How Wall Street Changed Commercial Real Estate

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Goals of Presentation

- Wall Street Creations and their Size
  - REIT / MBS / CDO / CDS
- Loan Stat's & Trends
  - Securitization
  - Credit Enhancements
  - "The Fall"
- Securitization – "Novus Ordo Seclorum"
- Greer's Requisites for Recovery

Fundamentals

Supply / Demand – Not as bad as early 90's

- Supply Growth – Development has Stopped
- "Big Picture" ties to Gross Domestic Product
  - Office – FIRE Employment, Portion of Service Employment
  - Retail – Household Formations, Income Growth
  - Industrial – Manufacturing vs Distribution
  - Multifamily – Households
  - Hotel – Corporate Travel – Office Employment
- Jobs & Retail Sales Drive Supply & Demand!!!

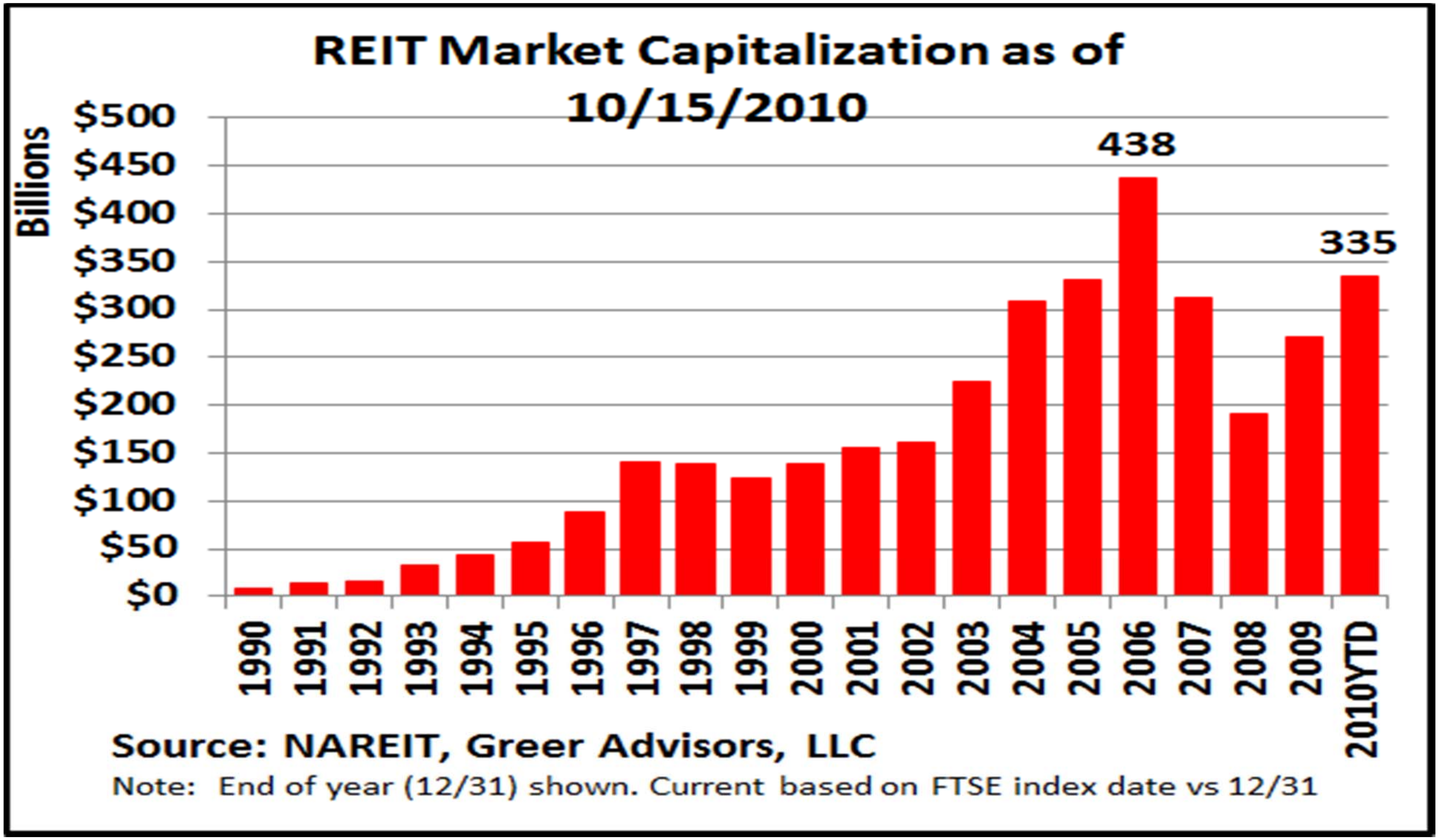
Financing – Currently Most Important Fundamental

What is REIT?

Real Estate Investment Trust

- Type of Pass-through Security
- Effectively a corporation
- As long as 90% of income passed is through to shareholders, there is no "corporate" tax. All earnings are single-taxed at shareholder level.
- Current "Industry" Issues:
  Definition of Assets, Max Debt Load, Yield

REIT Market Capitalization

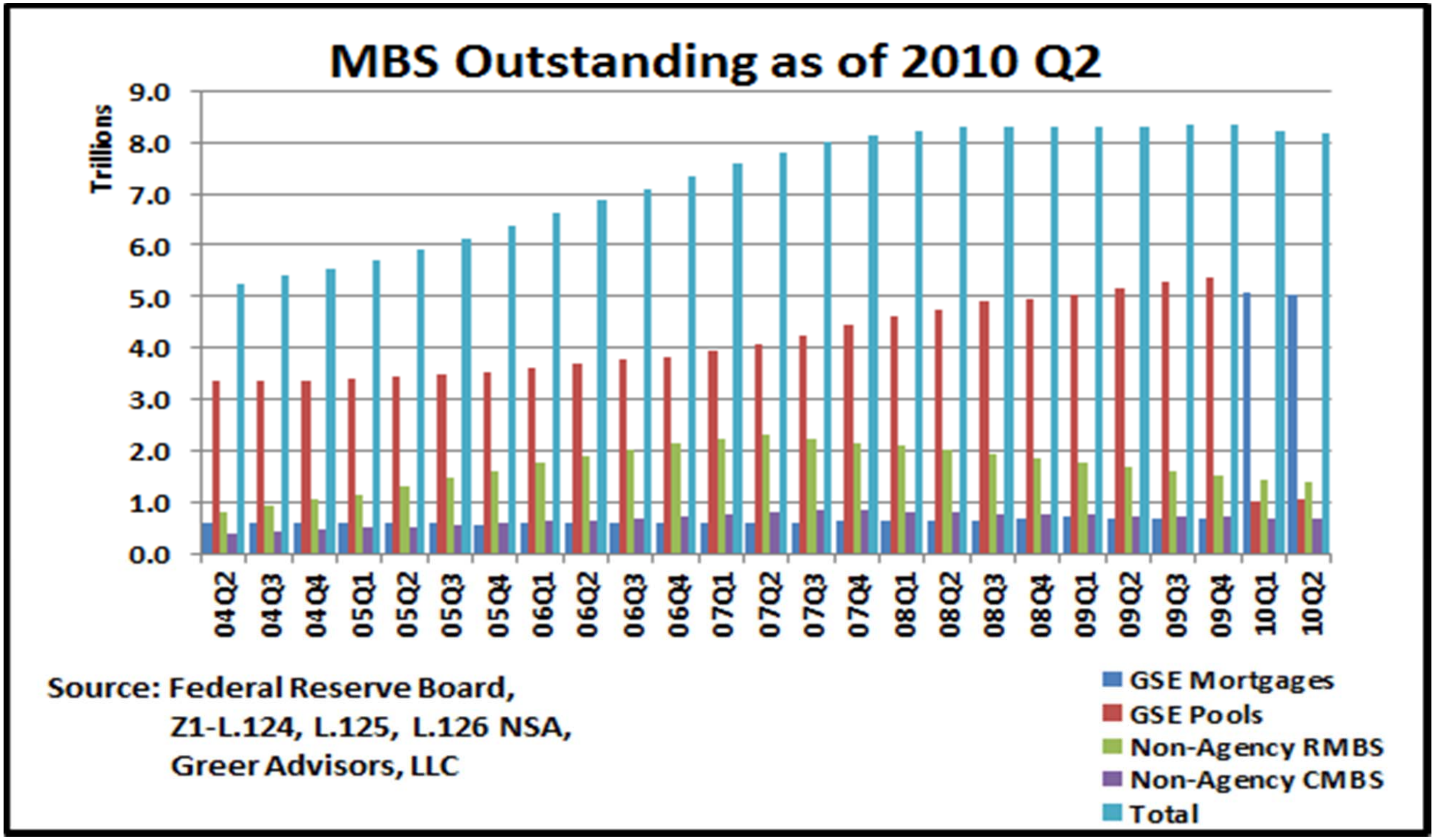


What is a MBS?

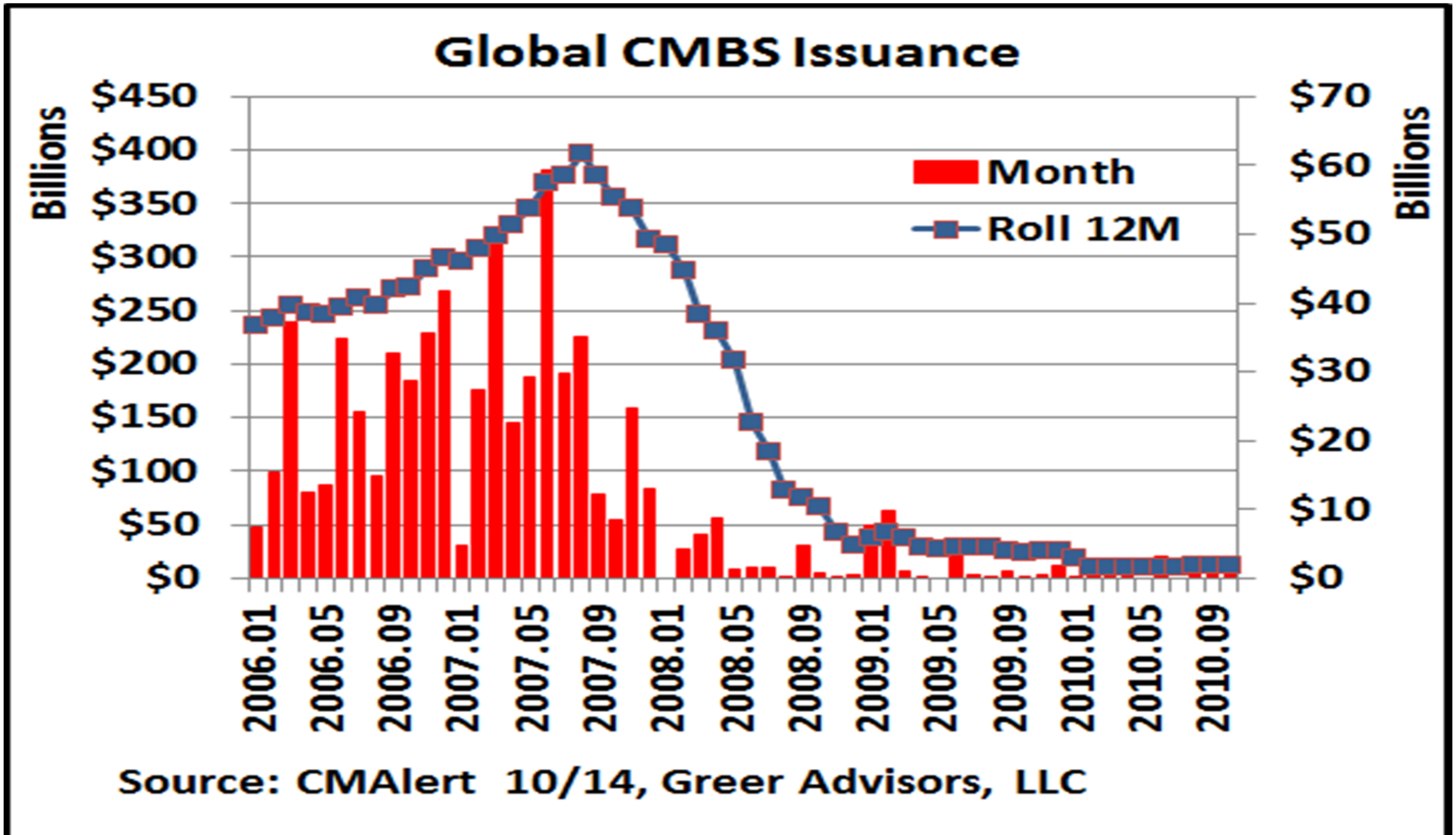
Mortgage Backed Security

- Type of pass-through security
- Mortgages are securitized into a pool. Rights to the revenue from the mortgages are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- During 2006-2007, accounted for slightly less than 40% of all commercial real estate lending, and higher rate for residential.

MBS Outstanding in U.S. - Dropping



CMBS Issuance - Dropping



Structure of a MBS – Then vs Now

No. Loans	250		
Avg. Loan Size	$10,000,000		
Total Loan Amt.	$2,500,000,000		
Index Name	10-Year Treasury		
Index Rate	3.790%		
Avg. Margin on Loans	1.750%		
Avg Yield on Loans	5.540%		
		THEN	NOW
Tranche Rating (10Y)	Approximate Subordination	01/07	04/16/10
AAA Sr	30.0%	3.250%	4.153%
AAA Jr	12.5%	3.300%	4.387%
AA	9.0%	3.350%	5.264%
A	8.0%	3.450%	7.999%
BBB	5.0%	3.700%	14.496%
BB	4.0%	3.950%	27.580%
B	2.5%	4.450%	28.921%
Unrated	0.0%	5.450%	32.000%
	Weighted Average Yield	3.358%	5.884%
Implied Annual Excess Return		1.182%	-1.344%

Note: Markit Data and Calculations based on close of 04/16/2010. 10 Year Swap Yield as of close of 04/16/2010 at 3.77%.
Source: Coupon and Price data from Markit for AAA Senior through BB bonds were used to calculate Spreads.
Source: Subordination levels were from Markit.
Source: The Calculations to determine Spreads were from Greer Advisors.
Notes: Interest Rate Swap (variable to fixed) fees were ignored. Spreads were assumed over 10-Year Treasury, not swap rate
Profit / arbitrage opportunity for the Issuer was ignored.
The yield spread for the "Unrated" class was based on (BBB- yield minus BB yield) times 2.00, rounded to 100 bps.
Class-A property equity yield was assumed equal to the BBB- (last investment-grade piece) yield, rounded to 100 bps.
Class-B property equity yield was assumed equal to the Unrated yield, rounded to 100 bps.

CMBx Data

The following table is somewhat complicated, as is evidenced by the numerous footnotes. From a practical perspective, several conclusions can be drawn from this table. First, as long as the 'Implied Overall Debt Yield' is much greater than loan rates in the marketplace, the CMBS market CAN NOT recover. The required yields are too high to make debt affordable to borrowers. Secondly, as long as the spread between the AAA and BB tranches remains above 500 (now at 9964 bps), the market will not recover because of risk aversion associated with lower-rated tranches. Lastly, the yields for each of the tranches provide tremendous insight into the required yields for very granular layers in the capital stack.

Greer CMBS / CMBx Yield Rate™

Tranche	Yield	Suboord	Weight of Debt	Contribution to Total
AAA	2.90%	29.76%	70.24%	2.04%
AJ	3.85%	12.70%	17.06%	0.66%
AA	5.91%	10.63%	2.07%	0.12%
A	10.53%	8.00%	2.63%	0.28%
BBB	26.18%	4.72%	3.28%	0.86%
BBB-	27.05%	3.68%	1.04%	0.28%
BB	102.54%	2.69%	0.99%	1.02%
Unrated	178.00%	0.00%	2.69%	4.79%
Implied Overall Debt Yield			100.00%	10.04%
Loan to Value Ratio				75.0%
Class-A Equity Yield | Total Yield			27.00%	14.28%
Class-B Equity Yield | Total Yield			103.00%	33.28%

Note: MarkitTM Data and Calculations based on close of 10/15. Swap (10Yr) as of 10/15.

Source: Coupon and Price data were from Markit™ for AAA Senior through BB bonds. Markit™ data was used as part of the calculations by Greer Advisors, LLC to determine Spreads. Subordination levels were from Markit™.

Note: Profit / arbitrage opportunity for the issuer was ignored.

The yield spread for "unrated" clases were based on (BBB- yield minus BB yield) times 1.0, round to the nearest bp. Class-A property equity yield was assumed equal to the BBB- (last investment-grade piece) yield rounded to the nearest 100 bp. Class-B property equity yield was assumed equal to the BB yield, rounded to 100 bps.

What is a CDO?

Collateralized Debt Obligation

- Type of pass-through security
- CDOs are securitized debt pools, similar to CMBS, but debts can be CMBS/CDO paper, car/boat/plane loans, credit cards, or virtually any type of debt obligation. Rights to the revenue from the obligations are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- Tough to gauge accurately, but most experts believe these have accounted for 5-10% of all commercial real estate lending the past few years.

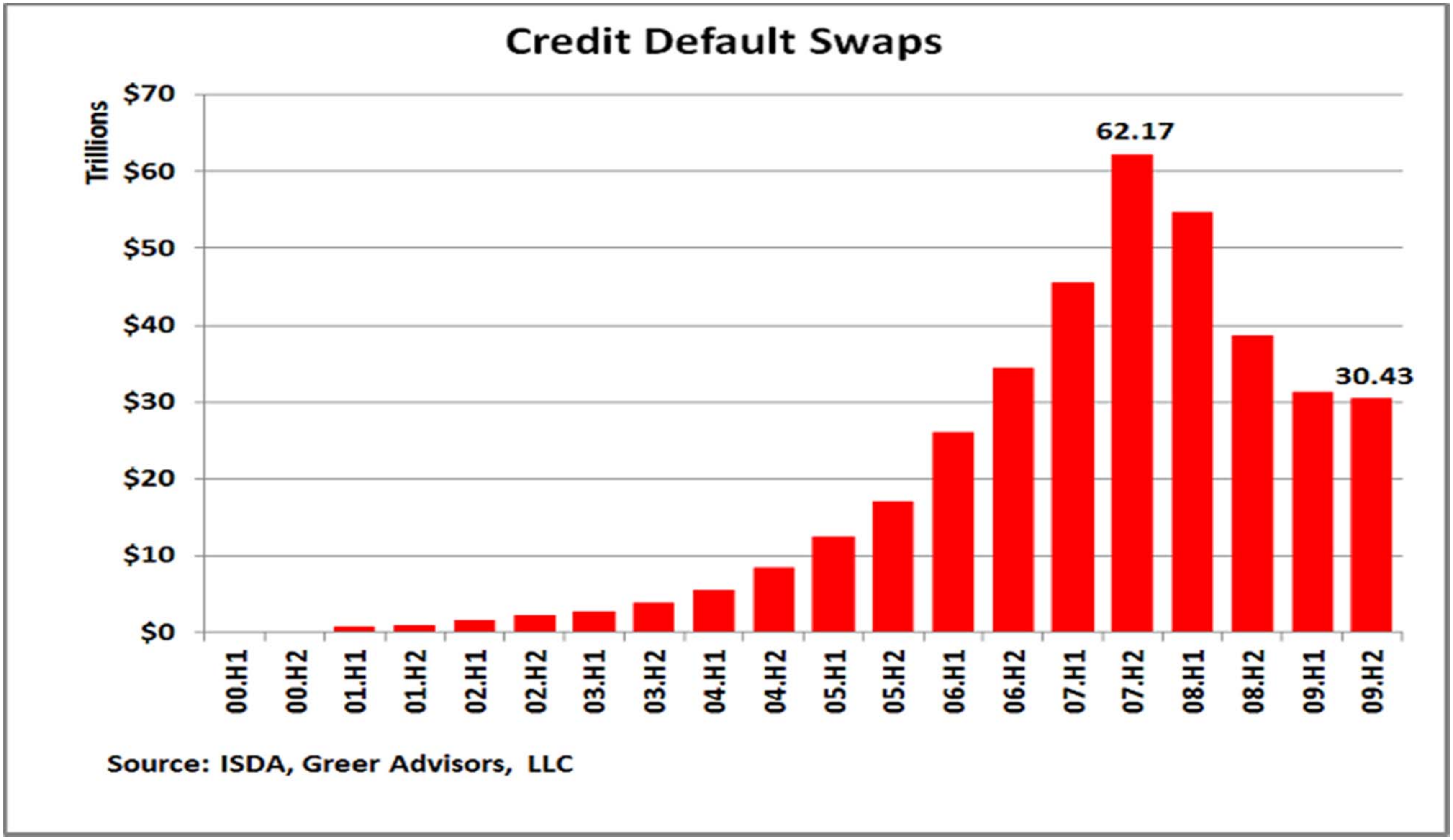
What is CDS?

Credit Default Swap

- A bilateral contract where two parties agree to trade the credit risk of a third-party. A protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a default or failure to pay. Once triggered, the seller either takes delivery of the collateral (eg bond, note) or pays the buyer the difference between the par value and recovery value of the bond (cash settlement).
- They resemble an insurance policy, as they can be used by debt owners to hedge against credit events.

- Warren Buffet calls these "Weapons of Mass Destruction"

Credit Default Swaps



Players in “Simple” CDS

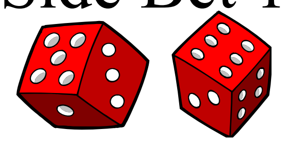
Business Issues Bonds

Bonds initially rated too poor
for market, eg “BB”

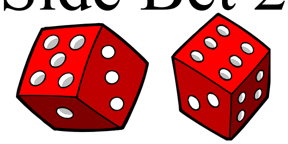
Rating Agency Rates Bonds

Gives loss forecast & amount
required for “AA” rating

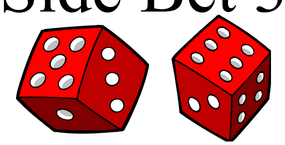
Side Bet 1



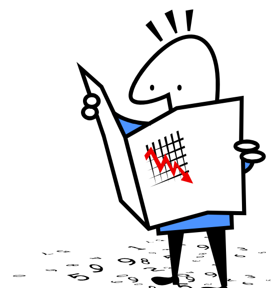
Side Bet 2



Side Bet 3



Investment Bank issues CDS
(aka Credit Enhances Debt)
Enough to make BB = AA, if
debtor fails, IB buys bonds



Pension Fund Buys Bonds
with CDS enhancement
Thinks it’s AA investment

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Evolution of CDS

- Simple CDS = “Full Coverage”
  - Buyer is Party to Credit Instrument
  - Seller Provides “Full” Coverage
  - Seller Pays (makes up) Shortfall or
  - Seller Buys Credit Instrument from Buyer
  - Buyer is “Made Whole”
- Buyer is Not a Party to Credit Facility, merely a speculator
- Sellers Provide Partial Coverage (ceiling on loss)
- Sellers Provide Incremental Coverage
  - Goal is to provide “Partial” Credit Enhancement
  - Ratings Are Enhanced (eg “BB” to “A” rating)
- CDS – Complex Credit
  - CMBS (vertical [multi-tranche buyer] or horizontal)
  - Multiple facilities
  - REITs added

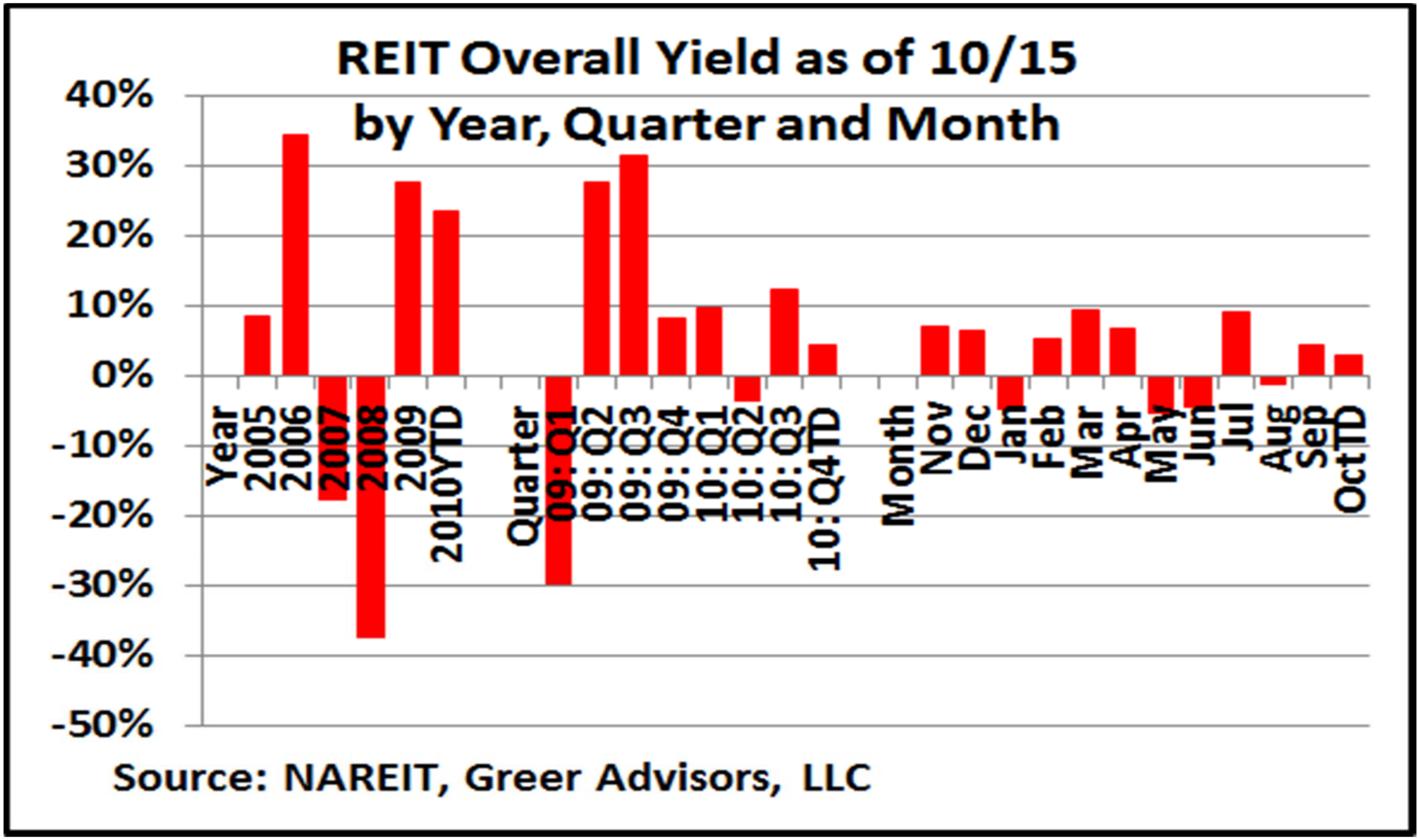
CDS – Credit Enhancement – Market Change

- **DEBT ISSUANCE**
- Debt Issued $1B
- SRA Rates Debt
- Estimated Loss =$10MM = "B" Rating
- SRA says $1MM = AA
- $9MM CDS bought
- Debt "credit enhanced" from "B" to "AA"

- **DEBT RE-RATED**
- Existing Debt 6 mo's later
- SRA Re-Rates Debt
- Estimated Loss now $20MM = "unrated" security
- SRA says $1MM = AA
- CDS provided $9MM coverage, now addtl $10MM expected loss
- Credit Enhancement not enough to yield desired rating on security

Note: Above is Hypothetical Example

Overall REIT Dividend Yields - Stabilizing



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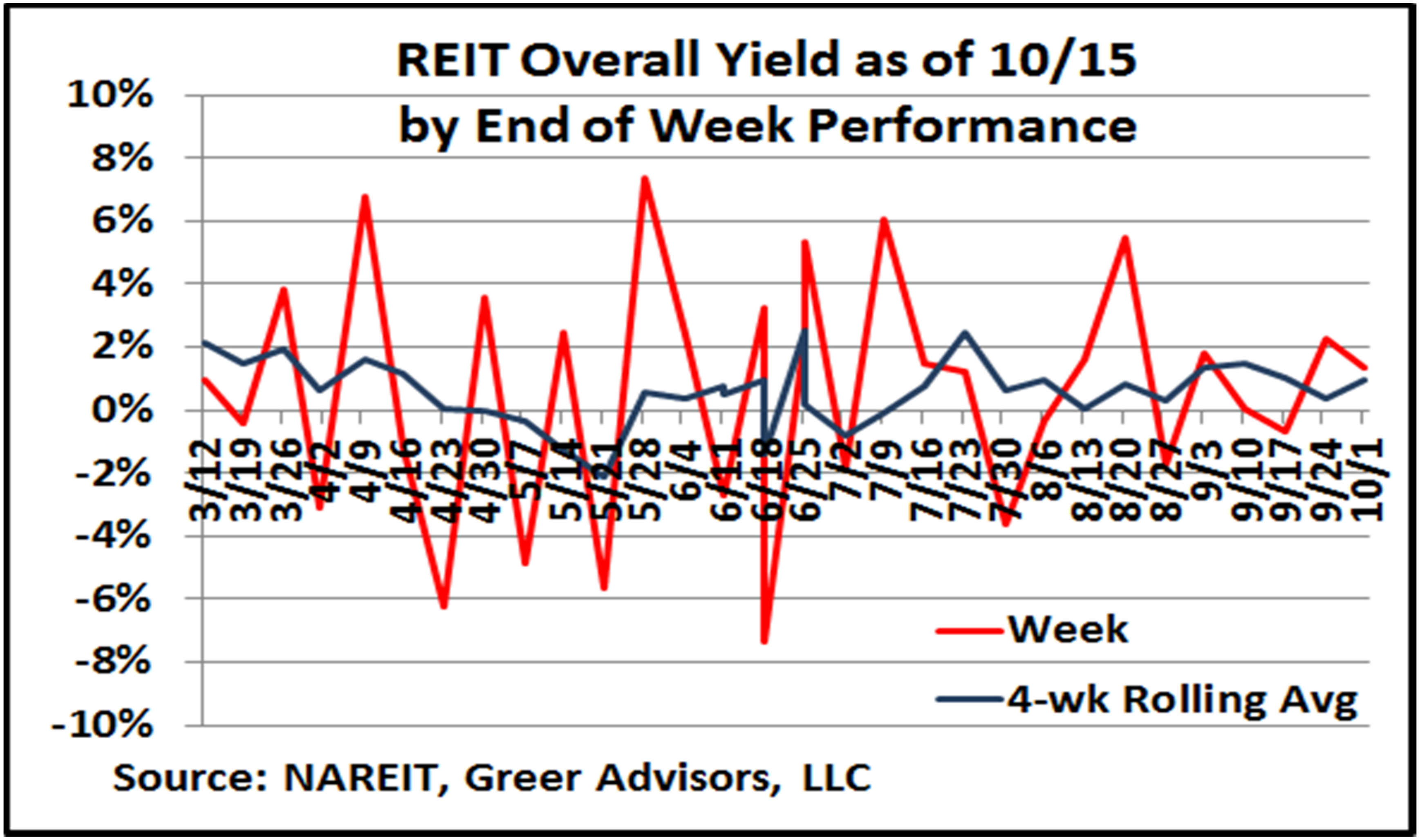

Future - Mortgage Backed Security

- ‘Til MBS Returns, Real Estate markets WILL NOT recover
- Most banks ARE NOT in the business of holding debt
- New MBS WILL EMERGE with terms as follows
  - No “quick buck” investment banks/mortgage bankers
  - Issuer holds 1-5% of pool as “1st Loss / Good Faith” position
  - 60-80% of pool will be AAA, not 90+%
  - Buyers of paper will “re-underwrite” pools, regardless of SRA
  - Loans will get “kicked out” of pool by B-piece buyers
  - Could Fed’s replace NSROs?

Bank's New Underwriting

- Latest Quarterly Banking Profile from FDIC shows largest lending declines in history 08Q4 onward.
- Loss Rates are Climbing FAST. CMBS all time highs.
- YOY Loss Rates continue to climb
- Deleverage – Expect More
  - Lower LTV (80-85% versus 50-60%)
  - Higher DSC (130-150 versus 1.05-120)
  - 100% Guarantee
  - Restrictive Covenants

Wall Street Real Estate Fundamentals

CMBS Market is Completely Broken = Opportunities

CMBS/CMBX Industry – Imply R.E. Yields Doubled

REITs are “Off” roughly 25%, this creates Opportunities

NCREIF is Down Significantly

De-Leveraging Will Continue

Cash will Remain King!

Market Change brings Opportunities!

If MBS is “put” back to banks, add 3-5 years to recovery

Cause — Run Away Value Growth - Coolaid

Year	Rent	RentG	Ind Cap	Value
2002	750,000	3.30%	7.50%	$10,000,000
2003	774,750	3.30%	7.12%	$10,880,000
2004	800,317	3.30%	6.76%	$11,837,440
2005	826,727	3.30%	6.42%	$12,879,135
2006	854,009	3.30%	6.09%	$14,012,499
2007	882,192	3.30%	5.79%	$15,245,598
2008	911,304	3.30%	5.49%	$16,587,211
2009	941,377	3.30%	5.22%	$18,046,886
	average	3.30%		8.80%

- Increase in value was only “interest rates” first 2 years.
  Momentum effect carried it further.
  What happens when it stops?

Quote of the Day

"…prediction is very difficult, especially when it's about the future…"

~~NY Yankees #8, Yogi Bera~~

Niels Bohr

Nobel Laureate, 1922

Atomic Structure /

Quantum Mechanics

Conclusions

- MBS Market – Yield Spreads are 10-100x higher than 1/07
- MBS – New Business Model will Arise
- REITs – Down +/- 25%
- Most Lenders Closed, Stopped or Reduced Lending
- Insurance Companies and Fannie/Freddie Lenders are Active
- Financing / Cap / Yield Rates Have RISEN
- CASH IS KING!
- Value Growth will Lag Rent Growth – by a Lot
- Rents / Vacancies Remain better than early 1990s
- Commercial Value Correction will Continue

Greer's 3-Year Forecast as of 10/20/2010

- Borrowing Rates will Continue to Rise. More banks will fail.
- Margins (to 10 Yr Treasuries or LIBOR) will rise and settle at 300±50 bps over 10 year Treasuries, but might over-correct in the short run, say 10Yr 400+ bps. If country defaults occur (eg Dubai, rates will rise due to default risk.
- Rent Growth will Lag CPI growth by 2-8%
- Values will continue to fall 5-15%/yr thru mid-2011. Individual Market Performance will very widely. (10-30% difference in Top vs Bottom)
- Capitalization Rates will Rise 2-4% during 2010-2012 (eg 5.0% to 7.25% = 30% decline in value)
- Declines: #1=Retail; #2=Industrial & Office; then Apartment
- Change Creates Opportunities

Greer's Recovery Signs – Prereq's to Recovery

- CDS Exposure under $25 Trillion (i.e. under 50% of peak)
- Stable or Decline in CMBx Yield Spreads for 6 straight weeks
- Re-emergence of CMBS market
  - New CMBS Market will include:
    - Issuer Keeps 1-5% 1st-loss piece
    - AAA Subordination near 30%....
    - AAA is 70%, not 90% of issue
- √ REIT Market Capitalization (Total Value) Stabilizes or Increases for 6 months
- Consumer Confidence Rises and Stays Above 70 for 6 months
  - As of 9/28/10 (last report) index at 48.5 (1985=100)
- Risk Curve (AAA vs BB) flattens to under 500 bps. As of 10/15/10, CMBx spread stands over 9,964 bps.

Questions / Answers

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