

Real Estate Capital Markets Update – April 11, 2008

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Bank Write Downs Continue to be a Drag on Capital: Threat of More de-Leveraging Weighs on the Market; Lending Capacity “At-Risk”

There isn't a day that goes by that we are not bombarded with articles regarding the lending capacity of various financial institutions and the deals that have fallen apart or been withdrawn due to the lack of available financing. To help size the magnitude of the write-downs, we reproduce the following chart which was presented at the recent JPMorgan Securitized Products Research Conference:

Survey of Bank Write-Downs Reported for Q307 and Q407			
	Q307 Write-Down (\$ Billions)	Q407 Write-Down (\$ billion)	Total Reported Write-Down(\$ Billions)
Merrill Lynch	8.4	14.6	23.0
Citigroup	3.8	18.0	21.8
UBS	4.4	13.7	18.1
Morgan Stanley	1.4	9.4	10.8
Bank of America	1.5	5.4	6.9
RBS	2.5	2.4	4.9
Barclays	1.0	3.1	4.1
Calyon	3.7	0.0	3.7
Societe Generale	0.6	3.0	3.6
Deutsche Bank	3.1	0.0	3.1
Wachovia	1.3	1.7	3.0
JPMorgan Chase	1.6	1.3	2.9
Credit Suisse	1.9	1.0	2.9
Bear Stearns	0.7	1.9	2.6
HSBC	0.9	1.2	2.1
Lehman Brothers	0.7	0.8	1.5
Goldman Sachs	1.5	0.0	1.5
Total	39.0	77.6	116.5

Source: JPMorgan; company reports; and estimates.

More Trouble Ahead: International Monetary Fund Rethinking On Risk Management

The International Monetary Fund (IMF) **estimates** that financial institutions may face losses of as much as \$945 billion over the next two years due to the problems in the housing sector combined with the credit crises.

The IMF's numbers look like this: losses on residential mortgages and residential mortgage securities - \$565 billion; losses on commercial real estate securities

(presumably commercial mortgage-backed securities) - \$240 billion; losses on corporate loans - \$120 billion; and losses on consumer loans - \$20 billion.

Who's going to take the losses? According to the IMF, commercial banks will end up with half the losses (\$440 to \$510 billion) with insurance companies, hedge funds, pension funds, money-market funds, et al sharing the balance.

Goldman Sachs, Morgan Stanley and Lehman Brothers Report Increase in Level 3 Assets—Problems Continue to Plague Balance Sheets

In their most recent filings with the regulatory authorities, Goldman Sachs, Morgan Stanley and Lehman Brothers all reported an increase in “Level 3” assets which are assets which are “hard-to-value” and include residential and commercial mortgage related securities, corporate loans, and other debt securities.

Goldman's level 3 assets equaled \$82.3 billion at the end of February, up from \$54.7 billion at the end of November 2007; Morgan's level 3 assets were \$78.2 billion versus \$73.7 billion in November; and Lehman's level 3 assets were \$42.5 billion as compared to \$42.0 billion in November.

Commercial Mortgage-Backed Securities Remain on Life Support

Consensus predictions of issuance of commercial mortgage-backed securities (CMBS) (and therefore securitized commercial mortgages) in 2008 continue to be revised downward in light of the anemic issuance—\$5.9 billion—which occurred during the first quarter 2008. Issuance in the U.S. was down 90% as compared to the same period in 2007; issuance in the non-U.S. markets was almost as dismal, down a mere 78% as compared to the first quarter of 2007. Predicted issuance, which started at \$113 billion, is now more like \$60 billion due to a combination of unsold inventory weighing down originations and a very shallow pipeline.

The following quote, which appeared in the April 7th issue of *Commercial Mortgage Alert*, summarizes the state of things pretty well: “2008 is dead. People are taking their lumps and trying to figure out how to fix the problems and prepare for next year”.

Transaction Volume Down 50% in First Two Months of 2008

No one should be surprised by this headline as fully 75% (and possibly more) of all real estate transactions involve mortgage financing and mortgage financing—both conventional and obviously securitized—is scarce. As the following analysis by Real Capital Analytics indicates, sales were down 78% during the first two months of 2008 as compared to the same period in 2007. Interestingly, it is the established markets that are suffering while transaction volume in the emerging markets seem to be continuing to grow quite nicely.

Change in Volume of Property Sales

(January – February 2007 versus January – February 2008)				
North America	South America	Europe	Asia	Australia
-78%	+106%	-37%	+104%	-63%

Quarterly Sales Volume (in \$ Billions)					
	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08*
U.S.	\$148	\$144	\$129	\$125	\$29
Europe	92	99	79	71	39
Asia	34	47	53	54	32

* Preliminary.

Wall Street Banks Seek to Ring-Fence Bad Assets

According to recent articles in the financial press, a number of Wall Street investment banks are investigating ways to separate themselves from the toxic debt securities currently on their balance sheets by “ring-fencing” such securities in separate subsidiaries, a portion of which will eventually be sold to third-parties.

If this strategy sounds familiar, it should as it is a variation on the “good bank—bad bank” strategy utilized during a prior banking crises. It is too early to tell how many financial institutions will adopt such as strategy or how successful it will be in providing much needed liquidity.

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.)

MORE HELP...The Fed is playing the role of lender of last resort full tilt, enhancing the scope of its lending facilities, easing its Federal Funds Rate target below headline and core inflation and even providing credit to a commercial bank to orchestrate an acquisition. Not to be outdone, Ofheo loosened capital requirements on Fannie Mae and Freddie Mac, providing flexibility for them to add more mortgage securities to their bloated balance sheets. Not surprisingly, volatility reigns in financial markets. Meanwhile, economic performance continues to disappoint.

Fed Chairman Ben Bernanke told Congress that he was increasingly worried that **Wall Street** and **Main Street** could drag each other down in a reinforcing loop of bad news.

The Fed: Lender of last resort, and lender, and lender...Spreads were noticeably better as the Fed’s move to support liquidity in the market, through additional lending facilities as well as opening the window to broker-dealers, helped drive spreads tighter.

Hoarding by banks stokes fears of credit crises...Central banks' efforts to ease strains in the money markets are failing to stop financial institutions from hoarding cash, stoking fears that an end to the credit crises may not be in sight.

Capitalization rates for most commercial real estate sectors have been rising in recent months, with one exception: apartment buildings. In February, the average cap rate for apartment buildings was 6.08%, unchanged from January. Meanwhile, the average cap rate for office properties in central business districts jumped to 5.96% from 5.42%.

You can blame the usual suspects—tighter credit, tighter underwriting standards and soaring construction costs—coupled with eroding real estate fundamentals and a softening economy for putting the brakes on new development this year and jeopardizing hundreds of millions of dollars in construction loans already made by banks.

Dismal Scientist's Summary of Federal Open Market Committee Meeting on March 18, 2008 and Conference Call on March 10, 2008

On March 18, the FOMC reduced the federal funds target by 75 basis points, to 2.25%. Members cited a further weakening in the economy and the ongoing problems in the financial markets. The minutes noted that the forecast prepared for the March 18 meeting showed a decline in real GDP in the first half of 2008. During a March 10 conference call, in an effort to increase liquidity, FOMC members agreed to create a lending facility for broker-dealers that would allow them to exchange highly rated assets for Treasuries.