
Valuation for Financial Reporting: Capital Markets: Implications

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August 17, 2011 – AI – Las Vegas

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Goals of Presentation

- Disclaimers
- Size of Real Estate Capital Markets
- Recent Activity
- Financial Regulations Impacting MBS (Dodd-Frank)
- CDO 101
- CDS 101
- Expected Changes / Outlook
- Greer's Forecast / Signs

What is a MBS?

Mortgage Backed Security

- Type of pass-through security
- Mortgages are securitized into a pool. Rights to the revenue from the mortgages are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- During 2006-2007, accounted for slightly less than 40% of all commercial real estate lending, and higher rate for residential.

Players in “Simple” MBS

Lots of Real Estate Loans
are Pooled Together

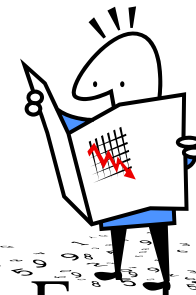


Rating Agency
Rates Bonds



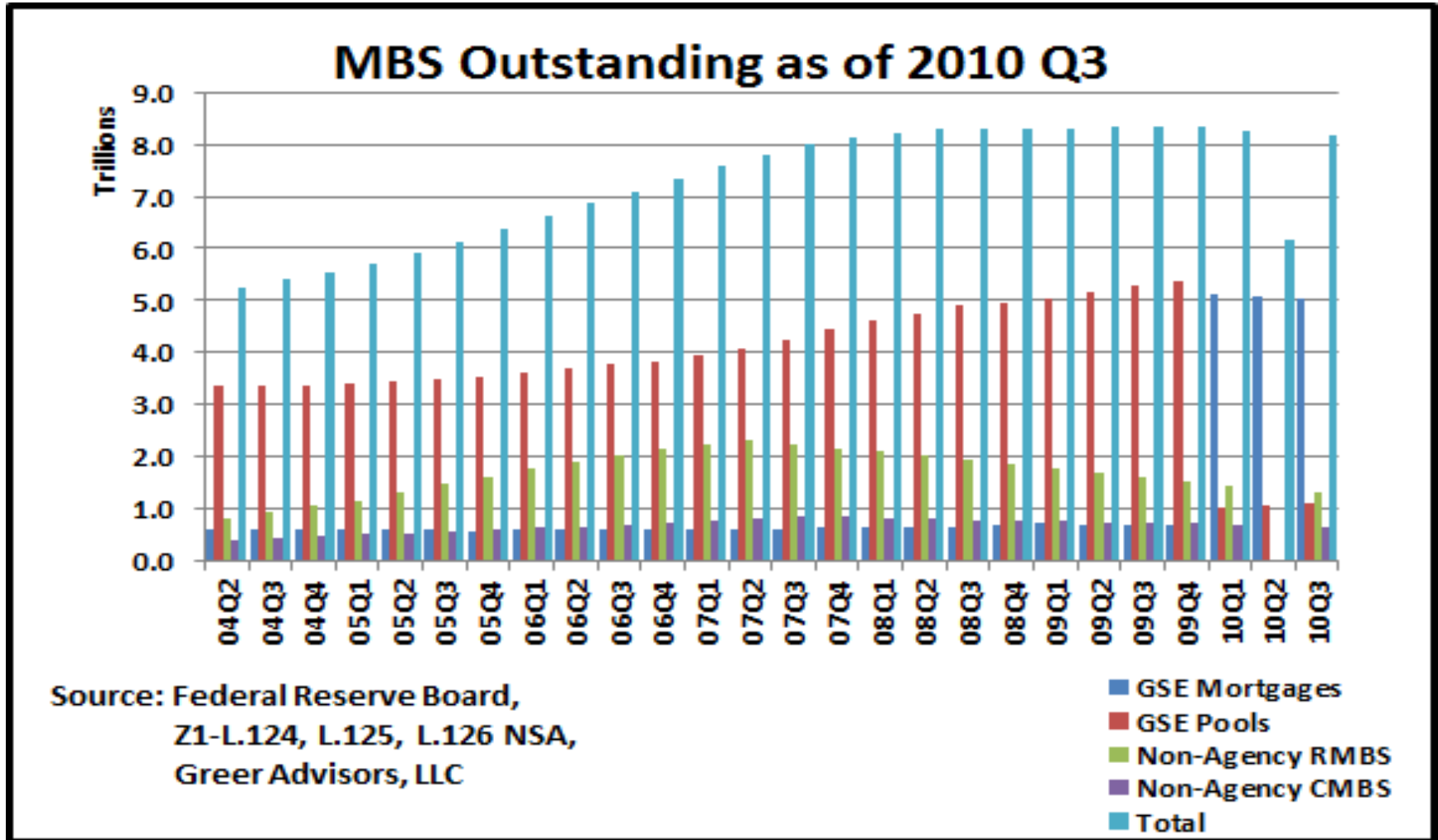
Gives loss forecast & amount
required for “AA” rating

Investment Bank Securitizes Loans
(like forming Corporation) and
Issues MBS

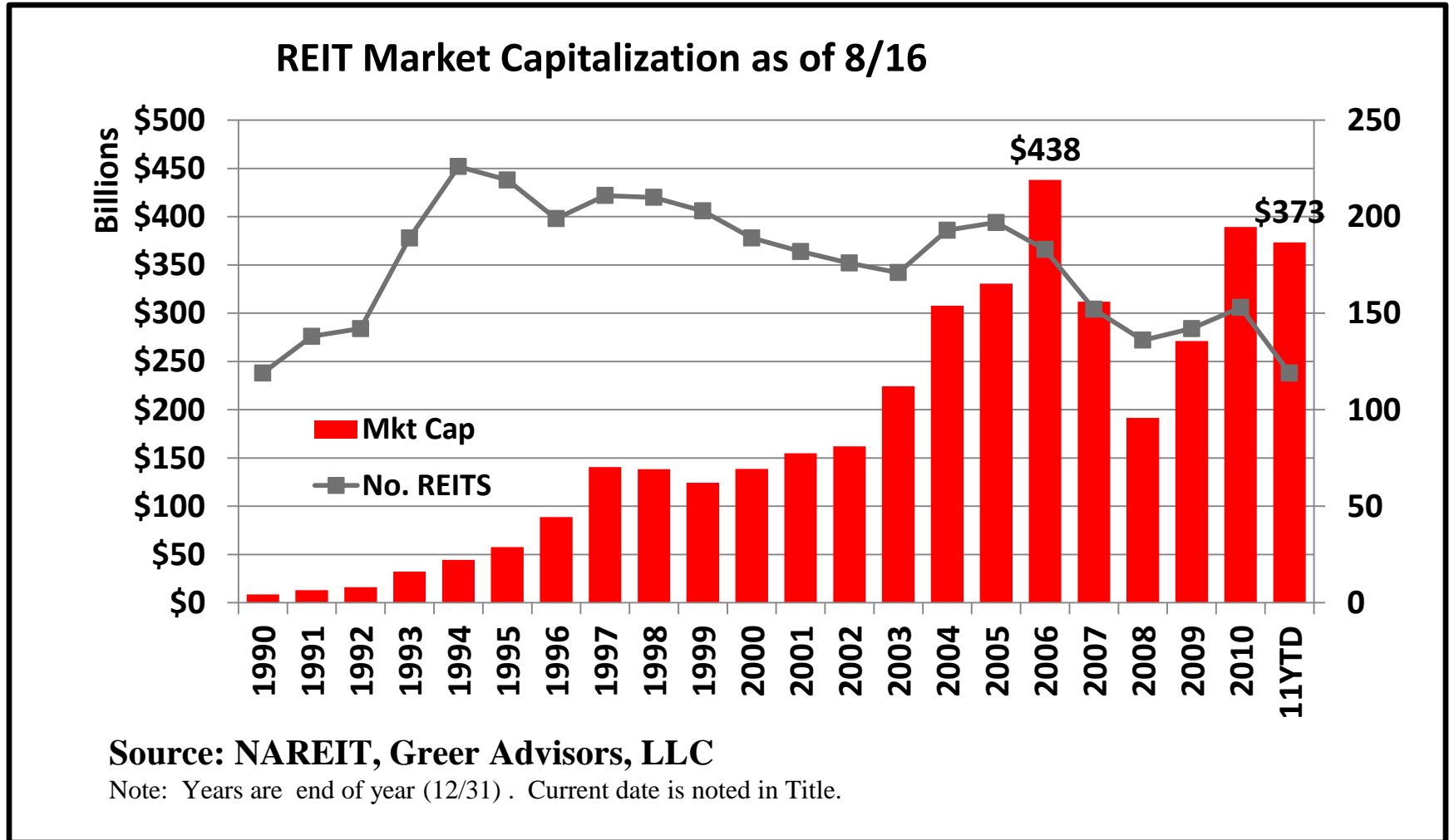


Pension Fund Buys most
AAA Bonds, Hedge Fund
get most of rest

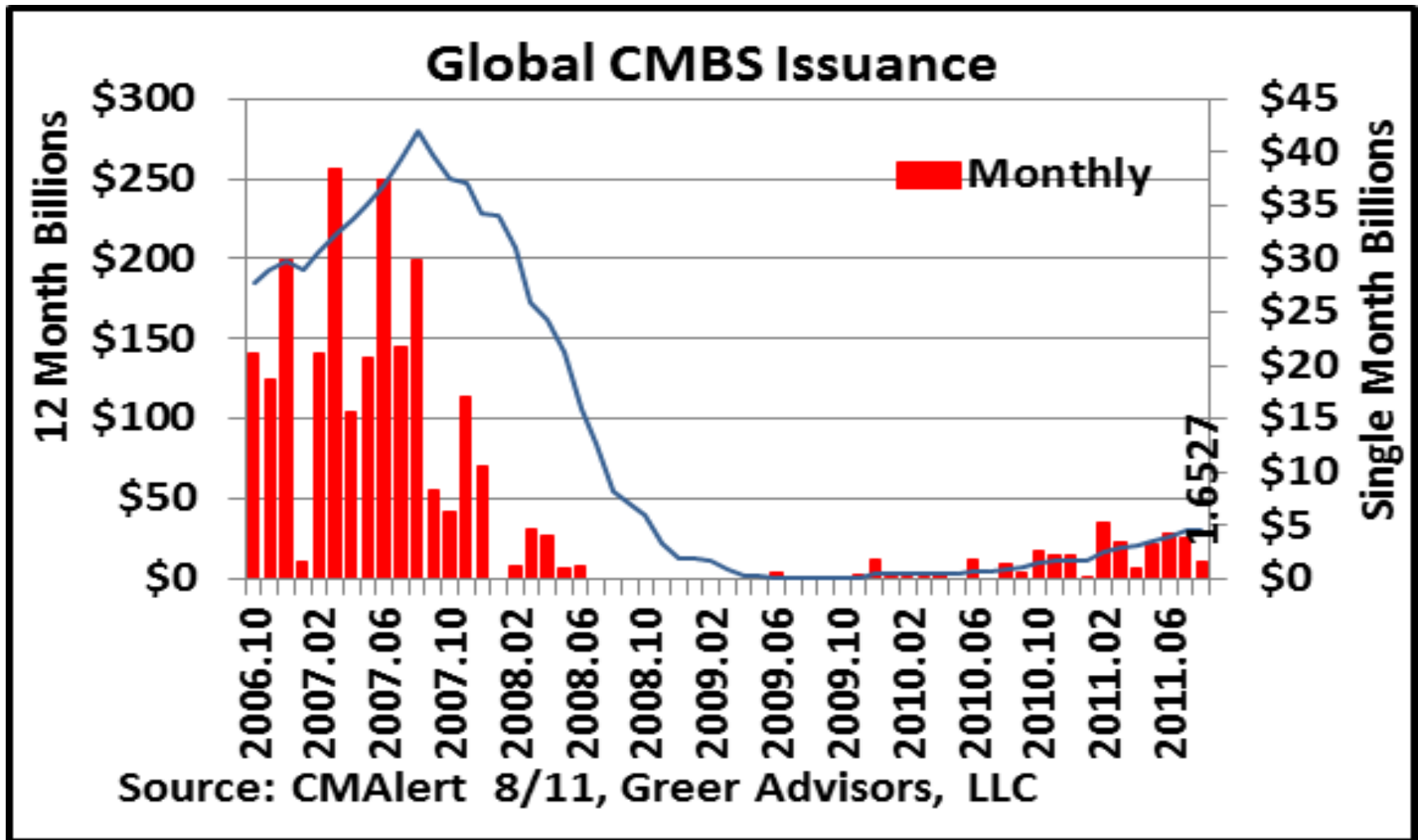
MBS Outstanding's in U.S. - Dropping



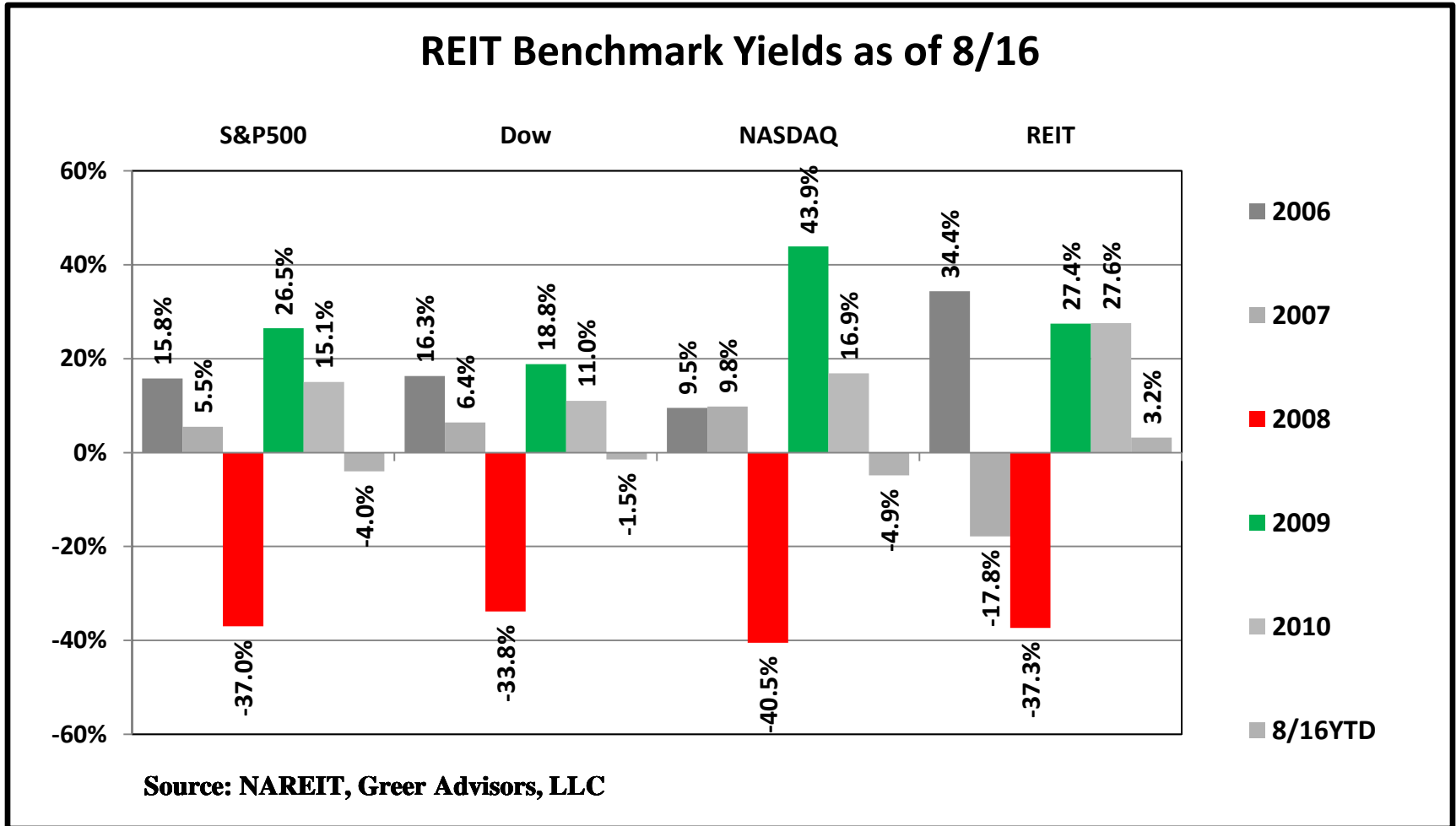
MBS Outstanding's in U.S. - Dropping



Global CMBS Issuance – Not Recovered



Global CMBS Issuance – Not Recovered



What is a CDO?

Collateralized Debt Obligation

- Type of pass-through security
- CDOs are securitized debt pools, similar to CMBS, but debts can be CMBS/CDO paper, car/boat/plane loans, credit cards, or virtually any type of debt obligation. Rights to the revenue from the obligations are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- Tough to gauge accurately, but most experts believe these have accounted for 5-10% of all commercial real estate lending the past few years.

Financial Regulations

Dodd-Frank Wall Street Reform & Consumer Protection Act

- 16 Titles – See Summary on Wikipedia
 - 243 Rules to be created (reportedly 62% not done)
 - 67 Studies required (most are not done)
 - 22 New Periodic Reports
- Restructure of Regulators, elimination of OTS
 - Financial Stability Oversight Council (New)
 - Office of Financial Research (New)
- Keys for Commercial Real Estate:
 - Rating Agency Reform
 - Securitization Reform (nominal change due to QIB clawbacks)
 - Derivatives – minimal change thus far due to “netting”

What is CDS?

Credit Default Swap

- A bilateral contract where two parties agree to trade the credit risk of a third-party. A protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a default or failure to pay. Once triggered, the seller either takes delivery of the collateral (eg bond, note) or pays the buyer the difference between the par value and recovery value of the bond (cash settlement).
- They resemble an insurance policy, as they can be used by debt owners to hedge against credit events.
- Warren Buffet called **ED** these “Weapons of Mass Destruction”
-counterparty???

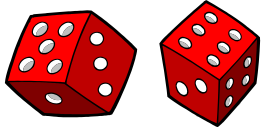
Players in “Simple” CDS

Business Issues Bonds

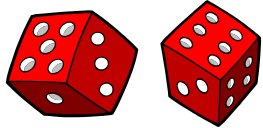


Bonds initially rated too poor for market, eg “BB”

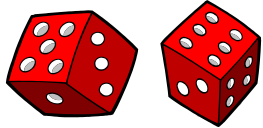
Side Bet 1



Side Bet 2



Side Bet 3

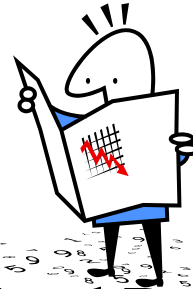


Investment Bank issues CDS (aka Credit Enhances Debt) Enough to make BB = AA, if debtor fails, IB buys bonds

Rating Agency Rates Bonds



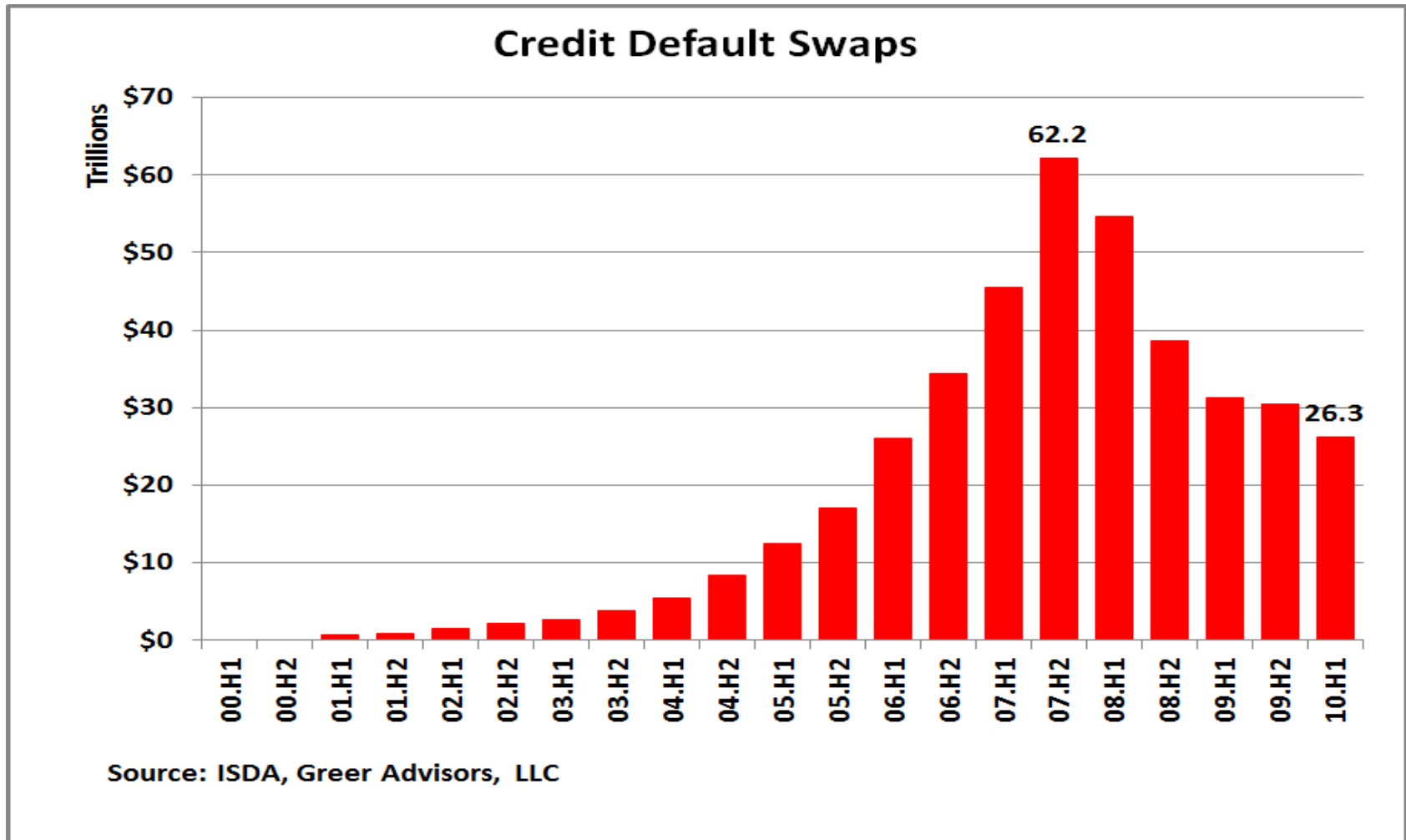
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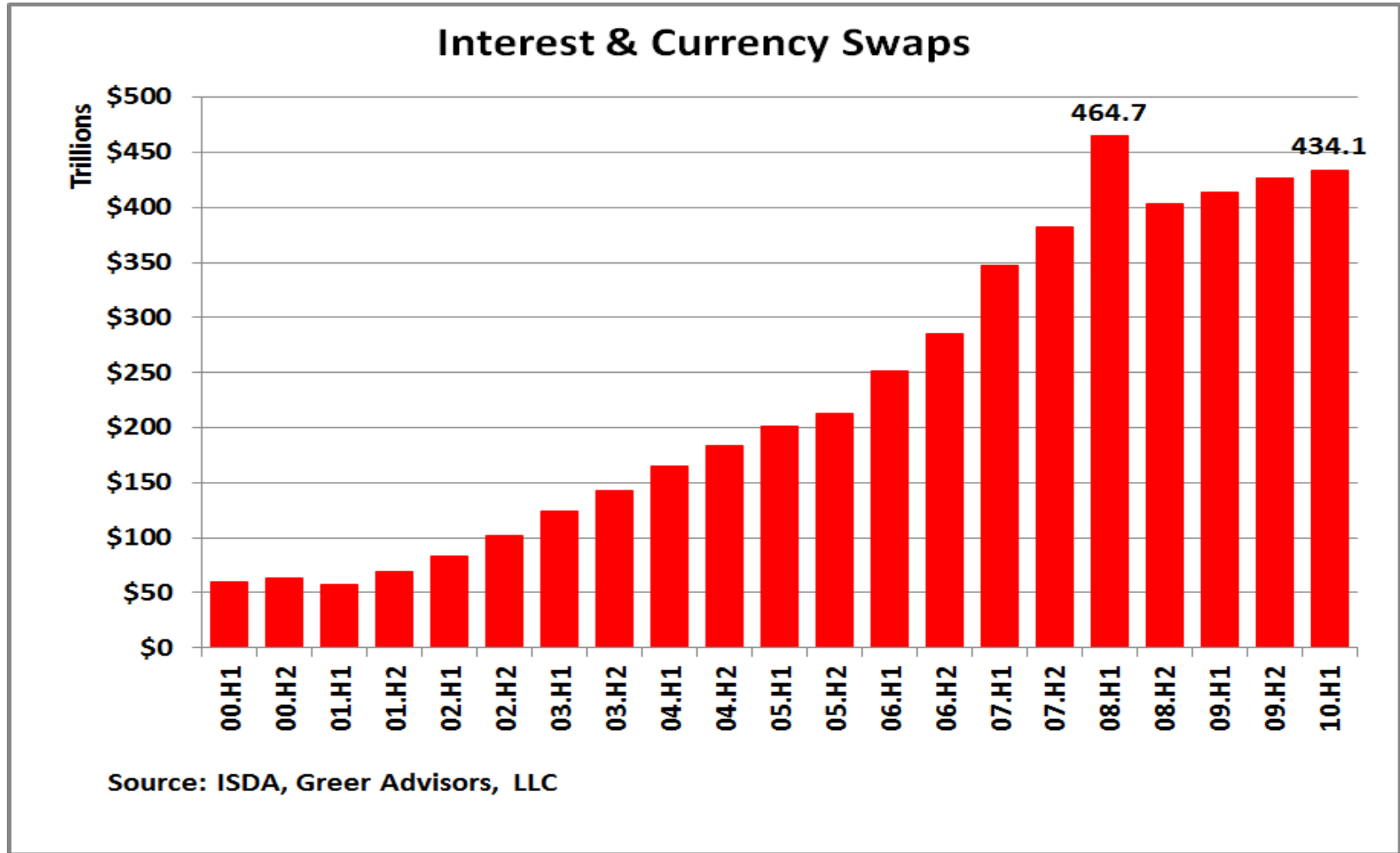
Pension Fund Buys Bonds with CDS enhancement
Thinks it's AA investment

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Credit Default Swaps



Interest & Currency Swaps



Future - Mortgage Backed Security

- If NSROs don't "**Get It**" Feds could replace them
- 'Til MBS Returns, Real Estate markets **WILL NOT** recover
- Most banks ARE NOT in the business of holding debt
- New MBS WILL EMERGE with terms as follows
 - No "quick buck" investment banks/mortgage bankers
 - Issuer holds 1-5% of pool as "1st Loss / Good Faith" position
 - 60-80% of pool will be AAA, not 90+%
 - Buyers of paper will "re-underwrite" pools, regardless of

Future of Banking

Past Three Years have Shown largest lending decline in history - see FDIC QBP

CMBS Loss Rates – Still All Time Highs, Banks better

Separation of “Best of Best” Class A vs. Class B/C

Deleverage – Expect More for Class B/C

More Restrictive Covenants for REITs, CMBS

“R” word for Loans (recourse)

Capital Ratios – Leverage – QE2

Conclusions

- MBS Market –Spreads will remain 10-100x higher than 1/07.
- MBS – Very Slow Return. Need New Business Model
- Many Lenders Closed, Stopped or Reduced Lending
- Insurance Companies and Fannie/Freddie Lenders are Active
- CASH IS KING! Cap/Yield Rates Have RISEN for Class B/C
- Value Growth will Lag Rent Growth – by a Lot
- Rents / Vacancies Remain better than early 1990s
- Real Estate Cost is **NOT** the Largest Cost of Business!!!

Quote of the Day

“...prediction is very difficult, especially when it’s about the future...”

~~NY Yankees #8, Yogi Bera~~

Niels Bohr

Nobel Laureate, 1922

Atomic Structure /

Quantum Mechanics



Greer's 3-Year Forecast as of 8/15/2011

- Global Economy Heals = Recovery (Barbell)
- Cap Rates will Rise 0.5-2% during 2011/12, almost all in class B/C. Trophy Class A will remain low – Flight to Quality
- Margins (to 10 Yr Treasuries or LIBOR) will rise and settle at 300 ± 50 bps over 10 year Treasuries, but might over-correct in the short run, say 10Yr 400+ bps.
- Rent Growth Lag CPI growth by 1-2%, expect more Yrs 2-5.
- Values appear to have stabilized. They fell from through mid-2011. Individual Market Performance will varied widely. (10-30% difference in Top vs Bottom)
- Declines: #1=Retail; #2=Office & Industrial; then Apartment
- Change Creates Opportunities – Build Businesses
- Complete Barbell Forecast

Greer's Recovery Signs – Prereq's to Recovery

- \sqrt CDS Exposure under \$25 Trillion (i.e. under 50% of peak)
- \sqrt Stable or Decline in CMBx Yield Spreads for 6 weeks
- Re-emergence of CMBS market
 - New CMBS Market will include:
 - Issuer Keeps 1-5% 1st-loss piece
 - AAA Subordination near 30%....
 - AAA is 70%, not 90% of issue
- \sqrt REIT Market Capitalization (Total Value) Stabilizes or Increases for 6 months
- Consumer Confidence Rises and Stays Above 70 for 6 months
 - As of 6/28/11 (last report) index at 58.5 (1985=100)
- Risk Curve (AAA Sr. vs BB) flattens to under 500 bps. As of 8/15/11, CMBx spread stands nearly 100 pts (3.44 v 103.07)

Questions / Answers

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