

Prospects for economic turnaround

This recession has been severe and unpredictable. The Federal intervention since 2007 has simply been unprecedented and thus its full impact is for now only theoretical. This fact almost necessitates the “hedging” of predictions coming from many prognosticators. To date, the Central actions seem to have accomplished two things: 1) saved our system from complete meltdown, and 2) delayed any rapid or robust recovery. Businesses have largely de-leveraged and become more efficient (read profitable). The survivors of the Great Recession are highly competitive, which indicates they now have the capacity to expand. Moody’s reports that GDP is expected to grow 3% in 2010, 4% in 2011, and 5% in 2012, with unemployment falling to 5.5% by 2014. Demand for most commercial real estate (CRE) is positively correlated with job growth. Historical observations suggest that employment growth trails corporate profits by roughly 6 to 12 months. On a macro sense, the consensus is qualified, and predicts that if the current purported recovery has stamina, then demand for real estate will increase and health will return to the industry. Most seem to believe 2013 will be a fairly healthy year with lower vacancies, defaults and foreclosures.

In the nascent recovery, the classic engine for CRE described above, may be mitigated by interest rate and regulation risk. In the near term, interest rate risk does not seem to be an issue because it is highly unlikely that the Fed will raise rates until there is a meaningful decline in unemployment. Ultimately, rates will rise, and when this occurs, CRE values typically decline as this central component of capitalization rates expands. Interestingly, we are observing many factors that may reduce this effect. Today we are still experiencing a major credit crisis. Credit is available but in a virtual “barbell environment”. Quality assets with strong credit leases have many choices for debt and first mortgages and are often priced in the 5% range. These assets amount to less than 40% of the CRE market in terms of capitalization (in terms of actual number of CRE assets it is likely closer to 20%). At the other end of the spectrum there are transactions with less cash flow or significant roll-over risk, these have great challenges finding any debt. When they do, it is priced very wide: 50% leverage at 8-9% rates or more and often with recourse components. If no debt is available, the alternative is 100% equity with its high teen - mid twenty percent return requirements. It is highly probable that as the economy improves and real rates rise (assume the 10-year T grows to 5% from its current sub 1% level) it is reasonable to expect the credit crisis will abate and more lenders and capital will become available at more traditional spreads of about 200 basis points (but of course with new credit standards). Should this occur, the interest component of capitalization for most real estate could actually decline!

Regulation of real estate capital sources is still being studied by authorities. Most believe we will see some regulation in 2010. It is unlikely any form of regulation will increase the availability of capital in the near term. It may in fact have the opposite effect. In the long term, good regulation and increased transparency should expand real estate capital availability which theoretically should lower rates and increase values. All of these factors need to be dialed into the current re-priced market (with its below replacement cost setting) and void of new development from 2008-2011. In summary, there are a lot of competing forces at work. Which force will carry the day in terms of value movement will only be certain as more of the unknowns are filled in. Tremont believes supply and demand and the complex rebalancing of this industry will result in generally higher values in three years.

The above discussion, while accurate and robust, fails to take into account that real estate investing is, at its core a microeconomic exercise. It is not a commodity as evidenced by the reality that adjacent, identical buildings can have vastly different values due to “micro” factors. The fact is, there does exist the ability to make healthy returns in down markets (as it is equally possible to lose money in good markets) based on individual investment underwriting. Similarly, it is possible to make predictions relating to specific categories or subcategories of the market. For example, virtually every hospitality analyst today believes this segment has hit bottom and will enjoy a

slow steady climb over the next three years in terms of occupancy, ADRs, and REVPAR. Some see stronger results in business-oriented hotels versus resorts; but the overall trend has consensus. The takeaway is that it is difficult to market-time real estate. If you recognize that this is a special asset class with unique attributes, you should back managers with certain skill sets who possess multi-cycle experience and who can achieve above average returns on a risk adjusted basis across economic cycles.

New construction prognoses

New development, especially speculative development will be rare over the next three years. There will continue to be development for medical/educational/institutional users and specific build-to-suit situations as needed. Multifamily development already makes sense today in certain markets especially with some subsidized elements. Overall, reduced development is due to many factors including: a) over supply in many residential areas, b) the recession has created certain slack in the CRE industry and this vacancy must be absorbed before new development can make economic sense, c) value corrections in place today that have current values priced at less than replacement cost, making new construction uneconomic, and d) the ongoing credit crisis means many alternative choices for active lenders. It is not surprising that these lenders shun most opportunities with significant construction risk.

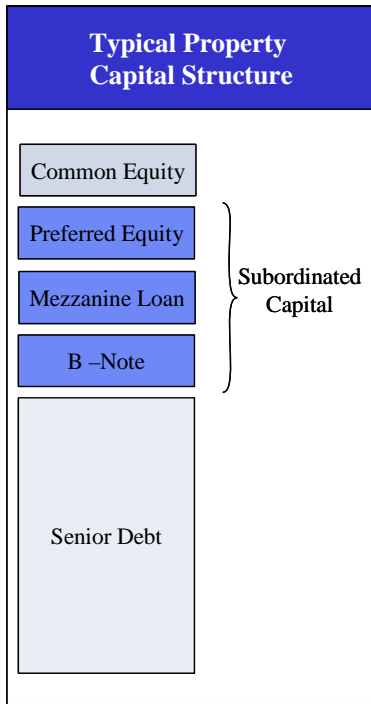
Does the recovery in REITS prices signal a new bull market in real estate and mandate a rush to invest in this asset class?

We believe there should never be a rush to invest in any environment, or at any time. That said, we know there is certain CRE market opportunity due to the lack of senior debt, distressed portfolios, and general market dislocation. Markets often react to “perceived upside” relatively quickly (as evidenced by the current stock market run up). Therefore, if there are continued signs of economic recovery, and/or the debt markets look like they are stabilizing we can expect it to become more difficult to achieve a greater than “normal” risk adjusted return. At Tremont, we believe this unusually dislocated period will exist for the next 18-36 months. The 2010-2011 CRE market will not be stabilized. It will be fragmented and give rise to opportunistic and off-market situations that provide above average returns. During this period, banks and special servicers will get busy with the needed process of cleaning their balance sheets of busted deals and ORE. This will result in an uptick in new transactions, re-priced to today’s dynamics (i.e. in general at cap rates 200+ bp wider than PC (pre-crash). Distressed investors will have opportunity during this period, but these investments could be problematic if real health is delayed, and a leveraged strategy is pursued here.. Core investments are priced very tight today on an income basis. We’re seeing core caps in the 5-6% range, (i.e. at 2007 levels), due in some measure to the lack of well located, stabilized assets. However, if you note core assets are mostly trading at 50-70% of replacement cost, and at some point it is reasonable to expect a “pop” in value.

On a basic level, it is sometimes difficult aligning REIT investment even with real estate investments. For example, when a REIT stock market value is close to its underlying real estate value it’s usually an accident or coincidence. There are so many other market factors that impact REIT stocks that while it’s a nice data point, we do not generally believe the REIT market equals the CRE market. As we all know, REIT stocks are equities, not real estate. Historically, REITS stocks have performed inversely to real estate fundamentals. REITs sold \$15.6 billion in stock in 2009 much of which was mostly used to de-leverage their existing portfolios. The REITs do have capital to invest, but this money is largely targeted toward core assets in major markets. That said, the recent REIT price recovery has some merit. Most believe that the new world will be significantly less leveraged than PC. REITs have historically been low leverage investors with access to the least expensive form of equity, thus REITs would seem to have a distinct advantage in the new market dynamics. It is still unclear if this advantage justifies the run up in price.

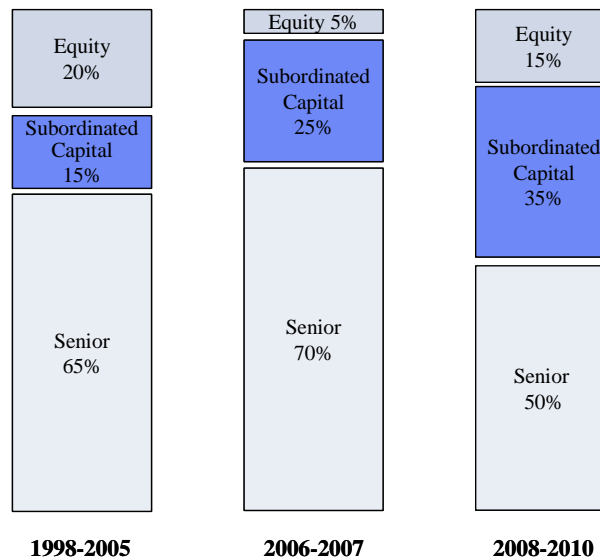
New Real estate financing and debt structures

As the chart below illustrates, senior lenders have pulled back creating greater demand for subordinated capital in addition to significantly more sponsor equity that is required.



Changing Conditions

- Excess liquidity, non-traditional lenders, and loan securitization all contributed to relaxed underwriting standards.
- Today's senior debt providers require more equity and lower LTVs.



One of the more troubling aspects of the overheated 2006-2007 CRE debt market involved the fact that many lenders funded or partially funded themselves with very inexpensive CDO/CLO debt vehicles. Lenders who were able to create exotic financing instruments were driving the overall cost of subordinated capital downward. Effectively, these loans were priced to the lender's cost of capital rather than to the inherent risk in the real estate investment itself. This was especially frustrating to us at Tremont, for we believe that these types of real estate investments should be made by real estate professionals, not financial engineers. We are now seeing life companies generally maxing out at 50-60% leverage and banks stopping at about 70%, but with some recourse. The new Commercial Mortgage Backed Securities (CMBS) product is anemic (maybe \$8 billion in 2010 volume vs. \$200 billion in 2007.) It is also more akin to Life Company lending than the old CMBS lending in terms of deal quality--but with max leverage approaching 70%. It is very unclear what the new CMBS market (read post Congressional intervention and investor feedback) will ultimately look like with: a) more Fed regulation, b) covered bond requirements, c) rating agency restructure with peer review or other, etc. In any event, we do not expect the CMBS market to ever approach its heady days of 2007; simply due to the fact that the majority of B piece buyers (SIV, CDO, CLO and their "squared" offspring) are unlikely to return for a very long time. So the big question is who will fill the missing source of financing. I believe new private lenders will continue to emerge, and these will play meaningful roles throughout the capital stack. Debt structures are and will continue to be more conservative, but that does not mean simplistic. Many investors appreciate the benefit of tranching debt especially when fully transparent with clear inter-creditor agreements. Subordinate capital will play a more significant role as the need for gap capital has increased. Mezzanine capital, formerly thought of as high leverage, is now better defined as "middle of the stack" capital. Loan terms from all lenders will include far more conservative terms than the last borrower-dominated generation. Reserves, coverage tests, recourse (both hard and springing) are all finding their way back into loan agreements.

Federal intervention success status

The US Government has worked hard to devise numerous programs in an effort to, a) halt the free fall we were in, and b) jumpstart the economy going forward. These programs were primarily sponsored by the Federal Reserve, the Treasury and the FDIC. Space here does not permit an exhaustive review of all programs. Having spent five years of my career at the FDIC, let me address it's response to the crisis first.

The FDIC is dealing with a very different landscape than the late 1980s and early 1990s. Back then, bank portfolios were generally not terrible. Most assets had some cash flow so you often had something to structure a workout around. From 2003-2007, most real estate with cash flow went to securitized lenders for the better rates and terms. The banks were generally left to everything else: land, development, lease up, etc. Thus, bank portfolios today are dominated with non-cash flowing loans that continue to burn through their interest reserves. The FDIC is a much smarter institution today because it studied and learned from the last cycle. Chairman Blair is not afraid to admit a mistake and correct problems. She also is happy to stand up to the Treasury and the Fed. This time the FDIC is consciously not staffing up to workout bank portfolios in-house. Rather, they have chosen to move assets into the private sector through various public-private partnerships.

The PPIP program has had limited success. The PPIP Legacy Assets program was terribly inefficient and cumbersome. Banks identified problem assets for sale, the FDIC underwrote them, the Treasury provided half the equity to acquire, and the FDIC financed the transaction. Once this process was completed, the asset was brought to auction and bid on but the bank was able to pull the asset if it didn't agree with the price. Buyers were disincentivized from participating in the program because of the bank's ability to back-out of the transaction and because of the fear of partnering with the Treasury and US Government.

One of the more effective programs has been the FDIC's Shared Loss Program. This program has the FDIC bearing 80% of any potential losses as well as providing attractive financing. Several large portfolios have traded using this structure. The program's mandate prohibited "flips" as most assets are required to be held for at least three years. This program will ensure that the ultimate disposition of the asset (thus return the most taxpayer money) will occur in a more normalized market three plus years down the road.

The Congressional Oversight Panel on the Troubled Asset Relief Program (TARP) estimates that \$1.4 trillion in commercial loans will require financing between 2010 and 2014. Many have been throwing around this number as if it was an estimate of the potential loss in commercial real estate loans, however, that couldn't be further from the truth. With debt investments in real estate, you rarely have a total loss unless you are in a subordinate or junior position. Research by Morgan Stanley indicates that over the same period, approximately \$1 trillion of the \$1.4 trillion in CRE loans maturing will be able to be refinanced with senior debt (i.e. at a 65% LTV ratio). The balance will be recapitalized with new equity and subordinate debt. This math would suggest that real estate collateral values will exceed these maturing loans. However, many banks and lending institutions may have already been forced to liquidate or write-off a portion of these loans.

The slow pace of the recovery and its muting impact on liquidity has resulted in a greater number of banks, life companies and CMBS services electing to modify and extend maturing or defaulted loans. According to a Deutsche Bank study, as of March 2010, 490 CMBS loans with a total balance of \$13.7 billion have been modified. The CMBS market is only about 20% of the outstanding commercial real estate debt in the US. Banks hold the largest portion of these maturing loans, which in the near term consist mainly of commercial bank mortgages and construction loans. Many of these banks cater to the middle-market and are not of the "too big to fail" variety. Therefore, the "pretend and extend" strategy has become the preferred method utilized to deal with these maturities. The alternative for these banks is to liquidate assets at levels that would effectively cause the bank to fail.

As mentioned above, Tremont believes that real estate values will generally increase over the next three year period. The main question remains, how much so. Many have estimated that the decline in real estate values, peak to trough, is somewhere in the 25-40% range. In the event the market is able to recover 100% of those losses over the next three years, valuations will be back to where they were just prior to the pre 2007 run-up. Construction or bridge loans originated in 2005-2007 with residual LTV's underwritten in the 70-90% range will simply return to the same exposure level with no significant reduction in LTV by today's standards. The same holds true for interest-only, and partial interest-only permanent deals on stabilized assets at the 80-90% LTV level. Without a significant increase in occupancy, lease rates, and net cash flows loans will likely face the same refinancing

obstacles without additional equity infusion or some sort of middle of the stack capital layer. As a middle-market debt provider, Tremont believes the opportunity exists both in the near-term (18-36 months) and longer term (36-60 months) to take advantage in this “equity gap” as it is defined above.

Opportunity amidst the dislocation

It is very disappointing that two years into the crisis, Congress has still not completed any meaningful financial reform. One would have thought that financial reform would have been the #1 job at hand.. It is of the utmost importance now to rebuild investor trust. We need a robust securitized market; and that cannot occur until investors come back. The mortgage agencies were at the center of the meltdown. Changes being discussed there include full government takeover, random assignment, peer review, and super enhanced supervision/regulation among others. The actual method chosen is actually less important than getting it done and ensuring the measures effectiveness as it pertains to the rebuilding of the investors confidence.

All recessions have some similarities to their predecessors and yet their own unique structure. The Great Recession has many root causes: the supply driven downturn in residential housing, the demand driven downturn in CRE, and across all sectors, easy access to debt that clearly fueled the run up in asset values, followed by the subsequent correction that is unprecedented in our life times. Central banks seem to have no choice but to keep money easy in an effort to try to “reflate” and then inflate asset prices so as to mitigate the bank losses. The predictable printing of money and consequential devaluation of currency to pay back the debt with cheaper currency is underway. The capital markets won't be fully functional again until enough time goes by (with a steep yield curve) so the banks can make enough risk free return to absorb the purge in their balance sheets and be in a position to re-lend the capital that has otherwise been stagnant.

It would seem that hard assets (gold, oil, real estate) as inflation hedge should perform well as this process matures. Tremont believes that real estate, which can be margined with long term debt, secured at today's cheap levels so that leveraged returns from in place cash flow, has a significant premium over dividend paying stock or comparable risk adjusted high yield corporate debt. Investing now is a classic value play on the cyclicity of both the economy and capital flows. We don't need a radical economic growth, merely stabilization which is now happening. The current period appears to be the time to be trying to acquire assets as the banks inevitably dump at the bottom of the cycle.

Status of Real Estate Debt Investment Strategies

There are many CRE distressed debt strategies today. Some target heavy distress (significant issues with collateral, documentation or borrower), and are really “loan to own” programs. Others seek less aggressive yields and target “performing / non-performing” loans. Such loans have potential to be worked out with existing borrowers. Today we are also seeing strategies that focus on “distressed sellers”. These loans are typically mis-priced and usually are overleveraged, but do not involve heavy distress at the property level. Many strategies are focused on the securitized space. These have various maturations: some target specific issues such as CMBS, CDO or CLO. Many were leveraged and failed early. Securitized debt structures are relatively new and yield realization will be impacted as laws resolving conflicts among tranches are resolved. This is complicated by the odd reality of this sector that has the most junior tranche leading the workouts. Whole loan distressed debt strategies have been stymied by “extend and pretend”, which has delayed many loans from coming to market. In other cases lenders have shown an unprecedented willingness to compromise loans with borrowers, thus reducing third party investment options. Although, we have seen a considerable number of requests for JV capital to assist such DPOs (discounted pay offs). Some believe the best opportunities in this space involve acquiring banks and with that, access to whole loans.

As noted above, we believe securitized debt markets will take years to return to anything close to their 2004-2005 levels. Private structured capital stacks are not terribly complex. Unlike CMBS, lenders in each tranche know their place and the laws governing collateral are well established (i.e. there is no Junior Creditor running the lender group). Due to the new paradigm of senior lenders and the lower leverage they are making available, shrewd

borrowers are doing their investors a disservice if they are not entertaining some layered capital to drive down overall K (cost of capital).

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.



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