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**NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®**

Statement of
Jeffrey H. Schwartz
Chairman and Chief Executive Officer
ProLogis
and
First Vice-Chair
National Association of Real Estate Investment Trusts®
Before the
Senate Finance Committee
Hearing on
“The Real Estate Market: Building a Strong Economy”
February 28, 2008



1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.nareit.com

Statement submitted before a hearing of the Senate Finance Committee entitled “The Real Estate Market: Building a Strong Economy” on February 28, 2008

My name is Jeffrey H. Schwartz, and I am Chairman and Chief Executive Officer of ProLogis and First Vice-Chair of the National Association of Real Estate Investment Trusts[®]. ProLogis, headquartered in Denver, Co, is the world’s largest owner, manager and developer of distribution facilities with more than one-half billion square feet of industrial space in 118 markets across North America, Asia and Europe. I am here today, testifying on behalf of NAREIT, the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. property and capital markets. I appreciate the opportunity today to provide an overview of the health of the commercial real estate market, but also the risks presently threatening that health.

As members of the Committee are well aware, commercial real estate contributes approximately six percent to the U.S. Gross Domestic Product. When it comes to building and maintaining a strong economy, the commercial real estate sector plays a constructive, creative and important role.

As an integral part of the commercial real estate economy, real estate investment trusts (REITs) are publicly traded companies that own and, in most cases, manage portfolios of investment-grade, income-producing commercial real estate, including office buildings, warehouse and distribution facilities, retail centers, apartment communities, health care facilities and hotels.¹ REITs operate like other publicly traded companies, including familiar names like Microsoft, Verizon or Citigroup. However, unlike Microsoft (which designs and provides software), Verizon (which builds and provides telecommunications services) or Citigroup (which manages and provides financial services), REITs own, operate, develop and lease commercial real estate as well as provide their tenants other real estate services.

Today, there are approximately 150 publicly traded REITs with a combined equity market capitalization exceeding \$300 billion. Together, they own a combined real estate portfolio of more than \$600 billion of commercial properties or approximately 10-15 percent of all institutional-grade, income-producing real estate nationwide.

In assessing the state of today’s real estate economy, it may be helpful to separate its two primary components: the commercial property markets and the capital markets which provide debt and equity financing to the property sector. The reason it is important to examine property and capital markets separately is that it may come as a surprise to some that the past several years are best described as a period of reasonably healthy and strong commercial property markets. The “boom and bust” cycle that has appeared from time to time in the real estate economy has been primarily the tale of capital markets, not the tale of property markets. While capital markets today are in considerable difficulty, the financial distress attending those markets has not yet spilled over into real property

¹ Some REITs also provide financing for commercial real estate.



business fundamentals. However, property markets could lose their fundamental strength rapidly if the difficulties in capital markets are not overcome relatively soon, and what may be viewed currently only as modest weakness in the broader economy could turn quickly into a hard landing.

Commercial Property Market Fundamentals

The most important metric with which to gauge the health of income-producing property markets is *net operating income*, or NOI, which equals the revenues generated by leasing space in a commercial property minus the expenses associated with operating and maintaining that property. Exhibit 1 summarizes from 2000 through 2007 median growth in “same-store” net operating income – that is, NOI growth for the same portfolio of properties – among 30 of the largest real estate investment trusts nationwide. Except for a three-year period of negative or weak growth (2002-2004), net operating income has grown by three percent to five percent in every other year from 2000 through 2007.

The two factors contributing most to net operating income are effective *rents* and *occupancy rates*, that is, the percentage of leasable space in a given building that is actually generating income. Exhibit 2 summarizes average occupancy rates in office, retail, industrial/warehouse and apartment buildings from 1987 through 2007. As revealed in the exhibit, the deceleration in 2002-2004 of net operating income growth coincided with a downturn in occupancy rates from about 94 percent to about 89 percent. Occupancy rates since then have recovered to about 92 percent – their approximate long-term average – and have propelled NOI annual median growth back to five percent in 2006 and 2007.

Market participants also assess property market fundamentals by analyzing property markets in terms of *vacancy rates*, which are shown in Exhibit 3 for the same period. Vacancies surged to about 11 percent during 2003 and 2004, but then declined to less than eight percent – again, the approximate long-term average – through the end of 2007.

The fundamental strength of commercial property markets over the past several years owes primarily to the growth of demand for space. As the economy expands, the demand for additional space grows likewise. For example, Exhibits 4 and 5 illustrate, respectively, two drivers of such demand growth: the level of external trade (imports plus exports) from 1995 through 2007 and the level of retail sales activity from 1998 through January of 2008. External trade, which drives much of the demand for industrial and warehousing space, has grown steadily, with only the slightest hesitation in 2001 and 2002. Similarly, retail sales have grown even more consistently and drive much of the demand for space in retail properties.

The second main factor in maintaining the fundamental health of income-producing property markets over the past several years was a substantial increase in construction costs. Developers generally respond to strong real estate fundamentals both by constructing new commercial space and by renovating existing properties. If construction costs are relatively low, then the response of developers can be swift. In



some cases, developers may respond too aggressively by building too much new commercial space. When excessive construction occurs, net operating income inevitably suffers as competition between owners of new and existing properties drives down both occupancy rates and effective rents.

Exhibit 6 illustrates year-over-year growth in construction costs in the U.S. from late 1997 through 2006. As the exhibit reveals, construction costs surged between 6 percent and 10 percent during the period 2004-2005, just when commercial real estate property fundamentals were improving following the comparative weakness of 2002-2004. This growth in construction costs made it more costly for developers to build new commercial properties and dampened what otherwise might have been an over-response to strong real estate fundamentals.

Owing to a combination of the factors I have noted, construction activity has been strong, but not so strong as to lead to the type of over-building that has undermined net operating income during previous commercial property cycles. Using data from the Bureau of Labor Statistics, Exhibit 7 summarizes the number of square feet of new non-residential construction put in place from January 2002 through December 2007. As the U.S. economy expanded throughout that period, we witnessed only a steady increase in the construction of new commercial space rather than a surge in new construction that could have undermined property fundamentals.

In summary, income-producing property markets today are fundamentally sound and have been sound for several years. The persistent strength in commercial property fundamentals can be attributed to a healthy growth in demand for commercial space – including such demand drivers as office-related employment, retail activity, and external trade – as well as only a moderate level of new construction activity in response to those strong fundamentals.

Commercial Property Capital Markets

I now will turn to the financial side of the U.S. real estate economy, which presents a very different picture. While commercial property market fundamentals have remained relatively strong, current credit market conditions for commercial real estate are in extreme distress.

Reflecting this distress, share prices for publicly traded real estate equity securities have declined approximately 26 percent from their peak levels of a year ago. The recent sell-off in share prices is revealed in Exhibit 8, which tracks the FTSE NAREIT total return index for equity REITs – companies that own, develop, operate and lease commercial property. Likewise, sources of private equity capital, though more difficult to measure, also have pulled back. However, the decline in equity valuations primarily reflects current conditions and uncertainty plaguing credit markets.

Conditions in the commercial real estate credit market run the risk, if allowed to worsen, to add to the woes currently plaguing the home mortgage markets. Not unlike



developments in the market for single-family mortgage credit, available data suggest that an excess supply of capital prompted lenders to relax commercial mortgage lending standards and to reduce commercial mortgage interest rates. This then led investors to bid up property prices beyond levels consistent with property fundamentals.

As revealed in Exhibit 9, the tendency toward an excess supply of credit first became evident in 2002. The Federal Reserve Board's Senior Loan Officer Opinion Survey on Banking Lending Practices conducted during the second quarter of 2002 revealed a marked decline from previous surveys in the net percentage of loan officers reporting a tightening of credit standards on commercial real estate loans. In the fourth quarter of 2003, the survey suggested that, on net, lenders were no longer tightening standards at all for commercial real estate loans, and during each of the next eight quarters, the survey indicated that lenders continued to relax commercial real estate lending standards.

The steady erosion of lending standards had the effect of making more and more financing available to prospective borrowers. As we have seen, the easy availability of credit did not prompt a surge in new commercial construction; rather, the surplus of financing supported acquisitions of existing properties at higher and higher prices relative to their net operating income.

A corollary to the increasing availability of commercial real estate credit has been the dramatic growth in issuance of commercial mortgage-backed securities or CMBS. CMBS represent a mechanism for improving the efficient allocation of capital. Through CMBS, investors transfer funds to lenders, who use the proceeds of CMBS sales to originate new loans. Exhibit 10 illustrates growth in issuance of CMBS from 1999 through 2007. As the exhibit indicates, the importance of commercial mortgage-backed securities as a critical component of capital markets grew rapidly in 2005, 2006 and the first part of 2007, when average quarterly issuance exceeded \$50 billion.

Reflecting the increased availability and lower cost of mortgage credit, Exhibit 11 summarizes the increase in transaction prices from the end of 1999 through the end of 2007 for commercial properties as reported by the MIT Center for Real Estate. During the first part of the period, commercial property values increased at about 8.5 percent per year on average. However, beginning in the third quarter of 2003, commercial property values increased at an unsustainable pace, averaging almost 22.5 percent per year through mid-2007, coincident with the relaxation of commercial real estate lending standards and the surging issuance of CMBS.

As problems surfaced in the residential sub-prime mortgage market, banks in the second half of 2006 began tightening their lending standards and raising their credit spreads for commercial mortgage credit (Exhibit 9). In the most recent survey of bank lending officers, just over 80 percent of lending officers reported a further tightening of lending standards, the highest level reported since the Federal Reserve initiated the survey in 1990. Today, bank credit is available, but only to a very narrow cohort of borrowers with the strongest credit prospects, placing great pressure on many borrowers, including those seeking only to refinance outstanding debt.



In recent months, CMBS issuance also has plummeted, and the credit market for securitized commercial real estate debt is, for all intents and purposes, closed (Exhibit 10). In January 2008, for example, CMBS issuance was zero, an astonishing turn of events. Sharply wider credit spreads in the market for CMBS reveal the heightened level of investor uncertainty with respect to credit quality, indicative of the illiquidity that has frozen the market. As illustrated in Exhibit 12, credit spreads for AAA-rated CMBS have more than doubled in the past 12 months, whereas spreads for investment-grade securities have increased a thousand percent.

Absent the availability of credit financing, property transactions have slowed to a crawl. Exhibit 13 reveals that the number of property transactions has declined to a level not seen since the beginning of the decade. Without an adequate level of liquidity in property markets, the ordinary price discovery mechanism will not work. Investors are unable to determine appropriate price levels consistent with current property fundamentals and conditions in capital markets. Thus, markets are seized and will not function properly until liquidity is restored in credit markets.

Evidence of the far tighter credit market conditions and the absence of liquidity in property markets is the decline in property valuations reported in the third and fourth quarters of 2007 (Exhibit 11). Even though property fundamentals have remained strong, prices are beginning to weaken.

As valuations decline, cap rates, of course, have begun to increase. The cap rate for an income-producing property represents the implied return that investors expect to receive on the purchase of a property and equals the expected net operating income generated by the property as a percentage of the property's value. The cap rate is analogous to the earnings-to-price ratio for a company in the stock market. Exhibit 14 illustrates cap rates for office, retail, industrial, and apartment properties owned by pension funds and other fiduciaries. If both capital costs and expectations regarding future growth of NOI are constant, then the cap rate should be constant as well. If property values increased without any corresponding increase in future expected NOI – thereby driving down the cap rate – then investors would redeploy funds to alternative investments with returns that had not declined.

Cap rates on commercial properties have largely trended downward since 1993. During most of that period, however, the expected return on alternative investments – represented by the yield on long-term U.S. Treasury bonds – also was trending downward. As a result, the cap rate spread – the difference between cap rates and long-term Treasury yields – remained fairly constant at about 1.75 percent. Beginning in 2002, however, cap rates continued to decline even though long-term Treasury yields had steadied at about five percent. From 2002 through 2007, the cap rate spread narrowed until the second quarter of 2006, at which time there was no longer any spread between cap rates and Treasury yields. During most of 2007, reported cap rates were actually less than Treasury yields.



The Current Situation and Outlook

Where do we stand now, following this period of rapid growth in commercial property values, moderate growth in net operating income, and declining cap rates? Quite simply, access to capital has become severely constrained – if available at all – property transactions have declined to a fraction of their previous level, and property values have started to decline as a result.

Bank lending officers have reported increasingly tighter lending standards in response to each Federal Reserve survey since the first quarter of 2006, and CMBS issuance has plummeted from its peak in the second quarter of 2007. Although not shown in the exhibit, no commercial mortgage-backed securities of any kind were issued during January 2008, the first month since CMBS gained prominence that no issues came to the market.

This sudden constriction in the availability of commercial real estate credit has been felt rapidly both in the level of commercial property transactions and in the level of property values. After peaking at nearly 1,900 transactions in May 2007, transaction volume plummeted to fewer than 250 transactions in January of this year. As with CMBS, property transaction activity is necessary to maintain an effective market for price discovery and to allocate available capital resources efficiently, as properties are typically transferred to owners who believe that they can improve the performance of the assets.

A more ominous result of the constriction of capital availability has been the nascent decline in property values. Commercial property values started to fall in the third quarter of 2007, and the decline in the two most recent quarters has been rapid, at an average annual pace exceeding 11 percent. Investors in publicly traded equity REITs have already seen even more of a correction in their share prices.

In light of the current situation, the commercial real estate economy as well as the overall economy is at appreciable risk. Real estate fundamentals have remained relatively healthy even as credit availability has tightened, REIT share prices have declined and property values have started to fall. However, the strength in real estate fundamentals has persisted because of growing demand for commercial space as well as because new construction has continued to grow at only a moderate pace.

It seems exceedingly unlikely that the current balance in commercial real estate markets will be upset by any surge in new construction. The possibility of slackening demand for commercial space, however, presents a much greater risk. For example, any significant decline in office-related employment would reduce the demand for office space, affecting both effective rents and occupancy levels in the office property market. Likewise, any significant decline in consumer spending would reduce the demand for retail space, while any significant decline in trade activity would reduce the demand for industrial and warehouse space.



Conclusion

In conclusion, the primary basis for our present outlook with respect to the commercial real estate economy is the risk that illiquidity and credit restraint in the capital markets could bring about a significant economic downturn. Commercial real estate fundamentals have so far weathered the significant capital market dislocations. But, without renewed liquidity in the financial sector, the situation could deteriorate rapidly.

With respect to actions the Committee may consider taking, our overriding recommendation would be: First, do no harm. To the extent that legislative steps are taken, we caution you to move in a careful, deliberative manner so that upheaval in the financial markets is not accelerated and so that harmful, unintended consequences are not seen years hence. As an example, we do not believe that initiatives that would disproportionately raise taxes on the real estate industry are appropriate, especially at this time. Instead, and second, appropriate steps should be taken to ensure that real estate markets remain liquid and healthy. We do believe that several provisions contained in legislation now before this Committee, S. 2002, introduced last year by Senators Salazar and Hatch, are a part of the solution.

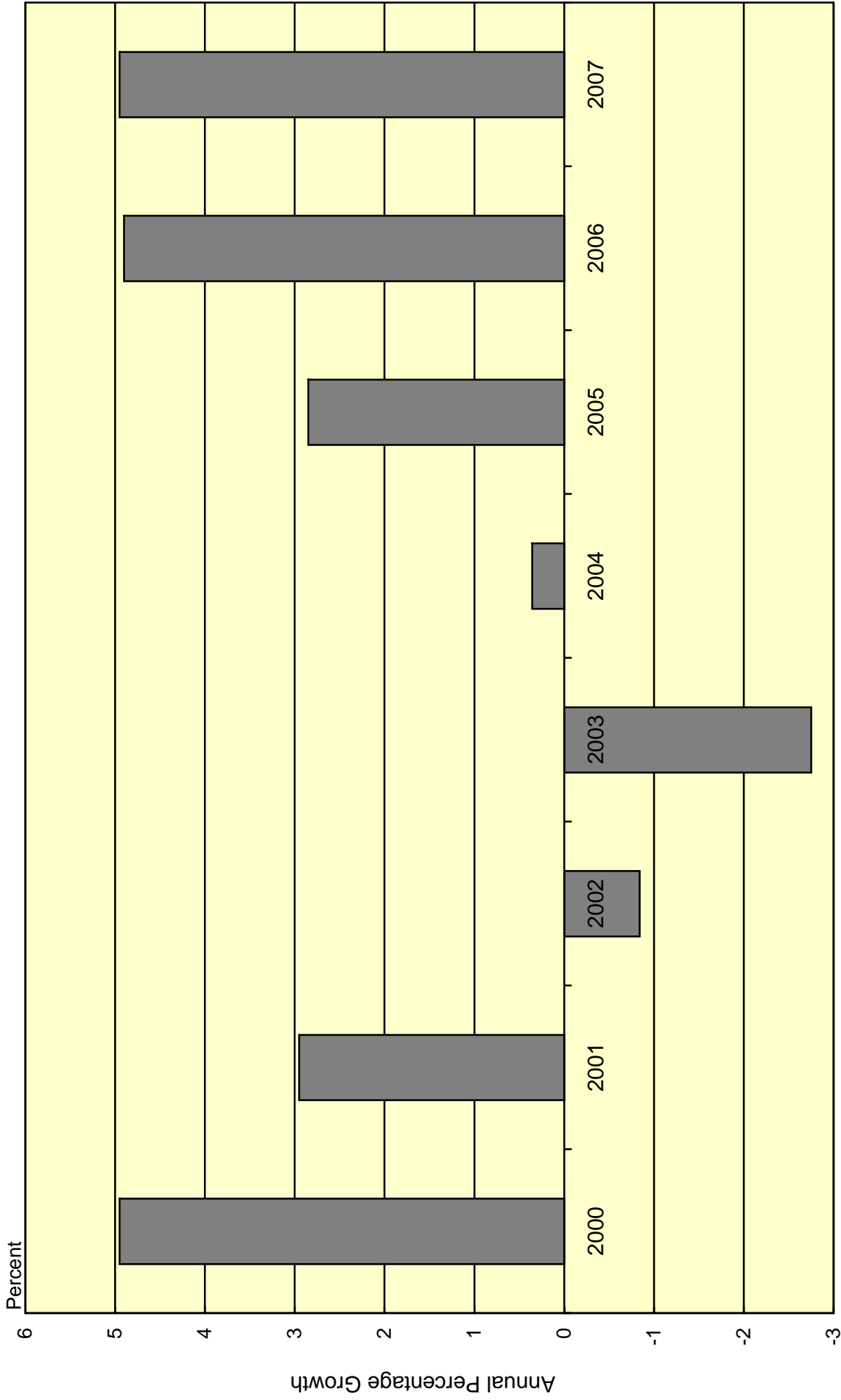
One of these provisions would authorize REITs to manage acquisitions and sales of their property portfolios more effectively and efficiently, consistent with their business goals as long-term holders of real estate. Allowing REITs to more readily access and recycle capital through the acquisition and disposition process would serve to enhance the property marketplace, much like removing the “lock-in” effect when capital gain rates have been lowered. REITs, which are largely well-capitalized and conservatively leveraged, would then be in a better position to inject desirable equity from the public markets into the commercial real estate marketplace, providing ballast to this sector at a potentially difficult time. In addition, under another provision contained in the Salazar-Hatch proposal, REITs engaged in taxable entrepreneurial, real estate activities that are ancillary to their primary real estate business, would be able to expand the range of these activities and infuse additional capital into the broader real estate economy.

We commend Senators Salazar and Hatch, as well as the other four members of this Committee who are co-sponsoring S. 2002, for their foresight in sponsoring legislation that would help facilitate healthy activity in the commercial real estate market at a time when it may be needed. To its credit, this Committee is desirous to build a strong national economy with a stable real estate base, and it is NAREIT’s strong opinion that one of the ways to help achieve this goal is adoption of these types of provisions.

NAREIT applauds you for holding this hearing and thanks you for the invitation to provide the insight we have on the state of commercial real estate in the United States today. We stand ready to assist this Committee and the Congress to achieve the overall goal of building a strong economy. I would be happy to respond to any questions that you or the other members of the Committee might have.

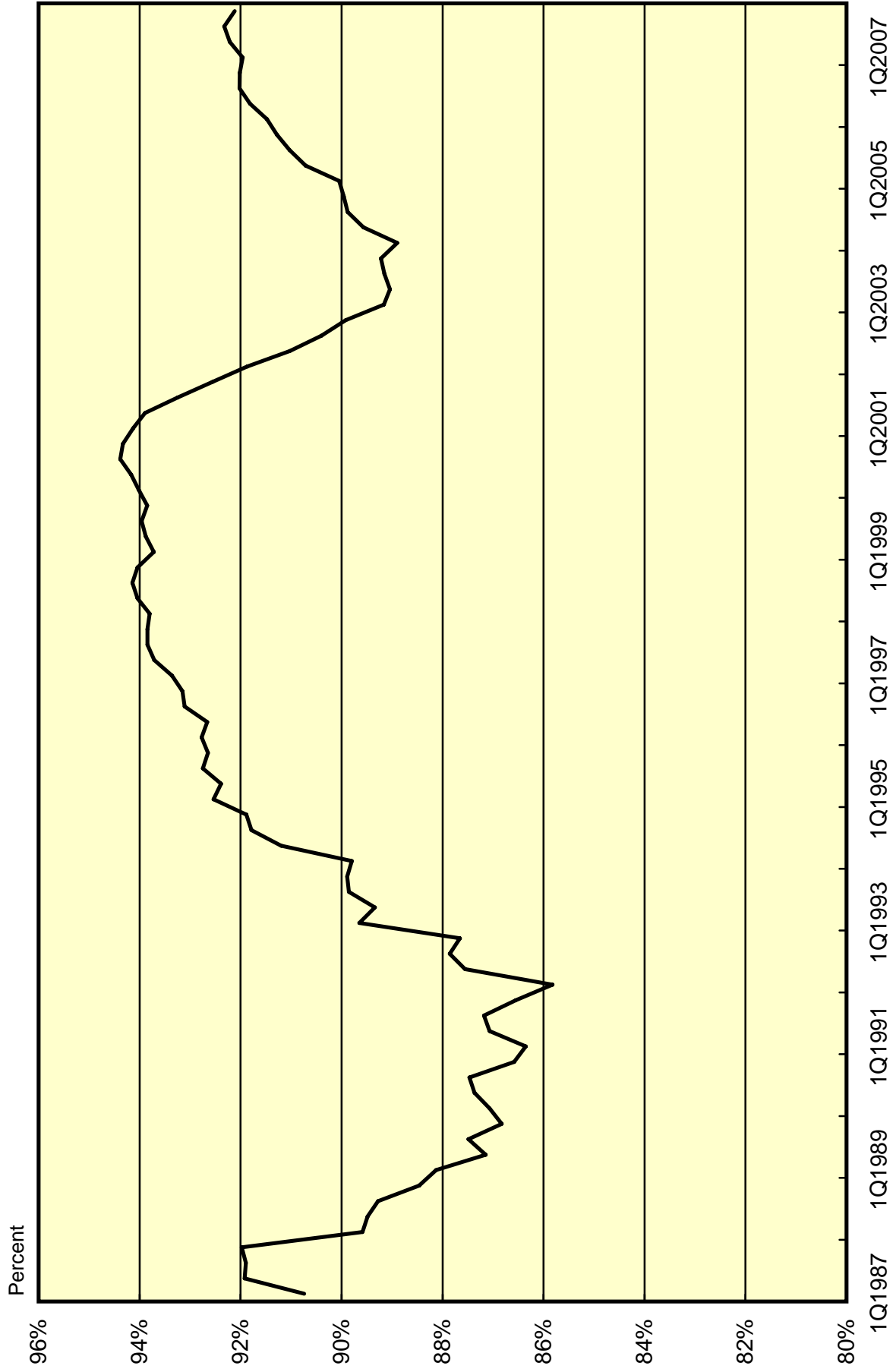


Exhibit 1
Annual Median Growth in Same-Store Net Operating Income
30 Large U.S. REITs, 2000 - 2007



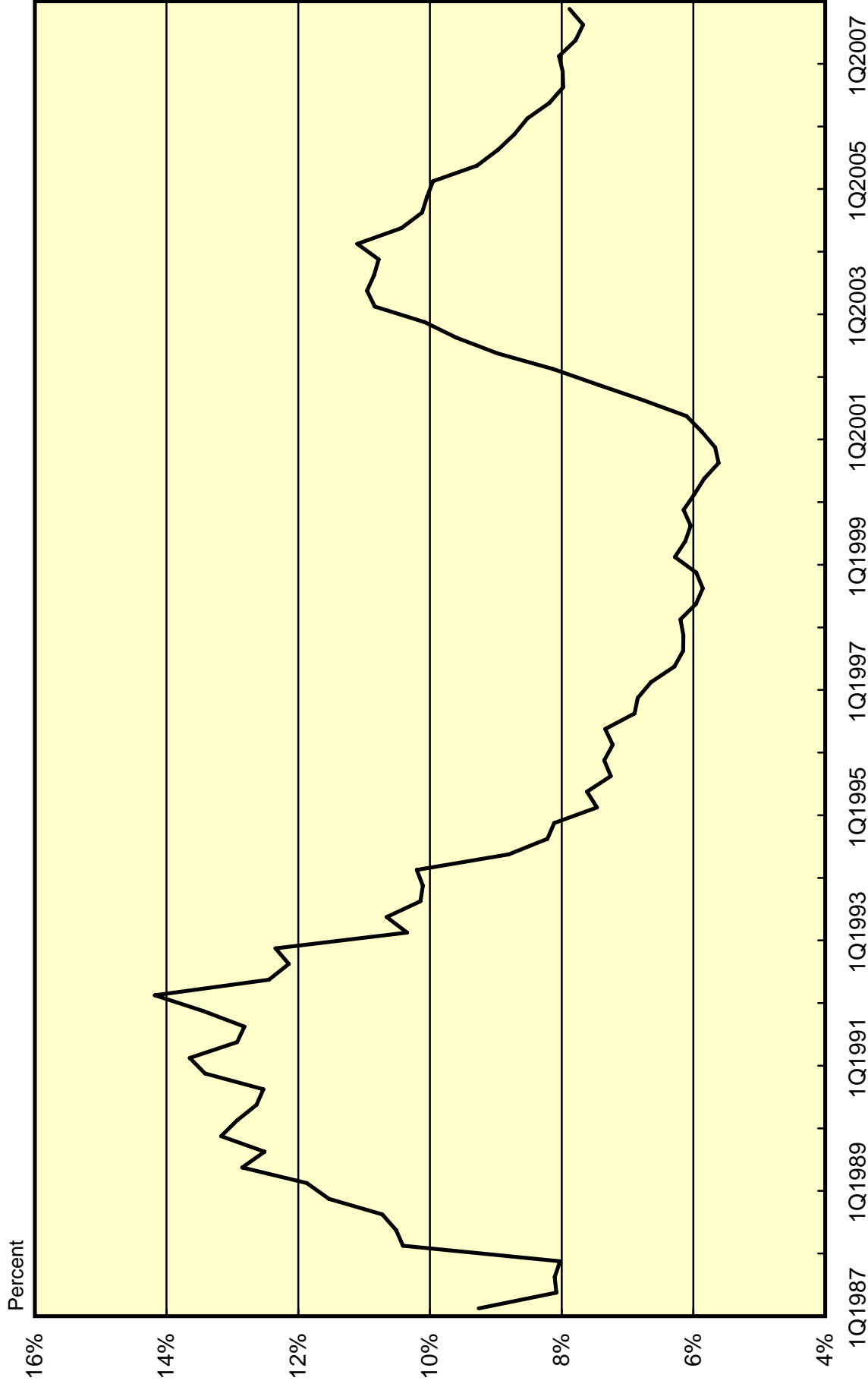
Source: SNL Financial

Exhibit 2 Average Occupancy Rates 1987-2007



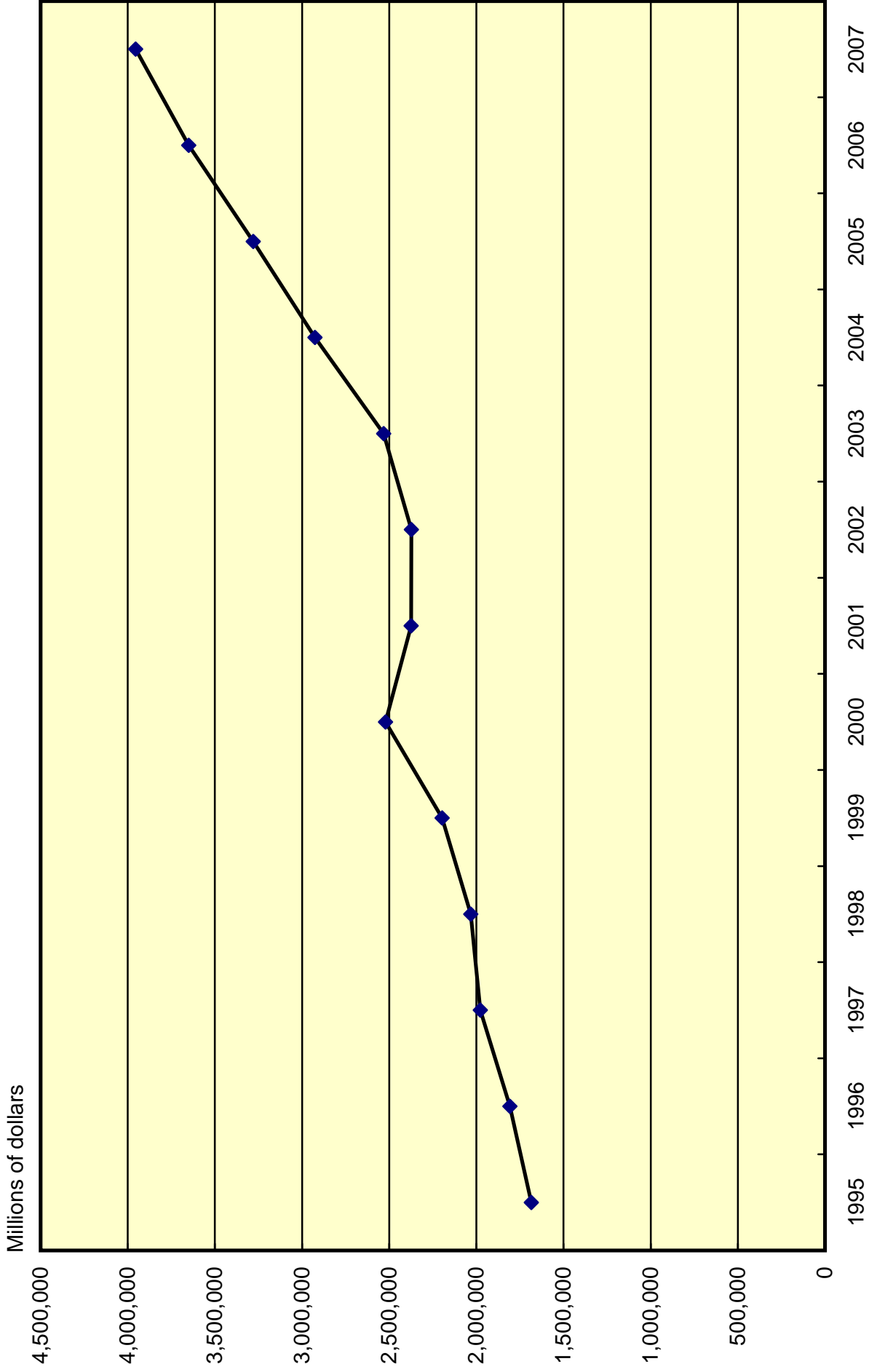
Source: National Council of Real Estate Investment Fiduciaries

Exhibit 3 Average Vacancy Rates 1987-2007



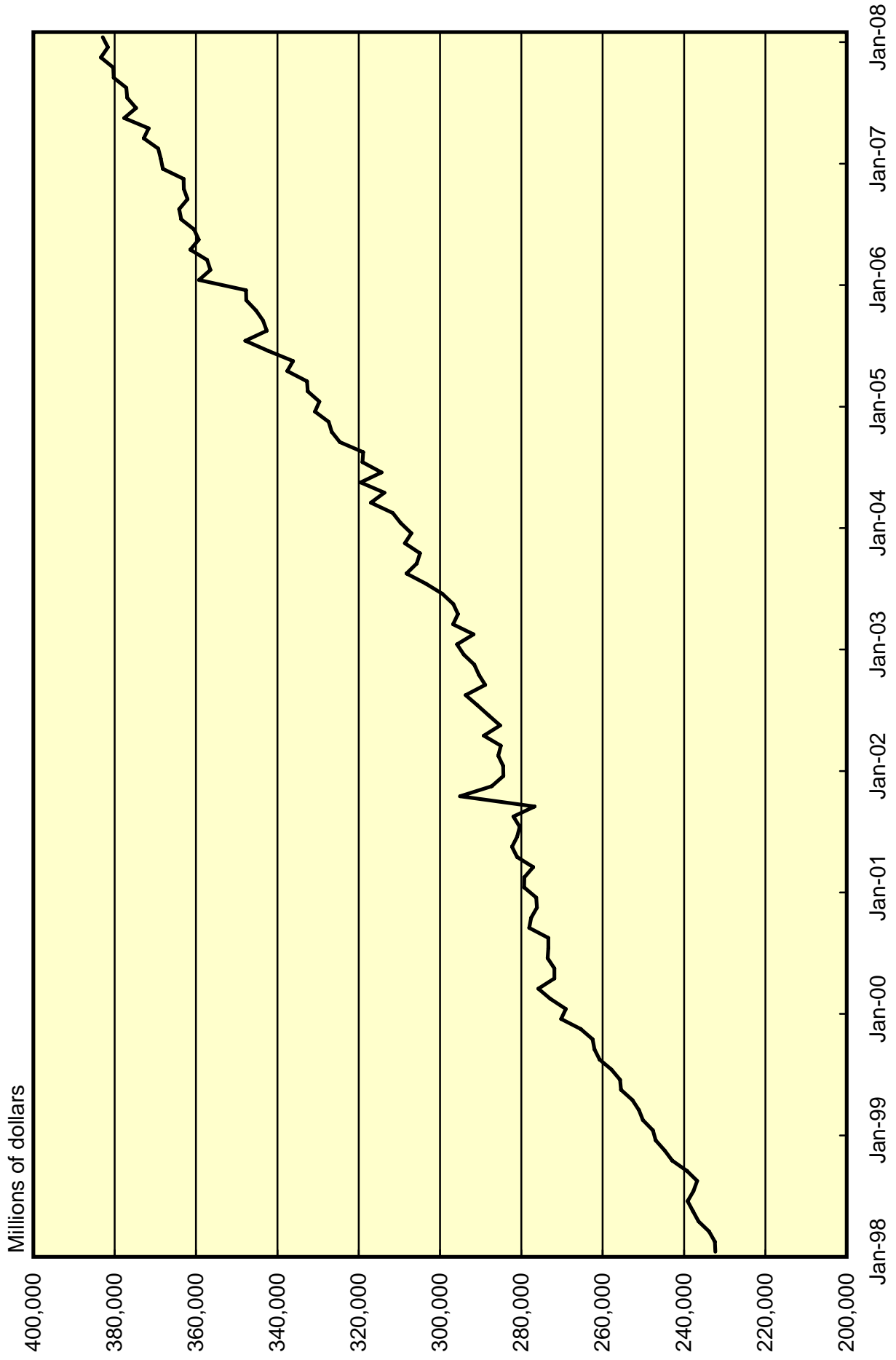
Source: National Council of Real Estate Investment Fiduciaries

Exhibit 4
Volume of External Trade
Imports plus Exports, 1995 - 2007



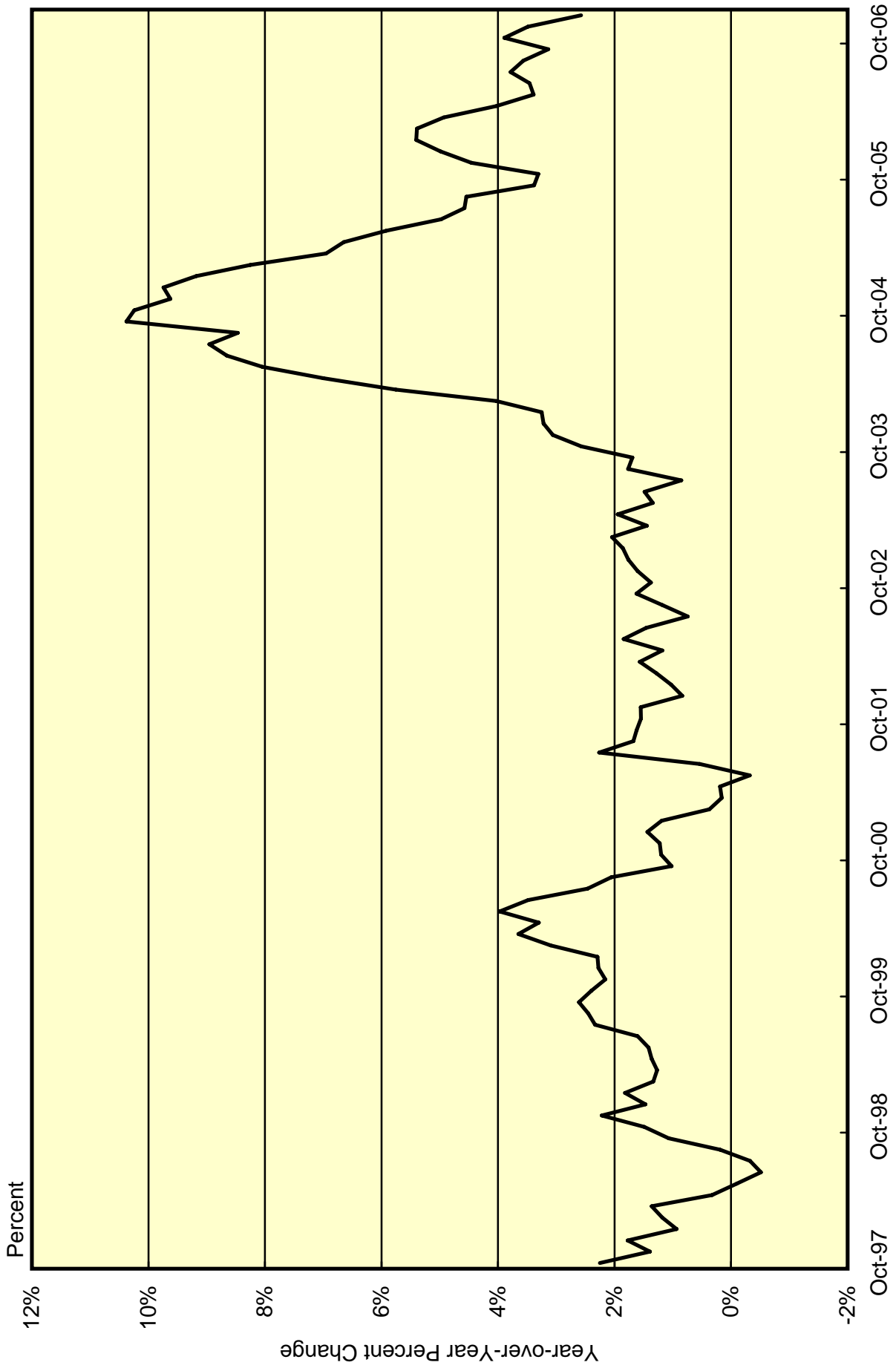
Source: U.S. Census Bureau

Exhibit 5
Retail Sales
1998 - 2008



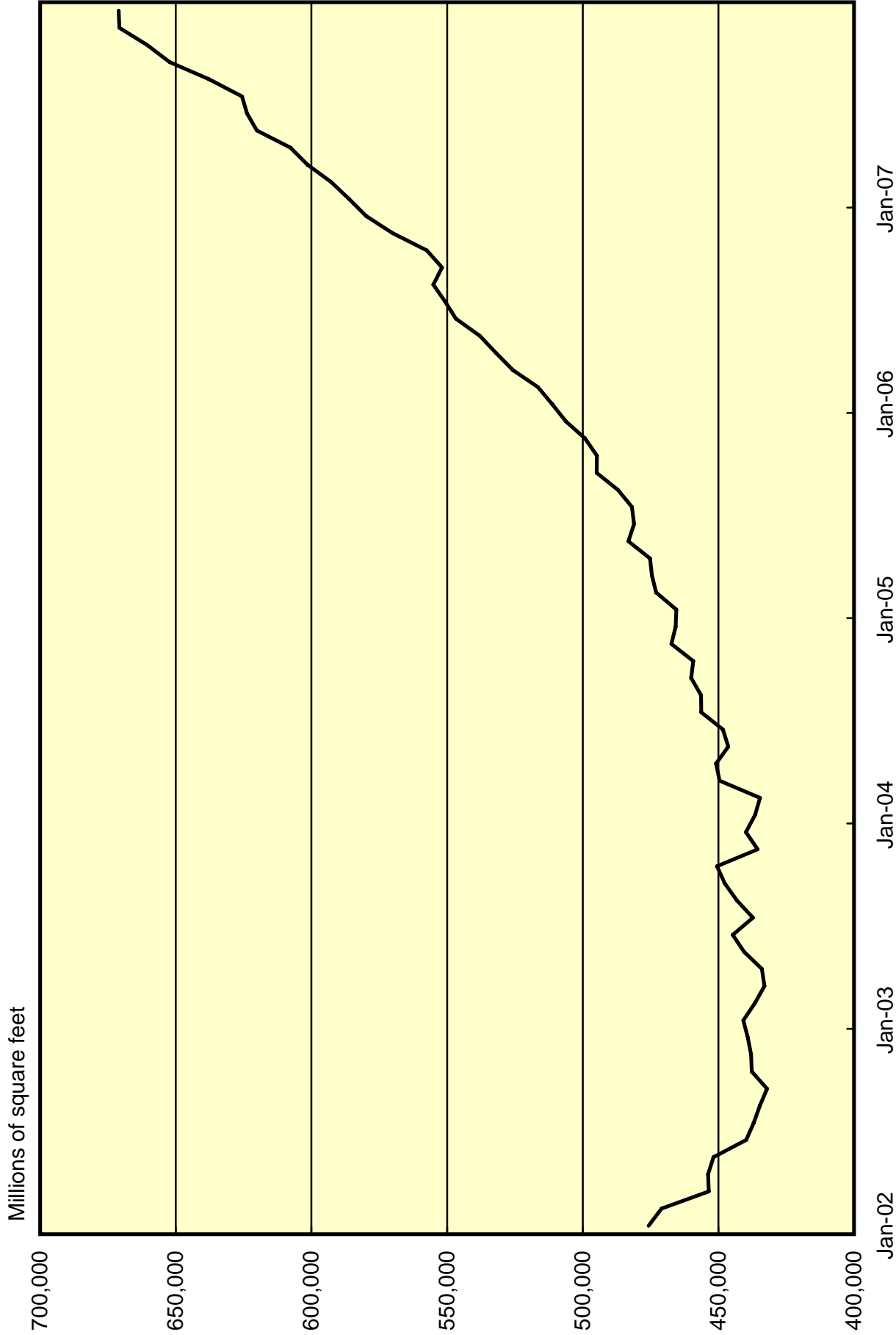
Source: U.S. Census Bureau

Exhibit 6 Growth in Construction Costs 1997-2006



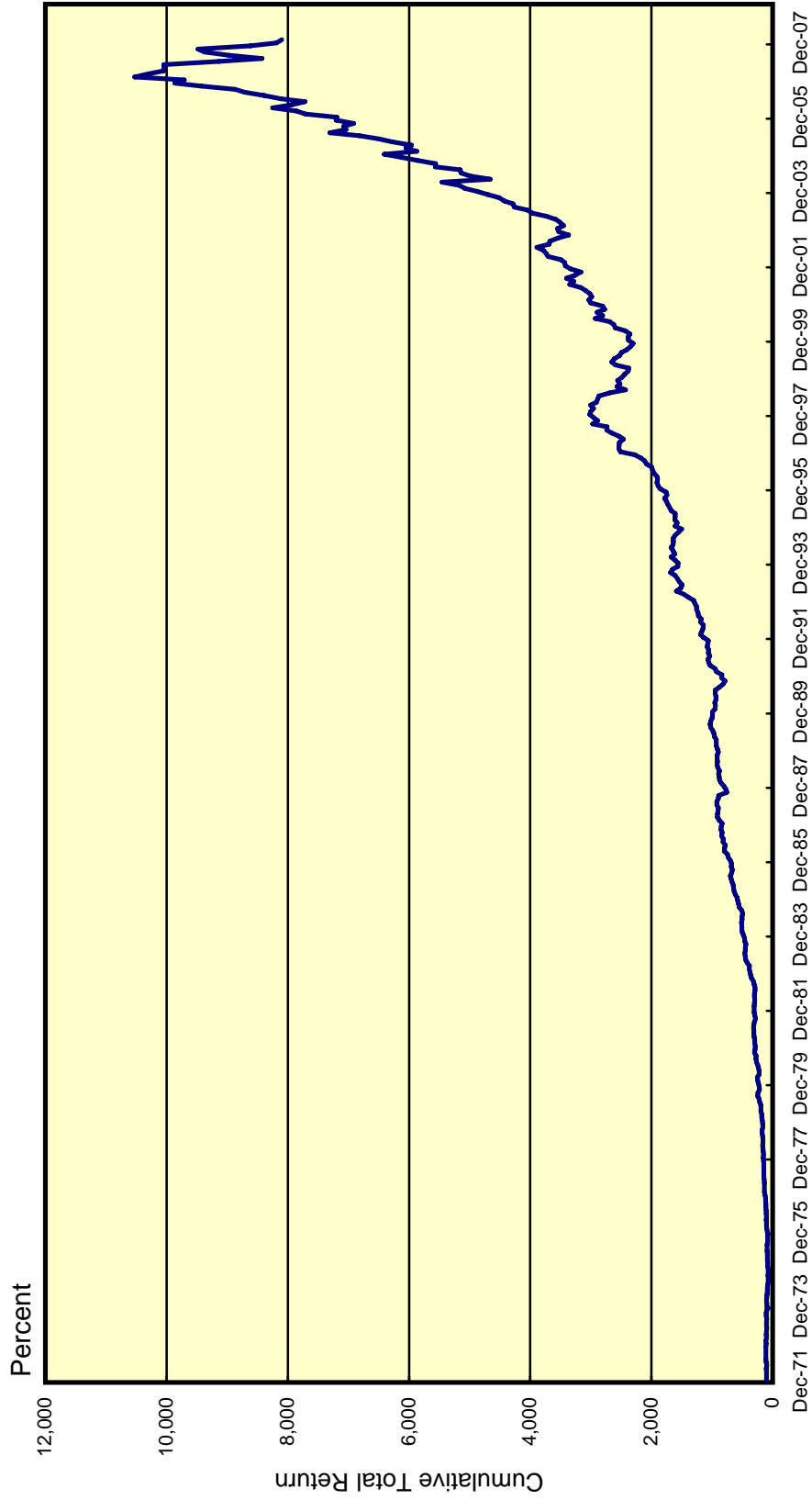
Source: Organization for Economic Cooperation and Development

Exhibit 7
New Construction Put in Place
2002-2007



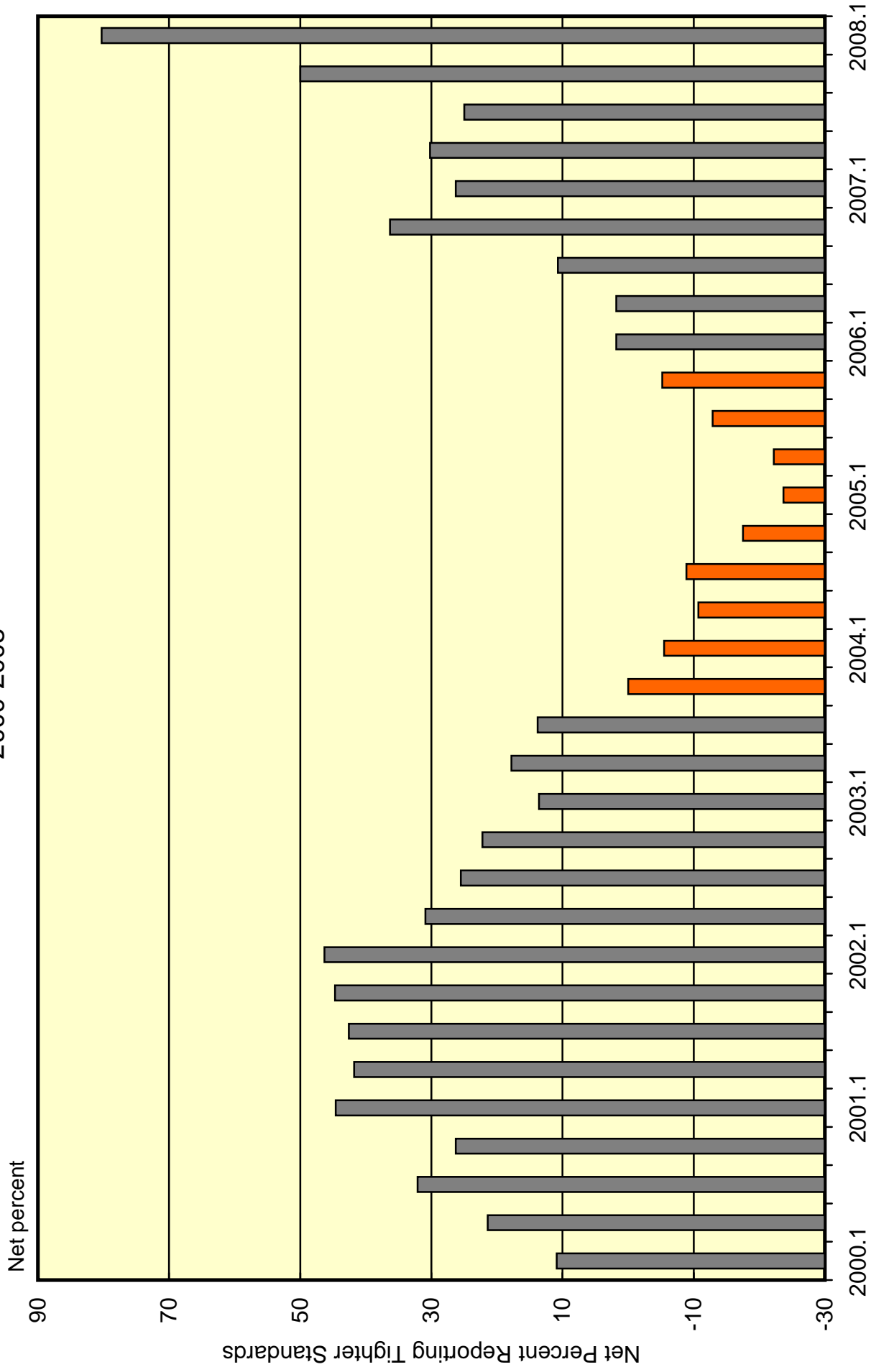
Source: Bureau of Labor Statistics

Exhibit 8 Cumulative Total Return for Equity REITs 1972-2008



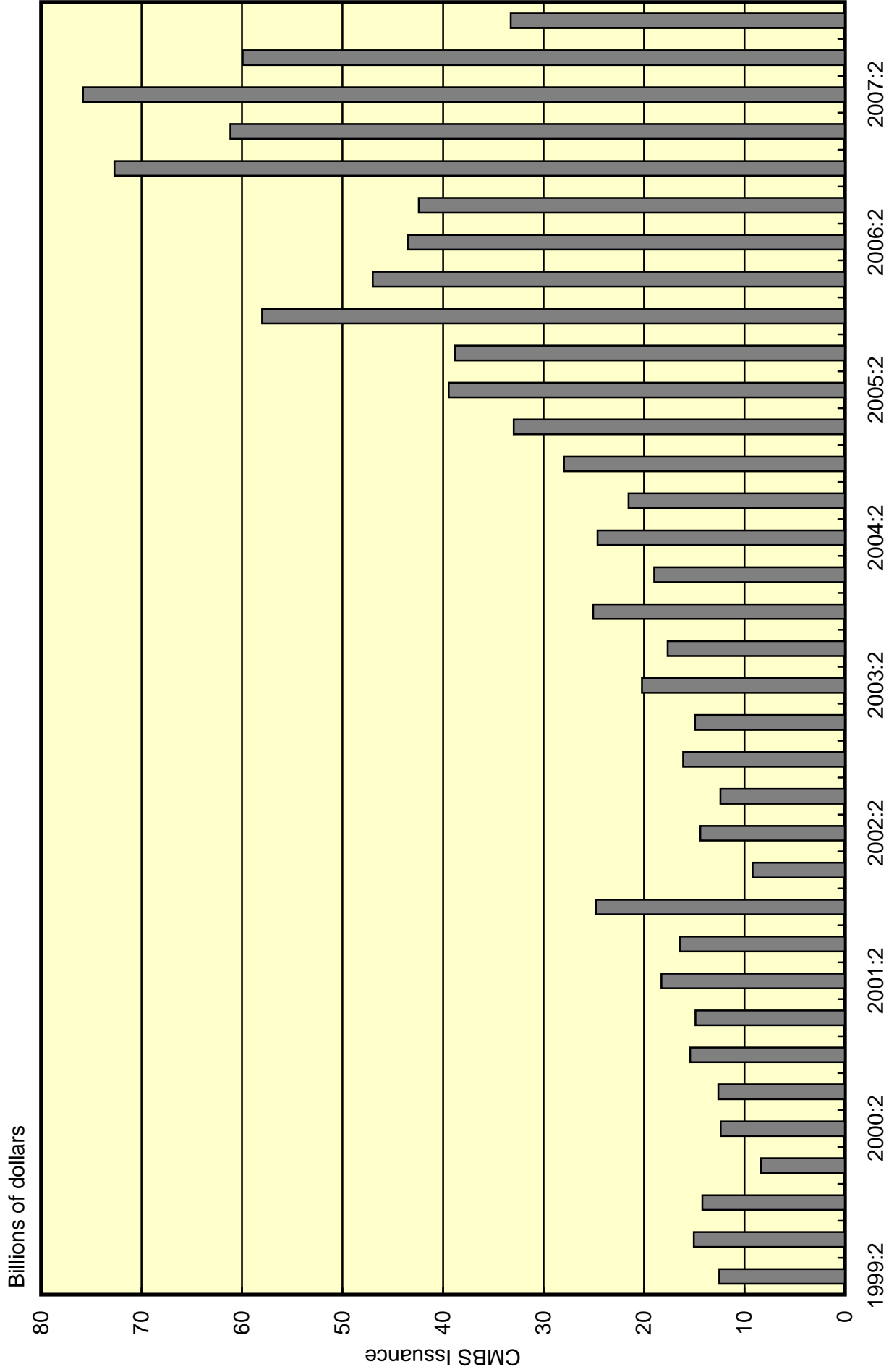
Source: National Association of Real Estate Investment Trusts®

Exhibit 9
Loan Officers Reporting Tighter
Commercial Real Estate Lending Standards
 2000-2008



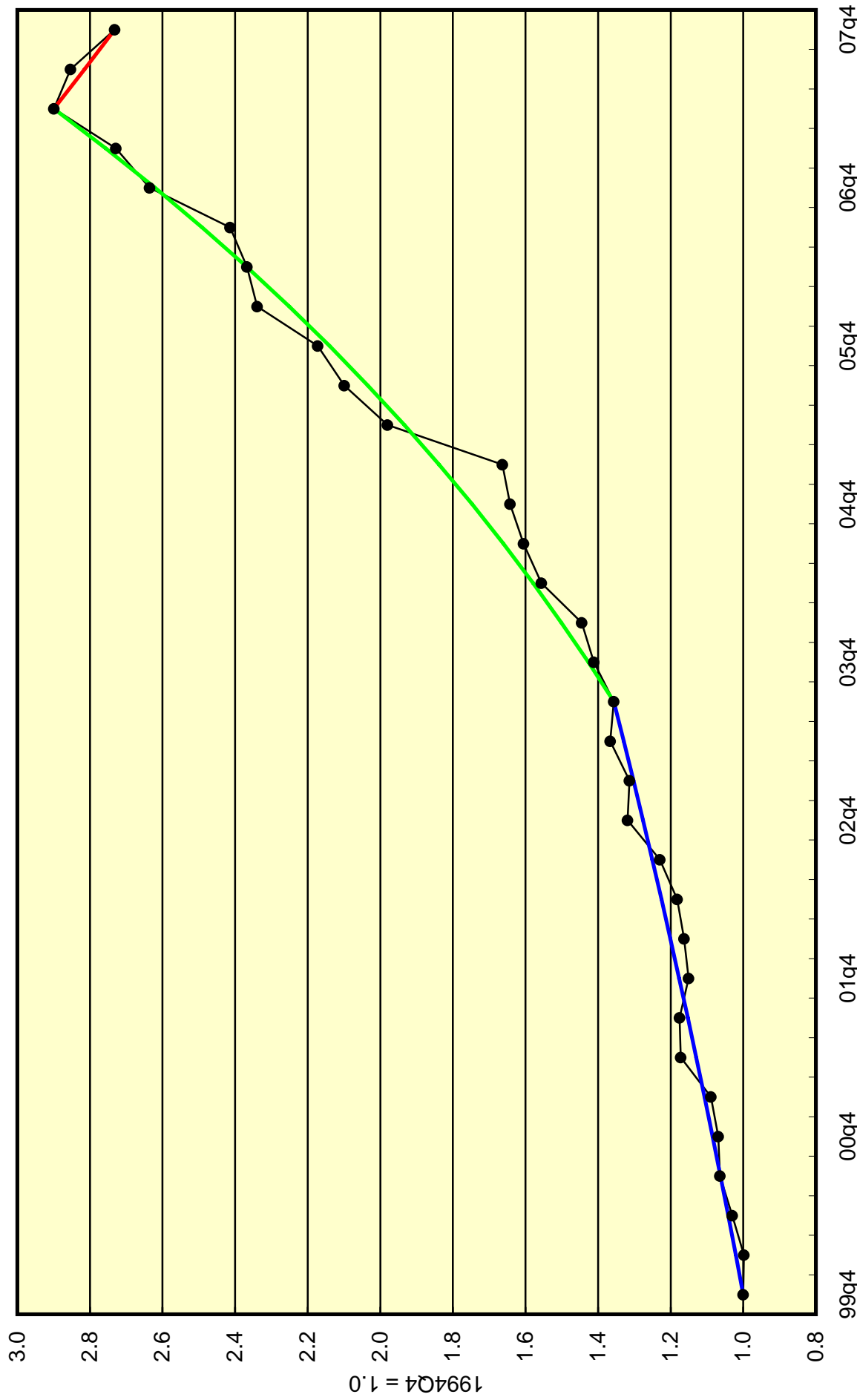
Source: Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices

Exhibit 10 New CMBS Issuances 1999-2007



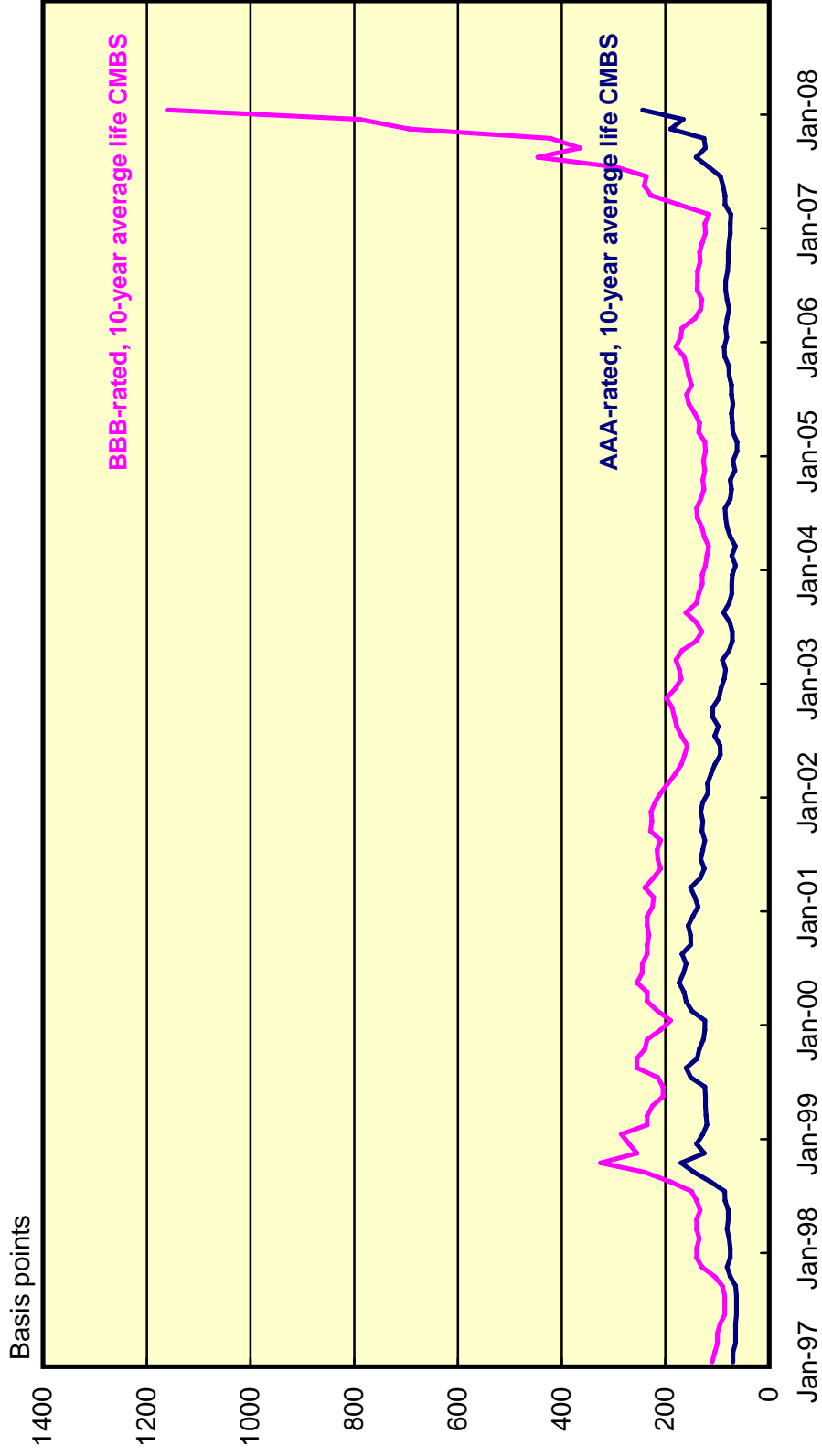
Source: Commercial Mortgage Alert

Exhibit 11 Growth in Commercial Property Values 2000-2007



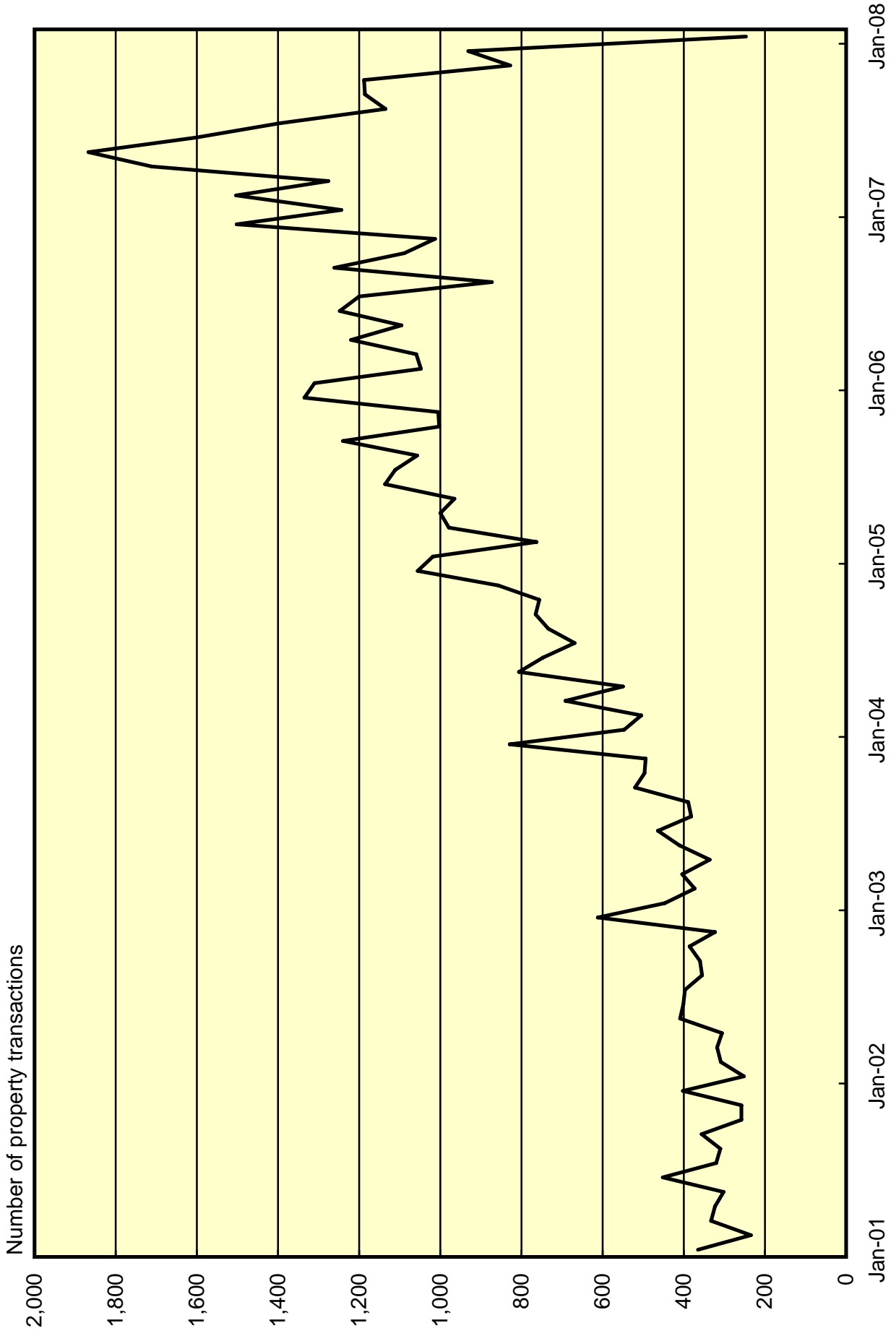
—●— Quarterly Growth in Commercial Property Values
 — Average 2000:1 - 2003:3 = 8.5% per year
 — Average 2003:4-2007:2 = 22.5% per year
 — Average 2007:3 - 2007:4 = 11.2% per year

Exhibit 12 CMBS Yield Spreads to U.S. Treasuries 1997-2008



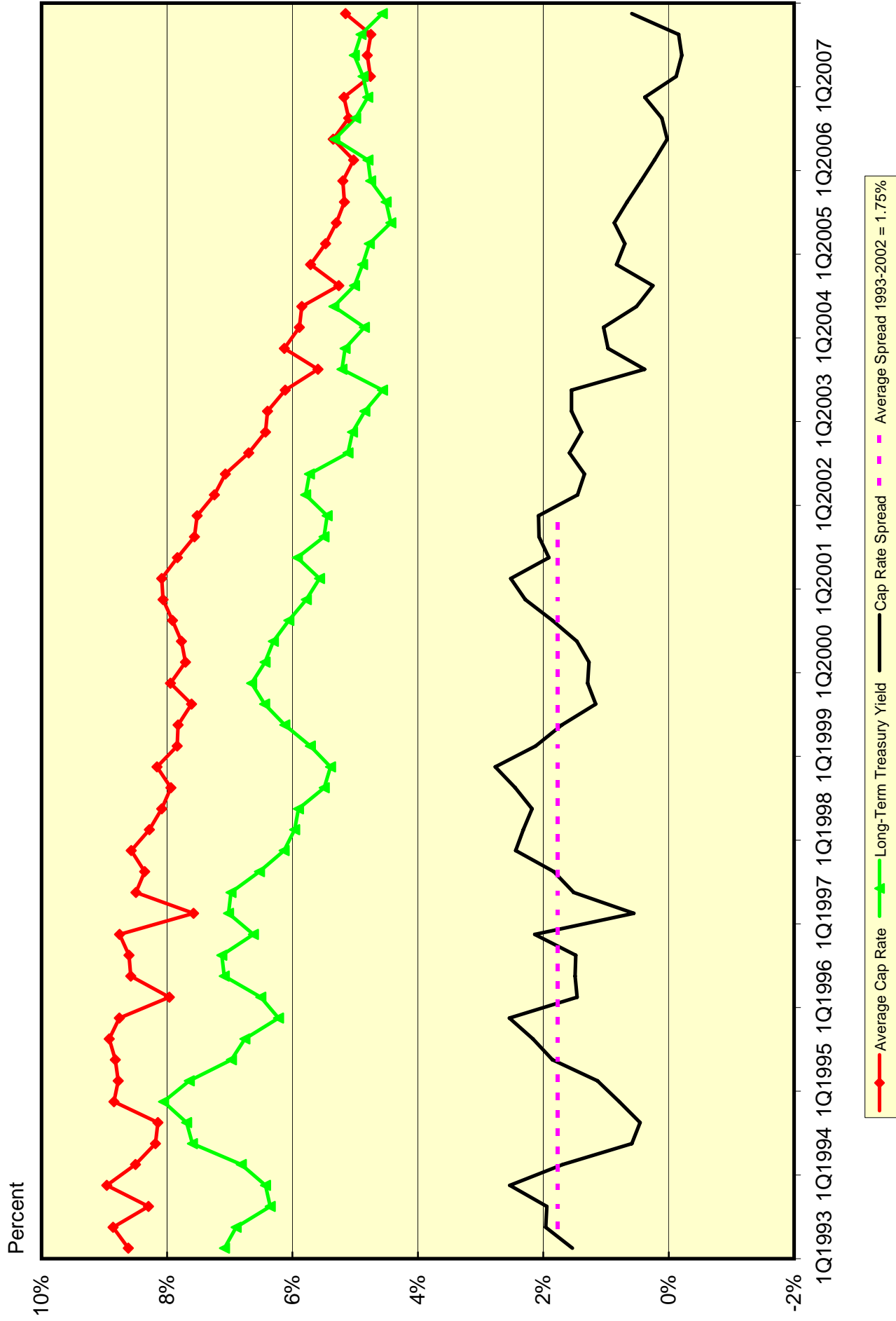
Source: Morgan Stanley

Exhibit 13
Commercial Property Transactions
2001-2008



Source: Real Capital Analytics

Exhibit 14 Cap Rates on Commercial Properties 1993-2007



Source: National Council of Real Estate Fiduciaries