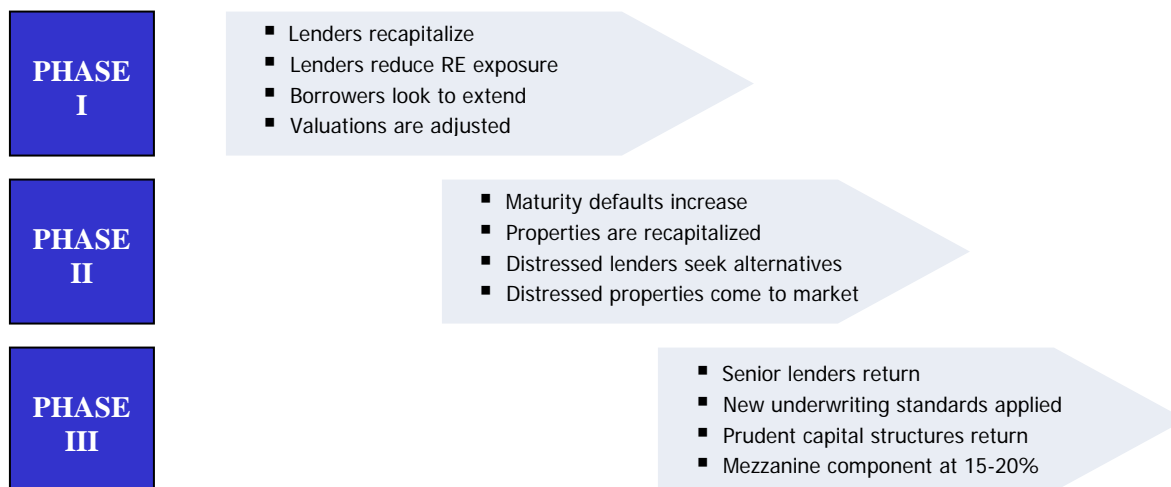


*"Well, we're waiting..."* Judge Smails to Danny Noonan. *Caddyshack*, 1980

One of my favorite movies of all time is *Caddyshack*. Those of us who have watched it more than once can recite many memorable lines from the movie. This above line was delivered to Danny Noonan by Judge Smails (Ted Knight) as Danny lines up the final putt. In this final scene, the putt sits on the edge of the cup until Carl Spackler dynamites the golf course and the putt falls in for the win.

The line also sums up our feeling on the commercial real estate debt markets. We have been waiting for some time for the debt markets to come back to life. What seems like an eternity has actually been just over a year since we first began talking about the opportunities to be presented as a result of the 2007-2008 credit crisis. However, in the last couple of months we have seen an increase in activity that leads us to believe the opportunities we have been anticipating are beginning to appear.

In the summer of 2008 we outlined what we believe are the three phases of credit opportunities presented in this real estate cycle:



Phase I is well underway and we see a marked increase in the activity associated with this phase. We are also seeing some early signs of Phase II, particularly as it relates to recapitalizing properties. While the "tsunami" of maturity defaults which will drive Phase II activity has yet to arrive, it is on the horizon. To no one's surprise loan delinquencies continue to rise in this economic environment. What is different this time is that performing loans are being extended or moving to the delinquent category. A shortage of available capital to refinance projects is colliding with capital constrained lenders looking to reduce real estate exposure. One of the major investment opportunities is with distressed lenders, not necessarily with distressed properties.

In our opinion, the market has been waiting for several factors to sort themselves out and serve as a catalyst to move these opportunities along. In this commentary we highlight a few of these and offer our current assessment:

- Waiting for the government. The long awaited PPIP program has been outlined, although the legacy loan component has been moved back into the laboratory. Many lenders with sound reasoning had waited until the program was released before making portfolio decisions. Its direct impact on the private debt markets is expected to be minimal. The real benefit we see as an investor is that the PPIP release may serve as a catalyst to get sponsors and lenders to move off the inertia that has occupied the market for the last 12 months.
- Waiting for the lenders. Over the last several quarters many lenders have been working to recapitalize their balance sheets some with the help from the government, others from capital raised through public or private sources. In addition, lenders (banks in particular) have benefitted from cheap money available from the Fed to

increase spread income which in turn has improved their ability to write-down and reserve against overvalued assets. Over the last three or four quarters the cumulative effect has provided many lenders the ability to smooth losses and their impact on income statements and balance sheets. As a result we are now seeing many of these lenders putting loans out to the secondary market. We believe this will increase for the next several quarters as reserves are increased and loan portfolios are further culled.

- Waiting for maturity defaults. This will be a key driver of investment opportunities and we are in the early part of this cycle. Estimates have this number as high as \$1-2 trillion with \$400-600 billion arriving in the next 12 months. Many of these opportunities will be driven by lenders wanting or needing to get out of the loan, many will be on performing properties. With no expectations that the securitized markets will be fixed anytime soon supply should be high with limited capital available for refinancing. This will provide investors a plethora of opportunities to sort through. Restructured properties will have new equity (15-25%), less senior debt (50-60%) and attractive subordinated pieces (15-20%) - all at valuations that will need to be supported in today's new environment.
- Waiting for inflation. With the massive amount of Federal capital injected and committed to the economy, there is little debate that inflation will soon rear its head. To date, most believe inevitable inflation has been muted by the historic levels of deleveraging on both corporate and consumer levels. However, as that impact levels off, we expect inflation to be significant. Consequently, we expect an increased demand for traditional inflation hedges including real estate and oil.
- Waiting for property values to bottom. This is perhaps the most talked about aspect by real estate investors. Depending on the source, average commercial property values are down 25% in the past year and as much as 35% in the last 18 months. This cycle now ranks as one of the most severe in the past 25 years, particularly given the speed of the correction. While we think the worst of the decline is over, notwithstanding inflation there is certainly potential for further declines in specific properties and geographies. We believe investing in real estate is a micro-economic exercise and the underwriting of individual transactions will be the primary determinant of investor returns.

Phase I and Phase II will offer investors the best opportunities for outsized returns. For early investors lender competition will be limited, deal flow will be plentiful, and premium pricing will exist. There will be opportunities to buy notes from existing lenders cleaning up their portfolios as well as to originate new loans on properties with new sponsors.

At Tremont, we believe successful investing in these opportunities will require the following:

- First and foremost is to thoroughly understand every investment. Quality underwriting of the property and sponsor are the only ways we know of to accomplish this. The ability to understand the property and the asset at a granular level, price to the risks involved and diligently manage the asset to exit is critical.
- Having market presence and an established network to source quality deals. With projected refinance volumes the ability to access and efficiently triage opportunities is an important factor in sorting through the large number of re-financings we are likely to experience.
- Knowledge and 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 the sleeves on a specific property is a valuable risk management tool.

---

**Tremont Realty Capital, LLC** is a nationally recognized provider of structured finance solutions to the commercial real estate middle market. Formed in 2000, now with six offices nationwide, 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.



**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.