

US Real Estate Capital Market Commentary: January 15, 2009

As evidence of a deepening economic recession continues to mount, the credit markets have shown signs of relative stabilization. And the broader capital markets have also shown relatively less volatility during the past 45 days. It is commonly accepted that the capital markets trade in advance of economy and business news. So does this mean we could be approaching the bottom of the economic downturn? Regardless of the answer, we have few clues as to the length and type of recovery we will experience. Most economists and business leaders generally expect the recovery to be drawn-out and not very robust. This uncertainty could keep investors on the sidelines, which would continue to negatively weigh on commercial property and security valuations.

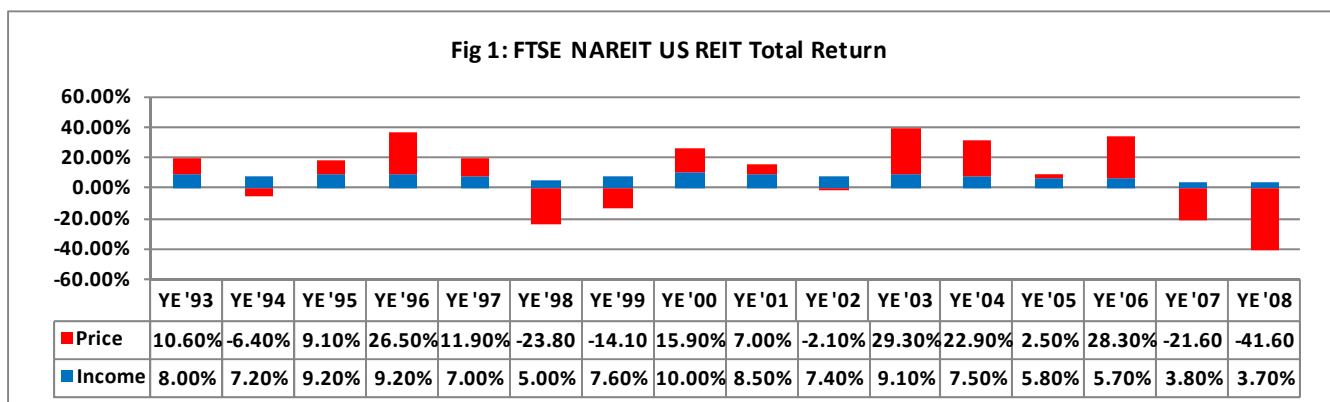
While the volatility in the credit markets may be abating, the level of systemic and participant risk remains dangerously high. We are cautiously optimistic that the Obama administration will re-ignite previous government-led market interventions geared toward stabilizing the entire banking system. These efforts appeared to have stalled during the recent Presidential transition period.

The Fed is running low on classical monetary policy tools; however the flexibility of the Fed and Treasury initiatives and Congress's desire to expand fiscal expenditures, will undoubtedly generate additional means of intervention. We welcome the desired outcome, but advise investors to remain vigilant to future non-traditional inflationary implications of such unprecedented liquidity injections. This liquidity has been appropriately used to shore up the capital positions of both large and small financial institutions and more liquidity is unquestionably needed at this time. We agree that any level of inflation in the financial markets would be a welcome relief from the recent deflationary pain, but we cannot help but raise the specter of unintended long-term consequences.

Should actual credit losses be less than recent write-downs and secondary trading levels predict, these institutions may find themselves with pumped-up capital ratios, allowing them to aggressively re-enter the capital markets. The result would be a rapid increase in the availability of money and credit. Without proper credit committee oversight, long-starved deal junkies could feast on the new found liquidity. Perhaps a long-shot from our current vantage point, but stranger things have occurred in the past 18 months.

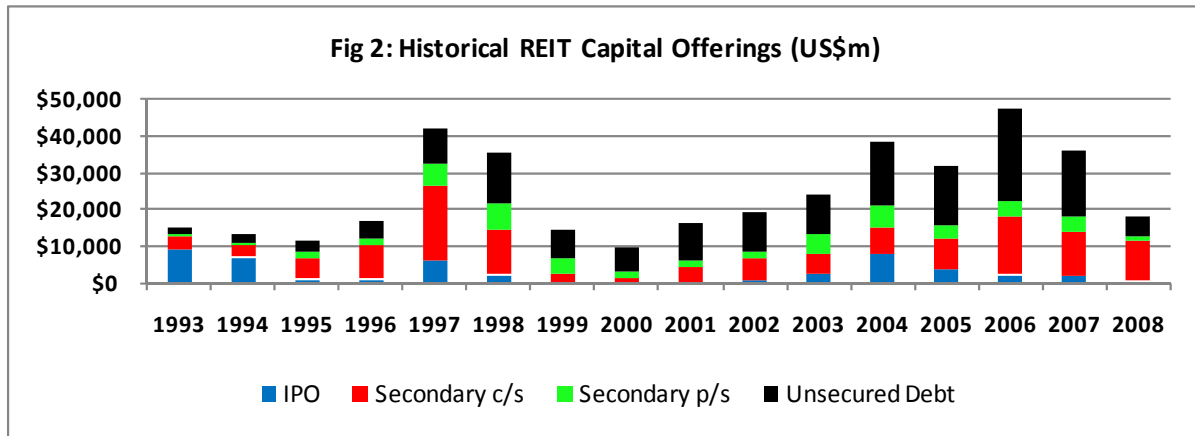
In light of this and the many other risks associated with direct government support of individual institutions, we actually prefer the growing calls for the creation of a government-sponsored "bad bank". Removing "bad loans" from financial institution's balance sheets could restore investor confidence while limiting longer-term inflationary pressures. For those of us who remember the S&L catastrophe that led to the formation of the RTC structure in the early 1990's, there are seemingly many similarities with today's toxic mortgage crises. The RTC proved to be both a quick and efficient distributor of risk and bad loans. The law of unintended consequences also came into play as the RTC ultimately kick-started the infancy of the securitization market. One wonders what an RTC 2 could give rise to in the next economic expansion.

It would be an understatement to say that 2008 will go down as the most difficult year in our lifetimes for stocks, bonds, and alternative investments. The speed and scope of which liquidity left the markets is nearly incomparable, particularly for the real estate sector. The REIT equity markets took a historical beating with 2008 total return falling nearly 38%. REIT capital offerings slowed to a historical trickle of just over \$15 billion, which was mostly driven by secondary common offerings in mid-year. Most painfully, CMBS issuance virtually vaporized with just \$12B being issued - the lowest amount since before 1995. The following three charts highlight these dramatic changes.



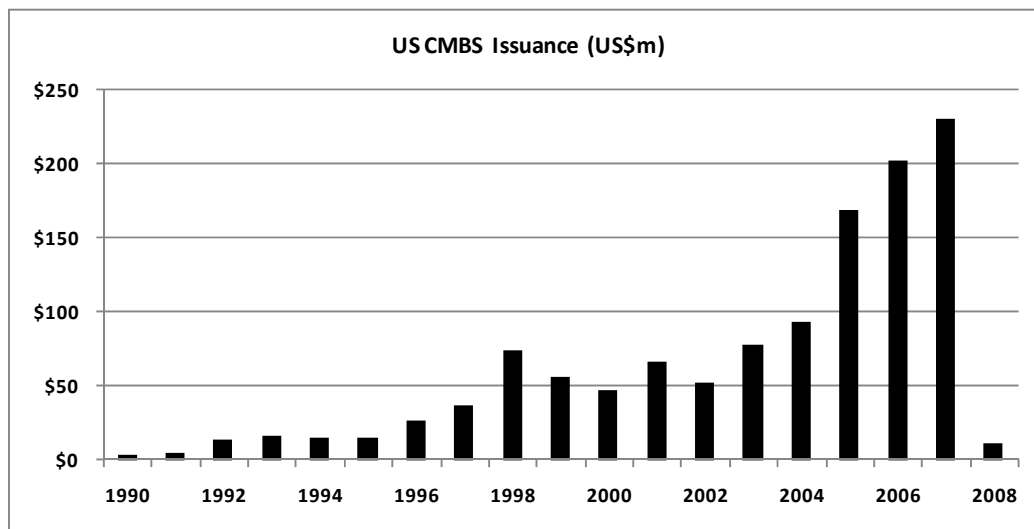
Source: FTSE NAREIT, Cadence Capital Group, LLC

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Source: NAREIT, Cadence Capital Group, LLC

Real estate is a capital-intensive industry with new money required to fund TI/LC requirements, debt maturities and of course new investments. It is estimated that there is nearly \$700B of outstanding securitized mortgage debt (fixed-rate and floating-rate; excluding the much larger portfolio/on-balance sheet market) and another \$100B of outstanding REIT unsecured debt and preferred stock. Nearly 15% of this debt matures in the next two years. We will therefore see this lack of liquidity most profoundly impacting debt maturities, resulting in a dramatic increase in maturity defaults and an increase in maturity extensions for those properties with positive cash flow coverage. We will also see a continuation of “headline” risk in the commercial real estate industry throughout most of 2009, further depressing investor confidence.



Source: NAREIT, Cadence Capital Group, LLC

The question everyone is asking is “what will it take to bring capital back to the real estate sector?” First, we would expect that once the economic impact on real estate fundamentals becomes clearer, investors would likely recognize value in the current levels of various capital instruments and become more receptive to re-entering the space. This could occur as early as mid-2009, provided the ongoing economic reports are no worse than the current reports. The broader capital markets seem to have discounted a deep and protracted economic recession at current pricing levels, which could support this thesis. Additionally, we would like to see a number of real estate bankruptcies and defaults work their way through the system. While this sounds masochistic, it will give investors confidence in the workout process and provide some sort of guidance to a “downside” valuation. Finally, structural changes in the market for securitized debt will need to be implemented.

We do not believe that all of these events will occur during the next twelve months (particularly the structural changes), but we expect that the real estate capital markets will generate better performance returns in 2009 than in 2008. Current pricing levels of CMBS debt (particularly at the top of the capital stack), REIT debt and REIT equity are compelling, regardless of your economic expectations. The key element however, is your tolerance for volatility and continued negative headlines, which will continue for the foreseeable future.



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