

## Real Estate Capital Markets Update – March 6, 2008

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**What? Another “Black Hole”!** You must be kidding me. I just learned about credit default swaps and monoline insurers.

In an article on the Bloomberg web site entitled “Goldman, Lehman May Not Have Dodged Credit Crises”, we learn about a new “witches brew”: variable interest entities (<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alExwdst38cQ>). Floyd Norris also commented on variable rate entities in the New York Times on February 29<sup>th</sup> (<http://www.nytimes.com/2008/02/29/business/29norris.html?ex=1204952400&en=5aadf72907c1a7e0&ei=5070&emc=eta1>).

Variable rate entities are special purpose vehicles whose structure allows financial services firms (such as investment banks) to keep investments in assets (such as sub-prime mortgages) off their balance sheets. According to CreditSights, a bond research firm, “VIE may contribute to another \$88 billion in losses” (which would be in addition to the over \$150 billion in losses taken to date).

### Heard at the Real Estate Capital Markets Forum at Columbia University

- “One thing I am worried about is extension risk; who is going to be there when these loans need to be rolled over?”
- “For the time being (and maybe longer), it’s advantage to the balance sheet lenders; great premiums/spreads and little competition”.
- “Equity is sidelined by uncertainty”.
- “We ignored premiums for complexity and then learned that complexity was not durable”.
- “Lender allocations will be mostly filled early in the year”.
- “Lenders are not compelled to make loans; they can always buy triple-A commercial mortgage-backed securities”.
- “The markets are replete with little [Harry] “Macklowe-like” stories where lenders bet on the borrower rather than the property”.

**Lloyd’s Wall of Worry: It’s the counterintuitive indicator: many worries, but; few worries, sell.**

“The Winter of our discontent—A near global market meltdown, the start of a bear market and a record loss by a rogue trader were all we needed to kick off 2008 in style. Market historians say a negative return in January usually portends a down year for the equity indexes. Still, a climatic sell-off that puts stocks at recession levels left the pickings looking pretty good. At 15 worries, the Wall remains in fear territory, but off the ledge for now. Enjoy the bear market, but handle your portfolio with care”.

Housing Prices: Still dropping...unless you have cornfields or oil wells in your backyard.

Oil Prices: Bobbing up and down like a very expensive ship in a storm.

Consumer Spending: Above subsistence levels but the Christmas slowdown certainly got the government cutting checks in a hurry.

Emerging Markets: Nothing grows to the sky except the BRIC markets, right? Let's hope so.

U.S. Dollar: On a long losing streak, but all streaks have to end sometime, right? Ask the New England Patriots.

U.S. Economy: Recession or not, the roaring 90's this ain't.

SIVs: Turns out even a Chinese bank was drinking from the triple-A rated punch bowl.

Inflation: Still a concern, but on the back burner until we get the economy off life support.

Interest Rates: With the Fed well into the limbo rock dance, it's time for the ECB and the Bank of England to join the fun.

Fiscal Stimulus: Opening the monetary spigot is a good start,. But we're gonna need a fire hose before this one is over.

Unemployment: Potentially, the straw which breaks America's economic back.

U.S. Mortgages: The 2008 vintage is eminently drinkable. The stuff from the past five years belongs in a salad dressing.

European Economies: When the U.S. gets a cold, does the rest of the world still catch pneumonia? Tissue, EU?

Stagflation: Last time it reared its ugly head, I had braces on my teeth. Given a choice, I'll take the braces.

### **Transaction Volume—What Transaction Volume?**

Excluding the mega-deals (Blackstone-Equity Office Properties and Tishman Speyer-Archstone Smith), transaction volume declined significantly during the last half of 2007, as follows:

	1Q2007	2Q2007	3Q2007	4Q2007	Total
Total (in \$ Billions)	\$96.7	\$113.1	\$99.3	\$62.4	\$371.5
% Change (Quarter-over-quarter)		+17.0%	-12.2%	-37.2%	
Source: Real Capital Analytics.					

Based upon a quick, back of the envelope analysis (which some will argue is overly pessimistic), transaction volume could be one-third lower in 2008 than 2007, calculated (in billions) as follows:

Projected issuance of securitized mortgages:	\$75.0
Projected issuance of conventional mortgages:	<u>\$75.0</u>
Total mortgage financing available:	\$150.0
Assuming 65% loan-to-value, implied total value of transactions would be:	\$231.0

### **Extension (or Rollover) Risk**

According to an analysis by Realpoint published in CommercialRealEstate Direct.com, approximately \$25 billion of securitized commercial mortgages will mature during 2008, thereby requiring repayment, either by refinancing or mutually agreed upon extension. Approximately \$15.6 billion relates to loans originated during the 2006 – 2007 period when the application of underwriting and credit standards were at their “weakest”.

The article states the issue pretty well (and bluntly): “If [capital] market conditions don’t improve markedly, it’s likely many of those maturing loans will face difficulties lining up sufficient [re]financing”.

### **Special Comments: Notes from the February 13, 2008 issue of “The Punch Line...”, published by Abraham Gulkowitz**

(Headlines and data in “The Punch Line” come from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and websites.)

- Fed stresses out...The statement issued by the FOMC with its latest cut referenced the fact that markets remain under “considerable stress.” The remainder of the description of current conditions was very similar to the wording used in the January 22 statement (i.e., tighter financial conditions, a deepening of the housing contraction, and softening in labor markets...).
- Senior banking executives said that unless pricing improved in the next few weeks, they could be forced to take further write-downs on leveraged loans in their first quarter results—even if they have no intention of selling the debt. Most banks have marked their leverage finance near 95 cents, and yet the real bid today is nearer to 85 cents to clear. According to Dealogic, around \$200 billion of leveraged loans agreed [to] since the beginning of 2007 are still awaiting syndication.

- *A fire sale...* the latest decline in the value of low-rated corporate loans are beginning to look like a fire sale as banks and other try to unload them. That, in turn, would trigger the next phase of the credit crises, extending it beyond the mortgage sectors that have cost banks and investors dearly and pushed the economy to the brink of a recession. After years of banks lending money on easy terms, “You’ve had the biggest credit bubble—probably the biggest credit bubble we have ever had,” one credit strategist said.
- **Credit default swaps could weigh on institutions:** The surge in the amount of outstanding credit default swaps, which are derivative instruments that protect against the possibility of bonds defaulting, represent a dramatic increase in risk for financial institutions running into trouble, according to Barclays Capital. Tim Bond, head of global asset allocation at Barclays Capital in London said counterparty risk is beginning to be priced into credit default swaps with the caveat that this risk is almost impossible to calculate with any accuracy. The total risk of a credit default swap is the sum of the credit risk of the underlying debt plus the credit risk of the bank which writes the swap and then adjusted by the maximum ability of the bank to post margin against the position.
- **America’s monoline insurers,** which have sold protection via credit default swap contracts, are in dire straits. The netting-of-contracts concept tries to suggest that it is impossible to drown in a stream with an average depth of two feet...the risk is that distrust of counterparty risk could jeopardize the financial system.
- **Chief Financial Officer optimism plunges on U.S. recession fears, survey says.** The nation’s CFOs are becoming increasingly concerned that the U.S. economy will fall into a recession, a quarterly survey indicated. The quarterly survey by Financial Executives International and Baruch College indicated that its optimism index for Q42007 dropped to 52.26 from 62.95 in Q32007, with almost every chief financial officer polled saying they were concerned and/or more concerned about a recession than they were in the previous quarter.

#### **Credit Crunch Update (Courtesy of Real Capital Analytics)**

- One commercial mortgage-backed securities offering has been completed during the first two months of 2008. “Pricing [of the offering] does not offer much encouragement as the yields on the super senior AAA piece was 6.74% and the BBB+ [tranche] was priced at a yield just under 16%”.
- Banks and insurance companies will not fill the void left by the [current] demise of the securitization market. In fact, evidence suggests that rather than ramping up originations, balance sheet lenders are becoming more “discerning and cautious”.
- Regional and community banks are quickly reaching their regulatory limits.
  - “The American Bankers Association recently reported that almost 40% of community bankers indicated that commercial real estate loans were the main focus of their most recent [regulatory] examinations, up from 27% a year ago”.

The following article appeared in the February 2008 issue of *Urban Land*

### A Simple Analogy...

It seems that every three years or so we suffer a financial market crises of some kind. In 1987, it was the stock market crash; in 1990, it was the savings and loan crises; in 1994, Mexico devalued the Peso; in 1997, we suffered through the “Asian Contagion” and in 1998 Russia defaulted on its Sovereign debt and Long-Term Capital Management was “bailed-out” in a Federal Reserve Board orchestrated restructuring; in 2001, it was the tragic events of September 11<sup>th</sup>; in 2004, we had the Fannie Mae accounting problems; and in 2007, we had the sub-prime mortgage crises which in turn lead to the current global credit market crises which has reach epidemic proportions.

The question many are asking is: how did the “contagion” relating to the sub-prime mortgage market “jump species” to infect not only the commercial mortgage markets, but also the debt markets worldwide, resulting in today’s “liquidity” crises.

Against the backdrop of a sustained period of unprecedented global liquidity, increased demand for income-producing investments such as real estate, historical low interest rates, compressed capitalization rates, and low risk premiums, financial and physical assets became “priced to perfection”, and “old” asset classes (such as real estate) were invested in and/or financed in new (and believed to be more profitable) ways (such as through collateralized debt obligations, the use of the “carry-trade”, bridge equity and pay-in-kind bonds), a simplistic analogy may explain it all.

As toothpaste is to “Made in China”, sub-prime mortgages are to “Made in the U.S. capital markets”.

When it was discovered that toothpaste made in China had been contaminated by the introduction of a fatal foreign substance, it created a worldwide clamor for the recall, inspection, and testing of literally every product made in China, the result of which was a series of seemingly never-ending recalls of products including children’s holiday toys tainted by lead-based paint.

The capital markets crises in confidence, initially in the performance of securities comprised of sub-prime mortgages due to rapidly increasing delinquencies and defaults, and subsequently in the underwriting and structuring of sub-prime mortgage securitizations, led debt market investors worldwide to begin to question the underwriting and due diligence procedures of the originators of all debt securities, the methodologies and practices of the underwriters of debt securities, as well as the quality of the “homework” of the “independent” credit rating agencies retained by the sponsors to investigate and issue opinions as to the creditworthiness of the individual tranches which comprised the securitized offerings.

And so the contagion jumped species, from residential mortgage-backed securities to commercial mortgage-backed securities; from plain vanilla corporate bonds to leveraged

buyout debt; and from asset-backed commercial paper to collateralized debt obligations. And as the markets continued to question the underwriting and due diligence procedures underlying the various types of traded debt, spreads widened, markets seized, and a buyer's strike, which continues today, ensued. Buyer's have effectively turned up their noses at debt securities currently offered for sale due to an abiding concern regarding both the quality of the underlying assets as well as the quality of the due diligence underlying the structuring and pricing of the securities offered. This back-up is anticipated to continue for many months and there is substantial market support for the view that the present liquidity crises will require all of 2008 to be resolved. Buyers are fearful of purchasing bonds in the morning and then finding out that their price had declined and their investment had lost value by the end of the day. As has been said in many ways, you can price risk...you can't price uncertainty. This lack of trust in the quality control procedures of the originators, underwriters, and credit analysts will take some time to reverse itself. Over time, assets held in inventory for sale will be re-underwritten, restructured, and re-priced so that buyers will regain confidence in the process and the markets. The "fear of buying", which some on Wall Street characterize as trying to "catch a falling knife", will abate and trust will be reestablished. Losses will be taken and markets, suitably chastened, will re-open. And hopefully, we will not find ourselves writing a similar end paper a mere three years for today.