CAPITAL AND INVESTMENT TRENDS

FOURTH QUARTER 1993 • SURVEY OF TEXAS REAL ESTATE MARKETS

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OBSERVATIONS FROM THE EDITOR

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One year ago we noted here that local lenders were providing nearly 40% of the Texas real estate market's liquidity. Today, the securities market, in the form of Real Estate Investment Trusts (REITs) and Mortgage Backed Securities (MBS), is **lubricating the property markets in Texas as they begin to hum again.** From these sources alone, experts estimate that $30 billion of equity and debt capital flowed into the U.S. real estate market during 1993. Much of the money came to Texas as REITs gobbled up Sunbelt apartments and retail centers. Numerous loans were recapitalized by securitizing the mortgages and the resulting investment income was sold through Wall Street firms to investors looking for higher yields.

Why did this happen in 1993? First, long-term interest rates fell to 20-year lows which impacted the returns available to investors from alternative investments. From treasury bills to savings accounts, it was hard to find anyone who would pay even a 3% yield. Secondly, Wall Street rediscovered the real estate market where the typical yields were above 10 per cent.

REIT's benefitted from mutual funds and insurance companies who began purchasing REIT stocks to help keep their yields high. The small investor followed suit. This led to an insatiable demand which increased at the end of 1993 after the new tax bill allowed U.S. pension funds to buy REIT stocks for the first time.

The bigger story, however, is the MBS market. **Former FDIC Chairman, William Seidman, believes that this market could mushroom to provide more than $50 billion in financing for real estate in 1994.** This money will purchase new commercial mortgages originated at major regional banks around the country or refinance existing mortgages on commercial real estate.

The beauty of an MBS is that banks will no longer have to set aside capital and be scrutinized by regulators if they "upstream" the loans they underwrite into securitized pools. Investors will purchase an income stream which comes from a geographically diverse pool of commercial properties with the risk managed by stratifying the income.

Mr. Seidman noted that it was only one year ago that the first such pool (MBS) was created and it took four weeks for the investment bankers to sell it out. Earlier this year the same Wall Street firm securitized another $150 million pool of loans and it was sold in four hours.

What the RTC began in 1990, the private markets have imitated. **This new ability to create a large secondary market for commercial loans will revolutionize commercial real estate lending in the future.** Some caution that underwriting standards could be pushed to their limits as a glut of investment dollars chases the high yields tied to real estate. In fact, over forty percent of our Respondent Group said they had seen lenders relax their underwriting criteria to make a loan during the last quarter. Sound familiar? Remember the brokered deposits which the investment houses placed in jumbo CD's created by the S & L's in the mid-80's? This market will be one to watch.

The Texas real estate capital markets are not level in each metropolitan area as you will learn if you read on. In 1991, for instance, a REIT and commercial builder teamed up to build **San Antonio's** first new apartment complex since 1986. In **Fort Worth** new apartments were not built until 1992. Meanwhile in **Dallas** and **Houston**, 2,000 to 3,000 units per year were being built even in the dark days of the late 80's. The difference here is in the ability to find capital, not a developer's willingness to build. San Antonio is trying to catch up to Dallas and Houston. Today, over 2,000 units are under construction there. However, our survey participants still believe that San Antonio, along with Fort Worth, have the least liquidity and the most affordable property in Texas.

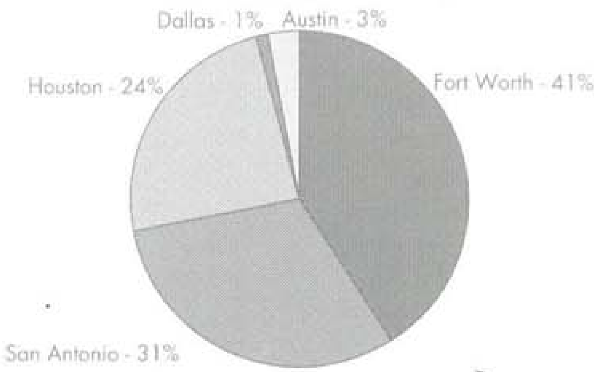
FOURTH QUARTER RESULTS

This publication is a result of a survey of active participants in the real estate markets in Texas including Investors, Lenders, Brokers, Portfolio Managers, Appraisers and Title Company Executives. The Group reported completing 310 transactions totalling over $700 million during the fourth quarter. All of them reported that property values in the major Texas markets have either stabilized or are increasing. This inflow of capital and demand from both users and investors gives confirmation to the Texas rebound.

TEXAS FOCUS

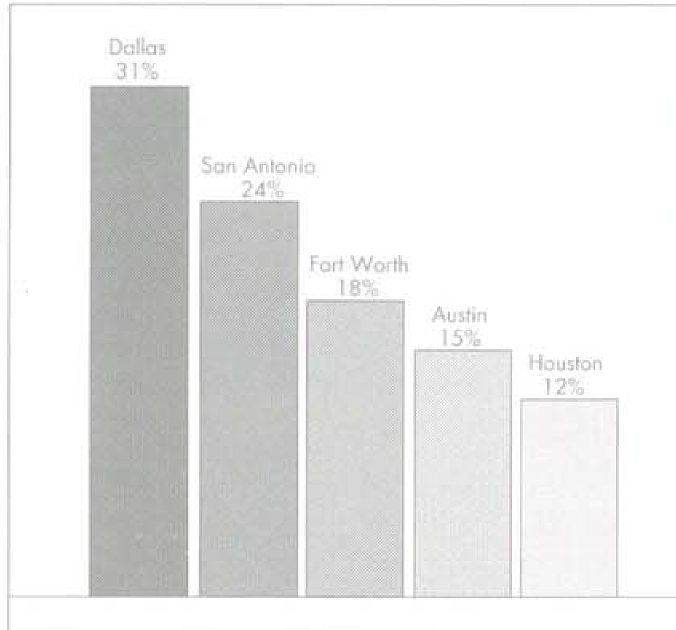
Our Group of Respondents were active in all major Texas markets; Austin, Dallas, Ft. Worth, Houston and San Antonio. We asked them,

"Which city has the most affordable property today?"



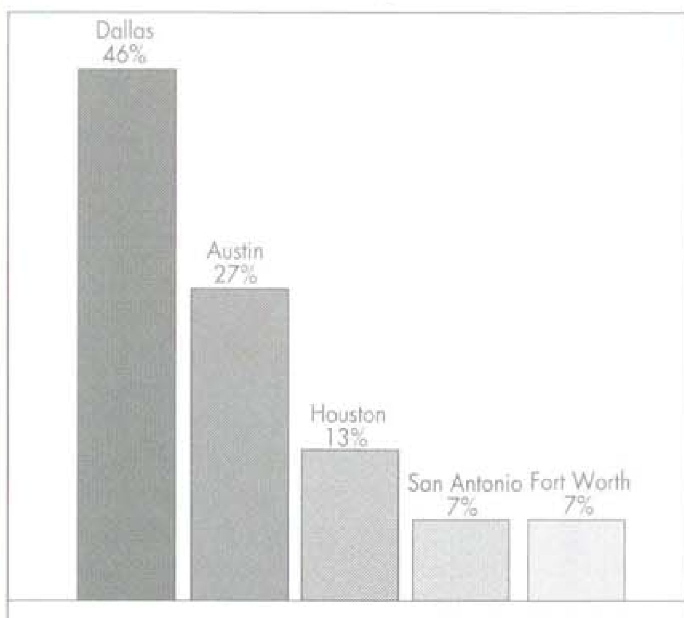
Fort Worth ranked first followed by San Antonio. Dallas and Austin were considered to have the least affordable property. This is a result of a reluctance on the part of most lenders and investors to stray from the larger more accepted markets like Dallas and Houston. We then asked the Group to select "the market having the most potential for price appreciation." Dallas and San Antonio were considered to have the best prospects followed by Fort Worth. Behind this answer lies the fact that San Antonio was capital starved and "over sold" during the late 80's and is playing catch up. Dallas and Fort Worth have DFW and Alliance Airports which, combined, will be the economic engine for the region in the 90's.

"Which Texas market has the most potential for appreciation in property values?"



Confirmation of the previous answers came when we asked,

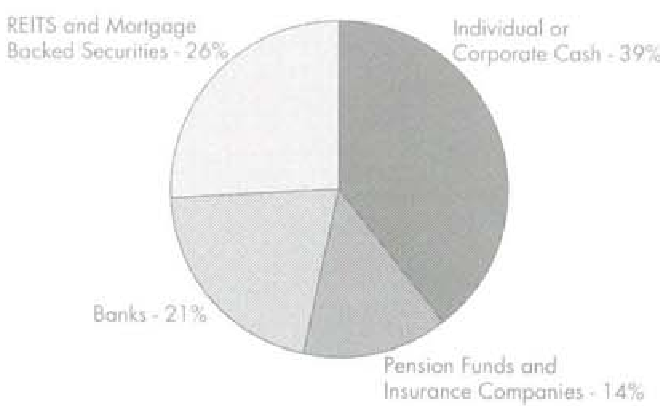
"Which market has the most liquidity in terms of available capital?"



In summary, Dallas followed by Austin and Houston appears to be favored by most investors as they look for investments in Texas. Dallas' diversified economy, stalegic location and NAFTA presence gives it strong growth characteristics which results in demand from users of real estate. Austin's hill country setting, high tech orientation and state government presence make it a strong contender for sustained growth. Houston is the state's larget market and has gained significantly in.net new jobs during the last five years.

TEXAS REAL ESTATE CAPITAL MARKETS

We surveyed the Group regarding the capital sources for real estate today. Individual and corporate cash and REITs were found to be providing most of the equity dollars invested in real estate today, while Mortgage Backed Securities (MBS), pension funds, insurance companies and banks provided most of the loans.

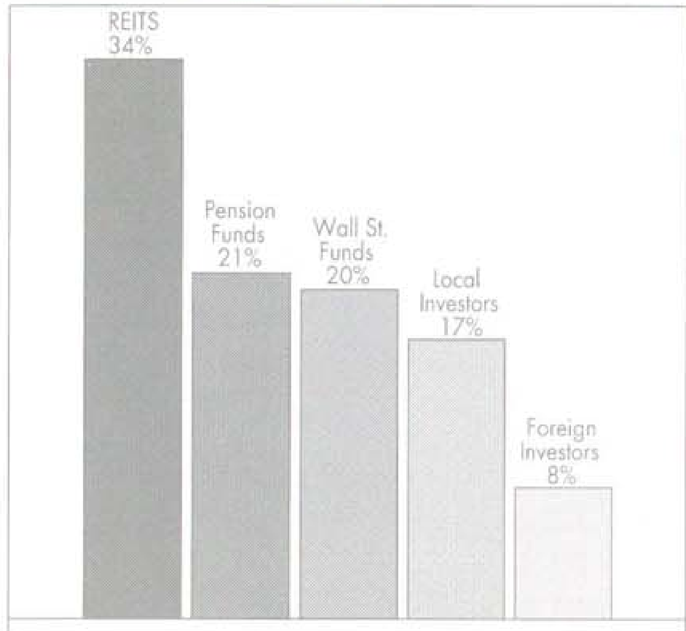


The emerging trend in the above graph shows a hugh increase in the market coming from REITs and Mortgage Backed Securities. This will likely displace bank lending and pension fund investments in the future.

REAL ESTATE YIELDS

The majority of our Respondents (85%) believe that investors are willing to take lower yields on their real estate investments today.

The most aggressive equity investors are as follows:



The Group clearly perceived that REITs were purchasing properties on lower yields. They believe that local investors as well as foreign investors were the least likely to do this as **the local investors are still pinching themselves when they see prices going higher.**

The Capitalization Rates below indicate a drop in yields since last year. However, the average real estate yield or IRR for all property types during last quarter was 12.0% up from 11.7% last quarter. The safe rate, measured by five to ten year treasuries, was only 5.4% to 6.1% reflecting a 6.0% to 6.5% risk spread for all real estate types. The lowest risk premium was for apartments, which ranged from 5.0% to 5.7%, while the highest premium, for hotels, ranged from 7.2% to 7.9%.

Capitalization Rates

	Going In		Stabilized		Reversion	
	4th Qtr 1992	4th Qtr 1993	4th Qtr 1992	4th Qtr 1993	4th Qtr 1992	4th Qtr 1993
Apartments	8.81%	8.98%	9.71%	9.40%	9.94%	9.76%
Office	9.66	10.14	10.99	10.64	11.24	9.66
Retail	10.92	9.91	12.06	10.46	11.22	9.42
Industrial	9.61	9.87	10.47	10.05	10.48	10.29
Hotel	11.75	11.38	12.46	12.00	11.23	11.98

Our Respondents believe that the average spread between safe rates of return like Treasuries and investment real estate will narrow to 4 percent. However, this may only happen due to rising Treasury rates, not decreasing real estate yields.

Discount Rates

	Weighted Average 4th Qtr 1992	Low 4th Qtr 1993	Weighted Average 4th Qtr 1993	High 4th Qtr 1993	Change From 4th Qtr 1992
Apartments	11.5%	5.5%	11.2%	14.0%	−0.30%
Office	10.5	10.0	12.9	16.0	2.40
Retail	13.2	10.0	12.2	16.0	−1.00
Industrial	10.1	10.8	11.8	15.0	1.70
Hotel	13.2	12.0	13.3	14.0	0.20
Ground Leases	10.0	9.0	10.6	15.5	0.60

FOCUS ON REASONABLE MARKETING PERIOD

Among other factors, one's estimate of Market Value is based on the premise that "a reasonable time is allowed for exposure in the open market". Therefore, when estimating market values, participants must consider what marketing time is reasonable when making an offer or putting a property up for sale. Thus, we asked our Respondents to estimate, in general, a reasonable marketing period for a sale to occur in the Texas markets by property type. The following chart shows new optimism for hotels and industrial properties.

Property Type	4th Qtr. 1992	4th Qtr. 1993	Property Type	4th Qtr. 1992	4th Qtr 1993
Apartments			Hotels		
Class A	7	6	Full Service	18	12
Class B	10	8	Limited Service	17	11
Office			Industrial		
High Rise	13	16	Bulk Warehouse	10	8
Class A Suburban	12	12	Off/Warehouse	11	8
Class B	15	16	Tech/Flex Space	13	10
Retail			Land		
Regional	8	10	Leased Fee Sites	11	12
Community	10	9			
Neighborhood	10	9			
Unanchored	15	12			

INVESTMENT DURATION AND NEW DEVELOPMENT

On another front, investors plan to hold properties for a shorter period of time. Forty to fifty percent of the group responding (depending on property type) said they plan to resell properties bought today within three years. Also, the consensus among the Group was that **speculative apartment and industrial development will be widespread in Texas in 1994** with speculative retail and hotel development occurring by 1996. **No speculative office development is predicted until 1997.**

FOURTH QUARTER SUMMARY

Last issue we announced the return of the Texas bull market; widespread capital availability and user demand. This quarter, as we look back at 1993 we see the yield hunting investors rediscovering real estate as an acceptable alternative to money market funds and CDs. New sources of capital coming from the securities markets will transform the commercial real estate markets of the 90's. Rising interest rates will narrow the yield spread in the future but will this be enough to turn off the yield-hungry capital to real estate? We do not believe it, so stay tuned.

Current Lending Criteria

	Interest Rate	LTV Ratio	Terms in years	Balloon in years	DCR	Points
Market	7.65%	73%	18	4.7	1.26	1