

# Understanding Uncertainty and the Capital Markets

SCOTT R. MULDAVIN

**SCOTT R. MULDAVIN** is president of the Muldavin Company, Inc., in San Rafael, CA. [smuldavin@muldavin.com](mailto:smuldavin@muldavin.com)

**T**he real estate finance and investment markets are undergoing turmoil and change as a result of the World Trade Center and Pentagon attacks, and the United States and world response to the attacks. The extent of the turmoil and impact on the economy and real estate markets will be determined by the collective response of billions of people as they approach their daily lives and work.

Today it is clearer than ever that economics is a behavioral science. The real estate debt and equity markets are proceeding cautiously as the implications of the September 11 terrorist attack become better understood. The uncertainty relates not just to the overall effect of the World Trade Center and Pentagon attacks on the economy, but understanding the highly variable effects of the attack, and related consequences, on different property types, geographic regions and finance markets.

The first level of uncertainty relates to the effect of the attacks, and continuing military and security actions, on the overall economy. A declining economy affects the growth of new businesses, retail sales, and the income that individuals have to pay for apartments and homes.

The second level of impact relates to the variable effect on property types. Clearly, hospitality, resort and related assets in which travel and tourism are key will suffer significant consequences, at least in the short run. However, select hospitality and related properties that

are not as influenced by international travel, or airplane travel, should feel less effect. Multi-family properties are likely to feel the effect more quickly, given their short-term leasing structure, but they also might get some benefit if people put off home buying decisions due to uncertainty about their incomes. Office and industrial properties have longer-term leases that insulate them from the short-term shocks, but they must still focus on the overall economic and business growth impacts.

A third level of complexity relates to picking geographic winners and losers as the implications on international trade, airports and business behavior become better understood. The impact of increased defense and security spending will have positive effects on some regions, while those regions with strong international connections, which prior to September 11 was positive, will have some short- to intermediate-term negative impacts.

Real estate lenders, investors and service providers cannot just look to facts and figures, or evaluate historic trends, to be successful. We must study the motivations driving business and finance decisions to be able to “predict” how tenants, lenders and investors will act. In this spirit, this quarter’s assessment of trends in real estate finance provides insight into the motivations driving real estate decision-makers to guide lenders, borrowers and investors as we make our way in today’s demanding investment environment.

## DEBT MARKETS

Private lenders have been closing committed transactions, accepting applications for new loans, and, for the highest-quality transactions, competition can be quite keen. In early October, the highest-quality low leverage deals could get adjustable rate financing in the 5½% range, including the purchase of a ceiling guarantee. Fixed rate quotes on similar highest-quality loans were a little over 6%. As of late October, spreads widened, but with 10-year Treasuries dropping to 4½%, borrowers are looking at rates of near 7% for apartments and 7.25% to 7.5% for commercial and industrial properties. Conventional lenders and conduit lenders are instituting floors to protect downside risks.<sup>1</sup>

The public debt markets have seen spreads widening by 20 to 30 basis points as CMBS issuers also move cautiously forward. Deutsche Bank AG/Bank of America delayed a major issue scheduled for early September, but then decided to move forward with a \$1.5 billion offering after removing a \$104 million loan on a multi-family property in Battery Park City near the epicenter of the World Trade Center attack. While pricing for AAA classes ranged from 42 to 55 basis points on September 5, final pricing on September 27 found the two AAA classes pricing at 67 and 77 basis points.

While the uncertainty brought on by the World Trade Center and Pentagon attacks has resulted in wider spreads, borrowers are still in good shape given the over 60 basis point decline in Treasuries and the drops in commercial bank prime rates to 5½% brought on by the Federal Reserve Bank's continued reductions in the federal funds rate.

Lenders, both conventional and conduit, have become more conservative since the terrorist attacks, but money is available in the marketplace. One sign of this is that according to *Commercial Mortgage Alert*, CMBS issuance is projected to be \$80 billion in 2001, eclipsing the record 1998 issuance of \$78 billion.<sup>2</sup>

While real estate debt capital remains available for most property types, tighter underwriting has increased significantly the equity required to get loans closed. Fortunately, in response to this trend over the last number of years, the mezzanine-financing marketplace continues to develop. Capital Trust, Inc., announced in October that CT Mezzanine Partners II has completed its final closing of \$849 million of total equity. This fund expects to originate up to \$2.5 billion in loans and investments in the next two years. This fund's strategies are to provide flexible,

medium-term mezzanine financing to owners of large high-quality income-producing real estate.

In addition to such mezzanine-financing funds for large properties, numerous mezzanine funds targeted at smaller loans have been formed and are active in the marketplace. Crittenden's July 2001 real estate finance survey identified 28 lenders that are active in the mezzanine-financing marketplace. These included thrift and loans like Imperial Capital Bank; life companies like Aetna Life Insurance Company; pension fund managers like American Realty Advisors; finance companies like Berkshire Mortgage Finance; and conduit lenders like Credit Suisse First Boston.<sup>3</sup>

Commercial banks and life insurance companies were cautious as of early October due partially to the uncertainty that terrorism-related upheavals have brought to the financial markets. They appear, in some cases, to be less concerned that projects have suddenly become more risky, but were more concerned about the changing interest rate spreads and the record low prime and Treasury rates. The caution really related to wanting to reach an equilibrium in rates so longer-term decisions could be made intelligently. However, the short-term effects of the terrorist attacks are that established developers with strong track records, projects with more pre-leasing, and projects without hotel and retail components, are being viewed the most favorably.<sup>4</sup>

Freddie Mac and Fannie Mae continue to provide a full range of financing solutions for multi-family borrowers, providing aggressive competition for other lenders in this sector. Fannie Mae's Delegated Underwriting and Servicing program (DUS) is straightforward and competitively priced. Importantly, Fannie Mae DUS lenders are delegated authority to make loans, quickening the underwriting and closing process.

Freddie Mac likes to think of itself as a flexible "custom shop" given its ability to creatively address borrower needs. Its ability to customize is a function of the variety of its finance offerings, as well as its policy to retain a large volume of loans in its own portfolio, which reduces the restrictions and uniformity imposed by securitization.

Both Freddie Mac and Fannie Mae are price competitive, particularly for the highest-quality loans. Spreads during the late summer were approximately 150 basis points on a 60% LTV loan to 200 basis points on an 80% LTV loan.

Freddie Mac expects to beat its record of \$7.1 billion in multi-family financing that was set in 2000.<sup>5</sup>

Some of the challenges of synthetic leases, and a cre-

ative solution for solving them, are presented in a well-thought-out article on corporate finance by Richard Graff. Graff argues that synthetic leases are less efficient for financial planning purposes than conventional on-balance-sheet debt. The primary purpose of synthetic leases is to get mortgage debt off the corporate balance sheet, but research suggests that credit analysts at lending institutions view off-balance-sheet fixed-income obligations as equivalent to on-balance-sheet debt, as do investment analysts at institutional portfolio managers. Accordingly, given the questionable value of this “off-balance-sheet” technique, the inefficiencies of synthetic leases need to be better understood.

The critical shortcoming of synthetic lease financing is that rental payments that service the debt cannot be large enough to provide principal amortization and still be deductible financings by the lessee for both tax accounting and financial accounting purposes. Accordingly, synthetic leases are invariably interest-only financing, raising the risk that a relatively large refinancing will occur when the real estate cycle is at a low point and the interest rate cycle is at a high point, or when tenant creditworthiness is at a temporary low.

Graff proposes that these inefficiencies can be avoided by replacing synthetic leases with synthetic debt. Synthetic debt finance transforms lease obligations into the investment equivalent of senior corporate debt. Synthetic debt can be structured to reduce the refinance risk, be off-balance-sheet, and provide the financier with immediate recourse that is comparable or superior to conventional senior debt.<sup>6</sup>

Finance companies, investment banks, financial institutions and investors that have become more active in real estate finance during the last 15 years now have a study that documents why this makes sense. The study documents the growing market share of real estate equity and debt in the finance markets over the last 15 years, despite the fact that real estate's impact on GDP has been quite stable at 11% over the same time period.

Total real estate debt outstanding in 1985 was about \$3 trillion and represented 35.8% of the total debt markets. By 1999, the total real estate debt outstanding had increased to \$11.3 trillion, accounting for 44% of total debt outstanding. The author suggests that, in the foreseeable future, real estate may account for a majority of the debt market. Accordingly, investors looking to diversify their investments, and companies who profit from finance transactions, need to pay attention to these trends and plan accordingly.<sup>7</sup>

## REITs

The REIT market, like the rest of the stock market, reacted negatively to the September 11 terrorist attacks. REIT returns dropped 5% during the first 25 days after the World Trade Center disaster. This compared to the 5.5% drop in the S&P 500 and brought year-to-date returns for REITs to 6.3%. In contrast, the S&P 500 has lost 18.2% since the start of the year. As might be expected, during the 25 days after the World Trade Center disaster, apartments, office and retail properties lost between 3% and 5%, while hotel REITs dropped nearly 27%.<sup>8</sup>

While REITs have been negatively affected by the terrorist attacks and the decline in the economy, the results from the third quarter of 2001 highlight REITs' defensive characteristics. The Morgan Stanley REIT Index declined only 2.6% during the third quarter compared to a 15% decline for the S&P 500 and an approximately 31% decline for Nasdaq. So, while the absolute level of returns for REITs is expected to decline to approximately 10% (7.3% dividend plus 2.7% share growth), their relative performance should continue to be strong.

Analysts have become more pessimistic about apartment REITs given their short lease duration, which makes the effect of an economic decline and consumer confidence drop more immediately felt. On average, internal growth rate estimates after September 11 are down 0.5% for 2001 and as much as 2.6% for 2002. Companies with a high relative development exposure are also being downgraded further by analysts.<sup>9</sup>

Another interesting development in the REIT sector is that Standard and Poor's has declared REIT stocks eligible for inclusion in its U.S. indices. Equity Office Properties, the largest U.S. REIT, with an equity market capital of \$13.1 billion, will replace Texaco, which is being acquired by Chevron. Hospitality Properties, New Plan Excel Realty, Colonial Properties, Kilroy Realty and Shurgard Storage Centers are also taking over spots currently held by other corporations. These changes were made after the close of trading on October 9, 2001.

This development is important because a substantial volume of money tracks the S&P 500, and will now flow into the REITs included in the index. It also raises the awareness of REITs among investors who regularly track the S&P 500.<sup>10</sup>

The inclusion of REITs in the S&P 500 will continue a trend that has occurred over the last four years where more index investors and specialty investors have moved into the REIT marketplace, replacing growth-

oriented investors. Index investors generally create portfolios designed to match the composition of an index, such as the S&P 500, while specialty investors tend to have a narrow focus with a predetermined bias towards certain companies or industries. Since 1997, specialty investors have increased their REIT and real estate operating company holdings from \$15 billion to \$27 billion. Most of these investors are pension fund managers who are consistently getting new money to invest as pension funds have grown.

Similarly, over the past year and a half, index investors have increased their REIT and real estate operating company holdings from \$8 billion to \$14 billion. While about half of this can be attributed to capital appreciation and dividend reinvestment, the remaining increase has come from inflows from 401k money and the small increase of REITs added to the Russell 2000 index.

The growth in index and specialty investors, and the corresponding decrease in growth-related investors, should provide a less volatile capital base for the REIT industry moving forward.<sup>11</sup>

One of the few major initial public offerings of recent years is expected to be marketed to individual and institutional investors in mid-to-late October. Heritage Property Trust filed its registration statement (Form S-11) on September 7. As of June 30, 2001, Heritage's portfolio contained 140 shopping centers spread across 26 states, as well as 7 office buildings and 11 single-tenant properties. Based upon share prices of similar REITs, Heritage's initial dividend yield should be in the 8% to 9% range.<sup>12</sup>

## INVESTMENT CONSIDERATIONS

A recent article in the *Journal of Real Estate Portfolio Management* provides further research evidence to support the relative importance of property type factors compared to regional factors in explaining real estate returns. This research suggests that property type composition should be the first level of analysis in constructing and managing a real estate portfolio. In this research, property type explained almost three times the variability in real estate returns compared to regional factors. The results also indicated that two properties in the same property type are closer substitutes than two properties in the same region. As a consequence, the potential for portfolio risk reduction is greater by diversifying across property types within a region than across regions within a property type.

This research also points out the importance of a proper definition of regional diversification, with a focus on regions defined by economic, rather than geographic

characteristics. Importantly, when interpreting research like this and thinking about these issues, it is critical to understand that property types and regions are not easily analyzed separately, but in fact, the quality of a particular property type, or region, is interlinked.<sup>13</sup>

One trend that will not likely be affected by the terrorist attacks are the differences between boomers and post-boomers in their selection of where to live. According to *American Demographics*, post-boomers, those born between 1966 and 1980 (currently between the ages of 21 and 35) are attracted primarily to the "economic hot-spots" of the country. The top 10 metropolitan areas with the largest post-boomer growth include Las Vegas, Austin, Phoenix, Raleigh-Durham-Chapel Hill, Atlanta, Denver, Boise, Dallas-Fort Worth, Orlando, and West Palm Beach. Apartment investors need to clearly understand these trends, both where the most likely renters are going to be, as well as where they are not going to be.<sup>14</sup>

The top cities for business expansion and relocation—based on the cost and availability of property, economic health, good transportation infrastructure and skilled labor force—are dominated by cities from the south and central parts of America. El Paso, Texas, came in first, followed by Tulsa, Oklahoma, Greensboro, North Carolina, Greenville-Spartanburg, South Carolina, Birmingham, Alabama, and Oklahoma City. There wasn't a single city from the Mid-Atlantic, Northeast or Pacific Coast in the top 20 markets.<sup>15</sup>

The Smart Growth movement, which emphasizes transit-supported infill development and a steering of new growth to existing transportation corridors, has run into opposition by people affected by increased density. While resistance to infill development is nothing new in outer suburban communities, this resistance to infill development in older suburbs and transit-dependent communities is new. While policymakers see such increased density as necessary for controlling sprawl and redirecting growth towards transit corridor locations, many inner-city communities see it as a movement towards gentrification and a threat to their community identity and cohesion.

This problem has occurred in Oakland, California, where Mayor Jerry Brown has supported large high-rise residential projects in downtown communities that have typically served lower-income populations. While everyone seems to agree with improving the downtown area, and the availability of housing solutions is critical, opposition has developed from those people concerned about being pushed out of the area as the value of the land and properties increases.

Some alternatives to infill densification that are being considered nationwide include:

- Getting serious about directing suburban growth towards transportation corridors;
- Deflecting new growth towards comprehensively planned satellite communities on greenfield sites beyond the reach of the automobile commute;
- The development of downtown redevelopment in edge cities to take a more planned approach to denser growth.<sup>16</sup>

In some recent interesting work looking at the kinds of cities businesses choose versus where people choose to live, there was a significant difference between what businesses find important and what households find attractive.

For example, Detroit, Gary, Baltimore, Philadelphia and Washington, D.C., all ranked near the bottom in the eyes of households, but were ranked in the upper half by firms. Research showed that improvements in the quality of life and the quality of the business environment had strong positive effects on urban growth, but had a negative effect on the migration of retirees to that community. Accordingly, economic development and ideas designed to attract workers and firms—such as tax breaks offered to industry—may have the unintended effect of repelling retirees.<sup>17</sup>

A recent study provides strong evidence of the value that creative urban planning and design can bring to real estate. This study by Charles Tu and Mark Eppli evaluated the price premium that single-family homes received, relative to comparable properties in surrounding developments, due to their location in a traditional neighborhood development. A traditional neighborhood development community combines homes, retail, workplaces and a pedestrian-friendly environment and other attributes not seen in conventional low-density, auto-oriented development as commonly seen in suburbs since World War II.

This well-researched study demonstrated that homeowners pay more to reside in a traditional development neighborhood community. This price premium was positive across all age groups and communities studied, independent of the age of the community.<sup>18</sup>

Michel Giliberto, in a recent article in the *PREA Quarterly*, introduced the approach he has taken at J.P. Morgan Fleming Asset Management to determine if capital flows into commercial real estate are excessive and whether a price collapse is likely. While appropriately caveating his

analysis, it is interesting in that it provides a practical way to measure the effect of capital flows on value to determine if properties are overpriced.

The basic approach is to evaluate the relationship between the real estate price/earnings ratio (P/E), the inverse of the capitalization rate, and the core consumer price index (CPI), to investigate whether excess capital is coming into the market. His model uses the CPI as an indicator of the current state of the economy, and establishes what the warranted P/E would be given different economic conditions. Given the economy, if the P/E multiple is not as expected, then capital flows may be causing economically unjustified divergence.

By using statistics to look at the relationship between a real estate P/E ratio and the CPI, the model indicates that the bubble period (for value) began in 1986, peaked in 1988, and then valuation returned to an appropriate level in the 1990s. The most recent valuation peak occurred in the third quarter of 1998, but the Russian debt default and the collapse of hedge fund operator Long-Term Capital Management brought values back in line.

Today, the P/E multiple is squarely in the appropriate range, upon which one can conclude that capital flows into commercial real estate are not excessive and that a price collapse is unlikely.

As we all have seen in the last few months, a methodology such as this can't predict outliers like what happened on September 11, but attempts like this to develop an empirical estimate of the effect of capital flows on property value are a positive step forward to better understand real estate as both an economic and financial asset.<sup>19</sup>

A thought-provoking article in *Investment Property* makes the case that real estate is a dynamic and complex business, and if you think that the only path to failure is through overbuilding or overpaying, you are wrong. It makes the point that during recent boom times for real estate over the last 10 years, many people made mistakes not related to overbuying or overbuilding.

While people can argue over the author's analysis of the mistakes, his point about staying on your toes is clear. Some of the areas where mistakes have been made include:

- Holding out for higher prices as the cycle moves past peak;
- Paying peak pricing and cap rates when lucrative alternatives are still available;
- Underestimating the clout of environmental groups;

- Relying on stability in the ever-fickle financial markets;
- Overbuying or overbuilding products subject to cataclysmic regulatory revisions;
- Straying from core functions by pushing the technological envelope just because capital is temporarily available; and
- Pursuing untested financing strategies in the face of vulnerability to market upheaval.<sup>20</sup>

## THE SERVICES MARKET

The debate between commercial banks and the real estate brokerage industry over the controversial Gramm-Leach-Bliley Act (GLB Act) is heating up. The GLB Act would declare that real estate brokerage, real estate management and employee relocation activities are “financial in nature” and can be offered by financial holding companies and national bank subsidiaries.

The American Bankers Association and the National Association of Realtors are debating this Act on many fronts; opponents fear that it will hurt the nation’s financial system and destroy one of the country’s largest entrepreneurial industries, while backers argue that it will enhance customer service, streamline the currently fragmented and complex transaction process, and reduce cost to the customers.

A particularly interesting observation is that the home transaction is already becoming more efficient, with many companies offering one-stop shopping, including brokerage, title services, insurance and mortgage finance. Some of these companies include Cendant, the nation’s largest real estate franchiser, which has created Cendant Mortgage and successfully expanded into the financial arena; General Motors Acceptance Corporation, which expanded its finance franchise through the acquisition of Better Homes and Gardens Real Estate, one of the six largest real estate brokerage franchisers; Home Services.com, which operates 10 of the nation’s premier independent real estate companies and offers a full range of integrated services online; and Long and Foster Real Estate, which offers a full range of mortgage, title, insurance and real estate services in 160 offices throughout the Mid-Atlantic region.

The fact of industry change can be argued effectively by both the banking and the real estate industries. From the brokerage perspective, the industry is moving quickly to become more efficient and provide better customer service; bankers argue that since all these companies are

mixing brokerage and finance, it is unreasonable that banks should be kept out of the brokerage business, when they are a natural to provide efficient one-stop shopping given their involvement in the finance arena.<sup>21</sup>

## MISCELLANEOUS IMPACTS OF TERRORIST ATTACKS

In an analysis that was prepared two days after the terrorist attacks, the Rosen Consulting Group predicted that the attacks would have a long tail, pushing us further into recession in the short term. However, because of the rapid and aggressive action of the world’s major central banks, they think that the recovery of 2002 will be stronger than it otherwise would have been. This is due to the additional monetary stimulus and extra fiscal stimulus provided by the cleanup and rebuilding efforts in New York and Washington. More problematic is the effect of the loss of human life, which is harder to assess.<sup>22</sup>

LaSalle Investment Management’s perspective on September 26, 2001, is that the terrorist attacks will exacerbate an economic slowdown that has already been gathering pace in Europe. In the short term, investors are expected to consider real estate to be a relatively stable place to invest and, in the long term, it will be seen as a springboard for renewed hope and future financial growth.

Retail, residential and warehousing/logistics across Europe are expected to suffer less than offices, which have already taken a hit by reduced demand from the technology, media and telecommunications sector.<sup>23</sup>

Standard & Poor’s announced on September 26, 2001, that it does not expect the tragic events of September 11 to have a direct effect on residential housing. However, indirectly, the effects of additional layoffs and general economic softening related to the attacks are expected to decrease housing starts and increase mortgage refinancing rates. The effect of these changes on the overall performance of residential mortgage-backed securities should be minimal due to the diversification of borrowers across the country.<sup>24</sup>

Clearly the most impacted sector of the economy and real estate markets is the hospitality industry. While it is hoped that the long-term impact on travel will be minimal, it is expected that declines in international tourism, reduced domestic travel and declines in business travel will seriously impact short-term hospitality profits.

Some examples of areas that were hit the hardest include San Francisco, where hotel occupancy fell to 42% for the week ended September 22, a 55% drop from

the previous year. Revenue per available room was down 69% from a year earlier. This compares to a 37% drop in the revenue per available room for the rest of the United States through September 22.

Luxury hotels have been hit particularly hard due to the decline in business and leisure travel, and the increasing propensity of executives to search for cheaper lodging as the economy declines. The luxury hotel market's problems are particularly difficult given substantial new building that has occurred recently. The Ritz Carlton chain, a unit of Marriott International, now has 41 hotels, up from 8 in 1989. It also has plans to open 17 more by the end of 2003. As of September 22, the average room rate at luxury hotels in the U.S. was nearly 20% below a year earlier.<sup>25</sup>

Positive news can be found in a study by PricewaterhouseCoopers which suggests current ailments should improve by November and pick up thereafter. They forecast revenues per available room to fall 5.3% this year, but grow 0.5% in 2002 and rise 4.7% in 2003.<sup>26</sup>

## CONCLUSION

Uncertainty is the enemy of the economy and real estate markets. Terrorists have injected uncertainty into our economy and minds, causing drastic short-term declines in the value and smooth functioning of markets. Optimism and hope are our allies, bringing life to our economy and capital to our businesses. America was built on hope and optimism, and no terrorist attack will keep us down for long.

## ENDNOTES

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