
Wall Street and Commercial Real Estate

Everett (Allen) Greer
Greer Advisors, LLC

May 10, 2011 - CREPOC

Greer Advisors, LLC

Goals of Presentation

- Disclaimers
- Market Drivers
- Financial Regulations (Dodd-Frank)
- Wall Street and Capital Markets (REIT / MBS)
- Market Conditions (Rent / Vacancy)
- Expected Changes / Outlook
- Greer's Forecast / Signs

Market Drivers

Supply / Demand – Not as bad as early 90's

- Non-Res. Supply Growth was Very Limited Growth
- Most Demand ties to Gross Domestic Product
 - Office – FIRE Employment, Portion of Service Employment
 - Retail – Household Formations, Income Growth
 - Industrial – Manufacturing vs Distribution
 - Multifamily – Households
 - Hotel – Corporate Travel – Office Employment
- Jobs & Retail Sales - Drive Supply & Demand!!!

Financing – Currently Most Important Fundamental for most of Country, add Global Economy for Las Vegas

Economy

Consumer Side

- Near Flat Line
- Consumer Confidence is Poor at 65.4
- New Claims rose last week
- Unemployment Remains High

Investment Banks

- Capital IQ and Deal Logic show LBO's /M&A on the rise
- Record Profits – GS near 1000 batting every day since the Crisis Started
- IB's record profits – cost of taxpayer

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 (modest due to QIB clawbacks)
 - Derivatives – minimal change thus far due to “netting”

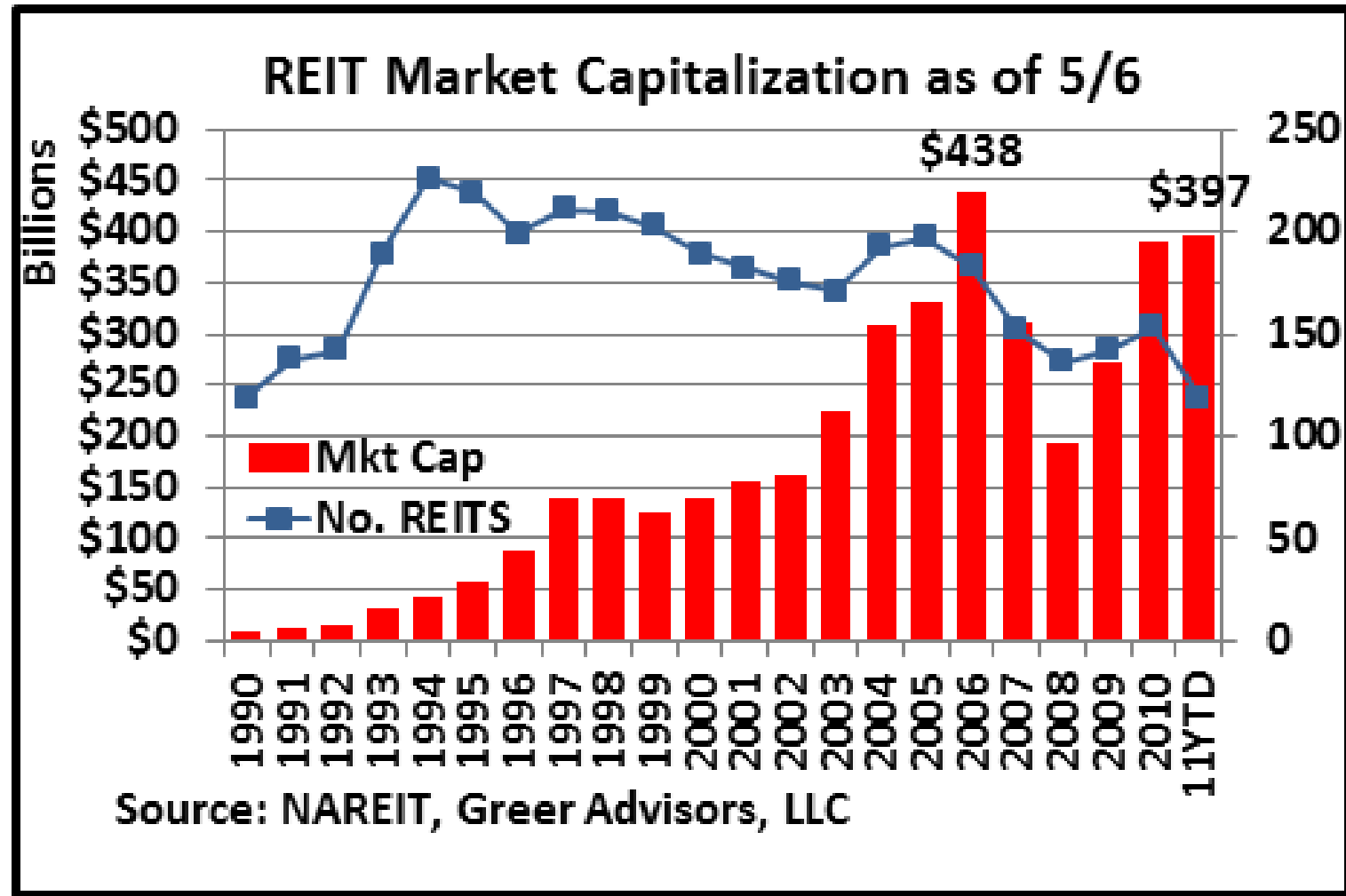
- Wall Street and Capital Markets

What is REIT?

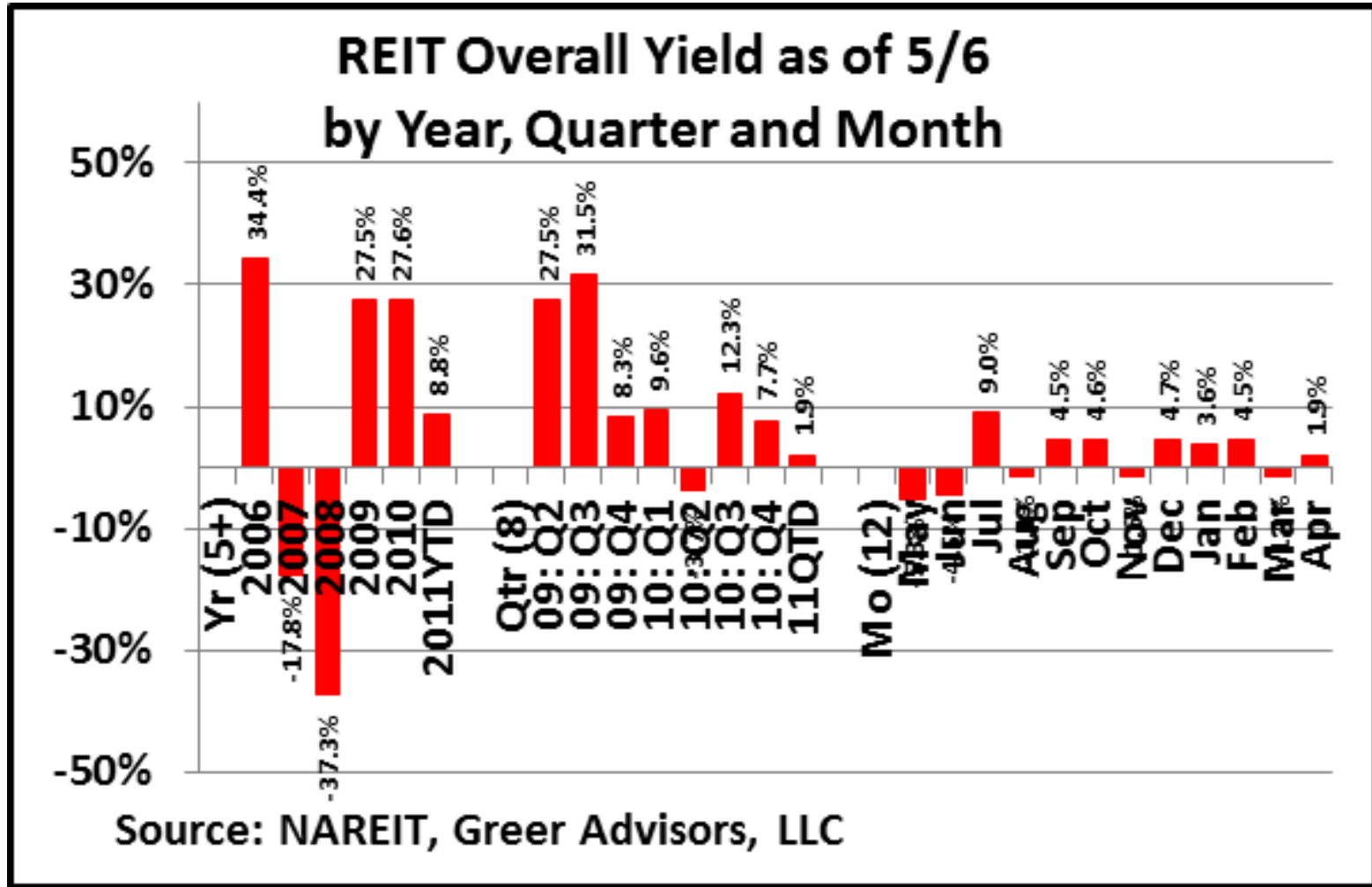
Real Estate Investment Trust

- Type of Pass-through Security
- Effectively a corporation
- As long as 90% of income passed is through to shareholders, there is no “corporate” tax. All earnings are single-taxed at shareholder level.
- Current “Industry” Issues:
Definition of Assets, Max Debt Load, Yield

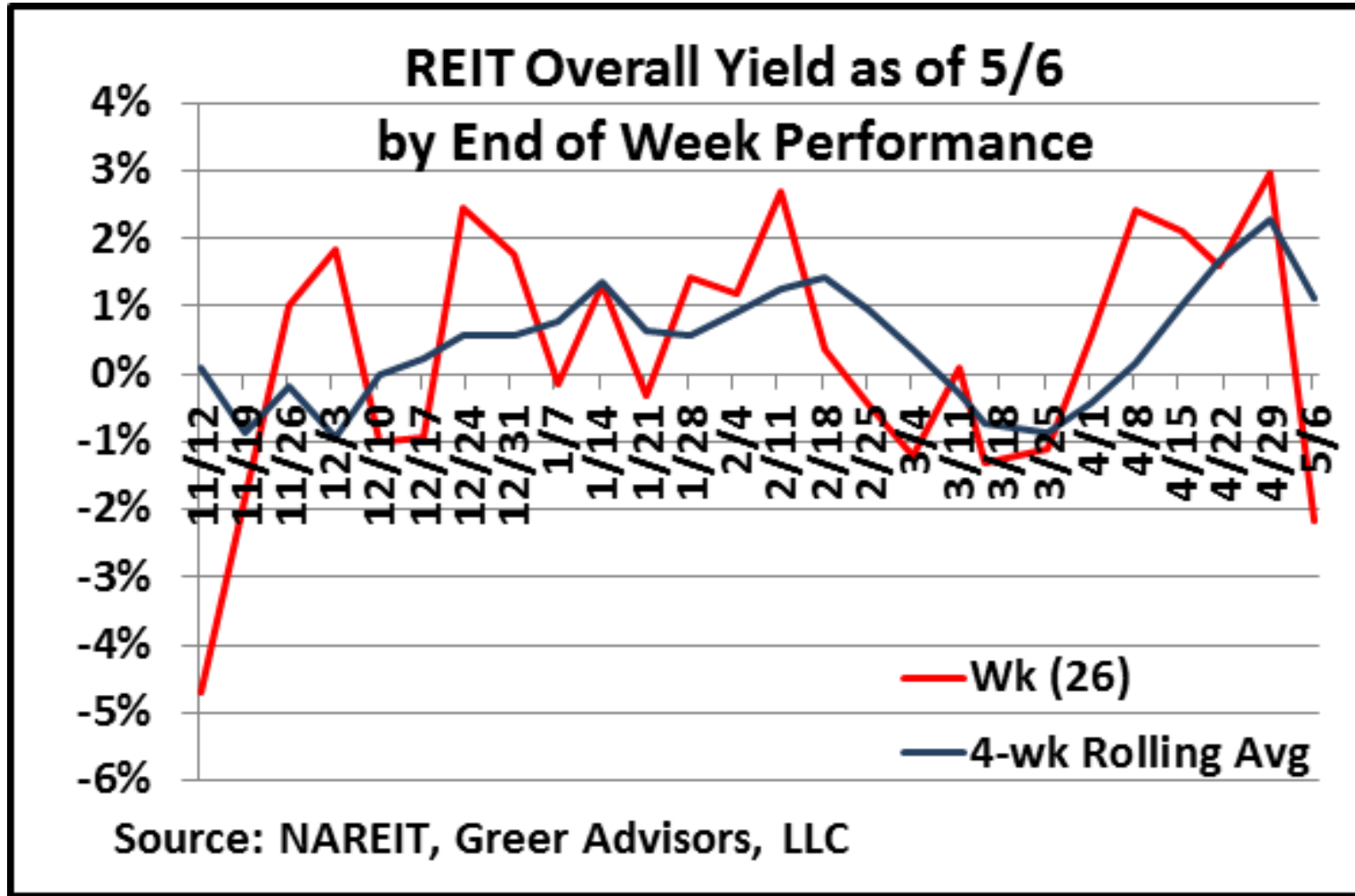
REIT Market Capitalization



Overall REIT Dividend Yields – Stable?



Overall REIT Dividend Yields – Stable?

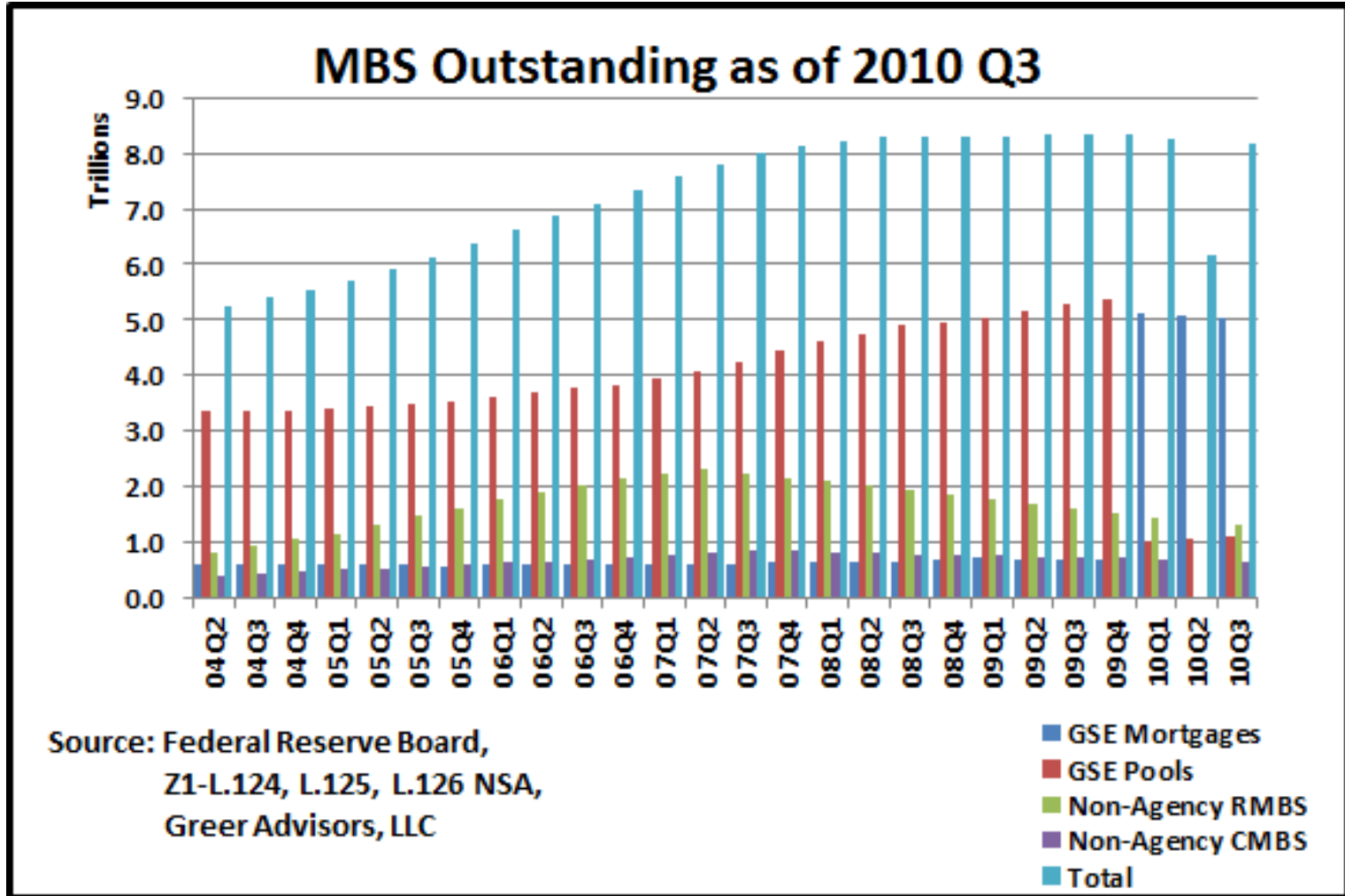


What is a MBS?

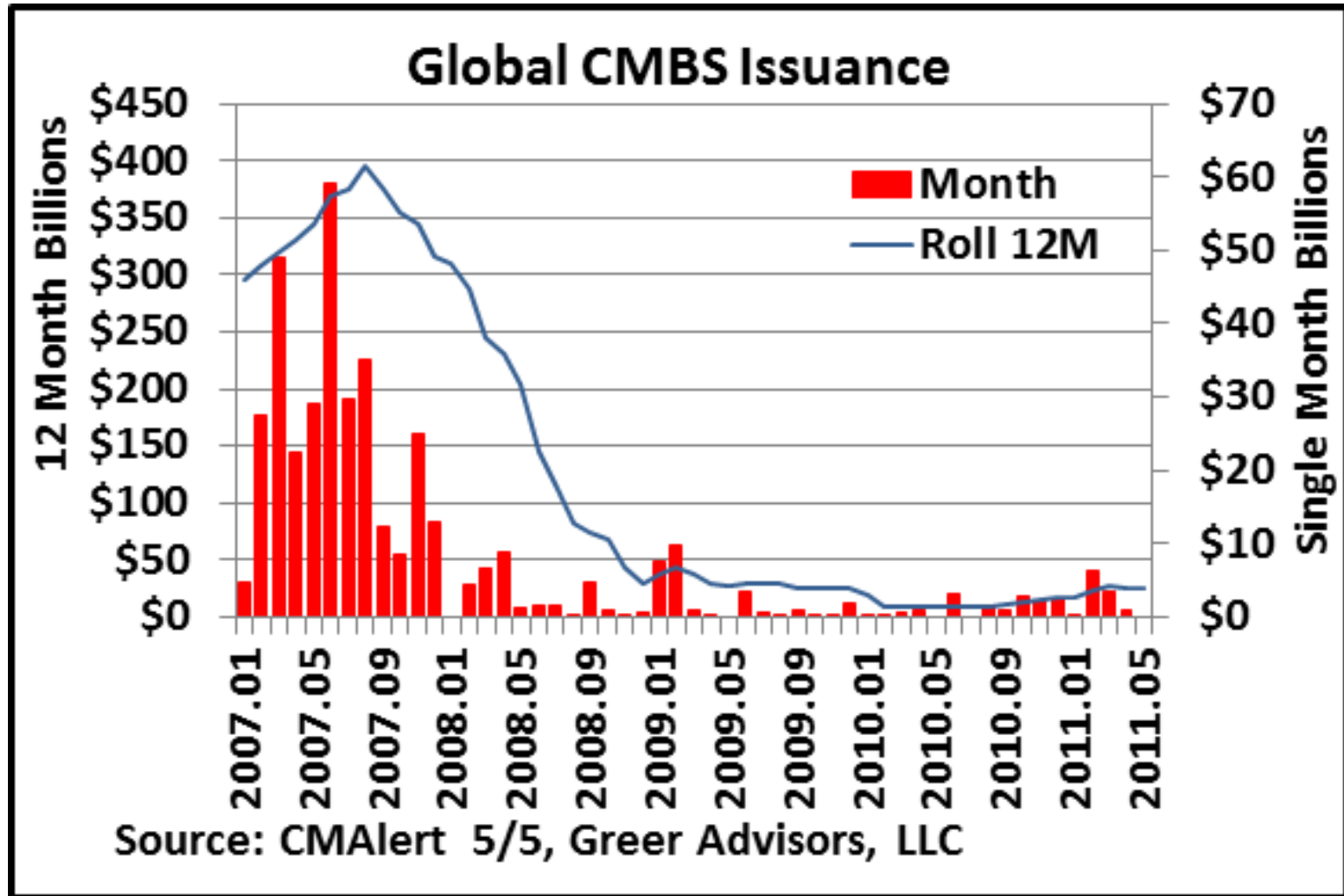
Mortgage Backed Security

- 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.

MBS Outstanding's in U.S. - Dropping



Global CMBS Issuance – Not Recovered



CMBx Data

Greer CMBS / CMBx Yield RateTM				
Tranche	Yield	Suboord	Weight of Debt	Contribution to Total
AAA	3.64%	29.76%	70.24%	2.55%
AJ	4.51%	12.70%	17.06%	0.77%
AA	6.13%	10.63%	2.07%	0.13%
A	10.56%	8.00%	2.63%	0.28%
BBB	28.23%	4.72%	3.28%	0.93%
BBB-	29.57%	3.68%	1.04%	0.31%
BB	103.27%	2.69%	0.99%	1.02%
Unrated	177.00%	0.00%	2.69%	4.76%
Implied Overall Debt Yield			100.00%	10.74%
Loan to Value Ratio				75.00%
Class-A Equity Yield Total Yield			30.00%	15.56%
Class-B Equity Yield Total Yield			103.00%	33.81%

Notes: ① The table is somewhat complicated, as evidenced by the numerous footnotes. Several conclusions can be drawn. 1) If the 'Implied Overall Debt Yield' is much greater than loan rates in the marketplace, the CMBS market CAN NOT recover because the required yields are too high to make debt affordable to borrowers. 2) When the spread between AAA and BB tranches is above 500 bps (now at 9,963 bps), the market can't recover because of risk aversion for lower-rated tranches. As a point of reference, January '07 AAA-BB CMBS spreads were around 65 bps. Lastly, the yields for each tranche provide tremendous insight into the required yields for each layer in the capital stack.

② MarkitTM Data and Calculations based on close of 5/6. Swap (10Yr) as of 5/5.

③ Coupon and Price data were from MarkitTM for AAA Senior through BB bonds. MarkitTM data was used as part of the calculations by Greer Advisors, LLC to determine Spreads. Subordination levels were from MarkitTM.

④ Profit / arbitrage opportunity for the issuer was ignored.

⑤ The yield spread for "unrated" classes were based on (BBB-yield minus BB yield) times 1.0, round to the nearest bp. Class-A property equity yield was assumed equal to the BBB- (last investment-grade piece) yield rounded to the nearest 100 bp. Class B property equity yield was assumed equal to the BB yield, rounded to 100 bps.

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.

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???

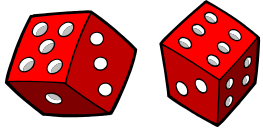
Players in “Simple” CDS

Business Issues Bonds

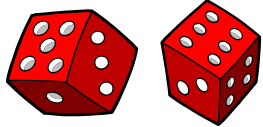


Bonds initially rated too poor for market, eg “BB”

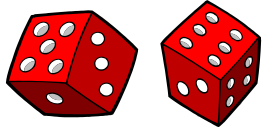
Side Bet 1



Side Bet 2



Side Bet 3

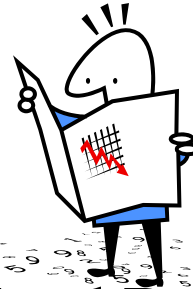


Investment Bank issues CDS (aka Credit Enhances Debt) Enough to make BB = AA, if debtor fails, IB buys bonds

Rating Agency Rates Bonds



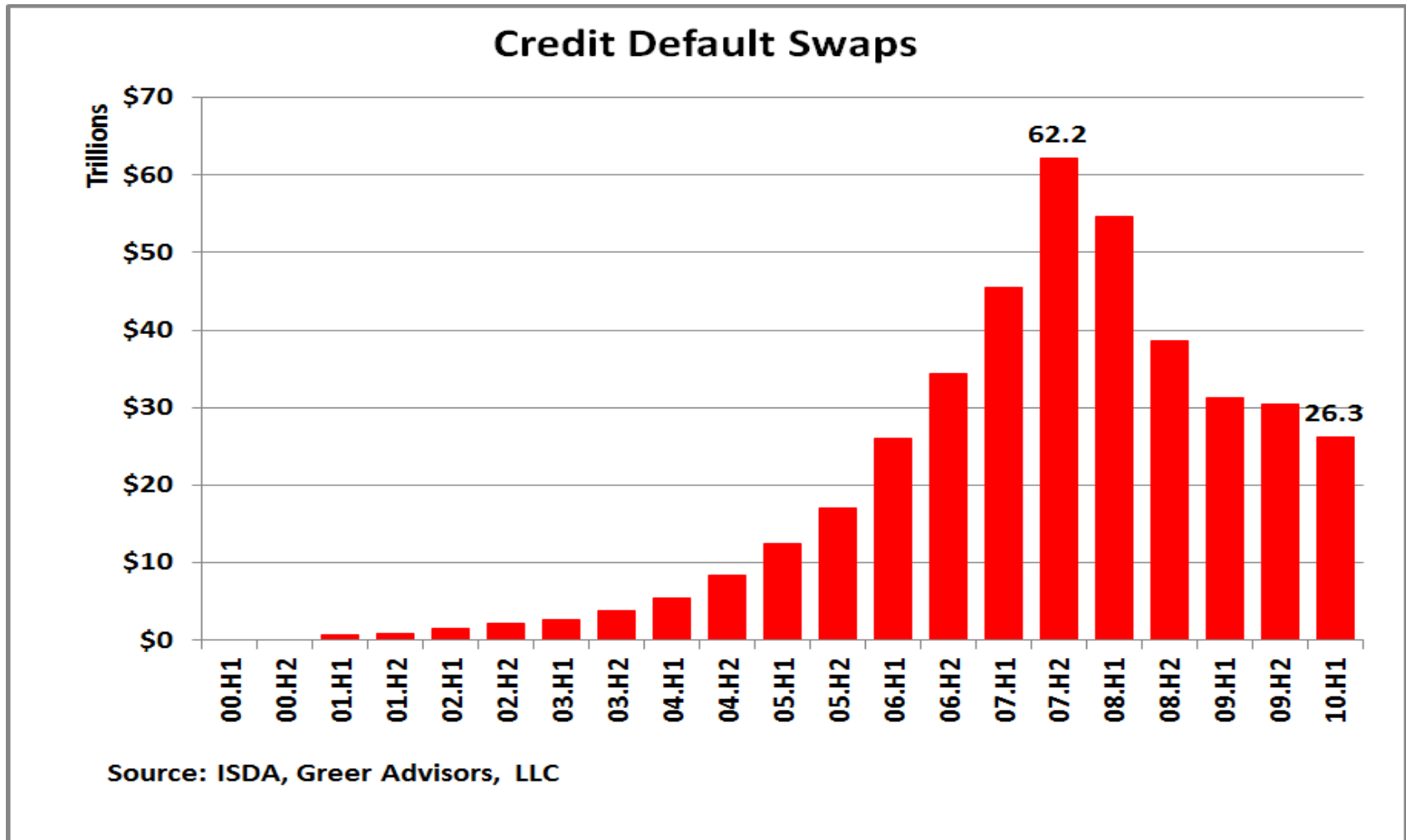
Gives loss forecast & amount required for “AA” rating



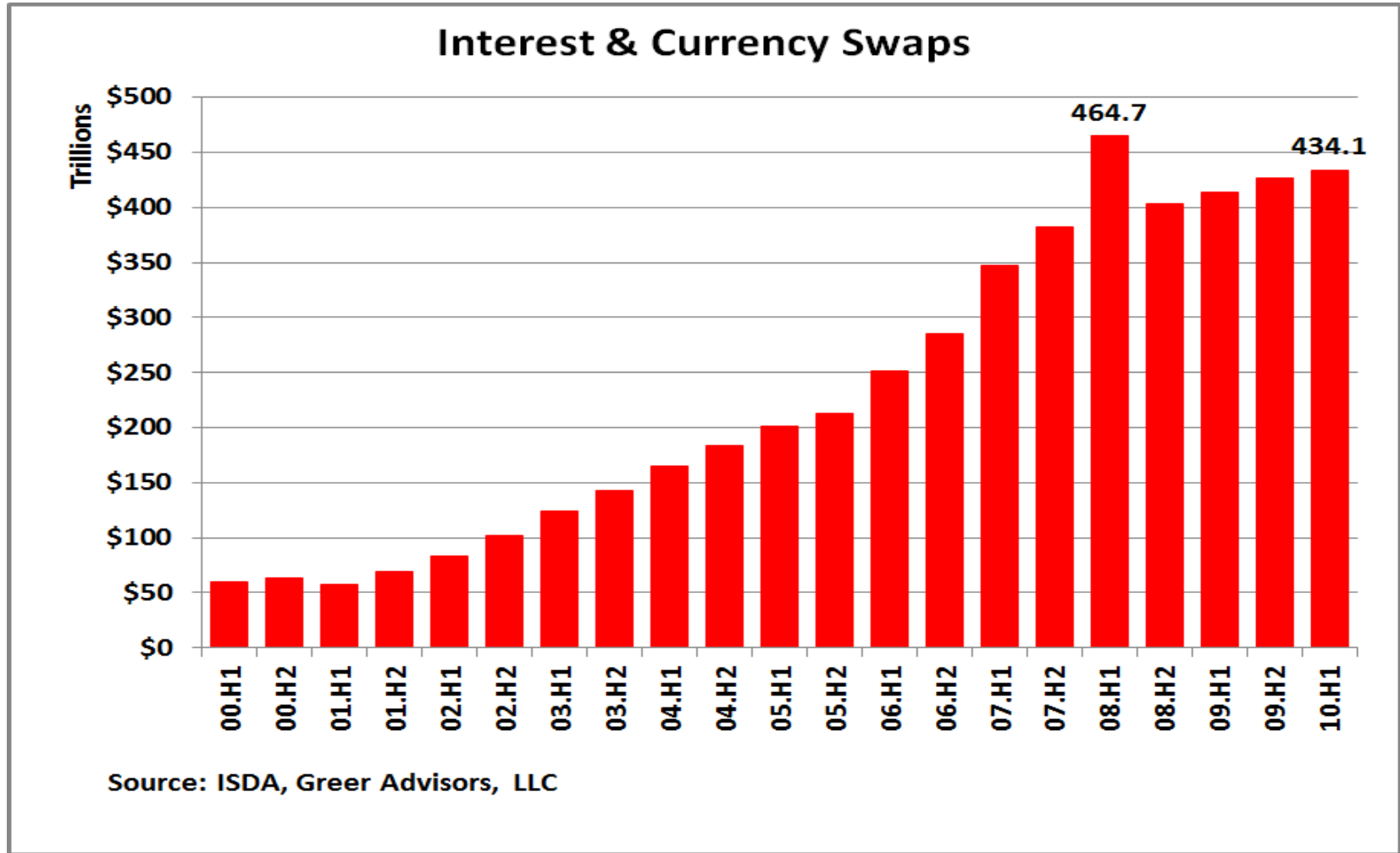
Pension Fund Buys Bonds with CDS enhancement
Thinks it's AA investment

Greer Advisors, LLC

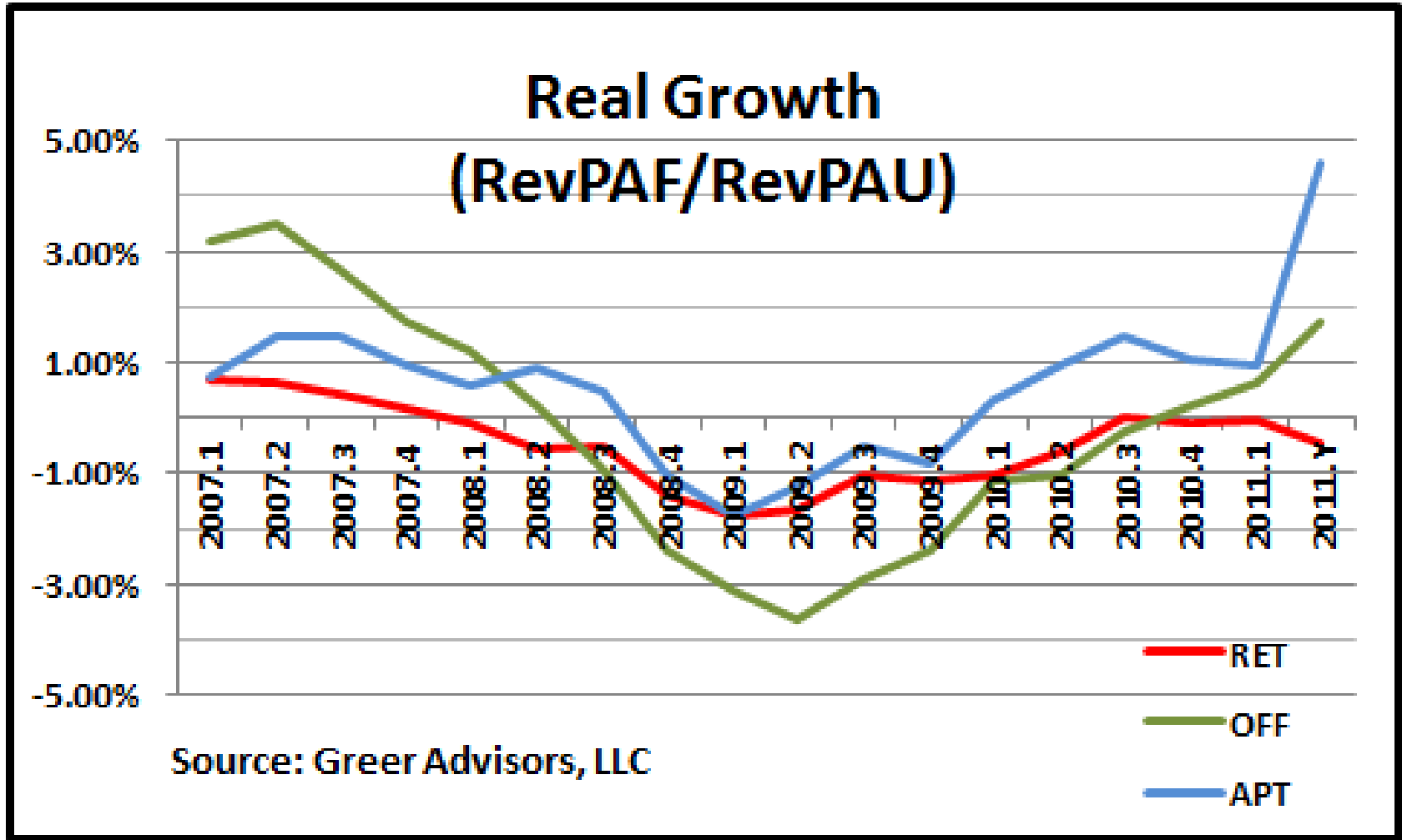
Credit Default Swaps



Interest & Currency Swaps



National Trends – as of 2011 Q1



Top - Bottom Market Stats – as of 2011 Q1

Office				Retail				Apartment						
	Metro	Inventory (SF/Units)	Vac %	Eff Rent \$		Metro	Inventory (SF/Units)	Vac %	Eff Rent \$		Metro	Inventory (SF/Units)	Vac %	Eff Rent \$
1	District of Columbia	102,071,000	9.2	\$41.20	1	San Francisco	9,601,000	3.6	\$29.89	1	New York	163,905	2.8	\$2,794
2	New York	356,068,000	10.7	\$44.95	2	Fairfield County	8,636,000	4.3	\$25.26	2	New Haven	16,217	2.9	\$1,083
3	New Orleans	19,492,000	12.1	\$14.97	3	Long Island	23,967,000	5.4	\$22.75	3	Minneapolis	154,608	3.2	\$909
4	Birmingham	18,270,000	12.2	\$15.50	4	Northern New Jersey	21,459,000	5.4	\$24.52	4	San Jose	109,789	3.4	\$1,473
5	Long Island	43,494,000	13.3	\$21.87	5	San Jose	19,968,000	6.0	\$26.68	5	Westchester	39,426	3.5	\$1,770
6	Nashville	27,500,000	13.8	\$15.48	6	Los Angeles	65,947,000	6.2	\$25.15	6	Central New Jersey	171,222	3.7	\$1,125
7	Buffalo	20,065,000	14.2	\$12.86	7	Orange County	40,157,000	6.2	\$26.56	7	Long Island	97,654	3.7	\$1,524
8	Louisville	21,671,000	14.5	\$12.50	8	Oakland-East Bay	27,553,000	6.3	\$24.88	8	Syracuse	17,316	3.7	\$675
9	Little Rock	10,103,000	14.5	\$13.07	9	Suburban Virginia	39,513,000	6.5	\$24.25	9	Rochester	36,586	3.8	\$738
10	Boston	125,624,000	14.7	\$29.24	10	Boston	36,268,000	6.7	\$19.49	10	Portland	104,609	3.9	\$783
73	Memphis	19,164,000	22.1	\$14.51	71	Oklahoma City	16,192,000	14.5	\$9.76	73	Columbus	124,916	8.6	\$646
74	Central New Jersey	64,682,000	22.3	\$19.07	72	Syracuse	5,894,000	14.5	\$10.53	74	Las Vegas	134,547	8.6	\$767
75	Hartford	24,396,000	22.4	\$16.80	73	Cincinnati	22,187,000	14.6	\$12.32	75	New Orleans	53,962	8.8	\$833
76	San Jose	52,185,000	22.7	\$22.64	74	Dallas	55,700,000	15.0	\$14.04	76	Phoenix	258,373	8.9	\$685
77	Dallas	153,682,000	24.3	\$14.89	75	Cleveland	24,977,000	15.1	\$12.83	77	Atlanta	362,071	9.1	\$758
78	Las Vegas	25,203,000	25.0	\$18.28	76	Indianapolis	17,957,000	15.4	\$12.38	78	Greensboro/Winston-Salem	63,173	9.4	\$622
79	San Bernardino/Riverside	20,181,000	25.1	\$17.00	77	Tulsa	12,049,000	15.5	\$9.77	79	Columbia	32,839	9.5	\$690
80	Dayton	12,483,000	26.2	\$10.93	78	Birmingham	12,067,000	15.9	\$12.19	80	Houston	497,013	10.2	\$733
81	Detroit	74,468,000	26.6	\$13.92	79	Columbus	26,954,000	16.2	\$10.69	81	Jacksonville	69,352	10.2	\$759
82	Phoenix	70,120,000	26.6	\$17.24	80	Dayton	16,752,000	17.0	\$8.82	82	Memphis	76,960	11.2	\$634
11	Los Angeles	195,021,000	14.7	\$25.69	6	Los Angeles	65,947,000	6.2	\$25.15	19	Los Angeles	760,351	4.5	\$1,350
64	Orange County	82,177,000	20.5	\$19.83	7	Orange County	40,157,000	6.2	\$26.56	27	Orange County	206,775	4.9	\$1,468
50	San Diego	62,735,000	18.6	\$22.44	13	San Diego	40,818,000	7.4	\$25.19	11	San Diego	180,400	3.9	\$1,303
79	San Bernardino/Riverside	20,181,000	25.1	\$17.00	28	San Bernardino/Riverside	50,714,000	10.0	\$17.95	44	San Bernardino/Riverside	131,558	6.0	\$1,001

Source: REIS, Greer Advisors, LLC

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 are 10-100x higher than 1/07
- MBS – New Business Model will Arise
- REITs – Virtually Recovered
- 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 5/10/2011

- Global Economy Heals = Recovery (Barbell)
- 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 1-3%, 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)
- Capitalization Rates will Rise 0.5-2% during 2011-2012, mostly in Class B/C. Trophy Class A still very low cap rates.
- 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 4/26/11 (last report) index at 65.4 (1985=100)
- Risk Curve (AAA Sr. vs BB) flattens to under 500 bps. As of 5/6/11, CMBx spread stands nearly 100 pts (3.64 v 103.27)

Questions / Answers

Greer Advisors, LLC

www.GreerAdvisors.com