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# Wall Street and Commercial Real Estate

Everett (Allen) Greer  
Greer Advisors, LLC

November 16, 2010

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**Greer Advisors, LLC**

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# Goals of Presentation

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- Market Drivers
- Financial Regulations
  - Consumer
  - Real Estate
  - Securitization
- Wall Street and Capital Markets
  - REIT / MBS / CDO / CDS
- Expected Changes / Outlook
  - Securitization
  - Lending
- Greer's Forecast / Signs

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# Market Drivers

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

- Supply Growth – Very Limited Growth
- Most Demand 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**

# Economy – Local Stats

## Demographic Statistics

	Orange County	LA County	Riverside County	San Bernardino	San Diego County	SoCal - 5 Counties	California State	United States
2010 Total Population	3,090,761	10,240,505	2,173,606	2,061,421	3,120,279	20,686,572	37,983,948	311,212,863
2015 Total Population	3,151,668	10,448,662	2,374,034	2,156,651	3,246,592	21,377,607	39,328,336	323,209,391
2010 Households	995,954	3,292,577	693,993	613,560	1,088,562	6,684,646	12,662,806	116,761,140
2015 Households	1,010,585	3,342,833	754,212	638,560	1,130,792	6,876,982	13,063,778	121,359,604

Source: ESRI, U.S. Census Bureau , Greer Advisors, LLC

# Economy – Comparison

<b>Demographic - Comparison</b>	Orange County	LA County	Riverside County	San Bernardino County	San Diego County	SoCal - 5 Counties	California State	United States
2010 - 2015 Population Growth	0.39%	0.40%	1.78%	0.91%	0.80%	0.66%	0.70%	0.76%
2010 - 2015 Household Growth	0.29%	0.30%	1.68%	0.80%	0.76%	0.57%	0.63%	0.78%
2010 Median Household Income	\$79,132	\$54,755	\$54,762	\$53,794	\$60,699	\$58,793	\$60,992	\$54,442
2010 Per Capita Income	\$33,143	\$24,448	\$22,040	\$19,895	\$28,053	\$25,584	\$27,845	\$26,739
<b>2010 Population by Age</b>								
Age 0 - 9 (young children)	14.8%	15.4%	16.0%	16.7%	13.8%	15.2%	14.7%	13.5%
Age 18+ (workforce)	74.2%	73.4%	72.2%	70.8%	75.9%	73.5%	74.3%	75.8%
Age 65+ (retirement)	11.1%	10.0%	13.1%	9.1%	11.4%	10.6%	11.1%	13.1%
Age 85+ (aging / health)	1.7%	1.5%	1.9%	1.2%	1.8%	1.6%	1.7%	2.0%
2010 Median Age	35.1	32.8	34.2	31.3	34.6	33.4	34.4	37.0
<b>Source: ESRI, U.S. Census Bureau , Greer Advisors, LLC</b>								

# Economy – Comparison

<b>2010 Employed Population 16+ by Occupation</b>								
	Orange County	LA County	Riverside County	San Bernardino County	San Diego County	SoCal - 5 Counties	California State	United States
<b>2010 Employed Population 16+ by Occupation</b>								
White Collar	68.6%	63.9%	56.7%	57.4%	66.0%	63.8%	64.1%	61.6%
Management/Business/Financial	18.3%	14.0%	11.9%	11.6%	15.2%	14.5%	15.0%	13.9%
Professional	22.6%	23.4%	18.8%	19.6%	25.0%	22.8%	23.5%	22.6%
Sales	13.6%	11.7%	12.5%	11.5%	12.1%	12.2%	11.6%	11.4%
Administrative Support Services	14.1%	14.7%	13.6%	14.7%	13.7%	14.3%	14.0%	13.6%
Blue Collar	16.3%	19.1%	23.2%	24.3%	15.8%	18.9%	18.8%	21.1%
Farming/Forestry/Fishing	0.2%	0.1%	1.1%	0.3%	0.4%	0.3%	1.0%	0.6%
Construction/Extraction	4.0%	4.1%	6.9%	5.8%	4.7%	4.6%	4.7%	5.4%
Installation/Maintenance/Repair	2.8%	3.1%	4.1%	4.7%	3.2%	3.3%	3.3%	3.6%
Production	5.4%	6.2%	5.0%	5.4%	3.6%	5.5%	4.7%	5.7%
Transportation/Material Moving	3.9%	5.5%	6.1%	8.1%	3.9%	5.2%	5.1%	5.7%

Source: ESRI, U.S. Census Bureau , Greer Advisors, LLC

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## Local Stats - Conclusion

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### **SoCal – Population and Employment are Not Growing**

- Local Population Growth is  $\frac{1}{2}$  the National Average
- Local HH Formation Growth is  $\frac{1}{3}$  the National Average

**We are dependent upon Services, and FIRE!**

**Wall Street and the Globe Drives our Real Estate!!!**

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# Financial Regulations

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## **Dodd-Frank Wall Street Reform & Consumer Protection Act**

- 16 Titles – See Summary on Wikipedia
  - 243 Rules to be created (about ½ done)
  - 67 Studies required
  - 22 New Periodic Reports
- Restructure of Regulators, elimination of OTS
  - Financial Stability Oversight Council (New)
  - Office of Financial Research (New)
- Keys for Commercial Real Estate:
  - Rating Agency Reform
  - Securitization Reform
  - Derivatives – minimal change



# Top - Bottom Market Stats – as of 2010 Q3

Office			Industrial			Apartment			Hotel			
MSA	Vac	Rent \$		Vac	Rent \$		Vac	Rent \$		Occ	ADR	RevPAR
New York	8.7	55.62	Los Angeles	8.1	6.67	San Jose	2.9	1,555.14	Honolulu	85.3	156.86	133.81
Honolulu	8.8	26.44	Salt Lake City	9.3	4.57	Pittsburgh	3.4	862.52	San Francisco	84.6	135.35	114.48
Long Island	11.3	19.82	Kansas City	10.3	6.10	Philadelphia	3.5	1,097.12	New York	84.1	215.02	180.89
Pittsburgh	11.5	17.10	Houston	10.5	5.32	Oakland	3.7	1,269.83	Boston	80.7	150.21	121.15
Trenton	12.0	23.82	San Francisco	10.5	7.76	San Diego	3.7	1,320.47	Seattle	79.0	114.84	90.77
Stamford	12.5	26.08	Long Island	10.9	5.58	Newark	3.8	1,230.23	Long Island	77.8	133.49	103.92
Washington D.C.	13.1	35.23	Portland	11.0	6.25	Boston	3.9	1,436.07	San Diego	76.0	129.12	98.14
Boston	13.2	27.18	Orange County	11.1	8.54	Minneapolis	4.0	913.52	Orange County	73.8	111.08	82.03
San Francisco	14.1	21.65	Seattle	11.2	9.21	Portland	4.0	818.95	Los Angeles	73.3	118.03	86.56
Nashville	14.2	19.85	New York	11.8	5.61	Albuquerque	4.1	688.38	Portland	71.5	91.52	65.39
West Palm Beach	21.5	20.87	Vallejo	16.2	5.62	Birmingham	8.2	755.83	Hartford	57.4	91.90	52.73
Edison	21.6	17.15	Hartford	17.7	6.39	St. Louis	8.2	726.50	New Orleans	57.1	103.15	58.91
San Jose	21.7	25.93	Boston	17.9	5.87	Tucson	8.3	619.43	Houston	57.0	89.92	51.25
Jacksonville	21.9	15.76	Sacramento	18.3	4.73	Atlanta	8.4	759.02	Dallas	56.8	82.20	46.72
Tampa	21.9	18.83	Phoenix	18.7	5.03	Fort Worth	8.4	652.28	Detroit	56.8	77.47	44.01
Dallas	22.3	18.22	Atlanta	18.8	3.25	Phoenix	8.8	676.62	Richmond	56.2	75.94	42.68
Riverside	22.4	18.57	Stamford	19.4	5.95	Jacksonville	9.2	740.65	West Palm Beach	54.6	95.69	52.26
Las Vegas	24.6	21.07	Detroit	20.5	3.67	Indianapolis	9.3	669.75	Tampa	50.4	82.48	41.59
Detroit	24.9	15.92	Memphis	20.7	2.36	Houston	9.5	754.46	Tucson	48.3	74.29	35.87
Phoenix	26.1	18.73	Trenton	21.2	3.92	Memphis	10.4	657.03	Phoenix	46.0	73.43	33.80
Orange County	19.8	23.14	Orange County	11.1	8.54	Orange County	4.3	1,453.23	Orange County	73.8	111.08	82.03
Los Angeles	17.2	25.29	Los Angeles	8.1	6.67	Los Angeles	4.1	1,474.02	Los Angeles	73.3	118.03	86.56
Riverside	22.4	18.57	Riverside	15.4	4.58	Riverside	5.4	1,016.64	N/A	N/A	N/A	N/A
San Diego	18.9	25.02	San Diego	15.1	7.42	San Diego	3.7	1,320.47	San Diego	76.0	129.12	98.14
Sum Of Markets	16.6	26.44	Sum of Markets	14.0	5.20	Sum Of Markets	5.7	1,158.30	Sum Of Markets	66.2	109.66	72.62

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- Wall Street and Capital Markets

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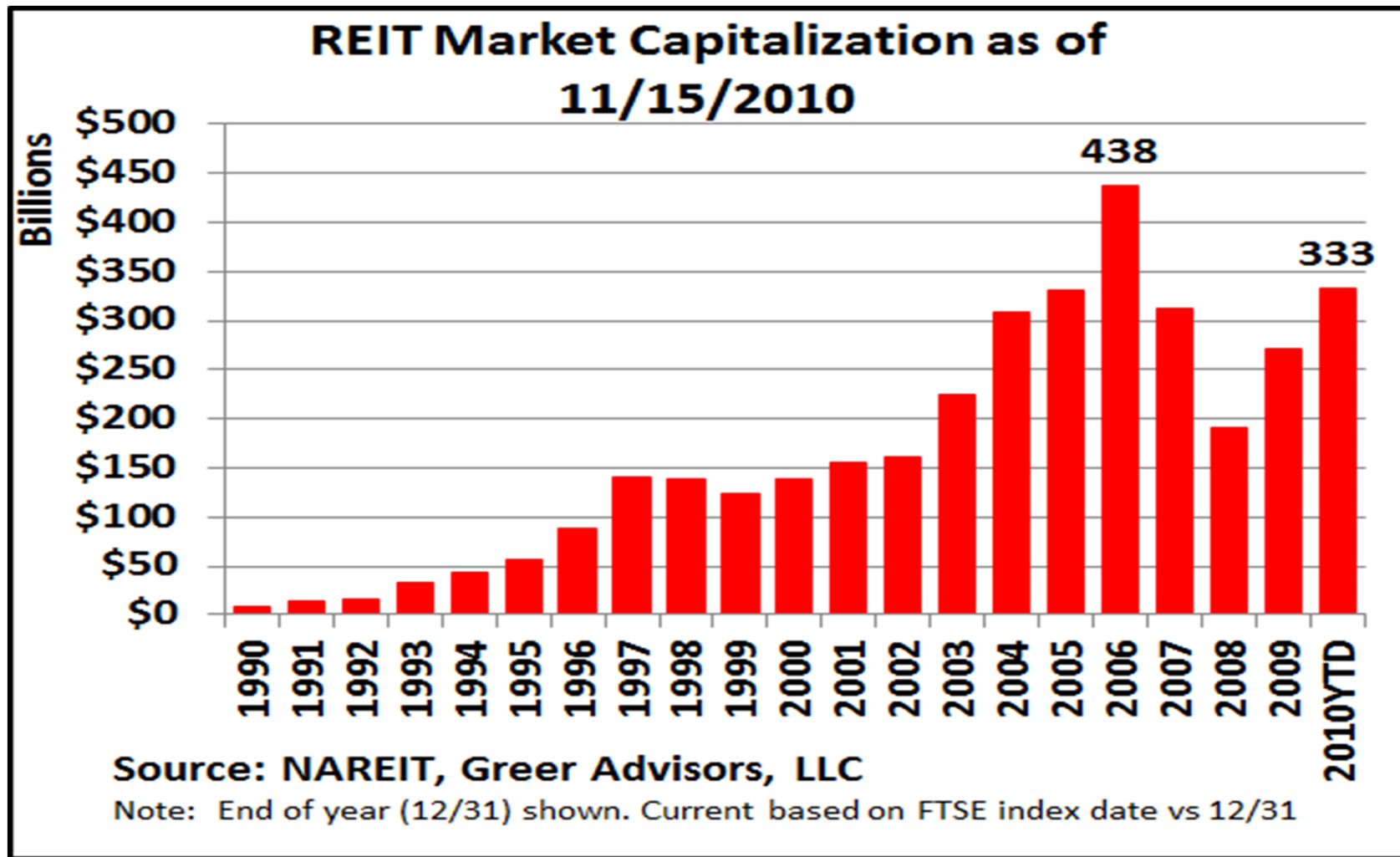
# What is REIT?

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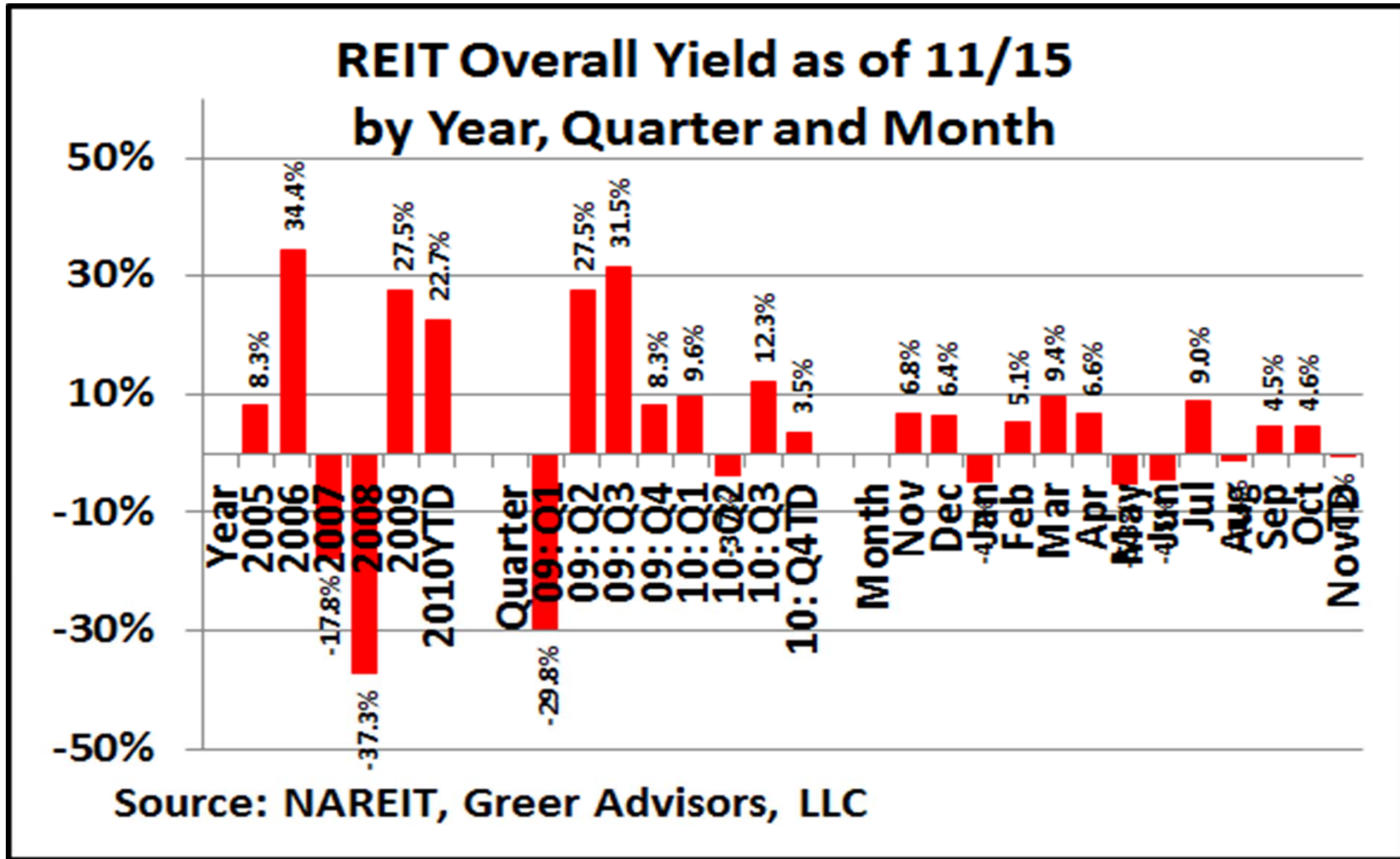
## Real Estate Investment Trust

- 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

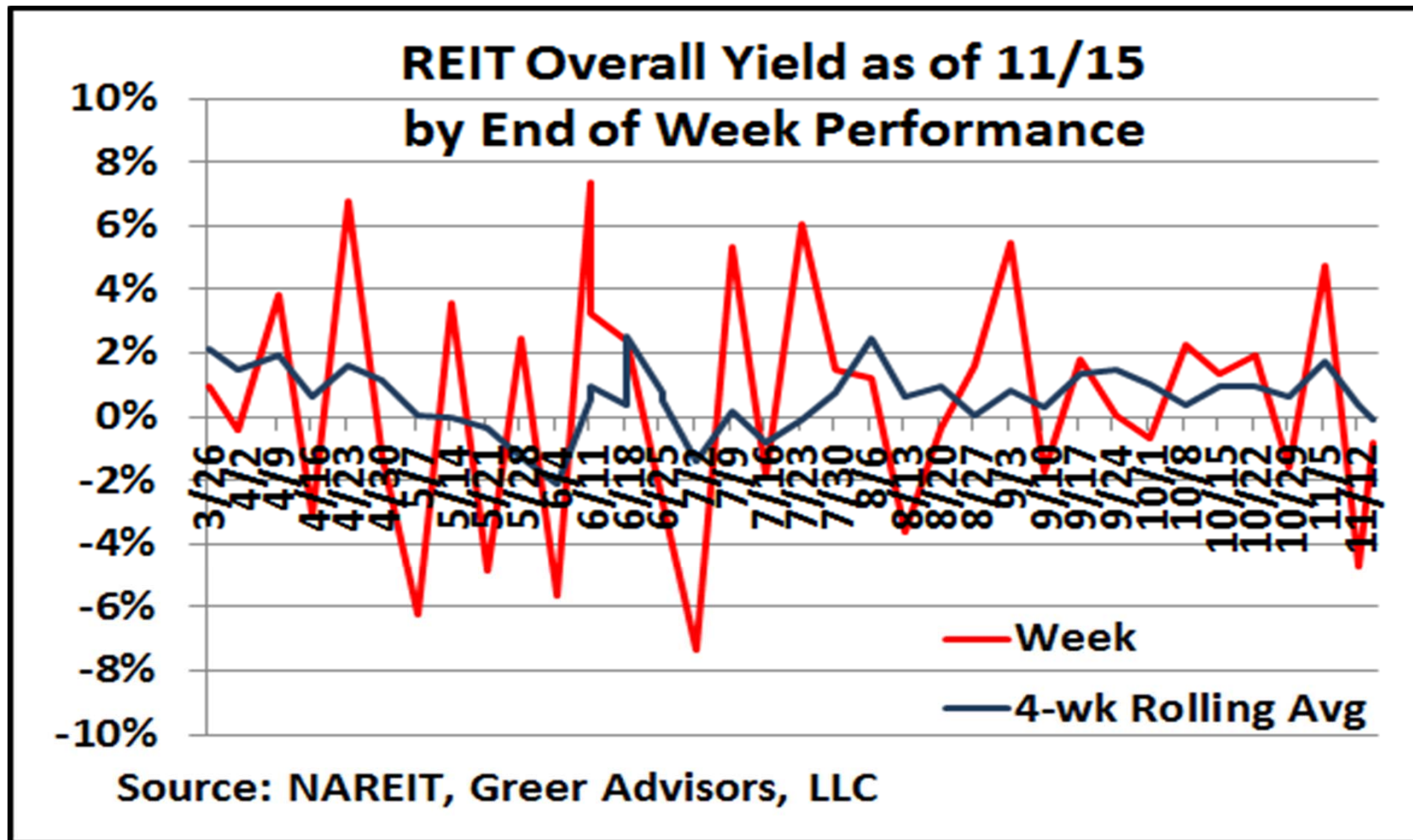
# REIT Market Capitalization



# Overall REIT Dividend Yields – Stable?



# Overall REIT Dividend Yields – Stable?





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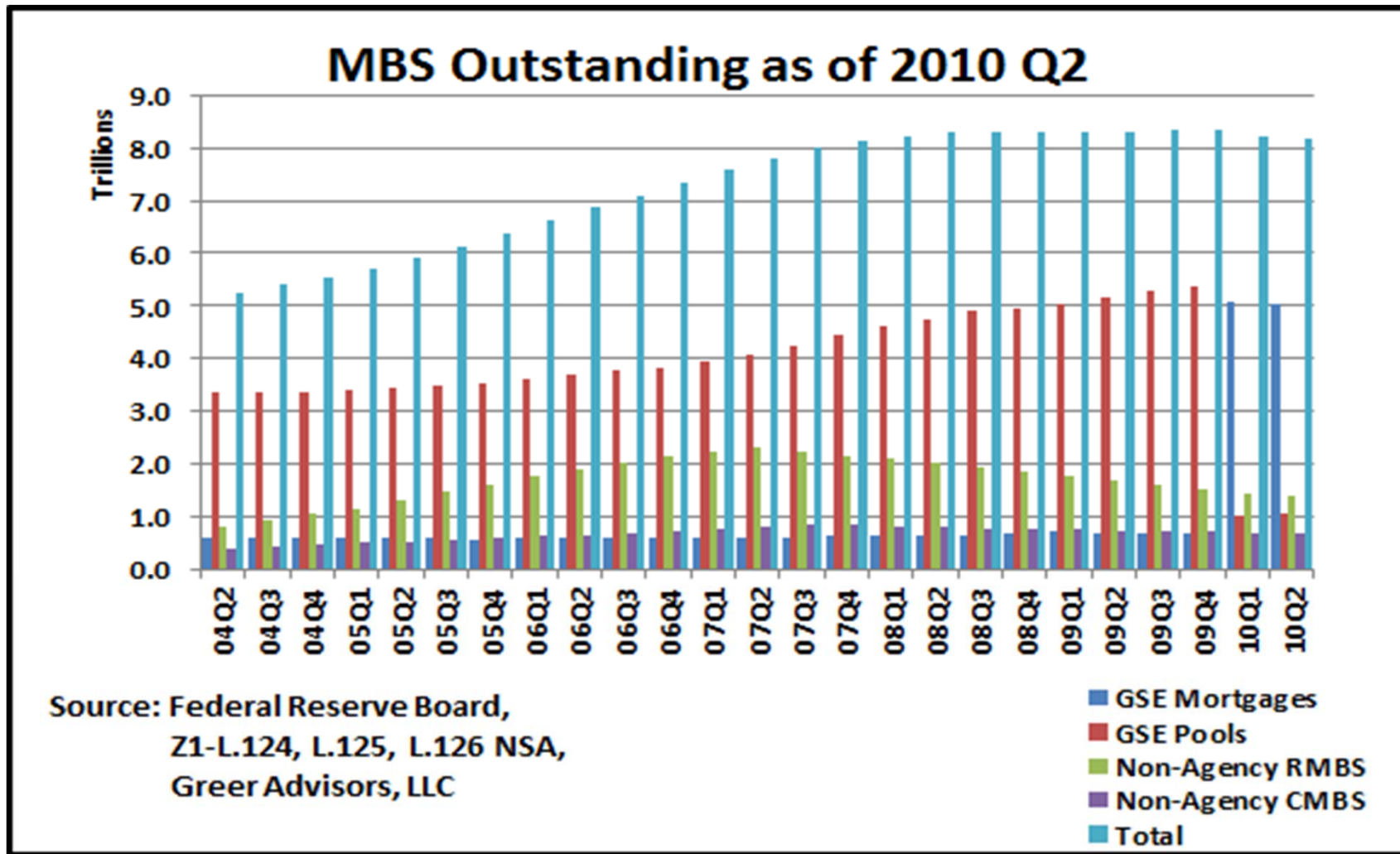
# What is a MBS?

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## Mortgage Backed Security

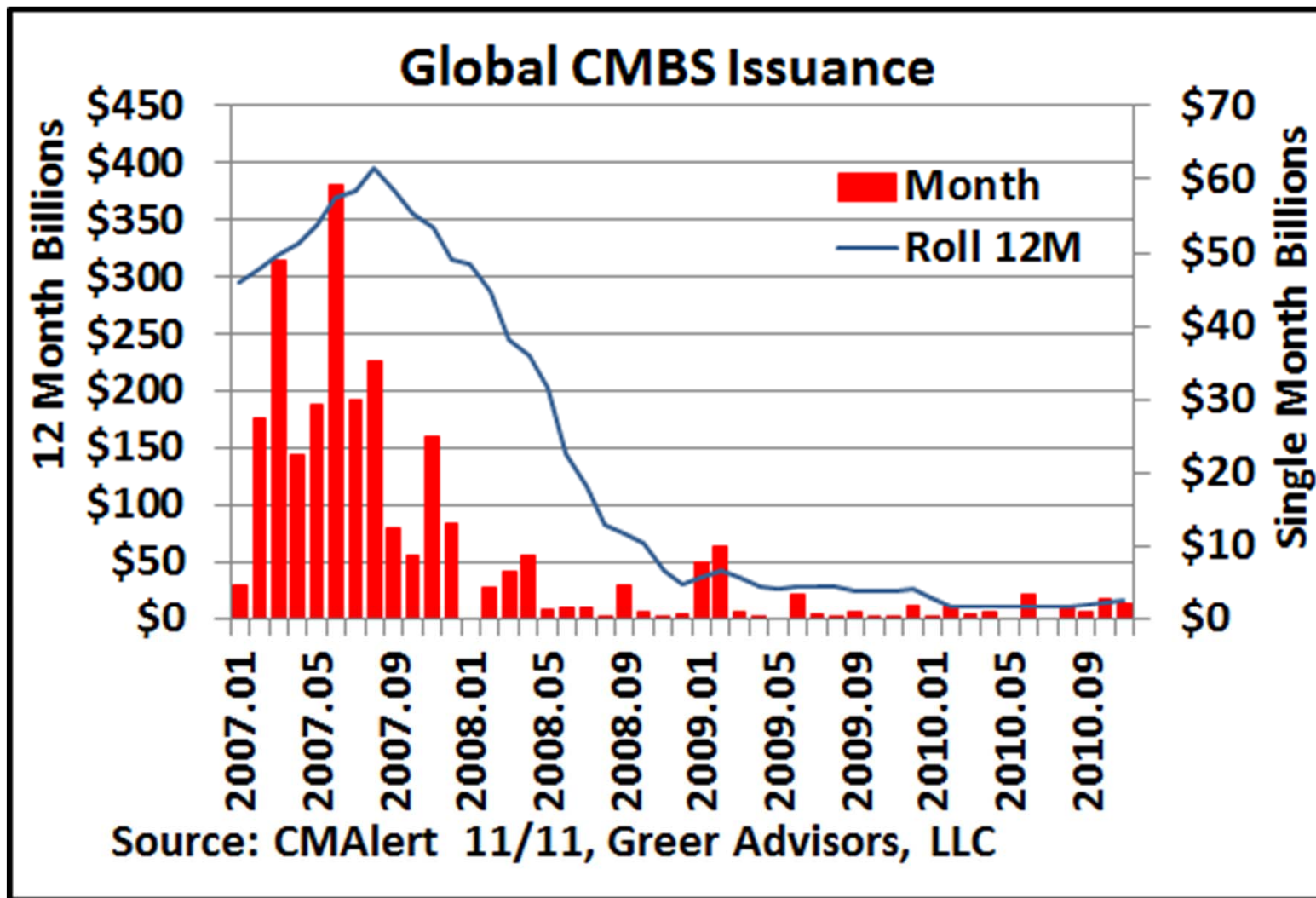
- Type of pass-through security
- Mortgages are securitized into a pool. Rights to the revenue from the mortgages are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- During 2006-2007,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

# MBS Outstanding's in U.S. - Dropping





# Global CMBS Issuance - Falls



# CMBx Data

<b>Greer CMBS / CMBx Yield Rate<sup>TM</sup></b>				
<b>Tranche</b>	<b>Yield</b>	<b>Suboord</b>	<b>Weight of Debt</b>	<b>Contribution to Total</b>
AAA	3.23%	29.76%	70.24%	2.27%
AJ	4.14%	12.70%	17.06%	0.71%
AA	5.87%	10.63%	2.07%	0.12%
A	10.57%	8.00%	2.63%	0.28%
BBB	28.10%	4.72%	3.28%	0.92%
BBB-	28.79%	3.68%	1.04%	0.30%
BB	102.86%	2.69%	0.99%	1.02%
Unrated	177.00%	0.00%	2.69%	4.76%
<b>Implied Overall Debt Yield</b>			<b>100.00%</b>	<b>10.38%</b>
<b>Loan to Value Ratio</b>				<b>75.0%</b>
<b>Class-A Equity Yield   Total Yield</b>			<b>29.00%</b>	<b>15.03%</b>
<b>Class-B Equity Yield   Total Yield</b>			<b>103.00%</b>	<b>33.53%</b>

The table is somewhat complicated, as evidenced by the numerous footnotes. Several conclusions can be drawn. 1) If 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. 2) When the spread between AAA and BB tranches is above 500 bps (now at 9963 bps), the market can't recover because of risk aversion for lower-rated tranches. Jan. '07 AAA-BB CMBS spreads were under 100 bps. Lastly, the yields for each tranche provide tremendous insight into the required yields for each layer in the capital stack.

Note: Markit<sup>TM</sup> Data and Calculations based on close of 11/12. Swap (10Yr) as of 11/12.

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

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

The yield spread for "unrated" classes 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.

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# What is a CDO?

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## 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.

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# What is CDS?

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## 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 called **ED** these “Weapons of Mass Destruction”
- .....counterparty???

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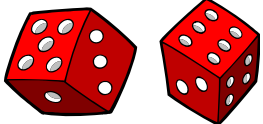
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# Players in “Simple” CDS

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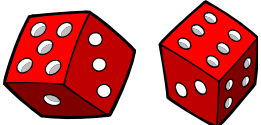
## Business Issues Bonds

Side Bet 1

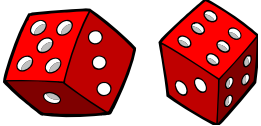


Bonds initially rated too poor for market, eg “BB”

Side Bet 2



Side Bet 3

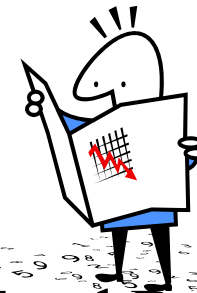


Investment Bank issues CDS (aka Credit Enhances Debt) Enough to make BB = AA, if debtor fails, IB buys bonds

## Rating Agency Rates Bonds



Gives loss forecast & amount required for “AA” rating



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

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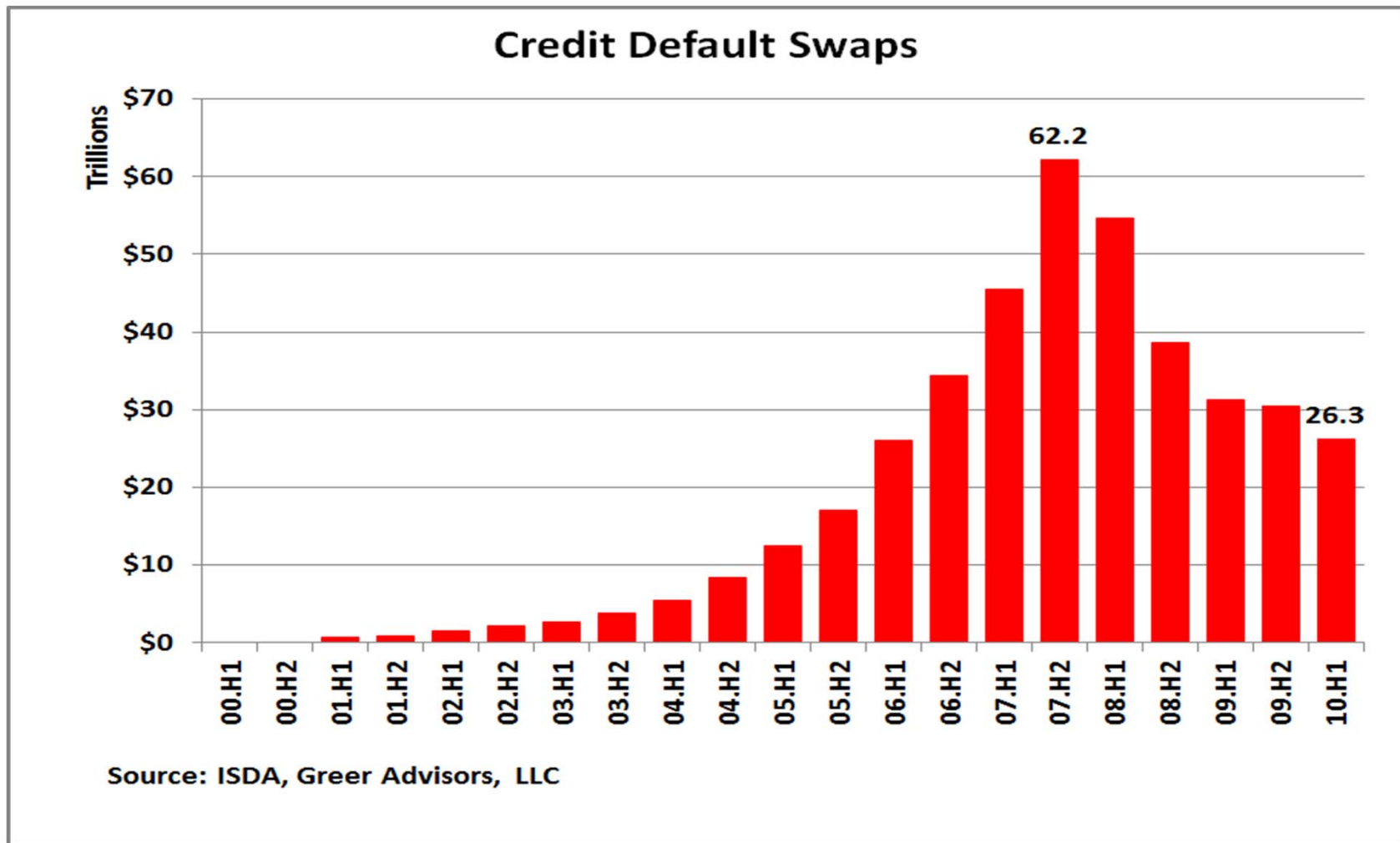
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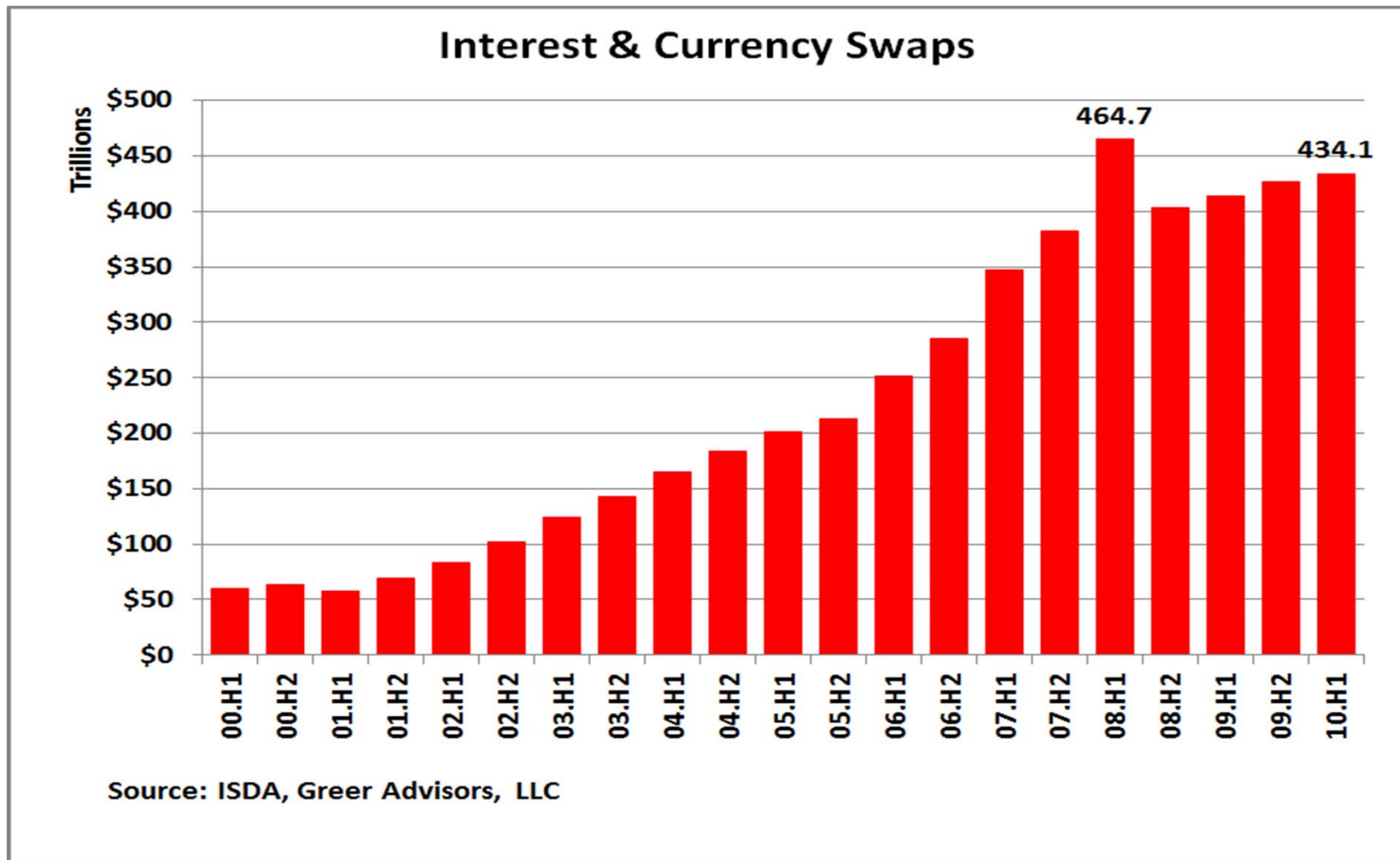
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# Credit Default Swaps



# Interest & Currency Swaps





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# Future - Mortgage Backed Security

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- If NSROs don't "**Get It**" Feds could replace them
- '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 "1<sup>st</sup> Loss / Good Faith" position
  - 60-80% of pool will be AAA, not 90+%
  - Buyers of paper will "re-underwrite" pools, regardless of



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# Future of Banking

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**Past Two Years have Shown largest lending decline in history - see FDIC QBP**

**CMBS and Banks Loss Rates - All Time Highs**

**Separation of “Best of Best” Class A vs. Class B/C**

**Deleverage – Expect More for Class B/C**

**More Restrictive Covenants for REITs, CMBS**

**“R” word for Loans (recourse)**

**Capital Ratios – Leverage – QE2**

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# Conclusions

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- MBS Market – Spreads are 10-100x higher than 1/07
- MBS – New Business Model will Arise
- REITs – Virtually Recovered
- Many Lenders Closed, Stopped or Reduced Lending
- Insurance Companies and Fannie/Freddie Lenders are Active
- CASH IS KING! Cap/Yield Rates Have RISEN for Class B/C
- Value Growth will Lag Rent Growth – by a Lot
- Rents / Vacancies Remain better than early 1990s
- Real Estate Cost is **NOT** the Largest Cost of Business!!!

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## Quote of the Day

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“...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



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## Greer's 3-Year Forecast as of 11/16/2010

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- Borrowing Rates will Continue to Rise. More banks will fail.
- Margins (to 10 Yr Treasuries or LIBOR) will rise and settle at  $300 \pm 50$  bps over 10 year Treasuries, but might over-correct in the short run, say 10Yr 400+ bps.
- Rent Growth will Lag CPI growth by 2-6%
- Values will continue to fall 0-10%/yr thru mid-2011. Individual Market Performance will vary widely. (10-30% difference in Top vs Bottom)
- Capitalization Rates will Rise 1-3% during 2010-2012 (eg 5.0% to 7.25% = 30% decline in value)
- Declines: #1=Retail; #2=Industrial & Office; then Apartment
- Change Creates Opportunities – Build Businesses

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# Greer's Recovery Signs – Prereq's to Recovery

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- 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% 1<sup>st</sup>-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 10/26/10 (last report) index at 50.2 (1985=100)
- Risk Curve (AAA Sr. vs BB) flattens to under 500 bps. As of 11/12/10, CMBx spread stands over 9,963 bps (3.23 v 102.86)

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# Questions / Answers

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# Greer Advisors, LLC

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