ColonyCapital

Today's Debt is Equity
PLUS
a Few Suggestions to Help President-Elect Obama Ease the Pain

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It has been a tough week for leadership and an epic week for fear.

- The Big Three embarrassed themselves in front of Congress and the American Public by misunderstanding the congressional mandate – they were told to bring a **"plan" not a "plane"**
- Financial Hurricane Hydra raised a few more ugly heads
- Nationwide unemployment accelerated dramatically
- Secretary Paulson announced that he would not use TARP to buy back toxic mortgages
- Stock market took another big step back
- Citi slipped below $4 per share on fears that it would take greater than expected write-downs
- REIT equities continue to get slammed – the RMZ is down nearly 60% YTD and down over 70% from its all-time high
- CRE mortgage market trumpeted hysteria as spreads widened to historic highs in virtually all forms Commercial Mortgage Backed Securities (CMBS); AAA-rated CMBS traded as low as 50 cents on the dollar, with yields approaching 20%
- Leveraged loans are trading around 65 cents on the dollar
- By March 2009, the hedge fund industry will experience up to 40% redemptions
- Publicly-traded private equity share prices have diminished in value by up to 80%
- The holding company of CBS and Viacom blew through debt covenants
- Forex markets worldwide are peripatetic – Canada and Australia in steep decline
- Commodity markets sinking globally
- Public Pension funds and College Endowments are encountering liquidity problems as a result of diminishing asset values and the dreaded "denominator effect"
- Maxim magazine went into restructuring and Condé Nast laid off hundreds as the National Enquirer and Star magazine endure restructuring battles
- Berkshire Hathaway's five-year credit-default swap spreads have gapped out to at 475 basis points, more than triple the level two months ago – even the Oracle is not prophesying
- Yields on two-year treasuries dropped to 1% for the first time; three month T-bills traded down to a yield of 1 basis point, the lowest since 1940
- Eurozone and Russia egg-beating to stay afloat
- Arab Gulf stocks are tumbling over fear of an impending funding crisis from lowering oil prices
- Five Biotech firms filed for bankruptcy in the past week
- This week Barrons cover is "Sand Castles – Half Price Mansions" – panic from Malibu to Manhattan

And just when we thought that all of the unpredictables had passed – a tribe of African pirates in speed boats hijack a Saudi tanker for ransom – a satirical headline read: "Somali Pirates in Discussions to Acquire Citigroup"

We thought now was a good time to re-examine something we should know more than a little bit about – the Commercial Real Estate (CRE) market in general and the health of the CRE loan market in specific.

Here is the Cliff Notes summary – **Real estate is experiencing a seismic liquidity shock as a result of a complete closure of the credit and capital markets for both debt and equity. CRE and the debt which fueled its growth are in a massive meltdown.**

Let's Go Back to Find the Future

CRE is rapidly depreciating in value across all sectors and geographic regions. For the past 14 years CRE has benefited from an expanding economy and cheap and plentiful debt that was lent on aggressive terms with no recourse to the borrower. The emergence of securitization dramatically increased available leverage and reduced its cost. New equity participants flooded the commercial arena, escalating real estate values. Equity REITs became popular and produced great decade-long returns and thus increased the equity pool available for acquisitions. Supply and demand remained in check, but only because construction financing didn't fit neatly into the securitization model. For well over a decade, values continued to climb and pension funds and endowments correspondingly increased their allocations to CRE as a diversification tool and an inflation hedge. The market had seemed to have finally recovered from the hangover of the last CRE crisis and capital was pouring into the sector. As always, more capital drew novices and speculative investors that bid up all the markets. Real estate was forgiven for being the "drunk driver" along the road of the USA economy.

The Last Commercial Real Estate Crisis

The previous crisis for CRE was in the late 80s and early 90s – the result of the Savings and Loan Crash. That crisis was highlighted by an oversupply of newly-built projects which had been poorly conceived and executed by deregulated S&Ls on a purely speculative basis. As the RTC harvested and sold these properties, new owners purchased them at relatively low prices inheriting very high vacancy rates and extremely low rental rates. As demand inched its way back from 1993, new owners would lease space for relatively short terms at whatever rate they could achieve with the hope that when those initial lease periods expired, demand would have increased and rents could be raised significantly. It was at this rental rollover that a refinancing could take place and capital could be extracted from these projects on a tax free basis. (This tax-free refinancing is also one of the drivers of borrowers' demand for debt and securitization vs. sales.)

How Did Wall Street Get Involved?

There was very little institutional capital interested in real estate in the early 90s. Most of the institutions had been badly burned and so capital had to be formed through another vehicle. In addition to a few contrarian distress buyers such as ourselves, Wall Street rolled out an old engine, polished it, refined it with low leverage and new acronyms like FFO and AFFO, and most importantly lobbied for an all important tax break for property owner debtors. Interestingly, the resurgence of REITs was not truly due to a rush of interested public capital, rather it was the solution of choice for large property owners and developers who had repurchased their debt from defunct banks and savings and loans at tremendous discounts. These REIT sponsors were able to transfer their assets on a tax free basis into a REIT vehicle in return for OP shares and avoid the horrendous tax recapture and forgiveness of indebtedness tax liability that was generated by the discounted purchase of their own debt. This is of note because **forgiveness of indebtedness income** will be a huge upcoming issue for the borrowers attempting to buy in their own debt in the current crisis. It is also of note because now, as in the early 90s, institutional real estate owners have exceeded their allocations to real estate as a result of the "denominator effect" and their shrinking asset base. **Who are the new equity suppliers of the current crisis?**

Debt securitization had been used in the residential market since the 70s and the technology was well engineered by Fannie and Freddie. The RTC had launched a few securitizations in the early 90s and this started the commercial trend. The architecture and engineering kept being refined from the beginning of the 90s until another major breakthrough for the securitization market took place towards the end of 1997.

The Quantum Leap for Securitization was the Repeal of Glass-Steagall

In 1998, the USA Congress repealed the Glass-Steagall Act which had previously prohibited commercial banks from selling securities or engaging in other investment banking services. You may remember this was the era in which Sandy Weill combined Travelers (insurance company), Smith Barney (broker-dealer) and Citibank (commercial bank). This was the opening gun to the largest boom in real estate securitization and lending in history. Wall Street weighed in like a 10,000 pound gorilla. The repeal of Glass-Steagall allowed the banks to originate commercial loans, batch and bundle them, carve them into tranches, induce rating agencies to create rated levels of securities within those commercial mortgage pools from AAA (highest investment grade) to NR (not rated) and then sell these securities to yield-hungry investors who had previously not been interested or enticed into buying whole loans.

Add Some Positive Fundamentals

By 1997 the real estate market had stabilized and a metamorphosis took place in the fundamentals of CRE. First, there was a dramatic increase in demand for office, retail, hospitality, industrial and multi-family, pushing rental rates higher. What made the situation even more attractive was that nothing new had been built since 1990, so available inventory was contained. Owners of existing buildings with lease expirations in 1997 found that they could substantially raise rents. Simultaneously, the "good banks" which had been re-equitized in the early 90s had clean balance sheets and were now focused on producing earnings. The best way to do this was to lend money and an upward-trending real estate market created the perfect quarry. Lenders were back in the game and the perils of the 1980s real estate debacle were all but forgotten. The big bank attacked the opportunity through originating and securitizing mortgage debt. The regional and community banks were not invited to that party and consequently supplied acquisition and development, construction and mini-perm loans to the B and C projects that did not lend themselves to securitization.

Now Add the "Green Machine"

Then came the tech wreck of 2001which forced Alan Greenspan to open the Fed floodgates of easy credit policy which inflated the residential and commercial bubble. What followed were the boom years of securitization, 2002-2007, and the market was dominated by commercial and investment banks acting as a conduit in which loans were funded, bundled, tranched, rated and sold.

Where is the World of Commercial Mortgage Backed Securities Today?

In order to understand the state of the CMBS market we need to take a few minutes to look at securitization and the players that participate within it:

Originating Bank

- As a simple illustration, a bank could fund a $100 loan using $5 of equity and $95 of debt (95% advance rate or 20x leverage – note that investment banks were using up to 30x leverage).
- During the boom, the bank could earn $1 (1.0%) for the loan origination fee and $2 (2.0%) for selling the securities at a lower rate than the underlying coupon of the loan. In the boom days, a bank could make up to a total of $4 (4.0%) on the whole securitization process.
- Assuming overhead is $2 (2.0%) and the cost of the debt is offset by the mortgage interest income while the loans are accumulated, the bank could make an **easy 20-40% profit on their $5 of equity**, while effectively retaining no risk as they were able to push 100% of the loans to CMBS buyers.
- An insatiable demand for both cheap mortgage debt and CMBS securities allowed the bank to package and sell each $100 loan in large pools within 30-60 days of origination, allowing it to recycle the $5 equity invested 6-12x per year – pushing ROE well above 100%.
- Once banks realized the profitability of these securitizations, competition became rampant and as usual, underwriting standards were sacrificed in a desire to source more product.

CMBS Investors

As much as 88% of recent fixed-rate conduit issuances were rated AAA, giving investors exposure to real estate debt in the form of a bond that seemingly had the same risk profile of a US treasury bond, with a higher yield and favorable risk-based capital treatment.

- AAA tranches also yielded a 20-30bps premium to similar corporate and RMBS bonds.
- Investor base primarily consisted of life insurance companies, pension funds, hedge funds, SIVs and money managers.
- Structured Investment Vehicles (banking alchemy) were created by originating banks to purchase AAA securities off their balance sheets into non-consolidated silos that would not require them to carry the corresponding liability. This was yet another technique to lower risk-based capital requirements and increase profitability.
  - Life insurance companies gobbled up AAA CMBS, which only required a 30bps capital charge, while whole loans, which used to be their bread and butter, required 3 to 7 times greater capital reserves.
  - SIVs, money managers and hedge funds had access to leverage even cheaper than the yield on CMBS bonds, allowing them to make huge returns off thin spreads with enormous leverage.
  - Mezzanine tranches (AA+ down through BBB-) were taken down by life companies, commercial banks and pension funds looking for yield and relative value – at the cost of incremental risk. More recently, CDOs, hedge funds and other "fast money" investors became active investors. Leverage on leverage gave birth to CDO^2.
  - Below-investment grade securities were sold to B-piece buyers – initially, experienced real estate investors affiliated with large financial institutions. The application of CDO (re-securitization) technology to CMBS introduced a new breed of financial buyer, pushing yields down and savvy real estate investors out of the market.

Real Estate Owners (Borrowers)

- The securitization machine lowered the cost of commercial mortgages; much as it did in the residential market. CRE owners quickly took advantage of the cheap debt to turbocharge their returns by purchasing CRE with less equity and refinancing existing mortgages to reduce their rates and cash out built-up equity on a tax-free basis.
- This virtuous cycle of cheap, plentiful debt, in the context of a very low interest rate environment, allowed investors to pay more for CRE assets, artificially increasing asset values to unprecedented levels that proved to be unsupportable once the source of debt was eliminated.

Rating Agencies

- CRE mortgage securitization was enabled by the rating agencies.
- Many investors did not bother to do any property level underwriting; choosing to outsource their due diligence to the rating agencies and picking up bonds that suited their tastes.
- The incredible irony is that the issuers paid and chose the rating agencies that issued the highest ratings, a clear conflict of interest that is manifest in the path of subordination levels over time.
  - Total revenues for the three rating agencies (Moody's, Fitch and S&P) doubled from $3 billion in 2002 to over $6 billion in 2007.
  - Moody's profit quadrupled from 2000 to 2007 and had the highest profit margin in the S&P 500 for five consecutive years.
  - Rating agencies were coach, player and referee.
  - No one was rating the rating agencies.

Master Servicers and Special Servicers

- Master servicers and special servicers are designated administrators of the pool.
- A master servicer oversees the pool, collects loan payments, maintains records, escrows taxes and insurance premiums, provides investors with reports and makes protective payment advances on behalf of the trust (subject to a recoverability standard).
- The special servicer is usually designated by the B-piece buyer and is responsible for foreclosures, restructurings or work-out loans that become delinquent. B-piece investors usually control the activity of the special servicer and both servicers are paid servicing fees.

- There is a complicated mandate based on cash flow flowing sequentially from the most senior and highly rated class (AAA) to the most junior (non-rated) classes with losses running in reverse sequential order.
- Default rates on CMBS have been at historic lows and CMBS has never faced a crisis like the current one. It is really important to understand that the tools of a special servicer have actually never been tested in such an impending work-out environment. **This will be a real challenge in the current crisis**.

Refinancing and Maturity Risk Is Upon Us

Loans securitized in fixed-rate CMBS pools generally feature a 10-year term and are pre-payable only through defeasance. Because of the arduous prepayment provisions, collateral securing these loans tended to be more highly stabilized. The bulk of fixed rate CMBS loans trading today were originated in 2001-2005 and will consequently begin to mature in the next few years.

Loans securitized in floating-rate CMBS pools generally feature a shorter, five-year term with much more flexible pre-payment provisions – frequently allowing for par prepayment within the first 12-18 months of origination. For this reason, the collateral securing these loans tended to be more transitional. Borrowers frequently refinanced floating rate loans within 12-24 months of origination, allowing them to monetize value creation and often cash-out invested equity, often several times over. Given its shorter term, maturing floating rate CMBS will reflect more of the underwriting excesses of recent years than their fixed rate counterpart.

Pro Forma Loans

As the market became more competitive underwriting standards were sacrificed in reliance on the argument that default rates on commercial properties in 2006 and 2007 were at historic lows. As a consequence, originators underwrote loans that did not have sufficient income to service the debt giving credit to pro forma ramp-up. Loans were up-sized to include an interest reserve to pay themselves interest until the property was able to do so. These loans are almost exclusively found in a floating rate CMBS pools.

A large majority of the pro forma loans were 2007 vintage (37% of floating rate securitization volume that year) and the interest reserves have been drained as the pro forma rents were not attained. **Bottom line is they are out of positive coverage and cash flow.**

Other Current CMBS Issues?

The cause of the CMBS meltdown was a simple follow-on tremor from the subprime and prime residential freeze. **Interbank lending stopped, distribution of securitized product no longer flowed, and originators were stuck with warehoused and unsold product**.

Additionally, there was no real organized exchange in which CMBS traded, buyers relied upon the brokers that sold them the product to create a secondary market. Once the financial meltdown started, the brokers were **unable to create a fluid secondary market for this product and yields started to widen**. Further, many foreign buyers had believed that the brokers had tacitly guaranteed to create a secondary market, which of course they did not.

Mark-to-Market accounting has been the inescapable palsy upon the CMBS market. As spreads started to widen the value of the held bonds deteriorated and owning institutions would be forced to take write-downs and correspondingly increase capital. In many instances, this caused the owner to sell more bonds to fix their balance sheet, which further pushed pricing down and the scenario continued. This is commonly referred to as the **death spiral**.

To further aggravate the situation holders of CMBS found that there **was no market for the junior securities forcing them to sell the senior securities.** By this time there were fewer buyers, again driving prices down. As a consequence of all this, what they were left with were the less liquid junior securities.

Sell off as a result of deteriorating MTM has simply led to further price declines and dispositions. Money managers, hedge funds and SIVs had MTM leverage and short-term debt and were hit with margin calls.

Credit Concerns Have Now Appeared To Form The "Perfect Storm"

Liquidity issues and technical MTM accounting problems are now being confronted by true credit concerns that are being presented by the recession. As a result, spreads on CMBS securities have blown out to historical highs causing tremors throughout the credit markets.

At first, pundits believed that the volatility in the CMBS market was as a result of Secretary Paulson indicating that he would no longer use TARP money to buy the toxic assets. The market had been hoping that TARP would set a floor to valuations and thereby induce liquidity.

Other analysts believe that the blow out in spreads was primarily due to unjustified fear and that there was no structural reason to be concerned. They argue that while delinquencies are creeping up, they are still well below levels of prior downturns. In spite of this argument, AAA CMBS spreads, which have historically traded at an average of 70bps over 10-year Treasuries, were trading at 1500bps over on Thursday.

Both the equity and credit markets are clearly pricing expectations of weakened fundamentals across every class of commercial real estate. Let's take a look at a few facts to put this dynamic in perspective:

- YTD Total returns for Office REITs is -48%
- YTD total returns for Retail REITs is -55%
- YTD total returns for Lodging REITS is -66%
- YTD total returns for Industrial REITs is -82%

Many REITs will not be able to continue cash dividends and meet their go-forward cash and refinancing needs. Since REITs have to distribute most of their income, they can not retain earnings to pay off principal on debt and keep AFFO payout at past levels.

All office tenants are suffering and correspondingly wanting to pay less for space. The largest tenants of office space are financial institutions, service providers such as accountants and lawyers, technology and industrial users. Massive consolidation throughout the financial sector has had significant knock-on effects throughout the service and other sectors. All of these users are attempting to reduce costs by giving back space and demanding lower rental rates since they cannot control revenues in this spiraling economy. Tenants are also increasingly looking for short-term leases in order to avoid any long-term commitments.

Sales transactions are off by 95% year-over-year in all sectors. Only sales taking place are hanging over exchanges that are tax deferrals. As a consequence cap rates are certainly creeping higher but since there are so few buyers no one really knows what an appropriate cap rate is. **A cap rate is the price that a real buyer will pay and there are none to be found.**

The retail sector is also suffering as a result of the consumer not consuming for lack of discretionary income. We have seen the effect on retailers: epic bankruptcies, massive closing of stores and outlets and dramatically reduced or stopped expansion plans. This results in directly negative sales growth and occupancy across the retail real estate sectors. Share prices for retail REITs have taken a serious beating with companies that have maturing debt leading the pack.

Hospitality, Industrial and Multifamily are all experiencing similar down drafts.

Are Default Rates An Accurate Indicator Of The Health Of The Industry?

Real Estate is slow moving business. Let's take an example of a B quality retail mall, Blackacre, with a CMBS Mortgage in place administered by a master servicer and a nationally recognized landlord. The tenant, who is a recognized national retailer, is renting space from landlord at $450 per sq. ft. minimum base rent, 2% percentage rent, pro rata Common Area Maintenance (CAM) costs and has paid for his own Tenant Improvements (TI). The tenant has predicated his rent payment upon his ability to sell $400 per sq. ft. of goods. In 2006, the tenant is experiencing sales equivalent to $450 per sq. ft. and is happily paying base rent and CAM expenses with total occupancy costs below 15% of gross sales. In January of 2007, the tenant reforecasts annual sales of $300 per sq. ft. of goods and starts getting concerned. He calls his suppliers and reduces inventory, he extends his payment terms to them and trims his advertising budget. No need for him to speak to his landlord and no need for landlord to speak to the master servicer of the mortgage.

In April of 2007, the tenant reduces annual sales forecast to $250 per sq. ft. of goods and now is more than concerned. He gets rid of his warehouse, further reduces inventory, puts goods on sale, and drags his CAM payment for a month. He still pays rent to the landlord and landlord in turn to master servicer.

In July of 2007, the tenant is on track for annual sales of $150 per sq. ft. and does not have enough revenue to pay the rent. Since the tenant is a national brand he makes the rent payment even though the store itself is not generating sufficient funds. Now, he goes to landlord and says "We are having a problem." The landlord tells him things will be better and the landlord will increase marketing budget, change merchandising of other stores, add kiosks and valet parking and switch theatre companies to increase traffic. The tenant takes a **wait and see** approach and drags CAM expenses longer, as well as starting to question the landlord on CAM reconciliations.

By September of 2007, nothing has changed and the tenant is tired of paying base rent from revenues derived elsewhere. Now he goes to landlord and says "I am done." If you want me to stay I will go to percentage rent only and no CAM expense. The landlord has many other tenants on the edge and does not want to deal with empty space so he renegotiates a deal with the tenant. Still the landlord makes the payment to master servicer.

The cycle of deferral and renewal of and hope is the same for the landlord in continuing to make debt service payments. The problems may have started over a year ago but do not show up in terms of a default for a long while. By the time defaults become transparent, problems have been stirring for a long while.

When default rates are the lowest they only have one way to go and the market is smarter than the statistician of default rates. The market perceives trouble is roaring down the pike. And it is.

"Go where the puck is going, not where it is" – a famous Wayne Gretsky quote of real value in anticipating these markets.

How Deep and How Long is this Trouble?

Simply put, at the height of the market, CMBS pools were originated at an average 70 - 75% loan-to-value ratio. If asset valuations drop 30%, the pro forma loan-to-value would exceed 100%, meaning the equity is entirely wiped out.

If you then applied this diminution in value and corresponding increase in LTV to a bond structure, life becomes interesting. Recent vintage fixed rate AAA-rated CMBS bonds generally feature 12% subordination (meaning 88% of total debt has been rated AAA). However, the AAA themselves are divided into subtranches with greater subordination characteristics. Super-senior AAA (AS) carry 30% subordination, AAA Mezz (AM) carry 20% subordination and AAA junior (AJ) carry approximately 12% subordination. Note that these designations and subordination levels were developed not by the rating agencies but by investors who refused to believe that 88% of these structures were worthy of the AAA rating assigned by Moody's, Fitch and/or S&P.

Let's put these subordination levels into perspective with regard to pricing, potential collateral losses and preservation of capital. Today, AJ (12% subordination) bonds are trading in excess of a 20% yield-to-maturity (30-35 cents on the dollar). At this pricing, cumulative underlying collateral losses of 18% would eat into the investors' basis. AM (20% subordination) bonds trade at up to 20% yield-to-maturity (40-45 cents on the dollar), suggesting that these investors' basis would face losses at cumulative underlying collateral losses of up to 24%. The diminution in values to reach losses that will pierce the "riskless" AAA threshold can easily be reached when the downdraft in fundamentals is mixed with a tornado of illiquidity. Empty space is very unforgiving and requires large go forward capital commitments to repair. Rehabilitating tenants will be tough and all capital will have to come from the landlord. It could be more severe than what even the market perceives.

What is CMBX and What Does It Do?

CMBX has also been an issue which has caused volatility in CMBS. The CMBX is an index of 25 CMBS securitization trusts that is utilized as a collateral reference to buy and sell protection under Credit Default Swaps. It was originally designed as a tool for CMBS investors and market makers to effectively hedge their positions in the cash CMBS market. Amidst an illiquid cash market, CMBX has assumed significance as a

pricing reference for CMBS securities. However, CDS are issued utilizing the reference without the necessity of actually having to buy the underlying CMBS security. Consequently, a buyer can gain synthetic credit exposure to a diversified portfolio of CMBS by selling protection (long position) or buying protection (short position) to hedge long cash bond portfolios or express a macro view on commercial real estate. Recently, cash bonds have traded at yields well in excess of CMBX spreads which calls into question the correlation between the two and also underscores the dearth of liquidity in the marketplace today (cash bonds don't have the inherent leverage of the CMBX market).

I have attached two "back of the napkin" charts which I used to explain CMBX to one of my Chinese friends. However, the main take away is that the index itself is one of the few reference points for MTM of CMBS securities themselves. Consequently, it is possible that by implementing a small transaction in CMBX one can effect the actual MTM accounting of all underlying CMBS securities. The present gross notional value of outstanding CMBX CDS contracts is about $270 billion.

Non CMBS Commercial Mortgages Are In Even More Trouble – Regional And Community Banks

The CMBS market is about $750 billion of CRE. There is over $2 trillion of commercial mortgages held in community and regional banks. **These banks, due to their size, were not invited to play in the securitization game. As a consequence, they had to source whole loans from their communities**. Usually these were of lesser quality and higher risk – otherwise these borrowers would have accessed the cheaper, more plentiful CMBS market. They consisted of acquisition and development loans, construction loans and mini-perms. Many of these banks have CRE as a large percentage of their portfolio. These smaller, geographically specific, value-added projects are the most problematic in the midst of the kind of recession we are now experiencing. The good news for the banks is that they have been able **to carry them at cost** since most of these loans are considered to be held to maturity. Many of these loans are currently in trouble and have not yet been sufficiently written down. The five regulatory agencies which supervise banks have been busy working on the big guys and are just now getting to the 3,000 or so community and regional banks. When they do however, they will scrutinize these loans and start the process of a true mark-to-market by making banks take adequate reserves. This can be the next great shoe to drop at the heel of the CMBS scare.

There are no refinancing sources for real estate today at any loan-to-value. Maturity risk is being out-paced by credit risk and it is unclear what return equity capital will demand to enter the real estate market at this point.

Foreign buyers have shunned CRE due to the punitive aspects of FIRPTA (a 30% withholding tax) which is applicable only to their investment in real estate.

Work-outs Will Be The Norm

Lack of viable refinancing options will force a majority of these loans into extensions and workouts which will be quite a mess. Many borrowers have significant tax problems in losing a property or incurring **forgiveness of indebtedness income** to the extent they buy back their own debt at a discount. Special Servicers as well as banks have lost their work-out teams and no longer possess the expertise or tools to timely restructure the massive amount of restructurings with which they will be confronted.

The Bottom Line?

CRE will suffer greatly in the near term, will struggle for refinancing options in the mid term, but will excel in the long term as a result of limited supply and eventual renewed demand. Well positioned properties in A and B markets which have been reasonably leveraged will be fine.

Realized losses in CMBS portfolios may hit or exceed subordination levels previously thought impossible and the complications of working through unproven structures with a special servicer will not be simple.

Many regional and small banks will be crushed by the weight of failing loans, especially of the CRE flavor.

The greatest opportunity is in surgically carving through complicated debt structures and being prepared to fund "non-milking cows" in the short term. This will be a **$2 trillion redistribution of real estate wealth** to those who have patient, non-mark-to-market capital and a restructuring tool kit.

Most real estate investors will be on the sidelines. Institutions will be overallocated, core and value-added funds will be handling their own issues, REITs are not structured to take advantage of this part of the cycle, Foreign investors are stymied by FIRPTA and volatility in exchange rates. This crisis will be more complicated than the early 90s, given the multiple constituencies involved with present structures: borrowers, master servicers, special servicers, trustees and myriad classes of investors with different motivations based on the specific priorities of their tranches within the securitized debt stack.

A Few Humble and Respectfully Submitted Suggestions To President Elect Obama With Regard To Commercial Real Estate

1) Shelve TARP!!!! **Create an RTC2 to harvest the toxic commercial debt**. Use the remaining $410 billion form TARP for direct capital infusion for those banks that should survive. Close and force consolidation for those that should not! The equity capital should be invested after write-down of the target bank's assets, transfer of bad assets to RTC2, dilution or extinction of existing shareholders and replacement of existing management. TARP capital should provide for matching side by side investment of private capital, which would provide an additional advantage of new management and governance.

   Good bank-bad bank structures should be revived and there will be great liquidity from the private sector as shareholders of a bad bank if the assets are transferred at the equivalent formula of the old RTC-defined "Derived Investment Value" (DIV).

   a. The defining of a DIV process will also set a bottom for the mortgage market and a method to calculate tradeable value as a percentage of DIV. This is the only way to truly find a market price. Mark-to-Market is a self defeating and useless process.

   b. The RTC2 will create a bottom for the mortgage market and private market trading will commence soon thereafter.

2) Empower one super regulatory banking agency (i.e. FDIC) which has seniority on the other 4 banking regulatory agencies. Get rid of the interagency warfare. Arm this agency with the ability to write forbearances, issue capital certificates to bolster balance sheets and rewrite Regulatory Accounting Principles and Risk-Based Capital Rules.

3) Banks must be encouraged to extend the maturity due date of performing commercial loans. Allow banks to deduct 100% of write-downs in the year incurred and to carry those losses back 3 years and forward 5.

4) Immediately put a moratorium on mark-to-market accounting – **a "mark-to-maturity" or "mark-to-cash flow" model should be adopted and implemented** immediately. The fight for integrity on mark-to-market was lost a long time ago.

5) CMBS must be included in Secretary Paulson's proposed GSE type funding facility of asset-backed mortgage acquisitions. This could be similar to those created for the money market funds and commercial paper. Funding and liquidity will relieve the **virtual losses** being incurred from trapped and stale mortgages.

6) Propose an IRS amendment which would provide a 3-year moratorium on **forgiveness of indebtedness income**. This would induce borrowers to engage actively in restructuring their own distressed debt. They are usually the best solution to the problem.

7) The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which currently inhibits foreign investment in commercial real estate should be repealed.

8) Most Important: Prior to confirming Tim Geithner (which by the way was a great choice) as your new Secretary of the Treasury make sure that he can answer the following Fibonacci mathematical problem:

   If a pair of rabbits were put into a walled enclosure to breed, how many pairs of rabbits will there be after a year if it is assumed that every month each pair produces one new pair which begins to bear young two months after its own birth?