



The Real Estate Roundtable

UNITED STATES SENATE

COMMITTEE ON FINANCE

“THE REAL ESTATE MARKET: BUILDING A STRONG ECONOMY”

215 DIRKSEN BUILDING

FEBRUARY 28, 2008

STATEMENT OF TIMOTHY H. CALLAHAN

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE¹

Thank you, Chairman Baucus and Ranking Member Grassley, for conducting today’s hearing on the real estate markets and the economy.

Introduction

I am Timothy H. Callahan, CEO of Callahan Capital Partners, a real estate firm formed in late 2006 focused on creating value in real estate by investing in high-quality office properties. My testimony today is on behalf of the Real Estate Roundtable. My firm, which employs 15 people, is primarily invested in Denver Colorado properties, but our longer term plan is to create a

¹ The Real Estate Roundtable brings together leaders of the nation’s top publicly-held and privately owned real estate ownership, development, lending and management firms with the leaders of the industry’s sixteen national real estate trade associations to jointly address key national policy issues relating to real estate and the overall economy. Collectively, Roundtable members’ portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than \$700 billion; over 1.5 million apartment units; and in excess of 300,000 hotel rooms. Participating trade association members represent more than 1 million people involved in virtually every aspect of real estate.

premier, national real estate platform with geographic diversification. I am also the former Chief Executive Officer of Trizec Properties, Inc. and Equity Office Properties Trust, formerly two of the largest public U.S. office REITs.

Thank you for the opportunity to testify today about the state of the commercial real estate markets and the current credit and capital markets. Real estate directly and indirectly generates economic activity equivalent to about 20 percent of GDP. It encompasses an estimated \$20 trillion in owner-occupied housing and approximately \$5 trillion in income-producing commercial property. It creates some 9 million jobs and generates millions of dollars in federal, regional and local tax revenue. Local governments, especially, depend on this revenue (approximately 70 cents of every local budget dollar) to pay for public services such as education, road construction, law enforcement and emergency planning and response.

These are very uncertain times for real estate markets, and I commend Chairman Baucus and Ranking Member Grassley for their foresight in holding this hearing. The current disruption in the economy resulting from the housing meltdown is serious and well-documented. Along with the many individual homeowners facing substantial hardship, many financial institutions and bond holders have recognized significant losses due to both borrower foreclosure and the revaluation of existing securities backed by subprime residential mortgage bonds. This has led to a lack of mortgage market liquidity and a substantial decline in residential real estate market values.

State of the Commercial Real Estate Markets Generally

The commercial real estate markets do not have a broad, subprime lending problem like the housing market does with respect to market fundamentals. Fundamentals in most major markets are generally favorable. Nevertheless, the housing and financial market problems and their effect on the economy are being felt by commercial markets. All business is linked to a global

credit market that reacts to events and moves capital accordingly. As a result of this and other factors, the commercial markets also are experiencing a serious credit crunch of their own.

Commercial real estate is comprised of five principal property types – apartment, office, retail, industrial and hotels. It includes many diverse regional, markets each with their own dynamics. Commercial markets depend on a healthy economy for occupancy and on a liquid financing market for investment. While they remain in relative equilibrium, the ability to finance residential and commercial real estate of almost any size has reached a crisis stage. The loss in confidence in the financial markets has created a situation that prevents adequate funding for the residential and commercial mortgage loan markets to function in a normal manner.

The role of Congress in responding to this economic turmoil is important. Proper policy actions could forestall a full blown recession or shorten one should it occur. We supported the recently enacted economic stimulus package. Coupled with the recent rate cuts by the Federal Reserve, it should serve to coax much needed consumer and business spending. It also provides additional assistance to homeowners seeking to refinance mortgages. The consumer, who led the economic expansion, is key to restoring health to the economy. The stimulus package recognizes this and the importance of supporting homeowners and homebuyers since the strength of home values is so closely tied to consumer confidence.

For the most part, the dislocation in the economy will self-correct -- albeit not without pain and over a period longer than any of us would like. As daunting and dramatic as headlines are about the housing/financial markets crisis, it is important not to overreact to them. Congress should navigate carefully any additional policy actions it takes. Excessive tax breaks and government spending may serve to only increase supply in the face of weakening demand.

Conversely, over taxation could stifle entrepreneurs, hamstring borrowers and weaken the resilience of investors. Overly aggressive regulation of lenders, risks tying the hands of the

institutions best equipped to provide financing to credit worthy borrowers. We urge a cautious and thoughtful approach on all fronts.

Fundamentals

Commercial real estate has experienced a vigorous market for the last decade. Fundamental to this has been an ample supply of equity capital and affordable credit. Real estate investment trusts (REITs) and the rise of mortgage backed securities aided this, particularly early on. Wall Street investment bankers and a wave of equity funds created new pipelines and conduits to inject large global capital pools into real estate markets.

This largely has been positive, and the commercial markets reflect that in their overall soundness and stability. As stated, fundamentals are generally favorable in the commercial markets. Some softening is occurring, however, particularly outside of major markets. Vacancy rates have advanced, but are not spiking. Absorption rates are slowing, but relative to a recent very healthy pace. Price appreciation has slowed, but we are not currently seeing a precipitous decline in values. However, there may be some significant correction in values for those who may have mismatched a long term investment need with short term debt because replacing that debt today is at best uncertain.

Also, unlike prior real estate down cycles, this one is not characterized by a lack of equity capital. While credit concerns abound and REIT stock prices have declined, equity capital appears to be poised to take advantage of potential market opportunities. Furthermore, this downturn is not marked by a serious imbalance between supply and demand. There is reasonable equilibrium. However, if the credit markets do not return to equilibrium soon, commercial markets could face daunting problems.

So, much depends upon what happens with the economy. There's a substantial amount of uncertainty. Some big questions loom: To what extent will the residential crisis affect consumer

confidence? If consumer confidence evaporates, business confidence may follow. Consumers used home equity loans to finance residential renovations, pay for college, buy new cars and take vacations. Household debt has increased to 136 percent of disposable income.

On the corporate front, how deep will job losses be? The driver of our business is jobs as employee growth is the key to space demand. If borrowing is limited it inherently restricts the ability of businesses to grow. If you add in the concern over the future of the economy, business owners, at the very least feel compelled to delay expansion of their employee base. With multifamily, hospitality and retail properties in particular feeling the strain of being tied closely to the consumer, the fate of the business owner, particularly the small to mid-size firms who have been generating the most jobs, will determine whether the current economic drivers will continue to support the office and industrial sectors.

Tightening Debt Markets

In the midst of this economic uncertainty, commercial borrowing has become more difficult and expensive. The decade long run of inexpensive debt led to a high volume of lending to real estate. Robust transaction levels bid up property values to record levels. Some prices reflected bullish outlooks about future price appreciation more than underlying fundamentals. That phase has crested, however, and the market is in an expected slowdown phase. Capitalization rates are increasing, meaning that prices are declining as valuations adjust to a level more in line with property fundamentals.

The inevitability of a slowdown was to be expected. What wasn't expected was the sudden and dramatic retrenching of the debt markets. What started as a sub-prime crisis rapidly spread into other structured credit products such as commercial mortgage backed securities (CMBS) and collateralized debt obligations (CDO) securities, as investors began to question valuations across a broad spectrum of securitized loans.

In June, what started as tremors in the debt markets, had become a crisis by July and August as investors fled certain markets when valuations became difficult to determine. The massive losses recorded by several financial institutions in the Fall drove more investors to the sidelines, either because of the pain they were incurring directly or the perception that greater bargains lay ahead.

Those that saw pricing opportunities in October were quickly proven wrong and more doubts on valuation arose, which led to more write-offs, and the downward spiral continued. With so much capital sitting on the sidelines, the ability of lenders to move loans off their books was seriously compromised. The regeneration of that capital for new loans, the basic premise of today's capital markets, was effectively gridlocked.

The CMBS market alone, \$741 billion in 2007, and between 20-30% of the commercial lending capacity, has been almost completely removed from the system and not replaced in any great measure. This is a crisis of investor confidence in the credit markets broadly, not just for real estate, and it could get worse before it gets better.

In this market, only those real estate transactions that have strong underwriting and are conservatively structured are able to close. Lenders, such as life insurance companies, that keep loans on their books and do not securitize them are filling some of the void left by the CMBS lenders. Nevertheless, these portfolio lenders do not have sufficient capacity to replace the capital that has been withdrawn from the market due to the CMBS market shutdown.

The full impact of this seizing up of the debt markets is not yet indicated statistically. Historical delinquency rates on commercial mortgage bonds are 2%, yet in January actual delinquencies were just 0.27%, a record low. Additionally, many heavily levered 2006-2007 buyers will come under increasing pressure with the passage of time and the inability to refinance. A slowing economy will magnify the impact. However, there are also other prudent investors who did not

overleverage or mismatch maturities of their investments, yet their misfortune is debt coming due shortly in the normal course of events in perhaps the worst debt market in a decade or more.

Future Opportunity

The downtrend will create opportunities, however. Since debt is more expensive and less available, cash is king. Investors with cash and low leverage investors, particularly insurance companies, pension funds and REITs, are well-positioned to take advantage of attractive prices and cushion property values. Foreign investors are increasingly attracted to U.S. markets by the investment return they get from the weak dollar. Investment banks and private equity funds, while working through the effects from leveraged investment strategies, still have substantial equity capital to deploy and take advantage of buying opportunities. Like the portfolio lenders, though, these capital providers need the debt markets to function to invest, and they simply are not.

Ironically, with fundamentals solid, subject to the emergence of recession, and more equity available for real estate now than we could have imagined even a few years ago, this should be the best of times. Yet the combination of debt and equity is our life blood, so the heart of our business is dramatically slowed without a stabilized debt market. With the significant role of commercial real estate in our economy and the global markets, it is no small matter if our business is stalled in the grips of the debt crisis.

Summary

In summary, commercial real estate fundamentals appear reasonably sound and at or close to equilibrium. Demand may ease, but development is in check in most sectors. Chastened lenders have pulled back and high leveraged, speculative investing is over. While some cash buyers and well capitalized investment funds stand ready to invest, they cannot do so without the credit

markets functioning. The ability of the credit markets to price risk is the key to loosening the credit gridlock. The current conditions have no end in sight. With credit tight, valuations are being depressed, leading to an even tighter credit environment. We are in the midst of a serious downward cycle. What breaks this cycle and when are questions to which everyone is awaiting answers.

For a more detailed market discussion, please see the attached document entitled "Leading the Enterprise 2008" -- a survey of leading real estate executives on the economic outlook, challenges and opportunities they see in 2008. The survey was done in November of 2007 and the world has continued to change, but the comments of the respondents are still largely relevant.

Government's Role

What is the role of government relative to economic policy from commercial real estate's perspective? As stated, we support the recently passed stimulus package and the Federal Reserve's aggressive movement on interest rates. It is important that government take appropriate steps to shore up consumer confidence, create a conducive environment for business and investors to invest and deploy capital, and implement appropriate monetary policy.

With respect to commercial real estate specifically, we don't believe now is the time to enact stimulative tax or spending policies. Some certainty with respect to real estate tax policy would help and we urge the Committee to re-authorize the expired tax extenders -- notably leasehold depreciation and brownfield clean up expense deductibility.

We are experiencing a crisis of the credit markets and, for the most part, the markets will have to work themselves out. We do urge that Congress refrain from imposing burdensome new taxes on the industry, such as the carried interest tax. Such a tax surely will exacerbate an already difficult environment for entrepreneurs and investors. Not only would it impose a heavy tax on

entrepreneurs of all sizes, it favors emphasizing debt in a time when our debt markets are in crisis.

Similarly, we caution Congress from over-stimulating the real estate markets. As mentioned, this down cycle is not a product of insufficient capital. There is plenty of equity capital. Demand is softening so we do not believe it would be prudent to stimulate supply.

Thank you for this opportunity to testify.