

Real Estate Capital Markets Update – March 31, 2008

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What's it worth?

If there is a question today which is on everyone's mind it is: what's it worth?

Whether we are talking about Bear Stearns or its inventory of mortgage securities, the value of hung commercial mortgage-backed securities on conduits balance sheets, or the myriad of other financial instruments that are not trading because no one wants to venture a guess as to what they are worth (or does not want to accept the bad news of what someone is willing to pay for them), value is on everyone's mind and has led to the current "Buyer's Strike" wherein buyers are afraid to be caught buying something that is worth less in the afternoon than it was worth in the morning. As someone said, pricing debt securities—from conventional to exotica—is like "trying to catch a falling knife".

While we have heard anecdotal stories of purchases and sale of a variety of financial instruments at discounted prices, the one "trade" that we have seen reported involved Citadel Investments purchase in December 2007 of approximately \$3.0 billion of mortgages from E*Trade Financial at \$0.27 per dollar of principal value.

The following article appeared in the Financial Times on March 23rd; it paints a grim picture of value. While not dispositive, it is clearly instructive; while possibly the first story of its kind, it certainly will not be the last.

Damage to securities revealed in court

By Gillian Tett in London

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The first public price estimates for specific structured credit securities to have emerged since the start of the credit crisis show that values have fallen sharply.

Some securities have lost almost a third of their value – even though many were considered to be so safe that they carried top-notch ratings from the credit ratings agencies.

Meanwhile, some subprime mortgage-linked securities issued by groups such as [UBS](#) have lost almost 95 per cent of their value.

The price estimates were made in a legal filing following a decision by [JPMorgan Chase](#) to publish detailed securities valuations in a Canadian court. The securities are linked to commercial loans and medium-grade mortgages.

The estimates are likely to be scrutinised by auditors and regulators since they come at a time when the issue of security pricing has become controversial.

Banks are under pressure from regulators to book losses they have incurred on such instruments. However, trading has virtually dried up in many corners of the credit markets, and it is hard to compare prices for these instruments between banks.

Many regulators and investors fear that banks are still varying in the degree to which they have booked losses on their credit instruments in recent months – not least because it is hard for auditors to compare internal estimates with external benchmarks.

The figures have emerged because the US bank is leading an effort to restructure a group of 20 Canadian structured investment vehicles that issued \$32bn of asset-backed commercial paper.

JPMorgan and Ernst & Young lodged a report with an Ontario court gives estimates for the securities held by the Canadian SIVs based on implied values.

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ULI Webinar: The Outlook for the Economy and Real Estate: Up? Down? Sideways?

The outlook for the economy and real estate was discussed during a recent ULI webinar featuring industry experts Peter Linneman and Arthur Margon. ULI Senior Resident Fellow Stephen Blank moderated the event. If you missed the webinar, a replay is available via the link below.

https://www2.gotomeeting.com/en_US/island/webinar/provideEmail.tpl?_sid=1000000004339787%3A8B0F816D6C82486&Action=rgoto&_sf=3

Please note that there is about two-and-a-half minutes with no audio beginning two minutes and 25 seconds into the presentation. This was the result of a slight error in the recording, but the audio picks up normally at four minutes and 54 seconds.

Lloyd's Wall of Worry (a trademark of Khaner Capital Management)

It's the counterintuitive indicator: many worries, buy: few worries, sell.

Bleep Year—Leap year aside, February made up for its short length by serving up daily volatility swings the likes of which the stock market hasn't seen in years. As the credit markets worked through a broadening wave of problems, equity market pros continued to de-lever and re-price risk in the classic style—frantically. The Wall adds one worry to secure its place in the zone of fear. Bargains are popping up, but you had best know your companies and prepare to buy into intense market downdrafts in the face of mind-bending rumors of financial calamity. And it's only March.

Inflation: You know things are getting tough when the price of a New York dirty water dog catapults past \$1.00.

Oil Prices: With the price of gas hitting \$4.00 per gallon, my local gas stations says they'll now accept direct deposit of my paycheck.

Consumer Spending: This buying-only-what-we-need rather than buying-all-we-want is so 1930s.

Fiscal Stimulus: Fair to say we have all done a complete mind-spend on the first round of cash. Wonder what the next goodie bag will be stuffed with?

U.S. Mortgages: Any chance we can take a giant mulligan on this mess?

European Economies: Seemingly non-plussed about potential euro-zone economic slide. Denial is a powerful emotion.

Stagflation: Think of it as driving a car without tires and having to buy new tires every five miles.

Credit Crises: Here's one solution—businesses go back to paying cash for everything. We'd get the system unfrozen in, say, one to two light years.

Housing Prices: We're smack dab in the middle of prime selling season. And...?

Interest Rates: More cuts to come. Let's hope we're pushing on positive economic drivers and not on the proverbial string.

Unemployment: Here comes that miserably cyclical teeter-totter—earnings down, job losses up.

U.S. Dollar: Not only did my eight year olds allowance double in the past year, now she's demanding we hedge it with a foreign currency swap. Preferably the Yuan.

Emerging Markets: Falling all over themselves to prove they aren't tied to the U.S. economy. They doth protest too much, me thinks.

U.S. Economy: Cue *Jaws* theme music.

SIVs: Still more mysterious than the ritual gift of Christmas fruitcakes or the ingredients thereof.

Auction-Rate Securities: The latest no-risk, yield-chasing financial domino to fall.

Federal Reserve Board Beige Book Economic Survey

The Federal Reserve Board recently released its Beige Book economic survey of the FRB's 12 districts. No surprise; the survey indicated a slowing economy since the beginning of the year with every district reporting either a "weaker pace" of business activity or "slow to moderate" growth.

Commercial Mortgage-Backed Securities Delinquencies "Inch Up Again" in February

According to data compiled by Realpoint, the volume of delinquent commercial mortgage-backed securitized loans increased for the fourth successive month, reaching approximately \$3.5 billion in February. While this represents the highest volume level since July 2006, based on a percentage of balances outstanding, the delinquency rate stands at a very benign 0.34%.

Most people we speak with think the storm is "brewing at sea" and will not "reach land" for some months when numerous interest-only, covenant-less, reserve-less, and escrow-less loans underwritten at high loan-to-value/low debt service coverage ratios need to be refinanced. Fortunately, there are numbers of investment funds standing by, waiting to help owners whose financial structures are "upside" down.

Special Comments: Notes from the "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.)

Loan rollover risk is on the rise...The leveraged debt market is different this cycle because of all the floating rate debt. The lack of demand—and heavy competition for available funds—suggests that loan rollover risk is on the rise. Companies with imminent funding needs may find both the loan and bond markets only open for relatively healthy companies; and even then at relatively high rates.

Stressed Out...A record 41 companies with high-yield, high-risk credit ratings are in danger of breaching terms of their loan agreements within 12 months as the slowing economy cuts into corporate profits. Moody's Investors Service said..."The percentage of speculative bonds that are distressed, meaning their yields are at least 1,000 basis points higher than benchmark rates, rose to 20.9% as of February 15, about the same ratio as in the months preceding the recession that began seven years ago.

More Credit Concerns... Federal Reserve officials are voicing renewed concern about the fragile state of U.S. financial markets, along with worries that more sectors may new waves of turmoil. Since the sub-prime mortgage market collapsed last year, financial stability has been a top agenda item for Fed officials worried about the economic outlook.

Those concerns have heightened this year as new classes of obscure securities collapse and drag the broader markets with them...The bottom has fallen out for complicated financial products like collateralized debt obligations and auction-rate securities. **The specific troubles of these instruments have, in turn, set off boarder retrenchment and contributed to ongoing Wall Street wariness. Combined with weak economic data, these woes present a big “downside risk” to an already slow economy, as Fed officials have noted in their recent public comments.**