

Financing Notes

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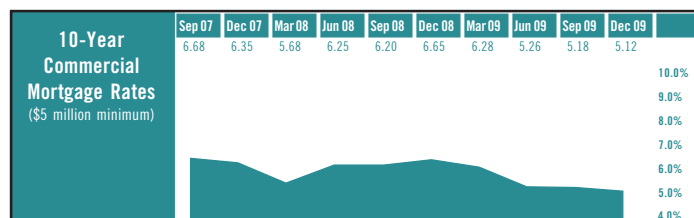
Decades ago, when investors first took to real estate as an asset class they were told that real estate was an attractive investment for three reasons: it was a hedge against inflation; rents essentially always went up because of the demand for space from tenants for growth; and, you could buy real estate with other people's money—leverage (mostly positive). As we end this decade and look to the future as to where and when we expect to find the bottom of this cycle, we have to ask ourselves if we are we in a period of inflation, deflation, stagflation or hyperinflation. Further, given the fact that our economy has lost 8 million jobs since 2007 and still has not ended job loss, the issue as to when we will reach the point where job growth will drive tenant growth is also obfuscating the value viability of the real estate asset class. Lastly, the seizure of the financial system across the globe has shaken the real estate user of capital's core belief that we really have deep and flowing capital markets where other people's money can be used for leverage.

This past year, considering their real estate investments, the user of capital finally had to recognize that the frequency and amplitude of three distinct cycles: the cycles of brick and mortar, the cycles of the capital markets, the cycles of our economy—matter, together. If we see these cycles overlaid on top of one another, where they converge is opportunity and where they diverge is risk. The risk associated with uncertain real estate values today has never been more paramount.

As we look to 2010, I posit that we must face as a new reality that none of us were as good as we thought we were. It is clear now that really low interest rates drove really high leverage and really high leverage drove bloated values. Without the leverage in the system, values have collapsed anywhere from 30 to 60 percent on otherwise healthy real estate. It's not clear how the industry will solve the hundreds of billions of dollars of loans that were extended but not refinanced over the last couple of years—but the “pig in the snake” aside—the losses must be taken and lower values, lower loan-to-values, and less velocity of transactions leads me to the conclusion that we will need less capital in the system than we believed in 2007 that we were entitled to.

The dramatic growth of CMBS during the period of 2004 to 2007 clearly came at the expense of banks, particularly regional and community banks. For higher quality properties with relatively stable cash flows, CMBS offered lower borrowing costs and greater all-in leverage. This siphoned off the better lending opportunities,

pressuring banks to become more concentrated in riskier types of lending. The situation in commercial real estate is the opposite of that in residential real estate: banks hold the riskiest commercial real estate debt. Regional banks needed growth and the local market was too hot, so they took in, as well as became participants for, riskier transactions. We can now see that it's these regional and community banks where our industry's problems lie. As recently reported by the FDIC there are 552 problem institutions with \$346 billion in assets. We as an industry have proven that whether we consider Wall Street, local banks, or the local entrepreneur, in any case, we cannot legislate against greed or stupidity.



I believe the industry came off the rails when the subordinate bond holder began “re-REMIC-ing” subordinate bonds. That was the beginning of the end because no one truly had risk in the transaction. My forecast view is that 2010 will be very much like 2009, only more volatile in the extremes of highs and lows. Part of the 2009 industry largess—“extend and pretend” driven—was that sellers and borrowers didn't really have motivations to trade. I think that during 2010 not only will motivations actually change and trigger a need to transact, but “brick and mortar” knowledge will actually get us out of this mess over time. The question I ask by comparison to the generation of borrowers in the late 80s and early 90s: does this generation of borrowers have what it takes?

My view of the past generation is those borrowers were “brick and mortar” professionals who knew how to make money from the real estate. It was a real estate business that they operated but ran into trouble when the capital markets themselves imploded. By contrast, my judgment of the borrowing community today is they are by and large capital markets financiers who lack the comparative “brick and mortar” skill set of professionals 20 years ago, to actually turn the real estate as a business around—that is what the industry needs most right now. Is the borrower “brick and mortar” skilled? Does he know how to get the

real estate turned around with stable and increasing cash flow available for debt service? Can he take the economic loss? Answers to these questions, more than any, will dictate how much longer the real estate industry toils in disaster.

According to a recent report by Deutsche Bank, the economy is now exhibiting clear signs of stabilization. They also confess that robust job growth may not appear until 2011 or later, and demand for space typically reacts with a 12 to 24 month lag to job creation. The report goes on to say that commercial real estate faces significant challenges over the next 3 to 5 years. During this period, commercial real estate fundamentals will continue to deteriorate; defaults will continue to climb; and the industry will face a severe refinancing crisis. The sooner losses are written off, the sooner assets will begin to trade and the sooner the commercial real estate market will begin to normalize. We could not agree more. And, speaking of the “pig in the snake”, there continues to be significant refinancing risk for loans that survive until maturity. A combination of asset devaluation (dramatic tightening in underwriting and financing terms and a real contraction of cash flows due to deteriorating CRE fundamentals), lower loan-to-values, and lower transactional velocity will become highly problematic for the 2005 to 2007 vintage CMBS loans. These problems are not the result of dislocated financing markets; they reflect the simple fact that the majority of loans lack sufficient equity to qualify for a loan sufficient enough to retire the existing debt. Since too few have actually faced this problem from the lending community’s perspective, there just is not enough capital to go around.

2009	30-Day Commercial Paper	90-Day CDs	Corporate Aaa Bonds	Corporate Baa Bonds	Municipal Bonds
Oct 2	0.17	0.24	5.00	6.14	3.94
9	0.17	0.24	5.06	6.22	4.06
16	0.16	0.25	5.21	6.38	4.32
23	0.16	0.24	5.16	6.30	4.31
30	0.17	0.22	5.22	6.34	4.39
Nov 6	0.15	0.22	5.27	6.39	4.41
13	0.15	0.22	5.28	6.40	4.40
20	0.15	0.21	5.16	6.27	4.35
27	0.15	0.20	5.07	6.24	4.33
Dec 4	0.15	0.21	5.11	6.29	4.24
11	0.14	0.22	5.25	6.37	4.19
18	0.13	0.22	5.26	6.33	4.18
25	0.13	0.21	5.32	6.42	4.21

Back in September, Stephen Mihm wrote in the Boston Globe that modern finance is far from the stabilizing force that mainstream economists portrayed. Rather it is a system that created the illusion of stability while simultaneously creating the conditions for an inevitable and dramatic collapse. Hyman Minsky, a hitherto obscure macroeconomist who died over a decade ago, looked to John Maynard Keynes theories, but where most economists drew a single simplistic lesson, Minsky argued that Keynes’ collective work amounted to a powerful argument that capitalism was by its very nature unstable and prone to collapse.

Minsky believed that in the wake of a depression financial institutions are extraordinarily conservative, as are businesses. With the borrowers and lenders who fuel

the economy all steering clear of high risk deals things go smoothly: loans are almost always paid on time, businesses generally succeed and everyone does well. That success, however, inevitably encourages competition and borrowers and lenders take on more risk in the reasonable hope of making more money. Minsky observed, “Success breeds a disregard of the possibility of failure.”

2009	Prime Rate	30-Day LIBOR	90-Day LIBOR	1-Year LIBOR	10-Year Treasury Securities	10-Year Swap Spreads
Oct 2	3.25	0.24563	0.28438	1.24188	3.19	0.0964
9	3.25	0.24438	0.28438	1.21313	3.25	0.2035
16	3.25	0.24500	0.28406	1.23813	3.47	0.1478
23	3.25	0.24375	0.28219	1.23188	3.42	0.2273
30	3.25	0.24350	0.28063	1.19813	3.50	0.1017
Nov 6	3.25	0.24156	0.27531	1.17000	3.53	0.1760
13	3.25	0.23875	0.27250	1.09813	3.44	0.1082
20	3.25	0.23656	0.26656	1.03375	3.35	0.1228
27	3.25	0.23594	0.26063	1.01375	3.32	0.0949
Dec 4	3.25	0.23469	0.25531	1.02938	3.38	0.1239
11	3.25	0.23406	0.25425	1.00650	3.48	0.1386
18	3.25	0.23313	0.25338	0.99163	3.49	0.1464
25	3.25	0.23188	0.24875	0.97813	3.74	0.1754

These rates are researched and posted daily at www.cohenfinancial.com—under Industry Resources, click on “Credit Market Report”.

As people forget that failure is a possibility, a “euphoric economy” eventually develops fueled by the rise of far riskier borrowers—what Minsky called Speculative borrowers, those whose income could cover interest payments but not the principal; and, those he called Ponzi borrowers, those whose incomes who could cover neither and could only pay their bills by borrowing still further. The overall economy would shift from a conservative but profitable environment to a much more free-wheeling system dominated by players whose survival depended not only sound business plans but on borrowed money and freely available credit.

This water shed moment later dubbed the “Minsky Moment”, would create an environment deeply inhospitable to all borrowers. The Speculators and Ponzi borrowers would collapse first, as they lost access to the credit they needed to survive. Even the more stable players might find themselves unable to pay their debt without selling off assets; their forced sales would send asset prices spiraling downward and inevitably the entire rickety financial edifice would start to collapse. Businesses would falter and the crisis would spill over to the “real” economy that depended on the now collapsing financial system.

What Minsky had warned about had materialized, complete with Speculative borrowers, Ponzi borrowers, and a precious few of the conservative borrowers who are the bedrock of a truly stable economy. Minsky didn’t know it but he actually has managed to explain best what has indeed happened to the commercial real estate capital markets and industry overall. Over decades we really have forgotten the meaning of risk.


Jack M. Cohen, CRI, CMB
Chief Executive Officer

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