

Richard Gallitto and Daniel Mee are the founding partners of Tremont Realty Capital, each with over 25 years experience in the commercial real estate markets. They recently commented on current conditions impacting the real estate markets and specifically the current state of the debt markets for financing real estate.

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The market seems to have slowed, have you seen this and what are the causes?

Dan: Transactions in the commercial property market are down 50-80% depending on who you poll. There seems to be several dynamics at work here, but the overwhelming issue is lack of liquidity or leverage. With less leverage, buyers must use more expensive equity and this drives capitalization rates up and values down. With values down sellers are not putting as many properties on the market and buyers seem to have a "wait and see" attitude. What's different this time around is that the driver is not an economic slowdown – although an economic slowdown has certainly occurred in some regional markets. Overall, traditional real estate lenders have less capital to commit and many are reducing their exposure to the asset class. Credit quality for real estate debt continues to remain stable on the deals we consider. At some level its the supply/demand equation we all learned in economics 101 – supply of credit is down, demand is stable so the cost of credit is higher.

What does the credit crunch mean for the market over the short-term?

Rick: Over the short-term we will continue to see a lack of liquidity and a dramatic reduction in transactions. Only high quality projects with well capitalized sponsors will be getting done.

Sounds like liquidity is the major problem for the market, any idea when that improves?

Dan: As an investor I'd call it an opportunity rather than a problem. If we can get similar credit quality with better pricing it's a great time to invest in real estate debt. As far as when senior lenders come back in the market, that's really the \$20,000 question we've all been asking since mid-2007 isn't it? Like everyone else, at Tremont, we don't have a crystal ball to

tell us exactly when things will occur. We do however have a firm understanding of "what" has to occur before senior lenders come back. First, lenders must improve their balance sheet and capital position. This will involve major write downs and loan sales. In the end we will likely see a few more failures and withdrawals from this sector and probably significant consolidation leaving fewer, but stronger remaining players in the senior lending arena.

So all we need is for banks to take a few more write downs and sell some paper and the markets will return to normal?

Dan: I think a return of normalcy will require a few more steps. Hopefully in parallel action to lenders improving their capital position, authorities and regulators will work hard at fixing the securitization market. We need the size and depth of securitization to get healthy before we have any kind of normalization. We suspect investors will need to see action on several fronts to regain confidence in the rating agencies. By the time this is over, we will likely have increased government regulation, enhanced peer review, or even a whole new oversight structure.

What changes are you seeing in today's capital structures of transactions and their pricing?

Rick: From a lender/investor's perspective we're seeing better capital structures and pricing than we have in the last 8-10 years. Equity in transactions is up, senior loans are a smaller percentage and mezzanine is filling the gap. As senior lenders have pulled back from the markets we're seeing tremendous deal flow and pricing for mezzanine is 400-600 basis points better than what we looked at 18 months ago. We are seeing debt investment funds – with debt risk – producing equity-like returns.

Have we seen cycles like this in the past? Any differences this time around?

Dan: We've been around a long time so most of us at Tremont seen our share of cycles, and have studied many more. This one will have characteristics of past cycles, with some new twists. First, this one began with a relatively stable economy in most geographic areas. Our economy's enormous exposure to securitized markets has never been tested in a major down cycle. The scale of this housing bubble hasn't been seen for over 20 years. But in terms of tightening credit and higher pricing, yes they all tend to share those characteristics.

What are the risks out there today?

Rick: The risks seem to be the usual ones in a real estate cycle. The economy weakens, occupancy drops, new projects take longer to complete and debt needs to be refinanced. Several geographic markets may be in for a prolonged slump and should be avoided. However, real estate is a very local market and there are always good markets for investing and good properties to finance.

As investment managers, what actions are you taking in this market to take advantage of new market opportunities?

Dan: The first thing we're doing is raising capital for investing. In every dislocation, there is opportunity. In this market there is a need for capital to fill the void created from those lenders who have pulled back. Our next fund will target assets fulfilling this need. Our deal flow is strong and we're confident in our ability to underwrite quality loans. The second thing we're doing is increasing our origination capacity. The ability to understand the local markets and source quality transactions is the key to making good investments.

What should investors expect from these asset classes?

Rick: We operate only in the direct lending market, so these are private market transactions not securitized transactions. That means volatility will be low compared to the public markets. Pricing is higher than we've seen in quite awhile and so returns should be good. We're looking at mezzanine loans priced in the 14-18% range and preferred equity in the 20-25% range. We also are in the market for

opportunistic bridge loans. These senior loans generally have time-sensitive closings and with our underwriting capabilities we can get a decision quickly for the right borrower. With coupons in the 10-12% range and some prudent leverage we are seeing returns in the 20-25% range.

You mentioned subordinated debt and specifically mezzanine debt, can you provide a little more information on why you like this investment?

Dan: Subordinated debt is a great asset when looking at risk/return profiles. While mezz is behind the senior lender in the capital structure, it still has the sponsor equity in behind it – and more equity is required to get a transaction done in today's market. This provides a first loss layer if you are at all concerned that the market may ebb further down. Another characteristic of mezz is what happens in the event of default. While we don't like defaults, many Tremont senior staff have significant workout experience so we don't fear defaults. With mezzanine one is able to have more control, because technically there is no lien on the property. The claim in the event of default is on the owner. Therefore, one doesn't follow a long foreclosure process as would a senior secured lender. This allows mezz lenders to very quickly step in and control the property if there's a problem.

Your firm doesn't invest in the securitized part of the market, why not?

Dan: Our core competency is underwriting the loan. In other words we are real estate debt professionals. In the case of a securitized asset, you often don't really know the specific property and the underwriting standards that were applied. In some ways you are several steps removed from the real estate and could almost be considered a bond trader versus a real estate lender. Tremont is more comfortable with our own asset specific underwriting and we only invest in actual property transactions, never in a pool of securitized transactions. If something goes wrong with loan collateral securitized investors cannot play a meaningful role in correcting the situation. As investors we constantly look at downside risk.

Any final comments or words of wisdom to investors?

Rick: While I think this cycle has a different root cause than other cycles – it is a cycle. There are usually certain points in time where market conditions present an opportunity to get outsized returns relative to historical returns. I think this is one of those times where capital structures and spreads are more favorable than they have been in a long time.

Dan: I'll also add that most opportunities usually have a finite life. Markets tend to be fairly efficient and lenders will eventually return en masse. Subordinate debt will continue to be a good asset class when that happens, but for now, it's a very good asset class.



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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.