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Commercial Real Estate's Exposure to Subprime Limited

The commercial real estate investor may feel uneasy following the unfolding crisis in residential subprime mortgages. Is there direct or indirect exposure to subprime risk in typical commercial real estate investments, such as commercial real estate collateralized debt obligations (CDOs)? It may surprise some investors to learn that a handful of commercial real estate CDOs do include subprime residential mortgages in their asset pools. A CDO pools debts, creates tranches and then sells securities, similar to commercial mortgage-backed securities. A chief difference is that CDOs allow a greater variety of assets, including short-term loans, whole loans, and even other securities. "Over the last few months, some issuers have been putting small amounts of subprime into commercial real estate CDOs," says Tad Philipp, managing director of the CMBS group at Moody's Investors Service. "So we have seen it, but not to a level that concerns us." In addition to rating CMBS transactions, Philipp's group rates CDOs backed primarily by commercial real estate. The vast majority of CRE CDOs consist entirely of commercial loans. However, there are a few exceptions in which subprime mortgages may make up 5% of the pool. In contrast, subprime assets make up an average of 45% of the assets in a structured-finance CDO. "Subprime has been an important part of the structured-finance CDO market generally, but not an important part of the CRE CDO market," Philipp says. The increasing number of subprime mortgages in CRE CDOs may be more a sign of investor caution than a cause for alarm among CRE CDO shareholders. "Some holders of subprime debt may be looking for multiple exit strategies, one of which is to place some of it in commercial real estate CDOs," Philipp says. A chain reaction to the subprime market, however, may be a rise in the cost of capital, according to Brian Lancaster, head of structured products research at Wachovia. That's because spreads for asset-backed securities (ABS) in general have widened, as residential investors have demanded greater returns to reflect the increased risk associated with subprime mortgages. Higher spreads for CRE CDOs limit the amount CDOs can pay for the higher-risk portions of CMBS deals. Because CDOs are the dominant buyers of the riskiest levels of CMBS, conduit lenders will eventually demand higher lending rates to compensate for the lower pricing of CMBS securities. "Ultimately that filters up through to the guy that owns a shopping mall and finances himself through the CMBS market," Lancaster says. "Conduit lenders will need to get higher rates from the borrowers. My sense is that it's only been a few basis points, but that's where we've seen the primary impact." Based on performance, commercial mortgages present a marked contrast to the residential market. In February, Fitch Ratings reported that CMBS delinquencies dropped three basis points to 0.34%. "According to Fitch, delinquencies are down for every product type," observes Jamie Woodwell, senior director of commercial/multifamily research at the Mortgage Bankers Association. "We're seeing some things going on in the credit markets as far as appetite for risk, but when it comes to the fundamentals of commercial real estate, they remain extremely solid." Market observers agree that subprime fallout is unlikely to have a significant impact on commercial real estate in general, although downsizing or closure of subprime lenders could create vacancy issues in Southern California, where many of those companies are based. In fact, multifamily owners could enjoy increased demand and higher occupancy rates in Dallas, Atlanta, and other markets where the monthly cost of owning a home is close to rental rates. In markets with a greater economic divide between owners and renters, such as those along the coasts, mortgage defaults are less likely to increase the number of renters.

The commercial real estate investor's greatest fear in this case may be government reaction to fear itself, says Anthony B. Sanders, professor of finance at Ohio State University in Columbus, Ohio. "The great fear, of course, is the deliberations in Congress about the dreaded R-word — regulation," Sanders says. "While the subprime residential mortgage market could clearly use some improvements, such as fully disclosing the costs and risks of contracts such as teaser-rate adjustable-rate mortgages in clear language, it is better if the market corrects its own problems, which they have an incentive to do." Philipp hopes the recent scrutiny of subprime lending will cast a spotlight on credit quality in commercial real estate as well. "We're far from hitting the panic button, but we do think it's helpful for people to focus on credit quality," he says. "Leverage has been rising and the share of amortizing loans has been falling. There's plenty of work that needs to be done in commercial real estate to keep it from becoming the next subprime." **(National Real Estate Investor/Matt Hudgins)**

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Colorado Jobless Rate Hits 5-Year Low

Colorado's seasonally adjusted unemployment rate fell to 3.8 percent in February, the lowest rate since July 2001, the Colorado Department of Labor and Employment said on Friday. The rate was down three-tenths of a percentage point from January 2007, and down from 4.3 percent in February 2006. "Although Colorado's jobless rate remains low, a slowing national economy and softening housing market will likely keep job growth modest in the months ahead," said Don Mares, executive director of the state Department of Labor and Employment. Colorado gained 12,000 nonfarm payroll jobs in February compared with January, putting the Colorado job total at 2.28 million jobs, up by 45,200 or 2 percent from February 2006, officials said. The increase was about typical for a February, officials said. Most sectors experienced small payroll changes. Seasonal gains in education accounted for the entire 10,600 increase in government in February, as well as the majority of the 2,600 positions created in education and health services. Construction rebounded from a lackluster January to add 1,600 jobs, while professional and business services grew by 1,000. Over the past year, more than one-quarter of the growth came from a 12,500 increase in professional and business services, state officials said. Strong gains also were seen in leisure and hospitality, up by 9,700 jobs, and education and health services, up by 9,100. Government and trade, transportation and utilities employment grew 5,200 and 4,000, respectively, over the year. The state's smallest sector, natural resources and mining, created 3,700 jobs over the past 12 months, an increase of more than 19 percent. Meanwhile, Colorado's largest industry group -- trade, transportation and utilities -- gained only 1 percent over the year. The information sector has lost 1,000 jobs since this time last year. Industry employment is down fully one-third since peaking at 113,200 in January 2001, state officials said. Manufacturing and construction are also down from their year-ago staffing levels. **(Denver Business Journal)**

Project to Begin Near Pepsi Center

Developer Jim Neenan is teaming up with Kroenke Sports Enterprises to develop two office buildings southwest of the Pepsi Center at the light-rail station. The development will include two 150,000-square-foot buildings developed in two phases. Neenan, president of NS West, said he expects to break ground on the first building in the third quarter of 2007. It is expected to cost more than \$30 million. "We can see that the market would really embrace a project that had ample parking (and) was on the perimeter of downtown but not in the heart of downtown," Neenan said. Several years ago, Kroenke Sports and Landric Corp. planned to take advantage of the site's proximity to the Invesco Field light-rail station by building retail, entertainment and housing there. They purchased the property from the Regional Transportation District. The current project, designed by Oz Architecture, will be built by M.A. Mortenson Co. Lease rates for the buildings are expected to be in the low \$20-per-square-foot range on a triple net basis. That's about \$2 to \$4 a square foot lower than the projected lease rates for the other buildings being developed in Lower Downtown, Neenan said. RTD may close the Invesco Field Station except for special events if it opens an Auraria Campus light-rail station a few blocks away. Neenan said both stations are close enough to serve his new office buildings. Nearly 2 million square feet of office-space development has been announced for Lower Downtown. Two have already broken ground: Hines' building, 1515 Wynkoop St., and Opus Northwest's building, 1400 Wewatta St. "We don't see ourselves competing for the Lower Downtown tenants," said Darrin Revious, managing director of Frederick Ross Co., who with Tom Lee and Todd Silverman is handling leasing for Neenan's development. "We're looking for users that want close proximity to downtown with great parking and light-rail service." Two other downtown projects will add another 1.1 million square feet to the market. "I think there's enough demand to warrant the new development," said Rob Link, executive vice president of Studley, a tenant-representation firm. "If you're in downtown Denver and looking at 20,000 square feet or more, you have dwindling options. "And if you're looking for 50,000 square feet or more, you only have a handful of options outside of the new product." **(Denver Post)**

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	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	5.25	5.25	4.75
3 MONTH LIBOR	5.35	5.35	4.99
PRIME RATE	8.25	8.25	7.75
10 YEAR TREASURY	4.65	4.70	4.69
30 YEAR TREASURY	4.84	4.80	4.72