Capital Markets Show First Signs of Recovery

As asset prices recover and rise, investors will move off the sidelines and leaders will become more active. Fully reversing the damage caused by the Great Recession will take years, but markets will show improvement by the end of 2010.

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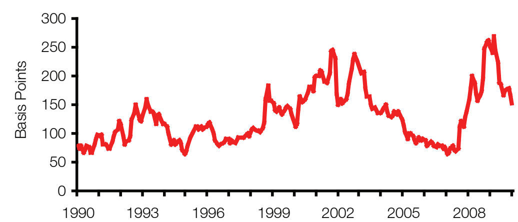
As asset values begin to rise, you will see consumers and businesses willing to buy and invest. This will lead to increased investment activity, and ultimately will cause lenders to lend. The process of price discovery always occurs first in the stock market, where assets are freely and frequently exchanged between third parties, with private markets lagging 12-18 months. As a result, we expect private asset pricing, including that of commercial real estate, to begin rebounding in the third quarter of 2010.

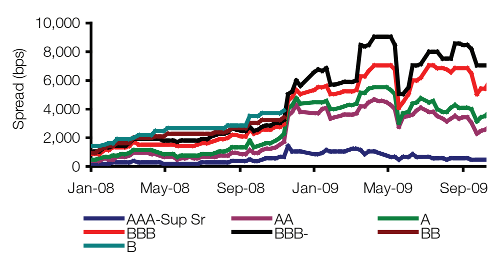
There is no doubt that capital markets are rebounding, as witnessed by the nearly 60% bounce in the stock market since the low in March 2009, and the greatly narrowed spreads on LIBOR, high-grade corporate debt, and, more recently, junk bonds. Bank excess reserves at the Fed remain slightly over $1 trillion, suggesting that these banks could create $7 trillion-$8 trillion in new loans. The reluctance of banks to lend primarily reflects their increased focus on dealing with Washington and problem loans, as well as the difficulty of making good loans in a world of falling asset prices. But as asset prices have hit bottom, we expect a return to selective lending by banks.

U.S. Corporate Investment Grade Spread



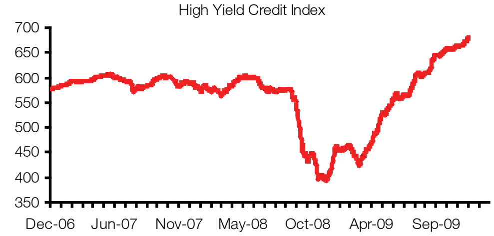
This is an important time for institutional investors to learn which of their real estate advisors are top-quality money managers. Quality managers provide a combination of commitment, integrity and alignment, with the basic real estate skills necessary to operate in a highly competitive real estate market. Investors should carefully watch which managers work as hard to move their funds from 0.6x to 0.8x for their investors as from 1.6x to 1.8x, even though such an improvement leaves the sponsor out of the money on the carried interest. It is in tough times, not easy times, when true greatness is defined. And we are in such times now.

CMBS Spreads (Weekly)



Meanwhile, bank holdings of U.S. Treasuries rose by nearly 15% ($185 billion) during 2009, while their holdings of other securities have risen by some $54 billion (6.2%). In contrast, total real estate loans have declined by $66 billion (1.7%) since December 2008. Also since December 2008, commercial and industrial loans have fallen by $304 billion (nearly 19%), commercial real estate loans have fallen by $102 billion, and consumer loans have fallen by $42 billion. Other bank loans have fallen by nearly $95 billion since June 2009. Recent guidance from the Fed on accommodative behavior for commercial real estate workouts should help many borrowers restructure their debt.

High Yield Credit Index



There is a myth that the economy is deleveraging. It is true that household debt has fallen by roughly $200 billion since the third quarter of 2008 (roughly 1.5%), the REIT sector has deleveraged by $50 billion (12.5%) over this time, and the non-financial sector deleveraged by approximately $100 billion. However, banks' outstanding debt remains unchanged, state and local government debt has risen by $100 billion, and federal debt has risen by $2 trillion! The net result is that the total debt liability of U.S. citizens has risen by $1.5 trillion year-over-year, primarily due to the skyrocketing federal debt. To some degree, this increased leverage by the federal government amounts to an arbitrage executed by U.S. citizens on foreign providers of capital. That is, foreign capital providers are unwilling to provide long-term debt to households and corporations, but are willing to provide nearly $1 trillion in long-term U.S. government debt. The net result is that we probably have a better match of the U.S. economy's fundamentally long-term assets with long-term debt liabilities. However, the question remains as to how long the U.S. government can effectively sell $2 trillion a year in net debt while maintaining low interest rates, as this cannot continue forever on the back of a $14 trillion economy.

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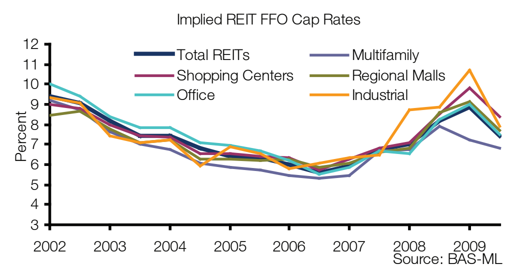
Real Estate Pricing

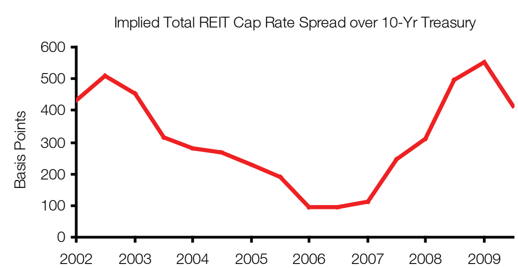
We are frequently asked if cap rates are going to fall over the next three years. To address this question, recall that for a stabilized property the cap rate (C) can be expressed as the risk-free rate (as proxied by the 10-year Treasury, (T)), plus the risk associated with the property (R), minus the expected long-term cash flow growth rate (G): **C=T+R-G**

Thus, the cap rate increases with increases in 10-year Treasury rates and real estate risk, and decreases as expected long-term growth rises.



Over the next three years, we anticipate that, absent an unusual inflationary surge, the 10-year Treasury rate will rise approximately 150 basis points, while the risk premium associated with property will fall by as much as 250 basis points. In addition, as job growth in the coming years absorbs the vast amounts of space emptied during the great panic, we anticipate that the expected long-term growth rate will rise by approximately 100 basis points. Taken together, this leads us to anticipate that cap rates will be approximately 200 basis points lower in 2-3 years.

This implies FFO (not cash flow) cap rates of 5-6.5%. As a result, we anticipate appreciation of property prices in the coming years, in spite of eroding cash flows. This is true despite the fact that REIT implied cap rates have improved by approximately 15% in recent months. Implied cap rates of 7-8.5% today will give way to 5-6.5% cap rates in the coming years.



Public Pricing

Research indicates that private real estate pricing lags public real estate pricing by approximately 18 months. REIT prices bottomed in late March 2009, so private pricing will erode through September 2010 before turning upwards. Until then, we expect to see little in the way of voluntary real estate sales. Instead, sales will be focused on those properties that cannot cover expenses (including Capex and TIs). One odd dimension of the anticipated economic recovery is that many properties will become stressed as the recovery occurs. This is because in the presence of few new tenants, limited TIs are required. However, as jobs are added and more robust leasing activity takes place, TIs will be required, placing many owner/lenders in the difficult position of coming up with the necessary TIs. In addition, as the economy recovers, LIBOR will rise, creating extreme stress for those properties staying alive on the basis of low LIBOR.

For a number of years, we have consistently applied two valuation models to the pricing of commercial real estate: the Capital Asset Pricing Model (CAPM), and a comparative risk analysis, which we have referred to as the "it tastes like chicken" model (ITLC). CAPM effectively calibrates risk as the covariance between commercial real estate returns and total market returns (the so-called beta). The ITLC model assumes that ownership of the perpetuity lease claim should generate approximately the same expected return as the perpetuity debt claim of the tenants, as proxied by BBB bonds. In these analysis, we proxy the cash flow return to real estate by the dividend yield on REITs, and use REIT implied cap rates as indicative of commercial real estate pricing over the long-term.

Both models indicate that the pricing of commercial real estate was systematically too low until early 2006. By early 2007, these models indicated a 20% premium relative to alternative investments. When capital markets collapsed in late 2008, real estate pricing dramatically overcompensated relative to long-term risk. This reflected the concern that things could get much worse in the short-term, particularly in light of difficulties with renewing maturing debt.

In the second half of 2009, the CAPM analysis indicated that real estate pricing had improved dramatically relative to its long-term risk. In particular, REIT pricing had gone from being under-priced by 230% in March 2009, to being fairly priced by year-end. In mid-February 2010, the CAPM model indicated under-pricing by about 12%. The massive under-pricing of 2009 reflected the fact that real estate no longer served as a diversifier, but in fact had heightened portfolio risk, implicitly increasing the implied REIT beta. The ITLC model suggests that the under-pricing of real estate has gone from being 75% undervalued in March 2009 to being fairly priced in February 2010, once again reflecting the strong rebound in REIT prices.

Private Pricing

Commercial real estate investments of almost all stripes have been clobbered during the current economic downturn. Why? The weakening of the global economy reduced the demand for space around the world, reducing cash flows and raising return uncertainty. Also, as global capital markets froze, the burden fell hardest on capital-intensive sectors such as real estate.

But even more important is the fact that real estate had been subverted from an investment in relatively predictable cash streams, into a pure residual value bet by most investors. Perhaps the clearest examples of this phenomenon are the German apartment portfolios purchased by many private equity funds. The

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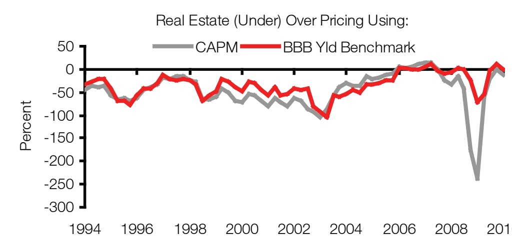
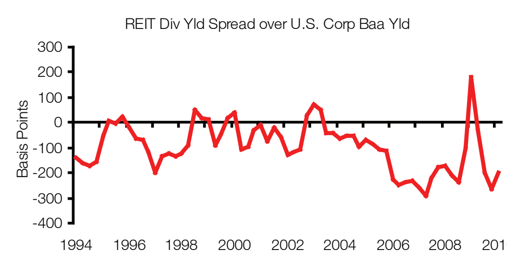
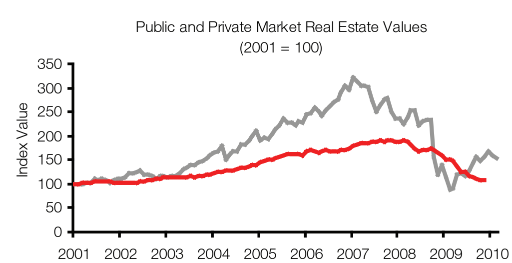
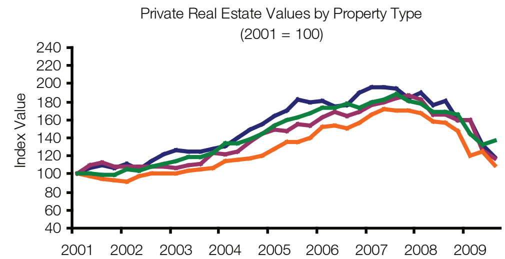


Liquidity premium assumed to be zero.





cash flows on these properties have been almost unaffected during this economic downturn, with rents and occupancy rates remaining unchanged. So why have private equity owners of these properties seen most, if not all, of their equity in these investments evaporate? Quite simply, because these portfolios were leveraged to the point where debt service approximately equaled operating cash flows, yielding a zero cash-on-cash return. This leveraging wiped out the great strength of real estate, namely its relatively predictable cash streams, and transformed real estate into a giant bet on residual values and the ability to roll over maturing debt until multiples expanded. This investment structure was applied to most real estate investments, as investors around the world created zero (and in some cases negative) after-debt service cash-flow investments.

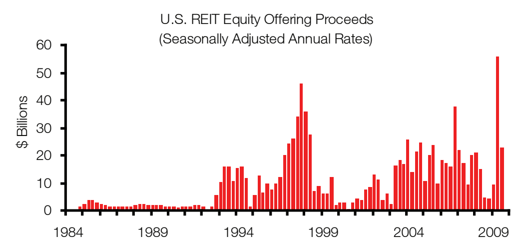


The fact that many of these investors are private equity funds (which generally keep no reserves for the unexpected), means that at the first sign of any economic slowdown, declining cash streams leave properties unable to service their debt. And when debt markets constricted and multiples for all assets plummeted, all residual investment bets were crushed by the same hammer. Irrespective of the nature of real estate or the performance of the underlying real estate, these investments suffered, as all depended on stable to rising multiples, plenty of cheap debt, and no short-term adverse movements in cash flows. The quality of the tenant base, location and design were contracted away to lenders, leaving equity performance subject purely to macro factors beyond the investors' control. And when these macro factors moved adversely, all of these investments suffered equally.

We expect the industry to experience a massive debt for equity swap, but the whole equitization process will be a lot slower than most people think.

The outcome is that investments in many disparate real estate cash streams are performing virtually identically. This is true whether the real estate is a mall, strip mall, apartment building, warehouse, hotel or office building. And it is true almost irrespective of country.

The most visible exceptions are U.S. REITs, which had notably less leverage. As a result, their real estate mattered more. In addition, they have been the most aggressive at re-equitizing. In contrast, most private real estate investments have not injected new equity. In an era where debt was cheap and abundant, REITs were disadvantaged. But in today's environment where equity matters, they again hold the advantage relative to private players.



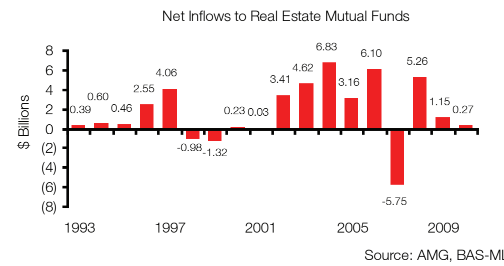
Source: Federal Reserve

Capital sources

Equitization will be a major trend. In the near term, commercial real estate capital will primarily come from equity sources, not debt. In fact, we expect the industry to experience a massive debt-for-equity swap. For example, to overcome high leverage, some private equity funds may go public and will use the proceeds to pay down debt and restructure. In other cases, we will see banks sell assets.

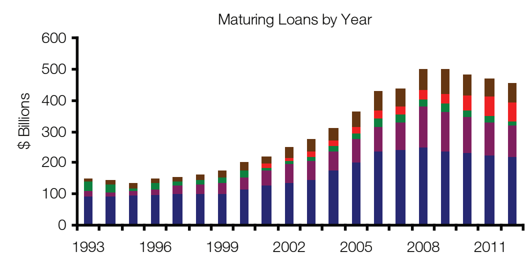
The whole equitization process will be a lot slower than most people think, as the U.S. government is acting like Japan in the early 1990s. That is, the U.S. government is giving blood to the dead rather than to the living. If this continues, insolvent banks will have less incentive to sell assets and create a market.

Pundits say the industry is over-leveraged, which at the face value of the debt is true, but not at the current debt market valuations. What we are is “over-face valued.” Because debt is a contract, it must be worked out and negotiated, whereas equity has no work-out potential; when it’s down, it’s just down. Debt work-outs are great for lawyers, but bad for everybody else.



Real estate capital for commercial properties will come from public capital markets first. The REITS are in the best position because they already exist, have track records, have the capacity to issue stock in exchange for properties, have low leverage, are transparent, and are name brands. The fact that public real estate companies are already in place is a big difference versus the early 1990s. In the last cycle, it took 9-12 months, and substantial cost and brain damage, to create these companies. This time, as opportunities arise, public companies will be able to take advantage of them more quickly than in the past.

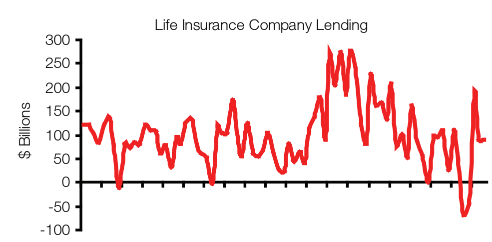
The private equity funds will take advantage of the current environment with slightly more difficulty, because in the past they told investors they were going to get 20-25% returns. In the absence of leverage, funds can only credibly get 12-18% IRRs on paper. In fact, when a pro forma can pencil out a 20% IRR, it will rarely happen. And when a pro forma cannot generate 20%, it just might be possible, as it means capital is scarce.



A number of private equity funds are going to struggle, some just to stay in existence, because of heavy debt burdens. Anybody who used extreme leverage is caught up in a negotiation game. And if all your energies are in negotiations, you are not in the create-new-value business, as you only have so much time and energy. Those who had low debt, including some high wealth families and public companies, are going to see their time, while many heavily leveraged players disappear.

Will commercial real estate be the next shoe to drop?

The answer is that it is not commercial real estate, per se, that is the problem, but rather the panic-induced loss of more than 7.2 million jobs, which wiped out the demand for commercial real estate. This precipitous drop in demand, combined with a roughly 1.5% increase in supply over the past year, has left a supply-demand fundamentals gap of more than 8.7 million jobs. The problem is not overbuilding but destroyed jobs.



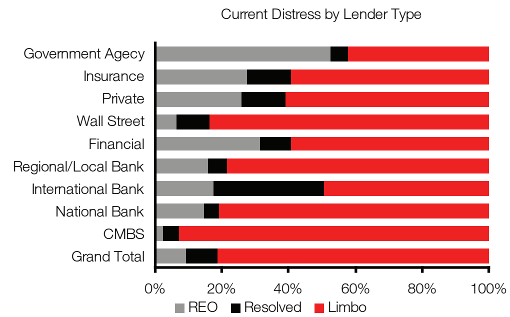
Approximately $1.2 trillion of commercial real estate loans are maturing in the next three years. Of these, approximately $300 billion are CMBS loans, $100 billion are life company loans, $450 billion are non-land related bank loans, and approximately $350 billion are land/acquisition/development bank loans. It is the land-related loans held by local and regional banks that will generate the greatest real estate acquisition opportunities over the next two years. First, some of these land loans will be acquired at attractive discounted prices. However, the bulk of these loans are on poor properties. The loans on these properties are at multiples of 3-4 times their value, indicating losses of as much as $200 billion-$250 billion. These losses will force many local and regional banks into the hands of the FDIC, which has decided that the largest 20 lenders will be kept alive, while all other banks will be allowed to fail (absent a change in the political environment). As these smaller banks fail, the FDIC will proceed to auction their performing and non-performing loans. These assets will be located primarily in smaller markets, as these institutions do not possess large enough balance sheets to make loans in the largest MSAs. As a result, we anticipate that the first wave of widespread acquisition opportunities for quality cash-flow real estate will occur in secondary and tertiary markets, as the FDIC takes over portfolios and ceases to “kick the can down the road.”

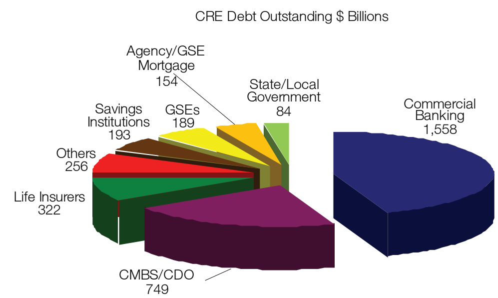
We anticipate relatively few defaults on the $100 billion of life insurance loans and roughly $300 billion of CMBS loans that will be maturing. The most notable exceptions will be for hotels and B and C apartments. Both of these categories have experienced precipitous drops in their cash flows, which makes successfully refinancing these properties a challenge, even though they were underwritten 7-10 years ago at high cap rates and low LTVs.

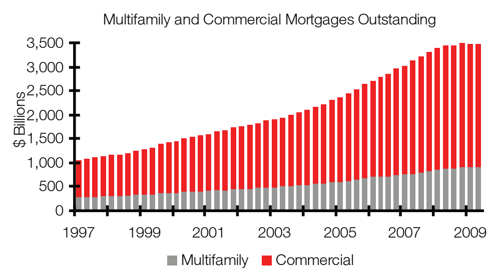
As of the third quarter of 2009 (latest available at printing), there was roughly $90 billion-$100 billion of delinquent commercial real estate debt. Of this, approximately $51 billion (2.9% of all real estate bank loans) were held by banks, $28 billion (3.9%) were non-GSE securitized loans, $2 billion (0.5%) were GSE-related loans, $1 billion were life company loans, and $10 billion were held by other lenders. If these delinquency rates were to triple before it is all over, it would amount to approximately $275 billion, of which $152 billion would be bank loans (8.7% of all real estate bank loans) and $84 billion would be non-GSE loans (nearly 12%). If the recovery rate on these delinquent commercial real estate loans is a mere $0.30 on the dollar, it implies a total of $192 billion in commercial real estate-related losses. This would amount to approximately 5.5% of the total $3.5 trillion in outstanding commercial real estate debt. Only time will tell what the true losses will be, but these losses would be far less than numbers being thrown around in the discussions about commercial real estate as the other shoe about to drop.

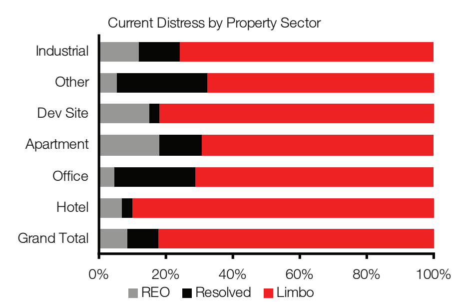
Thus far, retail accounts for 36% of all delinquent loans, followed by apartments (21%), office (20%), and hotel (15%). We anticipate that delinquencies will rise most dramatically for office and hotel in the coming year.

As previously noted, it will take until mid-2013 to fully reverse the damage created by the panic-induced job losses. Until then, any asset with a fixed debt burden will struggle, as its cash flow will suffer from dramatically lower demand. Real estate will be no exception in this regard. Thus, commercial real estate is less the next shoe to drop than one of the most dramatically impacted sectors, because of its fixed capital costs associated with relatively high leverage.









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