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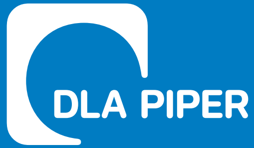
DLA Piper 2007 "Credit Crunch" Real Estate Survey

OCTOBER 2007



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EXECUTIVE SUMMARY

In April, DLA Piper's "State of the Market" Real Estate Survey found that 2007 was shaping up to be a "bullish" year for the markets as then-current pricing and abundant capital flows had fostered an insatiable demand for real estate assets.

However, since that time, concerns and speculation surrounding the subprime mortgage crisis and so-called "credit crunch" have dominated the headlines, trickling into the real estate markets.

To determine just how these developments have really impacted the U.S. commercial real estate market, DLA Piper once again surveyed leading real estate industry executives to gauge how their attitudes and perspectives have changed amid the credit crunch. Highlights of DLA Piper's 2007 "Credit Crunch" Real Estate Survey include:

- The strains of the subprime lending shakeout and resulting credit crunch have forced respondents to abandon their "bullish" outlook for the U.S. commercial real estate market – only 31 percent describe their outlook as bullish, down sharply from 78 percent in April.
- Consequently, 68 percent of respondents now describe their 12-month outlook as "bearish" – more than tripling the percentage of bearish responses from April (22 percent).
- The overwhelming majority of respondents (61 percent) anticipates that it will take between 9 – 12 months before the real estate markets stabilize from the effects of the credit crunch.
- The effects of the credit crunch on deals in the US commercial real estate market have been widespread, led by tighter loan underwriting standards, increased spreads, increased equity requirements, and delayed or cancelled transactions.
  - 63 percent of respondents have been involved in transactions that have been delayed or cancelled due to the credit crunch.
  - One out of four respondents (27 percent) report witnessing an increase in loan defaults.
- The market for public-to-private M&A has cooled considerably. Just five months ago 90 percent of respondents expected the recent public-to-private trend to continue unabated. While this figure dropped to 62 percent in the current survey, the majority of respondents still believes that this public-to-private trend will continue despite the credit crunch.
- Despite several verbatim comments to the contrary (see page two), 63 percent of respondents do not believe the Fed should take additional aggressive action to stabilize the credit markets following its Sept. 18 decision to cut interest rates by half a point.
- 80 percent of respondents describe their 12-month outlook for the CMBS market as "bearish" and, as a likely result, 83 percent also expect to see more conventional loans than CMBS loans in the next 12 months.

VERBATIMS

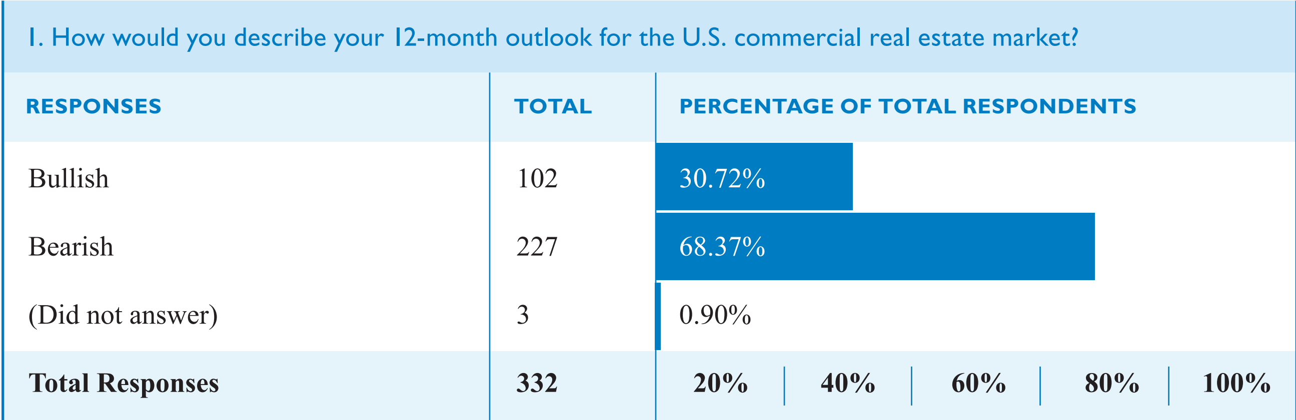
Respondents were asked to share their thoughts on the following question in an open forum for comment and feedback. The following represent select verbatims received from survey respondents.

What do you think the Fed should do in response to the subprime mortgage crisis and so-called "credit crunch" on the U.S. commercial real estate market?

- I think the key thing is not the Fed but the US government. The US government needs to take significant action to keep 2 million houses from being foreclosed and shore up our credibility in the financial markets.
- They already reduced the Fed Funds rate. Wait six months and see if credit begins to flow. If not, another cut would be in order.
- At this moment, there are essentially no buyers for downstream bonds in most transactions (high yield, RMBS, CMBS, second lien, etc.). The Fed will need to lower rates to enhance the relative value trade of buying these products to get liquidity into the RE market, M&A market, and other markets critical to avoiding a recession. The Fed will need to continue to cut rates even at the risk of inciting some inflationary pressures to avoid the impact of a housing depression on the overall economy.
- Whatever it takes to inject liquidity into the credit markets...it is clogged right now.
- Ensure subprime problems don't creep into unrelated credit markets.
- Reduce interest rates 150 bps more to assist banks in making up for the losses they will take in the real estate market.
- Continue to reduce when necessary and allow Fannie Mae/Freddie Mac to increase residential loan limits to lessen impact of subprime crisis and residential foreclosures.
- Not just the Fed, but other regulators and Congress should provide incentives to mortgage lenders to renegotiate loans with troubled borrowers who are subject to index increases in their ARMs, but only to owner occupiers who can be underwritten based on their income against the revised terms…not to speculators and investors.
- Ease rates 1/4 pt.....then hold....It should give just enough kick to provide an uptick in confidence and stabilize economic momentum (or lack thereof)...
- Maintain liquidity in the marketplace. Migrate interest rates downward so as to avoid negatively affecting the value of our currency. In encouraging the reduction in rates, they should do it in a series of small steps to spread the "good news" out without causing panic. The overall effect should be to encourage, to the extent possible, a reduction in both the index number: i.e., five-year and 10-year Treasuries, Libor.

2007 "CREDIT CRUNCH" SURVEY RESULTS

Respondents were asked to complete a short questionnaire designed to measure attitudes and perspectives regarding the impact of the subprime mortgage crisis and so-called "credit crunch" on the U.S. commercial real estate market. The following charts represent the collective input of 332 respondents to the survey, a 13 percent response rate. A full overview of the survey methodology can be found at the end of this report.

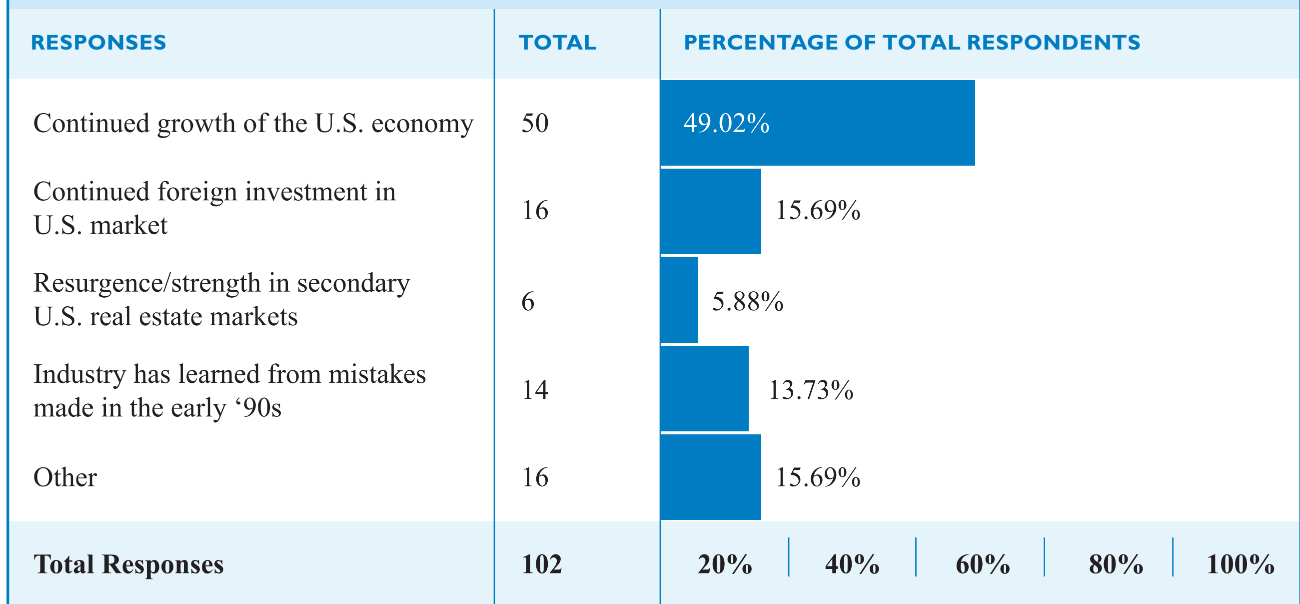


1. How would you describe your 12-month outlook for the U.S. commercial real estate market?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Bullish	102	30.72%
Bearish	227	68.37%
(Did not answer)	3	0.90%
Total Responses	**332**	**20% | 40% | 60% | 80% | 100%**

- Since the release of DLA Piper's "State of the Market" Real Estate Survey in April, the strains of the subprime lending shakeout and resulting credit crunch have forced respondents to abandon their "bullish" outlook for the U.S. commercial real estate market – only 31 percent describe their outlook as bullish, down sharply from 78 percent in April.

- Consequently, 68 percent of respondents now describe their 12-month outlook as "bearish" – more than tripling the percentage of bearish responses from April (22 percent).



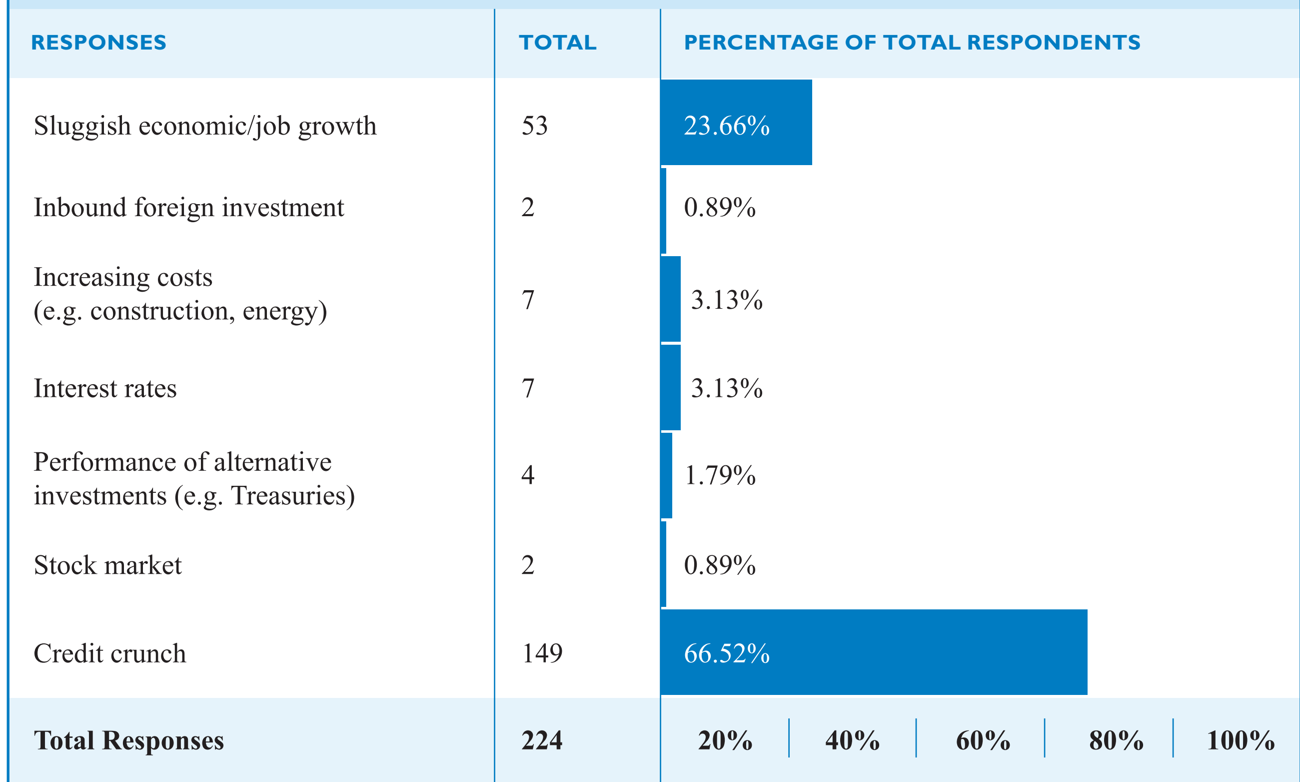
2. What is the primary reason for your confidence?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Continued growth of the U.S. economy	50	49.02%
Continued foreign investment in U.S. market	16	15.69%
Resurgence/strength in secondary U.S. real estate markets	6	5.88%
Industry has learned from mistakes made in the early '90s	14	13.73%
Other	16	15.69%
Total Responses	**102**	**20% 40% 60% 80% 100%**

- Among the "bulls," 49 percent of respondents cited the continued growth of the U.S. economy as the primary reason for their confidence in the commercial real estate market.

- Consistent with DLA Piper's 2004, 2005 and 2007 State of the Market surveys, respondents who hold a "bullish" outlook for the U.S. commercial real estate market continue to anchor that belief in the growth of the U.S. economy.

  Note: This question was made available only to those respondents who described their outlook as "bullish." For this reason, the question was not applicable to 227 of our survey respondents.



3. What is the primary reason for your lack of confidence?		
RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Sluggish economic/job growth	53	23.66%
Inbound foreign investment	2	0.89%
Increasing costs (e.g. construction, energy)	7	3.13%
Interest rates	7	3.13%
Performance of alternative investments (e.g. Treasuries)	4	1.79%
Stock market	2	0.89%
Credit crunch	149	66.52%
Total Responses	**224**	**20% 40% 60% 80% 100%**

- The overwhelming majority of "bearish" respondents (66 percent) attribute their outlook to the credit crunch, signaling the profound impact of this phenomenon on the perceived health of the U.S. commercial real estate market.

- Following the credit crunch, the prospect for U.S. economic growth, the No. 1 concern among "bears" in April (41 percent), remains a strong consideration today (24 percent).

  Note: This question was made available only to those respondents who described their outlook as "bearish." For this reason, the question was not applicable to 102 of our survey respondents.

4. During the past 60 days, which of the following credit crunch effects have you experienced? (Check all that apply)

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Loan underwriting standards have been tightened	259	78.01%
Equity requirements have been increased	219	65.96%
Pricing of assets has softened	187	56.33%
Transaction has been delayed or cancelled	208	62.65%
Additional collateral or greater recourse required	119	35.84%
Spreads have increased	228	68.67%
None	10	3.01%
(Did not answer)	4	1.20%
Total Responses	**1234**	**20% | 40% | 60% | 80% | 100%**

Multiple answers per participant possible. Percentages added may exceed 100 since a participant may select more than one answer for this question.

- The effects of the credit crunch on deals in the U.S. commercial real estate market have been widespread, led by tighter loan underwriting standards, increased spreads, increased equity requirements, and delayed or cancelled transactions.
- 63 percent of respondents have been involved in transactions that have been delayed or cancelled due to the credit crunch.

5. Does the credit crunch signal the official end to the recent public-to-private M&A trend?		
RESPONSES	**TOTAL**	**PERCENTAGE OF TOTAL RESPONDENTS**
Yes	103	31.02%
No	205	61.75%
(Did not answer)	24	7.23%
Total Responses	**332**	**20% | 40% | 60% | 80% | 100%**

- Despite the dramatic increase in respondents who describe their outlook for the U.S. commercial real estate market as "bearish," 62 percent of respondents, surprisingly, do not believe that the credit crunch signals the official end to the recent public-to-private M&A trend.
- The market for public-to-private M&A has cooled considerably: 62 percent expect the recent public-to-private trend to continue, down from 90 percent in April.

6. Have you experienced lenders which have modified loan terms on committed deals prior to closings?		
RESPONSES	**TOTAL**	**PERCENTAGE OF TOTAL RESPONDENTS**
Yes	162	48.80%
No	161	48.49%
(Did not answer)	9	2.71%
Total Responses	**332**	**20% | 40% | 60% | 80% | 100%**

- Nearly 50 percent of respondents report experiencing lenders that have modified the terms of loans for committed/existing deals prior to closing.
- Consistent with the responses to Question No. 4, lenders have aggressively amended loan terms in response to the credit crunch, changing the terms for one out of every two deals that had been previously scheduled.

7. How are lenders modifying these terms? (Check all that apply)

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Raising interest rate spreads	140	85.37%
Changing amortization	43	26.22%
Shortening interest-only periods	59	35.98%
Reducing loan amounts	128	78.05%
Total Responses	370	20% | 40% | 60% | 80% | 100%

Multiple answers per participant possible. Percentages added may exceed 100 since a participant may select more than one answer for this question.

- Raising interest rate spreads and reducing loan amounts are the two most prevalent loan modifications being used by lenders, according to respondents.

8. By how many basis points have your interest rate spreads increased?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
0-25 basis points	16	10.13%
25-50 basis points	63	39.87%
50-100 basis points	49	31.01%
more than 100 basis points	15	9.49%
I have not seen my interest rate spreads increase	15	9.49%
Total Responses	158	20% | 40% | 60% | 80% | 100%

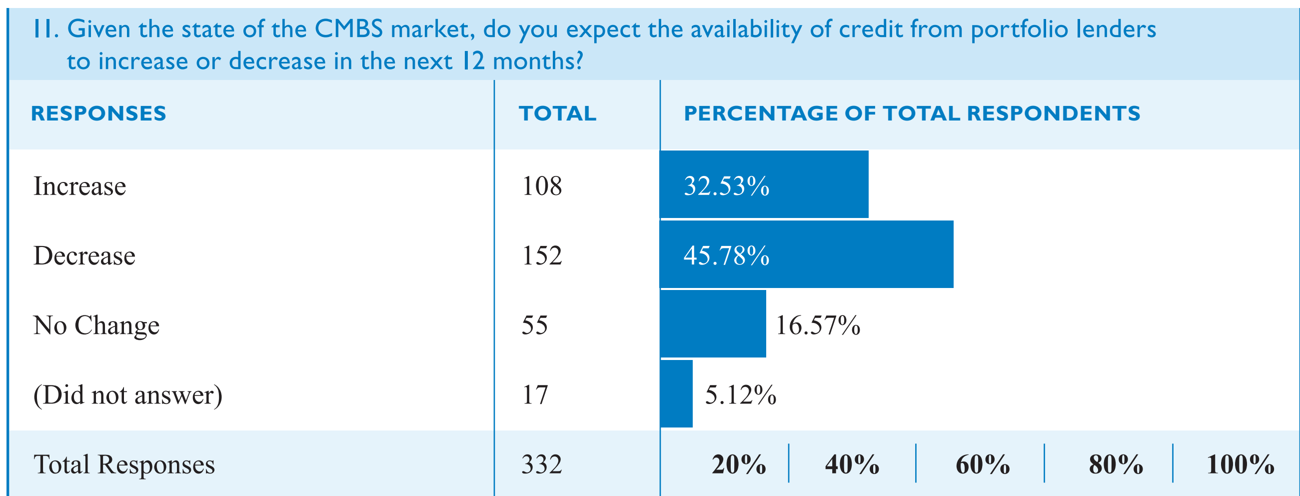
- Of the respondents who have experienced an increase in their interest rate spreads, over 40 percent report an increase of 50 basis points or greater.

9. Will the spread on CMBS loans (AAA spread over swaps) continue its recent upward trend?		
RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Yes	164	49.40%
No	139	41.87%
(Did not answer)	29	8.73%
Total Responses	332	20% | 40% | 60% | 80% | 100%

- Despite strong concerns about the health of the U.S. commercial real estate market by the overwhelming majority of respondents, 42 percent do not expect the spread on CMBS loans to continue its recent upward trend.

10. How would you describe your 12-month outlook for the CMBS market?		
RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Bullish	46	13.86%
Bearish	265	79.82%
(Did not answer)	21	6.33%
Total Responses	332	20% | 40% | 60% | 80% | 100%

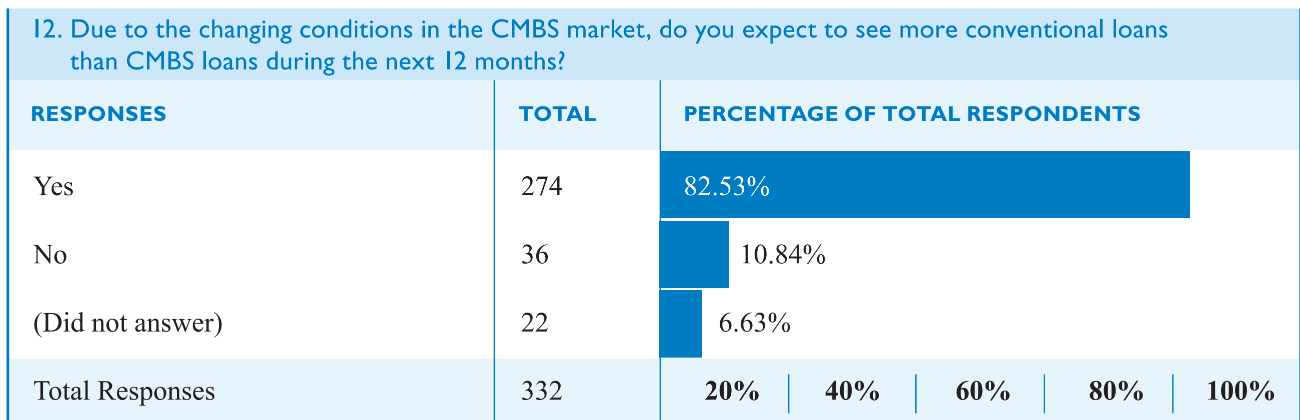
- Faced with the recent rise in spreads for CMBS loans due to the credit crunch, eight out of 10 respondents describe their 12-month outlook for the CMBS market as "bearish."



11. Given the state of the CMBS market, do you expect the availability of credit from portfolio lenders to increase or decrease in the next 12 months?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Increase	108	32.53%
Decrease	152	45.78%
No Change	55	16.57%
(Did not answer)	17	5.12%
Total Responses	332	20% | 40% | 60% | 80% | 100%

- Surprisingly, 49 percent of respondents expect the availability of credit from portfolio lenders will increase or undergo no change, which is inconsistent with the expectation from Question No. 10 that the CMBS market will slow down.



12. Due to the changing conditions in the CMBS market, do you expect to see more conventional loans than CMBS loans during the next 12 months?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Yes	274	82.53%
No	36	10.84%
(Did not answer)	22	6.63%
Total Responses	332	20% | 40% | 60% | 80% | 100%

- Over the next 12 months, 83 percent of respondents expect to see more conventional loans than CMBS loans, which is likely a parallel consequence of the "bearish" outlook for the CMBS market.

13. Should the Fed take more aggressive action to stabilize the credit markets?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Yes	115	34.64%
No	208	62.65%
(Did not answer)	9	2.71%
Total Responses	332	20% | 40% | 60% | 80% | 100%

- Surveyed two days after the Fed's Sept. 18 decision to cut interest rates by half a point, 63 percent of respondents do not believe the Fed should take more aggressive action to stabilize the credit markets.
- Indicative of the conservative nature of the U.S. commercial real estate market, the Fed's recent interest rate cut seems to have quickly assuaged broader concerns about how the credit crunch may impact the market.

14. When will the real estate markets stabilize from the effects of the credit crunch?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
3 months from now	17	5.12%
6 months from now	106	31.93%
9 months from now	78	23.49%
12 months from now	123	37.05%
(Did not answer)	8	2.41%
Total Responses	332	20% | 40% | 60% | 80% | 100%

- Consistent with the expectation that the U.S. commercial real estate market is headed for a bear market in the next 12 months, 61 percent of respondents anticipate that it will take between 9 – 12 months before the real estate markets stabilize from the effects of the credit crunch.

15. Have you seen an increase in loan defaults?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Yes	88	26.51%
No	229	68.98%
(Did not answer)	15	4.52%
Total Responses	332	20% 40% 60% 80% 100%

- Presenting a rare first look into lending trends amid the credit crunch, one out of four respondents (27 percent) report witnessing an increase in loan defaults.

16. What types of projects or loans are defaulting?

RESPONSES	TOTAL	PERCENTAGE OF TOTAL RESPONDENTS
Condominium conversions	66	76.74%
Office	8	9.30%
Multi-family	17	19.77%
Land-banking	33	38.37%
Construction financing	24	27.91%
Mezzanine financing	38	44.19%
Other (please specify)	5	5.81%
Total Responses	191	20% 40% 60% 80% 100%

Multiple answers per participant possible. Percentages added may exceed 100 since a participant may select more than one answer for this question.

- Of the respondents who have seen an increase in loan defaults, condominium conversions, mezzanine financing and land-banking rank as the top three projects experiencing defaults.

METHODOLOGY

In September of 2007, DLA Piper distributed a survey via e-mail to 2,500 top executives within the real estate industry, including CEO's, COO's, CFO's and other senior executives. The survey was completed by **332 respondents**, representing a **13 percent** response rate.

Question No. 2 was made available only to those respondents who described their outlook as "bullish."

Question No. 3 was made available only to those respondents who described their outlook as "bearish."

Due to rounding, all percentages used in all questions may not add up to 100 percent.