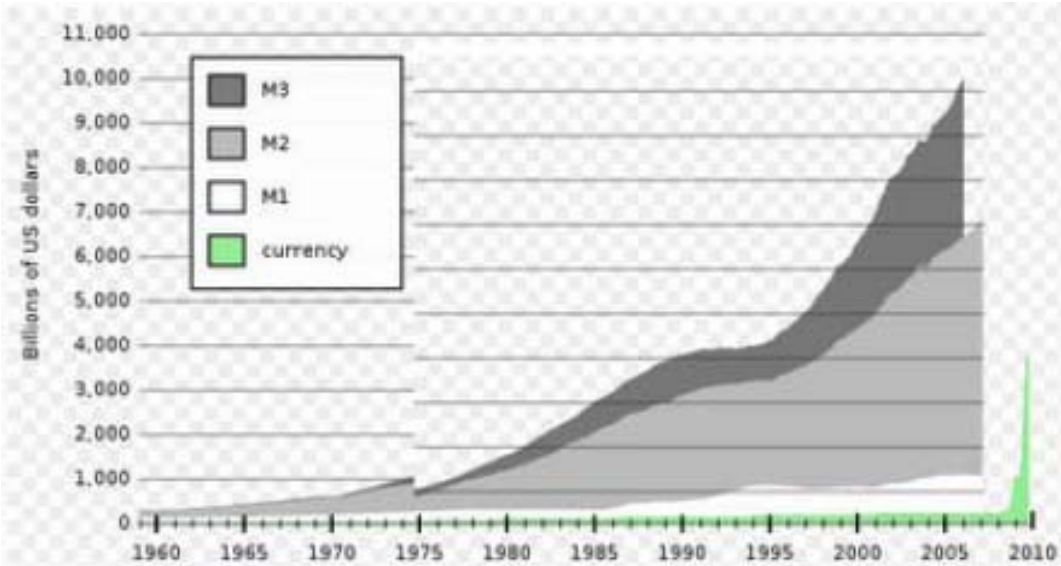
The Economy

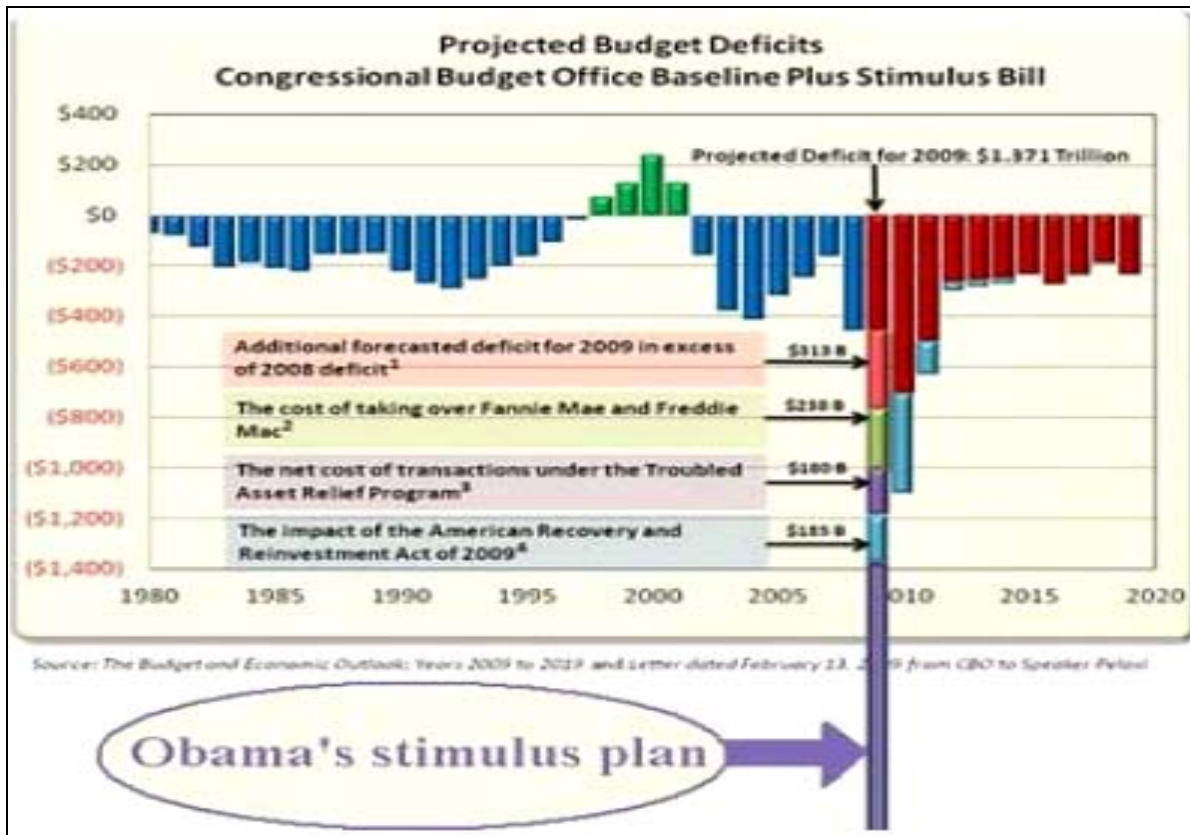
In an effort to bolster the economy, our government has taken dramatic and drastic action. Over \$1 trillion dollars has been dedicated to growing the economy by two administrations. The government owns the majority of stock in General Motors and significant positions in our banking and insurance industry by virtue of its capital infusions. The rationale behind this was that the country was in the worst financial crisis since the Great Depression and the course taken was necessary to save us from sinking further. At the same time, the Federal Reserve has ballooned the money supply at an unheard of pace to keep deflation at bay. China has cooperated by holding over \$1 Trillion of our debt. Assumptions made by government were that this Herculean effort would create jobs and restore economic growth in 2010 and beyond at 4% and higher. Based on those assumptions and the resulting growth in tax revenue, the government assumes that we can create national healthcare, create enough wind and solar power to stop worldwide pollution and wean ourselves from foreign oil, and continue fighting a war against Islamic terrorists.

The question is begged. Is it working? The economy has lost over 6 million jobs, 2.5 million since enactment of the Stimulus. Unemployment is over 9.5% and headed to 10% and higher. The United States has become a debtor nation and will expand its deficit to over \$10 Trillion by the end of the decade (under the most optimistic growth scenario) and thereby burden generations to come with interest payments alone that will exceed current deficits. This is not good policy. The charts below are illustrative. In layman's terms, Federal Reserve actions will devalue the dollar at a staggering pace.

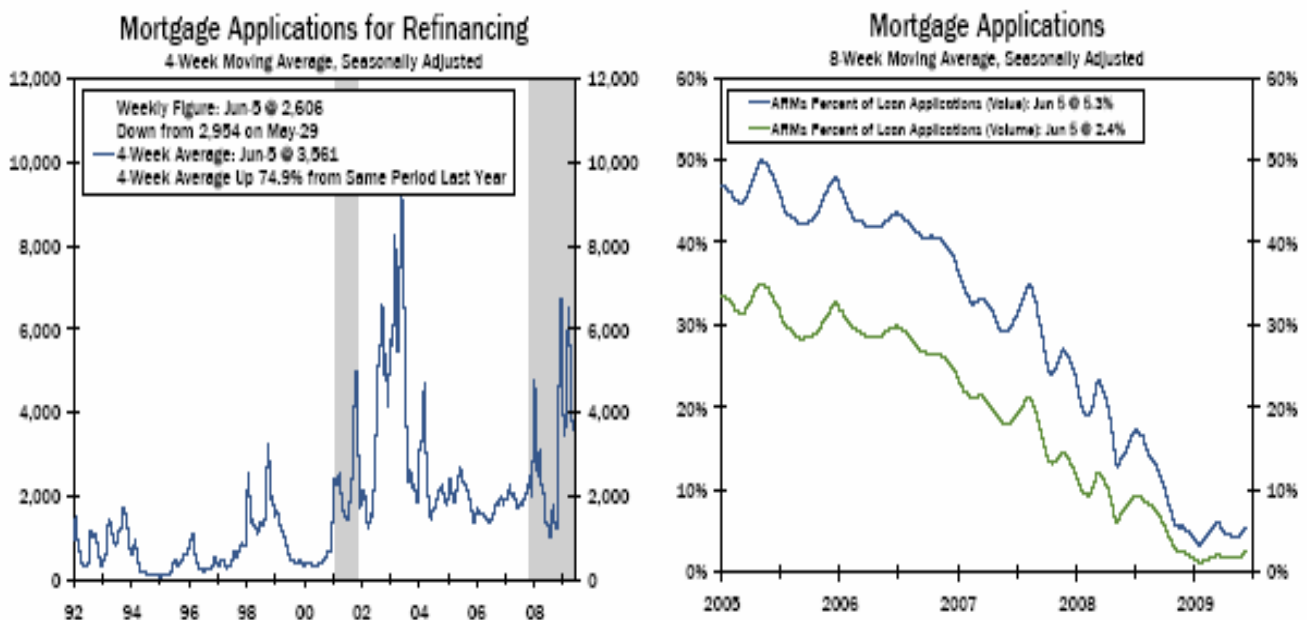


For every dollar that existed September of 2008, the Fed plans to create 14 more of them which will devalue the dollar in the international markets.



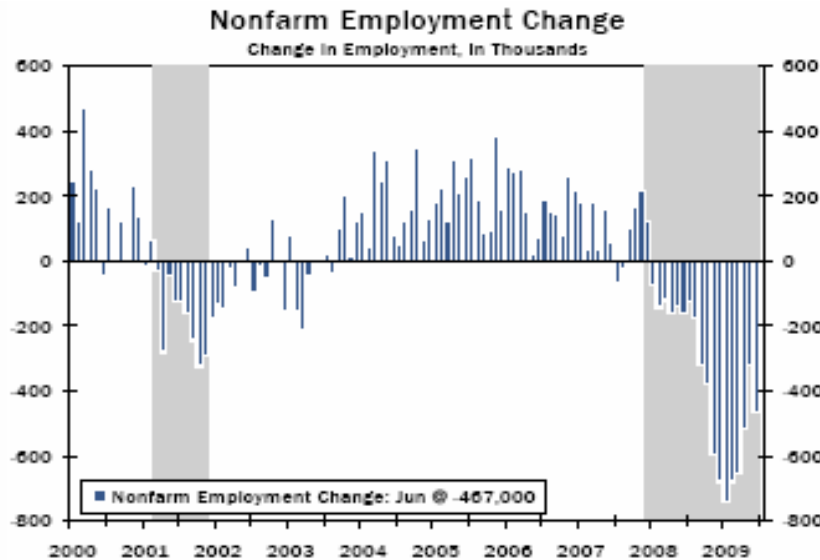


The unparalleled explosion in the money supply and historic deficits will lead to inflation. Interest rates have already begun to creep up as the foreign buyers of our treasury notes demand higher returns. This is having a dampening effect on the housing market which desperately needs to make a comeback to restore consumer confidence and purchasing power. The charts below show the relationship between rates and mortgage lending.



Source: Mortgage Bankers Association and Wachovia

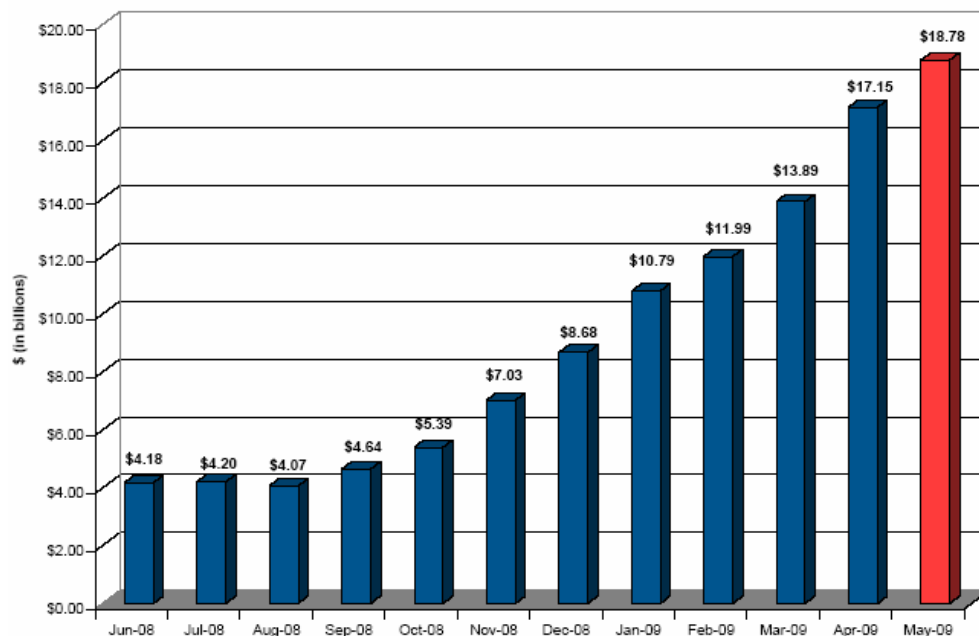
The best estimate is that only 10% of allocated stimulus has been spent to date, but employment is not improving and is no longer projected to until year end by our government. Some say we need more.

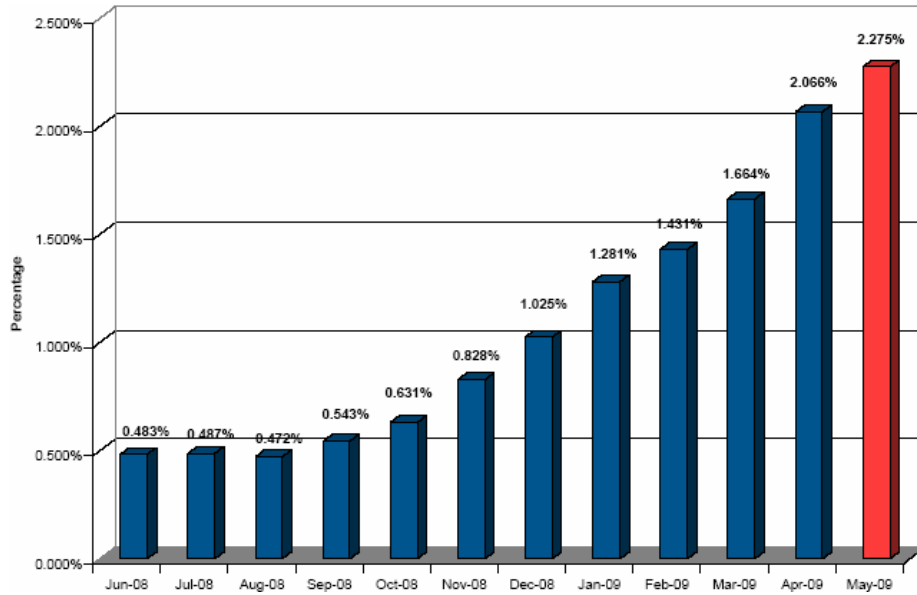


Capital Markets

Loss experience in the CMBS markets continues to deteriorate. Maturity defaults are becoming a way of life. Special servicing companies that often hold the unrated tranches of securitized debt are extending maturities for one year on a regular basis to the dismay of the A rated bondholders. Query: Can litigation or tranche warfare be far off? This does not bode well for a capital market recovery in the securitized arena. Over \$18 Billion in debt is currently in default which represents slightly under 3% of outstanding balances. It is not inconceivable given the lax underwriting of 2006 and 2007 that the default rate could climb to 6% or higher.

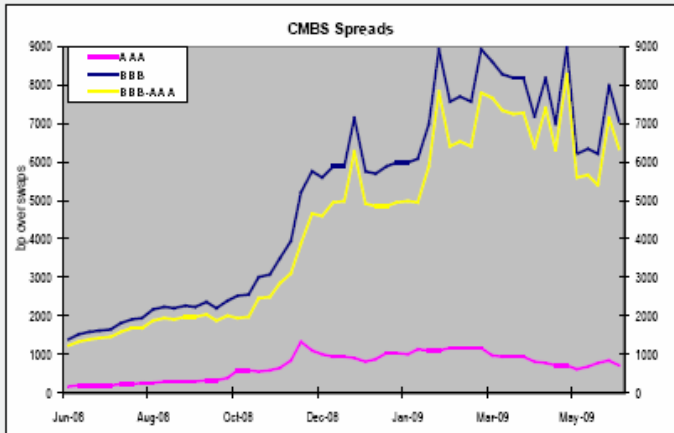
Charts 1 and 2 – Monthly CMBS Delinquency: Balance vs. Percentage (source: Realpoint)





Even if a CMBS market existed today pricing would need to be significantly higher than either bank or life insurance company rates. The charts below show Wachovia's math. For loans underwritten at 55% LTV on a 9% cap rate the breakeven interest rate needed is 8.5%. At 65% loan to value it is 9.5%.

CMBS Pricing Matrix



The CMBS Pricing Matrix is compiled every Monday using spreads for generic conduit paper provided by nine investment banks.

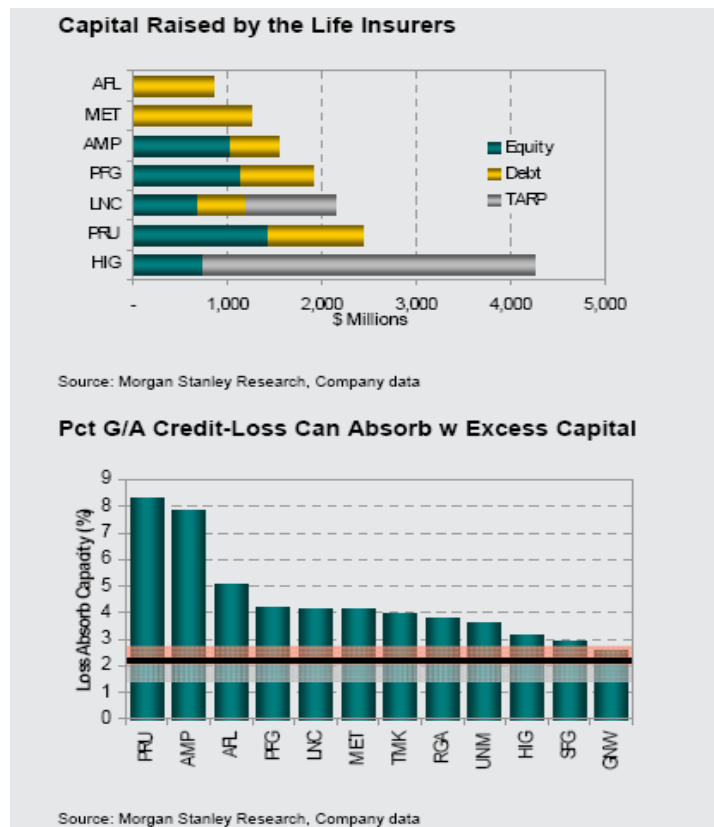
Reporting banks were quoting five-year swaps at 32-46bp over Treasuries, while 10-year swaps priced at 25-28bp over.

For historical data points, please visit the Commercial Real Estate Direct website, at www.crenews.com.

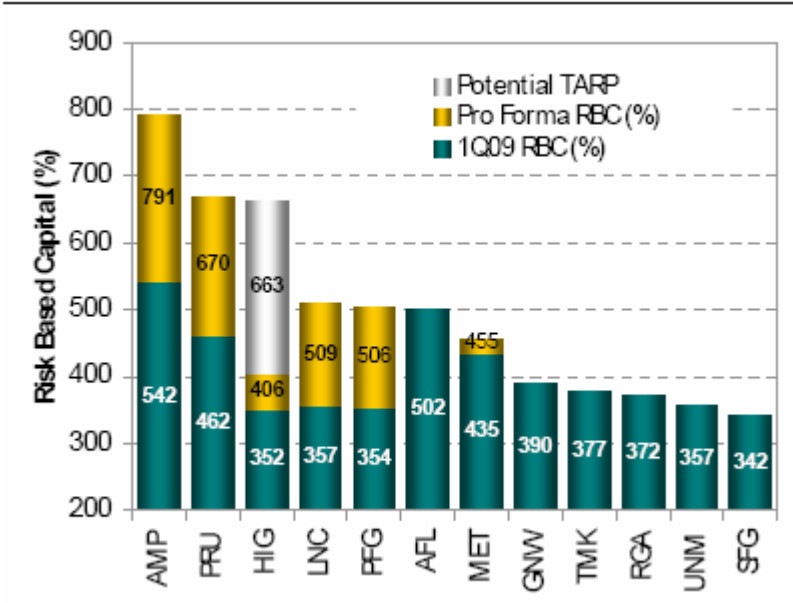
Median Spreads

	6/19 (bp over swaps)	6/12 (bp over swaps)	6/5 (bp over swaps)	5/29 (bp over swaps)
3-yr AAA	300	325	337.5	320
5-yr AAA	700	712.5	700	650
7-yr AAA	895	960	1,012.5	980
SuperSr AAA	707.50	832.5	760	675
20% Sub AAA	1,550	1,630	1,610	1,615
Junior AAA	2,250	2,275	2,200	2,200
AA	4,125	4,125	4,050	4,150
A	4,900	4,900	4,925	4,875
BBB	8,000	8,000	6,600	6,350
BBB-	9,000	9,000	7,350	6,850

On the other hand, the Life Insurance Industry has replenished its capital. Every one of the companies listed below has raised sufficient Risk Based Capital (RBC) to absorb expected losses and survive. Each of them has more than 340% of required RBC.



RBC Ratios Post Capital Offerings (w Hold Co Cash)



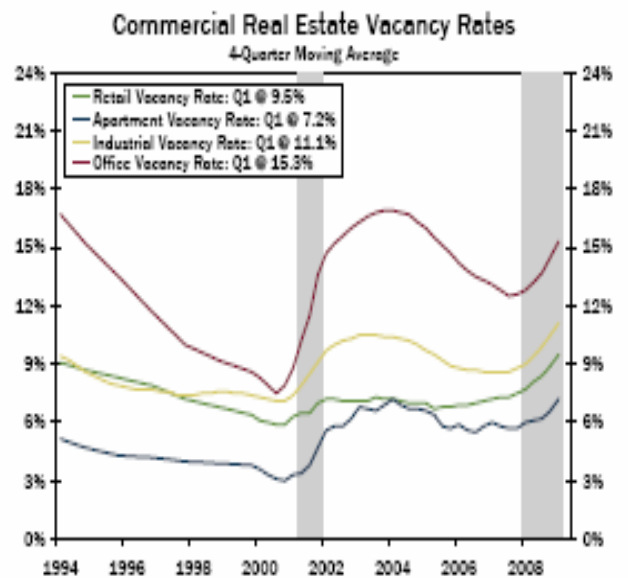
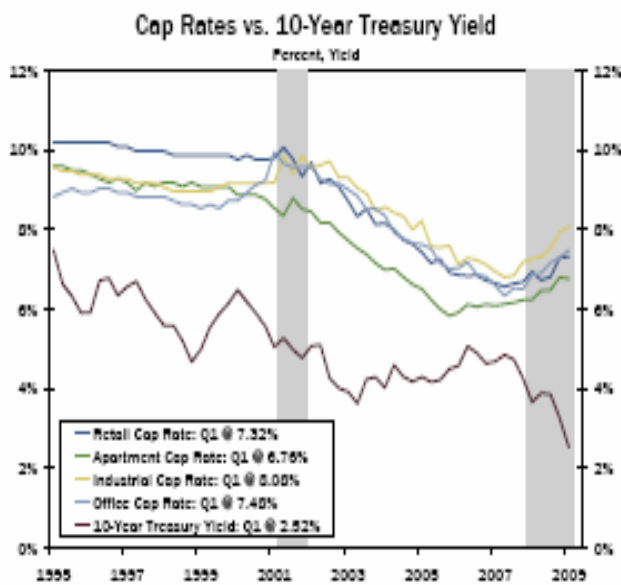
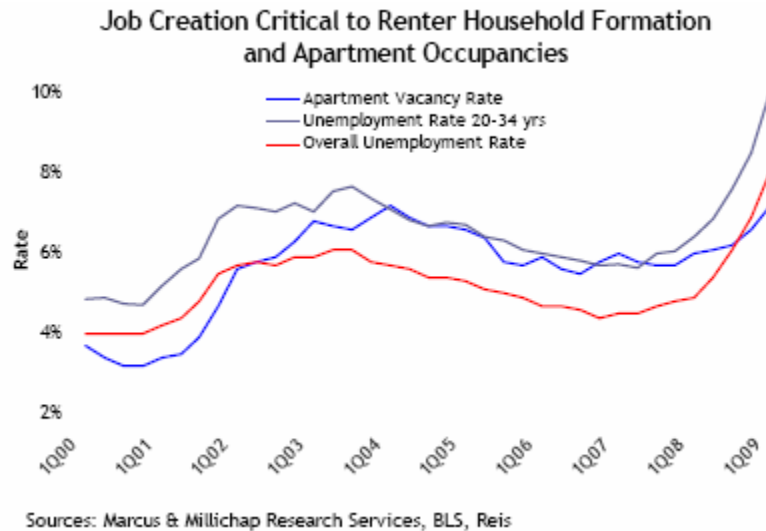
Source: Company data, Morgan Stanley Research

Key to Above Charts

AFL	AMP	GNW	HIG	LNC	MET	PFG	PRU	RGA	SFG	TMK	UNM
Aflac	Ameriprise	Genworth	Hartford	Lincoln	Met Life	Principal	Prudential	Reinsurance	Standard	Torchmark	Unum

Commercial Real Estate Demand

The remaining charts show the direct relationship that job creation and the capital markets have to vacancy and value in all four of the primary property types. It is clear that vacancy is rising, but values are beginning to stabilize at historic means for capitalization rates and transactions have begun to happen.



Source: Federal Reserve Board, PPR, Real Capital Analytics, Reis, Inc. and Wachovia

Q10|Capital is currently placing 10 year deals with life companies in the low to mid-7's at 60-65% loan to value! We are even able to find some interest only debt at 50% leverage.

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James M. Murphy 617-728-9522