
Tremont Realty Capital, LLC is a nationally recognized provider of structured finance solutions to the commercial real estate middle market. Formed in 2000 by a group of senior real estate finance professionals, Tremont has over \$15 billion of transactional experience in real estate capital markets. The firm is focused on middle market direct lending and investment banking transactions with expertise in structured finance, mezzanine debt, preferred equity investment and secondary note acquisitions.

Market Commentary

First Quarter 2009

Many of us were relieved to see the end of 2008 and the ringing in of 2009. The question is - will 2009 be any better for the commercial real estate markets? The answer requires a more precise question. There are too many variables to generalize across the real estate investment spectrum. The old adage of "all real estate is local" is certainly true today. Not all geographic markets will perform the same and not all property types will perform the same. From a capital structure perspective not all segments of the capital stack will perform the same.

As we look at capital structures - where are the opportunities, if any, in today's market? From our perspective, conditions in the market for mezzanine investing have not been this favorable since...the last real estate cycle.

Several factors have converged to create this opportunity which may last for the next 18-36 months. During this period we believe mezzanine investors will be able to get equity-like returns without taking equity risk.

Here is the basis for the opportunity and our opinion:

- The disruption in the credit markets (often called the "credit crisis") has caused a re-pricing of risk. For the last several years with the rise of the CMBS and CDO markets, pricing had been determined more by cost of funds than by projected credit risk. Fundamental credit underwriting and prudent capital structures were replaced by credit ratings services and risk tranches. Transactions were sized by a projected sale execution of the loan, not the creditworthiness of the borrower or the property. Over the last several quarters spreads have widened which we attribute to a return to fundamental credit underwriting standards.
- The developing reduction of liquidity in the market. Senior lenders have clearly pulled back from the market. Loan to values (LTV's) have dropped to the 60% range. Any property falling outside of these revised standards with a maturity event is facing restructuring - less senior debt and more equity. These restructurings create a renewed demand for subordinated debt or mezzanine. Someone needs to fill the gap in the middle of the stack to get these properties restructured.
- New mezzanine structures have wider pricing, more equity beneath their loan and better terms in this environment. We expect equity to move toward 15-20% of these restructured transactions and senior debt to be in the 50-60% range. That creates a 30% gap for mezzanine lenders to fill. Furthermore, loan covenants will be more strict allowing greater flexibility for mezzanine lenders to protect their position if necessary.
- Opportunities will emerge for both acquiring existing debt and originating new debt. While we hear a lot about distressed debt, today's market does not require investors to reach down in quality to get attractive returns. Given the volume of re-financings coming over the next 2-3 years there will be little need to focus on lower quality, non-performing properties. We believe high quality; performing real estate will support these new capital structures with very attractive returns.

- Trailing 10 year returns for real estate equity investments ranged from 10-11% for core to 12-13% for value-added. In today's environment mezzanine returns are in the 14-18% range. For new allocations, we think the risk/return tradeoff favors subordinated debt over equity for the next couple of years.
- How long will this last? Most likely until senior lenders come back to the market and the CMBS market re-opens in a material way. Even then capital structures, pricing and terms will be more favorable to investors for an extended period of time. The pain of this recent credit dislocation will stay with lenders for awhile.

What will be the key performance drivers to capturing these returns?

- First and foremost is to avoid defaults. Quality underwriting of the property is the most likely way to accomplish this. The ability to understand the property at a granular level, price to the risks involved and diligently manage the asset to exit is critical.
- Market presence and an established network to source quality deals. With projected re-finance volumes the ability to access and efficiently triage opportunities is an important factor in sorting through the large volume of re-financings we are likely to experience.
- Experience in work-outs and legal remedies to protect investments. While clearly not the preferred path, in today's environment knowledge of viable options and a willingness to "roll-up your sleeves" on a specific property is a valuable risk management tool.

As investors assess their asset allocation we believe a case can be made for new allocations to the subordinated debt space. Private mezzanine debt in today's environment can provide a portfolio with added diversification and attractive cash flow from interest payments. While not without risks, they are identifiable and manageable. In many respects it is a "back to basics" investment strategy. Mezzanine lending requires a fundamental understanding of the asset, quality underwriting, pricing to assumed risk and structuring of terms favorable to the lender. It may not be as glamorous as other strategies we've seen in the last few years but it's one that can be easily understood by investors and readily implemented by professional managers.



Richard C. Gallitto

Rick is a Founder and Executive Director of Tremont Realty Capital, LLC. At Tremont he is responsible for managing origination and deal flow. He also serves as a member of the Investment Committee. Rick has been in the commercial real estate industry for over 25 years. He received an AB in Economics from Harvard University, holds a Massachusetts Real Estate Brokerage license and is a member of the MBA, PREA, ULI and ICSC.



Daniel Owen Mee

Dan is a Founder and Executive Director of Tremont Realty Capital, LLC. At Tremont he is responsible for company operations and banking relationships. He also serves as a member of the Investment Committee. Dan holds an AB in Economics from Harvard University and an MBA from Harvard Business School. He has been in the real estate industry for over 25 years, is a licensed real estate broker since 1978 and is a member of PREA, the MBA and GBREB.

For additional information please contact our strategic marketing partner:

Capital Allocation Partners
1666 Massachusetts Avenue, Suite 5
Lexington, MA 02420

Phone: 781-274-1215
888-227-9030
Email: info@cap36.com