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The Case for Debt Investment

Prepared for RREEF

December 2010

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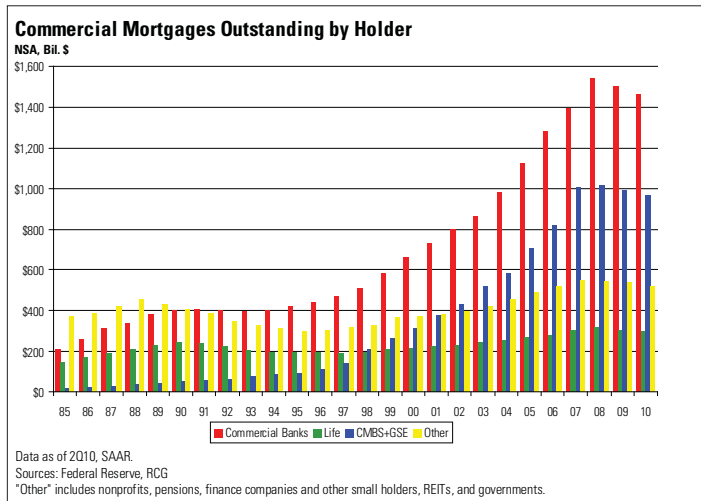
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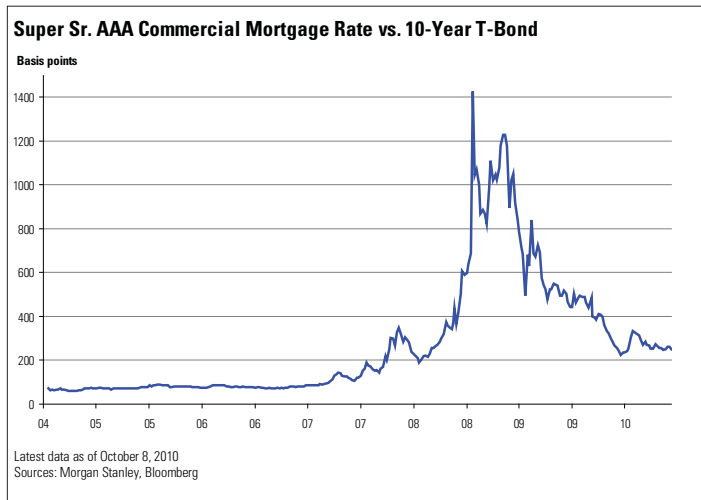
This study aims to examine the commercial debt market and evaluate potential current investment opportunities. The first section will provide a brief overview of the size, major players, and character of the debt market. In the second section, we will provide our analysis of current market conditions and opportunities. We will conclude with our outlook and the case for debt investment.



Size and Character of the Debt Market

The volume of commercial and multifamily mortgages outstanding climbed after the 2001 recession as low interest rates, improving fundamentals and investor appetite drove cap rate compression. According to the Federal Reserve Flow of Funds, commercial and multifamily outstanding mortgages rose to a peak of \$3.4 trillion in mid-2008.

Particularly in the 2004-2007 period, leverage on bank and securitized deals increased, and mezzanine debt was added to facilitate rising valuations. Underwriting terms loosened and the speed of transactions accelerated. In the aftermath of the financial markets crisis precipitated by the residential mortgage market, the commercial

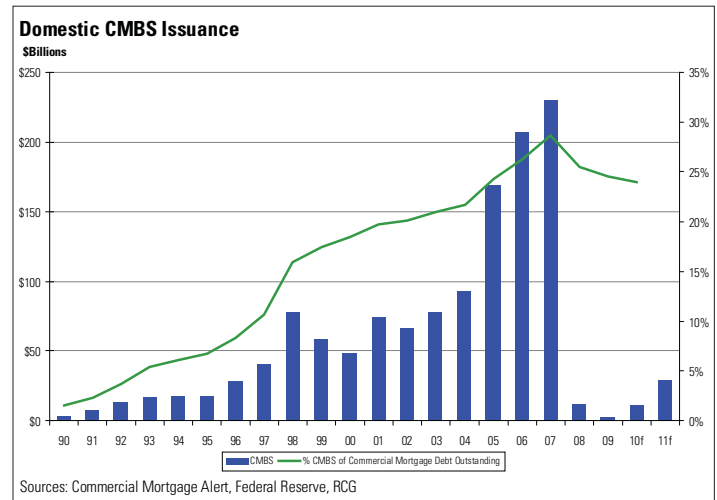


and multifamily markets shrunk and mortgage spreads widened to unprecedented levels. From a distress-period high of 1,426 basis points in November of 2008, commercial mortgage spreads narrowed by early 2010 and have remained in a band between 235 and 335 basis points since late February of 2010. Mortgages outstanding declined by \$109 billion to \$3.2 trillion as of the second quarter of 2010. The process of working out problem loans has been slow, with the decline to date more reflective of lender writedowns than loan paydowns or resolutions. Moreover, new origination volume fell off sharply with the near elimination of acquisition volume and construction.

Private Lenders

The majority of the \$3.2 trillion commercial/multifamily mortgage universe is held by private institutions. Commercial banks account for the largest share of total holdings at 45.0% or \$1.5 trillion. Banks participate in both whole and securitized loans. The smaller banks, those with assets under \$1 billion, hold a greater share of non-residential real estate loans to total assets at 29.0% compared with 12.0% at banks with assets over \$1 billion.

Life companies hold 9.2% or \$298.7 billion of commercial/multifamily mortgages as of the second quarter of 2010. During the boom, life companies were priced out of highly leveraged deals and instead invested in higher-tranched CMBS bonds. However, their lack of legacy burden has enabled them to increase activity in 2010. Other private holders, such as pension funds and savings institutions, hold 10.0%, or \$320.0 billion of outstanding commercial/multifamily mortgages. The government-sponsored enterprises (GSEs) hold \$310.5 billion in mortgages, of which all are in multifamily mortgages. The amount owned by GSEs represents 36.8% of all multifamily mortgages outstanding and 9.6% of the commercial/multifamily mortgages.



Securitized Lenders

Beginning with single borrower deals issued by Wall Street in the mid-1980s, CMBS took off in the 1990s, spurred first by Resolution Trust Corporation's securitized sales of distressed assets, and second, by the opportunity created by portfolio lenders exiting the origination market during the 1991-93 credit crunch. From 1.0% in 1990, the CMBS share of mortgages outstanding grew to nearly 29.0% in 2007. CMBS volume slowed substantially in the first half of 2008 and then stopped completely for three quarters. New issuance since the second quarter of 2009 totaled a mere \$7.7 billion. As of the second quarter of 2010, CMBS accounted for 22.7% of mortgages outstanding. The increase in government-sponsored agencies focused exclusively on multifamily activity has lifted multifamily securitization to 29.3% from 18.7% in 2007.

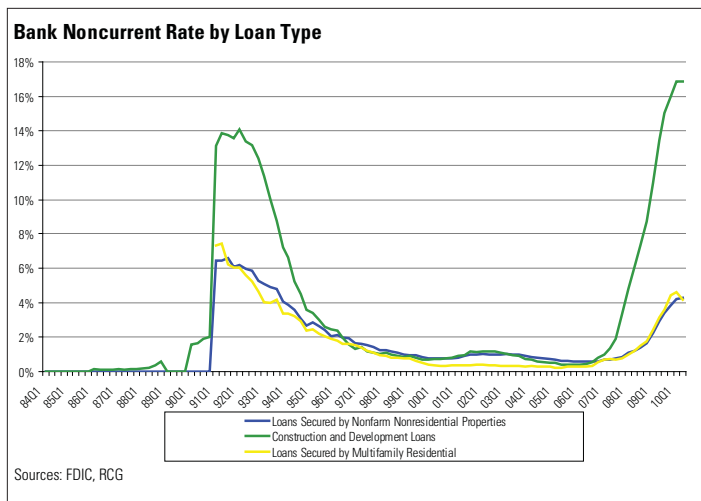
Distressed Mortgages

Commercial loan delinquencies began rising in 2008. In contrast with the 1990-91 downturn, in the current crisis, lenders and servicers have demonstrated a preference for resolution and restructuring over disposition. The earlier crisis was characterized by a speedier transition through foreclosure. In the aftermath, opportunity funds picked up deals at deeply discounted prices. Many seasoned lenders remember having left money on the table during that time. Beyond their reluctance to do so again, it is most likely that today low Treasury rates have facilitated the current long period of "amend and pretend" despite weakened net operating income. Along with lender concessions, borrowers have been able to stay current with artificially low mortgage payments in a phenomenon dubbed "Liber life support". Rather than returning to the RTC model, in the current crisis, the government has focused on providing capital to troubled banks and efforts to support the securitized market.

Private Lenders

Construction and development loans have proven to be the riskiest to date. According to the FDIC, the delinquency rate for these loans among all FDIC-insured banks climbed to 16.9% in March of 2010 from 3.2% in December of 2007.

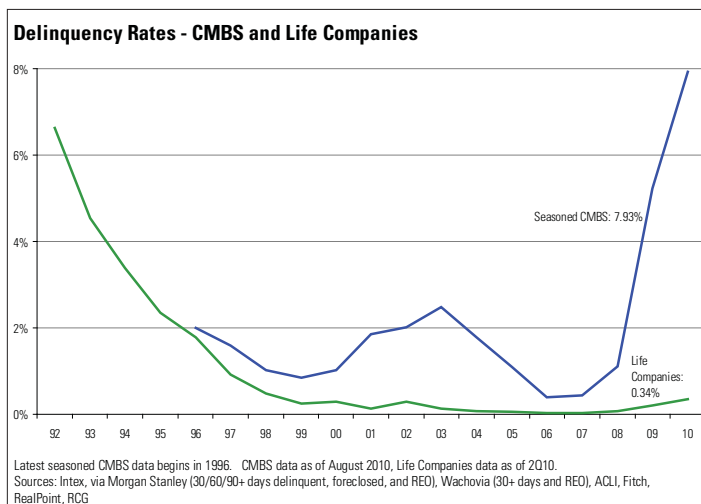
The rate remained at 16.9% in June of 2010 and dropped slightly in September 2010 at 16.6%. As of the third quarter of 2010, there were roughly 700 banks on the watch list, with between four and six closing each week. A total of 140 banks were closed in 2009 and 127 through the third quarter of in 2010. Real estate bank loan delinquencies have crept steadily upward as well. According to the FDIC, commercial and multifamily bank mortgages had non-current rates of 4.3% and 4.2%, respectively, in the second quarter. Life companies had a much lower delinquency rate of 0.3%, reflecting both their more conservative lending practices and the fact that they were priced out during the narrowed-spread boom period.

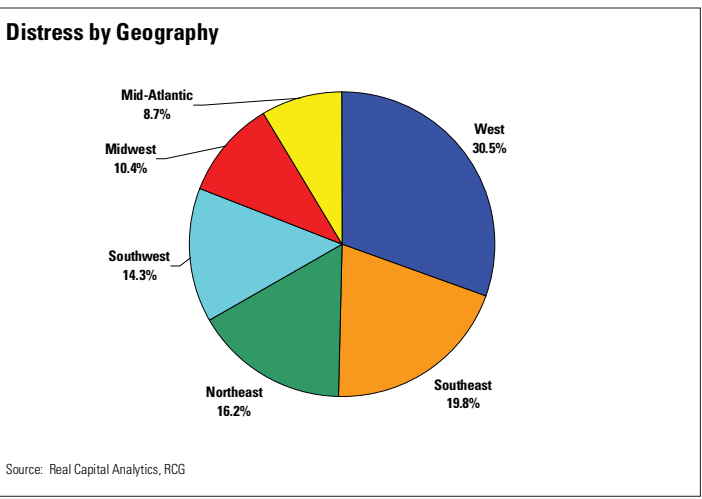
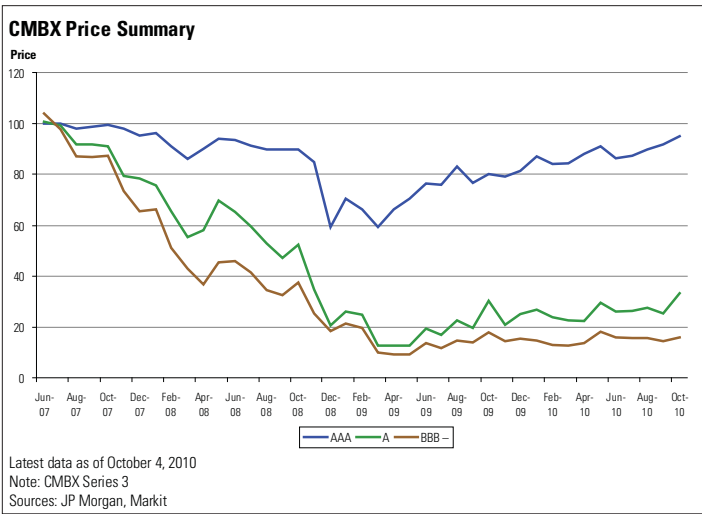


Securitized Loans

The trailing three-month delinquency rate for CMBS reached 8.0% in September of 2010, up from 3.9% a year earlier, according to RealPoint. Of total delinquencies in September, 80.0% were seriously delinquent (90+ day, foreclosure, and REO). By property type, multifamily led delinquencies at 24.7% in September, with hotels behind at 15.2%. Industrial properties had the lowest delinquency rate at 3.2%.

The government expanded the Term Asset-Backed Securities Loan Facility (TALF) to CMBS investors for legacy and new AAA CMBS bonds in February 2009. The Public-Private Investment Program (PPIP) was added in 2009 to facilitate the acquisition of troubled bank assets. Though little use has been made of these programs, they have provided a sense of security that, along with unusually low Treasury bond yields, has helped stabilize the market. The derivatives market indicates the pricing for AAA tranches has returned near to par depending on the instrument. In contrast, the A and BBB- tranches remain near crisis lows at 29.92 and 15.35, respectively.





Types of Distress

According to Real Capital Analytics, a total of \$280.6 billion in whole and securitized commercial loans have become distressed since January 2007. The pace of problem accumulation slowed in the third quarter of 2010, with the net addition of \$2.4 billion marking the lowest level since the third quarter of 2007. As of September, 31.8% of these loans had been resolved or restructured and 12.2% have transitioned to real-estate owned, leaving \$191.6 billion distressed. The remaining distress is distributed across property type and geography with office and the West dominating.

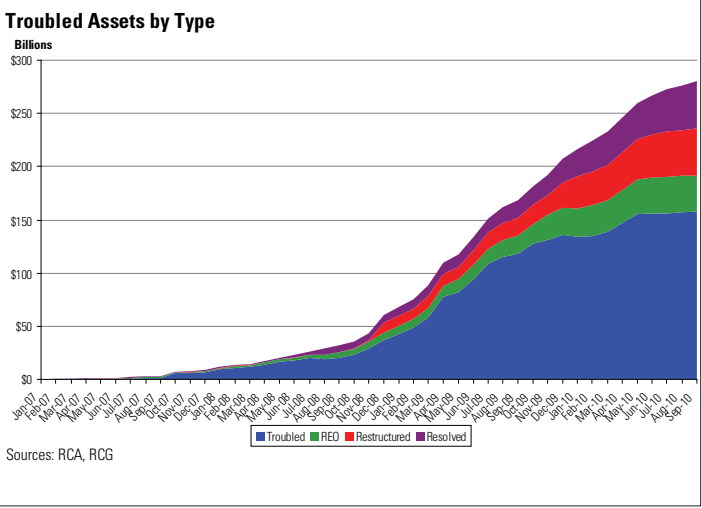
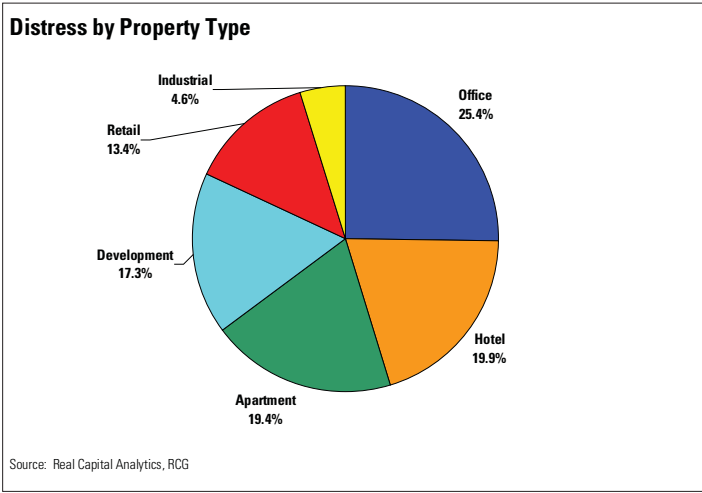
In the first eight months of 2010, job growth drove improvements in rent and vacancy across property types. Net job additions totaled 723,000 during this time, beginning the slow recovery of the 8.3 million jobs lost in the recession. Increased health in the job market is reflected in improving real estate fundamentals. Across property types, vacancy rates are peaking or beginning to decline after spiking in late 2008 and early 2009. Rising absorption is contributing to the removal of lease concessions and is expected to lead to the return of positive rent growth for all property types by 2011.

The latest data on distress by holder reported by Real Capital Analytics is as of year-end 2009 when distressed loans totaled \$207.5 billion. Due to their higher appetite for risk during the boom, CMBS and commercial banks held the lion's share of distress.

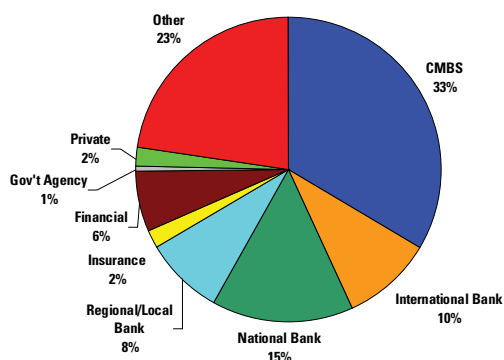
Artificially-low interest rates are drawing investor interest to higher-yielding assets, including real estate. Relative to 10-year Treasury rates, all property types are near highs in relative spreads. It is important to note however that transaction volume was fairly light in 2010. Therefore, cap rate levels are being estimated based on limited data. Within this low volume, cap rates have moved down from 2009 highs for apartments and office. Anecdotal evidence suggests the few transactions that have occurred are in core markets for trophy or near-trophy performing assets. Cap rates have moved up further for retail and industrial properties.

Office comprised the largest sector share of distress for all holders. The only exception was government agencies, which primarily hold apartment loans. The aforementioned hazardous nature of construction and development loans was clearly illustrated in regional and local bank loan holdings. Real Capital Analytics reports that during

Improving income and capital appreciation across property types lifted the NCREIF index into positive territory this year. As a separate confirmation of cap rate movement, NCREIF capital apprecia-

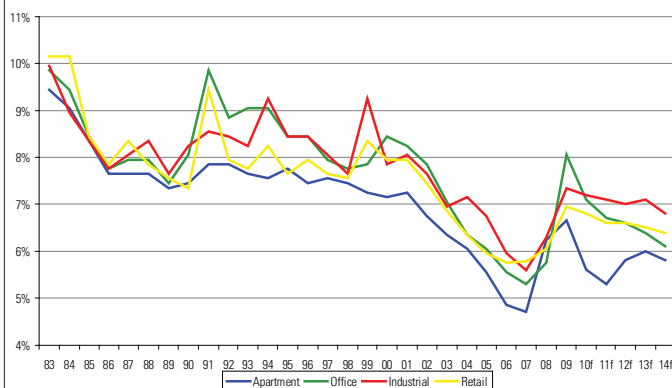


Distress by Lender as of Year-End 2009 (\$bn)



Source: Real Capital Analytics, RCG

Cap Rates by Product Type



Historical data as of 4Q
Sources: ACLU, RCG

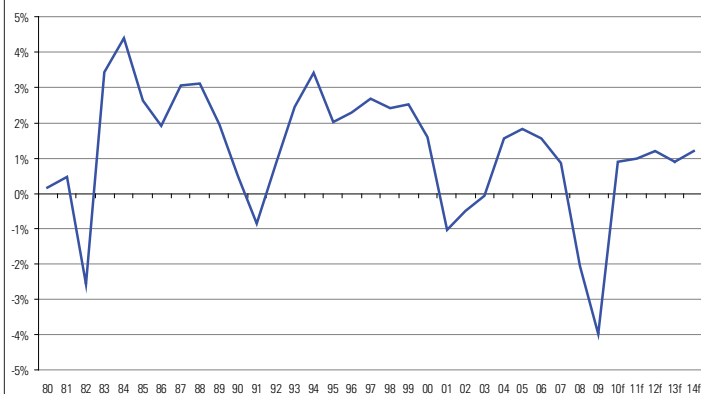
tion was positive for all property types, other than for industrial and hotel. For the latter two, however, capital diminishment was reduced to less than 1.0% and appears poised to turn positive in the next reporting period. Through the first half of 2010, the NCREIF total index grew by 4.1%, a significant rebound from the negative 13.0% return in the first half of 2009. The state of both property market fundamentals and the capital markets makes for favorable debt investment conditions.

Outlook

The environment for debt is strong and will likely remain positive over the forecast horizon. Improving market fundamentals are the leading reason for the positive outlook. Rising loan maturities, the resolution of troubled assets and the wind-down of the credit crunch are expected to enhance opportunities in the near-to-medium term.

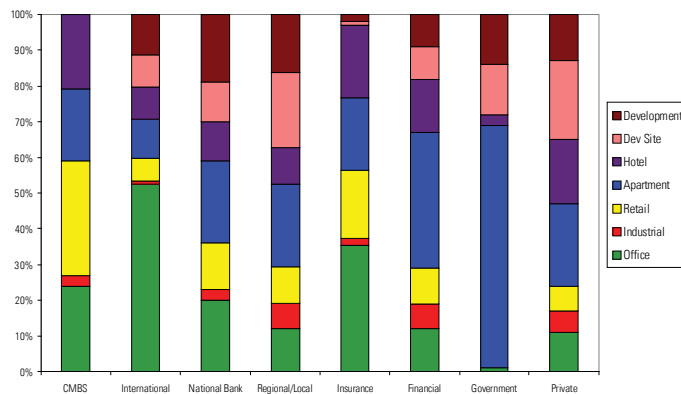
RCG expects slow but steady economic growth over the next five years. We expect faster growth in the recovery period, a dip in 2013 and a return to trend in 2014, resulting in an average 2.2% growth rate in GDP over the period. Employment growth is forecasted to average 1.0% annually. This slow pace is likely not enough to cover the annual growth in the labor force and the 8.3 million lost jobs

Total Employment Growth, Year-Over-Year at 4Q



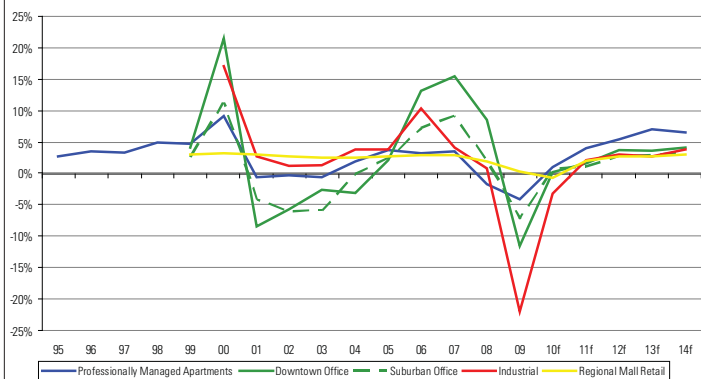
Sources: BLS, RCG

Shares of Distress by Property Type as of Year-End 2009

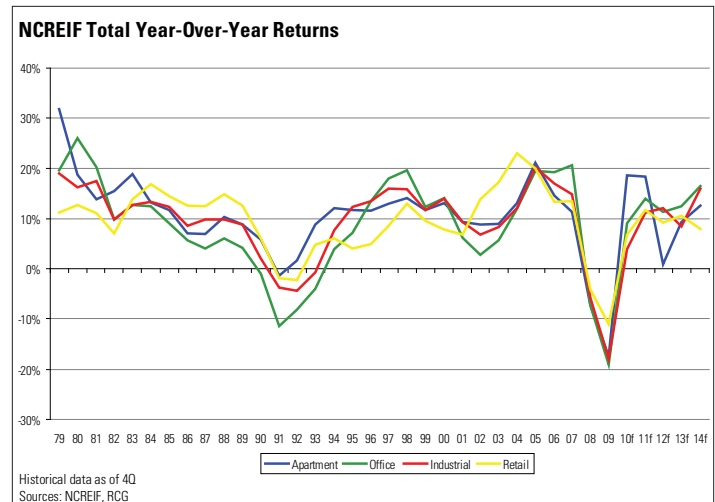
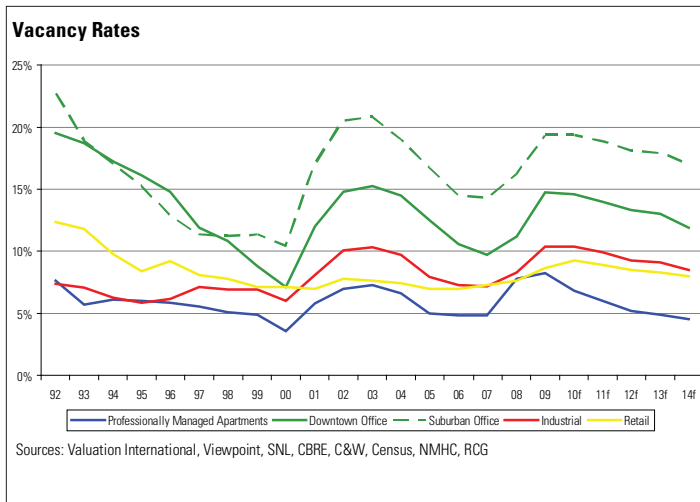


Source: Real Capital Analytics, RCG

Rent Growth



Apartment series starts in 1995, office and retail in 1999, and industrial in 2000
Sources: C&W, CBRE, NMHC, Grubb & Ellis, BLS, various local brokers, RCG



and, as a result, unemployment is expected to drift down only to 7.0%. We believe the low-interest rate period should end in 2011 with the 10-year Treasury bond moving up to 4.5% by the end of 2011 and 5.5% by the end of 2012. The recovery is expected to lead to improving market fundamentals across property types over our five-year forecast horizon. Construction levels are and should be low. Occupancies are expected to rise, pushing vacancy rates down. The slow growth, however, is likely to keep vacancy rates above lows reached in the two previous booms.

As with vacancies, rent growth should be healthy, but lower than during the two previous booms. Rent spikes are expected to occur in selected tight markets. The distress in the market has created different categories of buildings. Some buildings, whether Class A or B, with underwater or nonperforming loans, may not be actively managed today. Such buildings will likely be behind the curve as occupancies and rents rise. However, it will be important for lenders and equity investors to be aware of the status of such potentially competitive buildings as loan problems are abated. So-called “zombie” buildings may get new capital infusions, awakening them to compete for tenants. As a result of occupancy and rent gains, net operating income is forecasted to improve over the forecast horizon. Cap rates are falling across the board. The market is also restoring a great differential in cap rates across asset class and location. The boom era was characterized both by cap rate compression and minimal price distinction by quality or geography by the 2007 peak in pricing. We expect to see greater distinction in pricing between core and opportunistic deals and among prime, secondary and tertiary markets. Performance returns are expected to rise to double-digit levels, reflecting steady income returns and rising property values.

The Case for Debt Investment

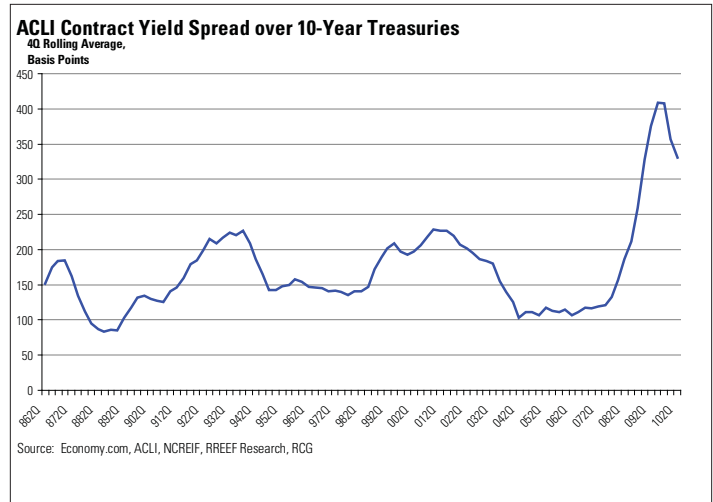
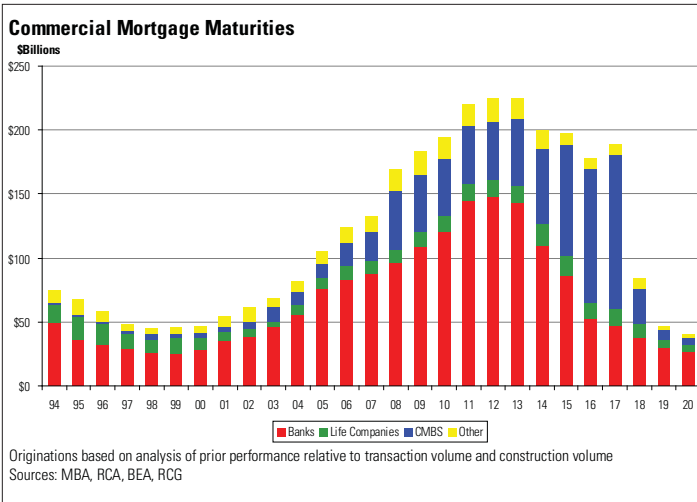
In addition to the economic and market fundamental positives for debt investing, capital market factors favor real estate in general and debt in particular. Real estate is comparatively cheap right now relative to 10-year Treasuries. The spread should narrow as

Treasuries rise and cap rates decrease over the forecast horizon. We expect commercial mortgage spreads to gradually narrow to 200 basis points, as Treasury rates increase in 2011. This is still above the long-run average spread of 170 basis points, but below the recent peak of 407 basis points at the end of 2009.

While the four-quarter rolling average spread narrowed to 330 basis points as of the second quarter of 2010, uncertainty and the lack of competition has kept spreads well-above the long-term average. In contrast, spreads had narrowed to 115 basis points during the 2005-2007 boom. Leverage is and should remain positive based on aggregate cap rates. For more highly sought-after trophy and top-ten market assets, cap rate compression will likely narrow this relative advantage.

We expect there to be a wave of challenging maturities from 2010 through 2017. According to the Mortgage Bankers Association, the volume of commercial loan maturities will peak at \$225 billion in 2012 and continue at the \$150 billion plus level through 2017. The challenge will come from possible value deterioration, impaired cash flows and high loan-to-value ratios of the maturing loans. While improving market fundamentals will help, a combination of fresh equity, lender write-downs and foreclosure or borrower bankruptcy will likely be required to close the equity gap. We estimate that the shortfall between mortgage originations and mortgage demand will total roughly \$345 billion over the next three to four years. To arrive at this estimation, we modeled the supply-demand relationship of non-CMBS new mortgages outstanding to changes in construction and transaction volumes between the first quarter of 2001 and the first quarter of 2010. The first independent variable, transaction volume, from Real Capital Analytics, represents all transactions over \$5 million. A regression was run to obtain a model, and RCG projections for transaction volume and construction over the next five years were inserted into the model to obtain an estimate of an average yearly non-CMBS origination level.

The CMBS market is awakening very slowly to date. Most of the major banks have announced they have reopened their CMBS



origination shops. We believe issuance will be limited to \$11 billion at most in 2010 and rise to \$30 billion in 2011. While we do not formally forecast beyond 2011, we do not expect a return to the plus \$200 billion level during the forecast horizon, nor potentially beyond. For CMBS and other real estate lending, the new financial regulations on capital markets will affect banks going forward. How the Volcker Rule and other new regulations will be implemented is still in formation.

It is important to note that both equity and mortgage REITs are well capitalized given their strong performance this year, high value relative to private real estate and new offerings. Through September of 2010, IPO and secondary equity issuance totaled \$16.4 billion. Of this, \$2.9 billion was raised by mortgage REITs. In addition, a total of 11 new REITs have formed over the past two years as blind pools. Of these new REITs, four equity REITs are targeting commercial financing. With an additional increase of \$15.4 billion in unsecured debt, REITs are positioned to be active. In fact, equity REITs are currently buying debt as a proxy for traditional investment because debt offers advantageous risk adjusted returns and provides access to previously unattainable assets. Whether as equity investors or providers of debt, we expect REITs will compete with private lenders particularly for value-added deals.

Debt capital is likely to be deployed in a range of formats including rescue capital, purchase of discounted whole and securitized loans in the secondary market, and through the origination of new loans. Mezzanine debt may be employed as part of rescue capital or new origination. Mezzanine debt, filling in the capital gap between traditional (first mortgage) debt and pure equity, combines the characteristics of debt and equity in that it has a preferred claim on assets, but is exposed to market risk (a fall in prices of 15%-20%). Conservative underwriting will limit first mortgages to 75% loan-to-value or less. Mezzanine debt will be able to fill the 65%-85% band in the capital structure. Compared with first mortgages, there are a more limited number of private players targeting mezzanine lending. This is because mezzanine lending requires a higher appetite for risk and a more refined set of investment skills than first mortgage

lending. Given that the current lending landscape is replete with opportunities to invest in highly desirable first mortgages at advantageous terms, it is natural that mezzanine lending would not be as popular. In addition, while non-investment grade CMBS tranches traditionally competed with mezzanine lenders, private investors will be able to activate lending ahead of slowly re-emerging CMBS issuers.

Opportunities for debt investment exist in three major categories: maturing loans (both performing and non-performing), broken deals, and new loans. We will describe the opportunities in these terms without making the distinction between loans in whole form or securitized, as the secondary market includes loans in both forms.

Performing Loans with Positive Cash Flow

Performing loans are attracting the most interest from currently active lenders such as life companies, pension funds, and international banks. The top ten markets, including New York and Washington, D.C., contain a high proportion of these loans. Long-term CBD leases in these markets allowed cash flow to continue at many properties. Thus, core performing loans in top tier markets have been the first choice among debt investors so far this cycle. Similarly, acquisition opportunities in these property types are drawing equity investors, pushing cap rates down. Such acquisitions are also creating new loan opportunities, but pricing for this select tier is competitive. This has created an aggressive environment among lenders, prompting them to lower their offered rates and thus narrowing credit spreads to Treasuries.

Performing loans with positive cash flow can also be found in secondary markets. Houston, Dallas, Philadelphia, and Denver are in the top ten markets with the lowest percentage of peak-to-trough job losses tracked by RCG. The focus on trophy lending has left plenty of opportunities in secondary markets without as much competition. For instance, international banks, which have increased their overall U.S. debt investment activity recently, have historically been hesitant

to look at secondary markets. Lenders with the confidence to perform due diligence and underwrite risk will find opportunities. Further, the current lack of construction mitigates the risk of overbuilding, which is a perennial problem in lower barrier-to-entry markets, many of which tend to be secondary.

Underwater Loans with Positive Cash Flow

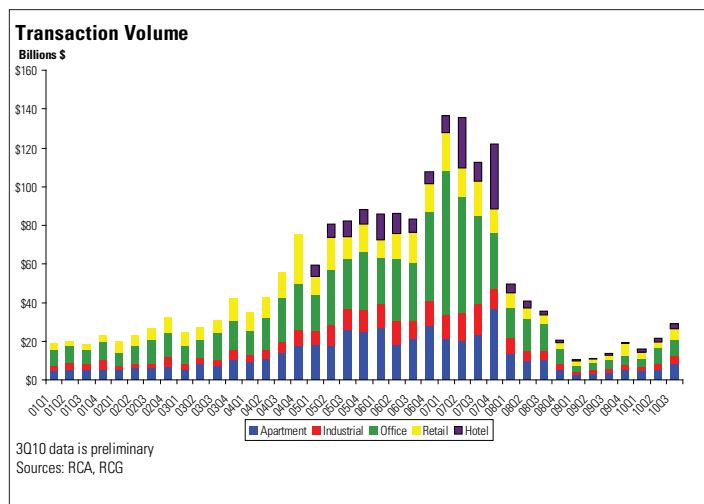
For underwater loans with positive cash flow, the devaluation of the property is likely due more to market-level capital depreciation rather than property-level problems. Mortgage holders have handled this type of distress through both a restructuring and/or resolution process. Restructuring largely involves modifying the loan terms or balance. It does not always result in a permanent solution to distress, leaving potential additional work for a later date, presumably when market conditions are more favorable. Loans in the office and retail sectors, which tend to lag in economic recoveries, are particularly good candidates for restructuring. A resolution, which involves new management and/or new financing, could be a better choice for apartments and hotels.

Nonperforming Loans with Low Net Operating Income Potential

Non-performing loans with low net operating income potential constitute a much more acute sub-sector of distress. In the most severe cases of distress among non-performing loans, the underlying properties have “zombie” status. They exist as part of the market stock, but are so severely under-managed they are temporarily removed from market participation. These loans require much more extensive intervention than restructuring allows. Non-performing loans with relatively less risk due to location or contract terms could be good candidates for resolution. Riskier loans may be more suited to rescue capital injection either from a new lender, an equity investor or a combination. New financing and new management could help to revive these properties.

Broken Deals

Broken deals, for the most part, involve development, retrofit or conversion and, therefore, constitute loans with no expectation of near- or medium-term cash flow. The large value-add category, including both broken development deals and FDIC construction/land loans, has been mostly ignored, especially by traditionally conservative lenders such as life companies and foreign banks. However, because of supply-demand imbalance, lenders who are willing to consider value-add deals will likely enjoy a higher return, deeper discounts, and less competition. Lenders may also find potential partnerships with opportunity funds targeting equity investment in such value-added opportunities.



Broken development deals will likely have the advantage of potentially being completed ahead of projects that are still in the proposal stage, enabling them to build revenue without much competition as soon as demand gains momentum. Rescue capital providers who swap debt for equity could benefit from this early outperformance.

Construction and land loans suffer from lack of financing, as their high non-current rate suggests. Because there is no existing property, these deals are the riskiest to lenders, and would require the most due diligence. However, construction and land loans, particularly for entitled land, can provide the same first-mover advantage to rescue capital providers at a deep discount. Construction and land entitlement, especially in high barrier-to-entry markets, will likely be very valuable once demand starts to swell.

New Loans

The pace of transaction volume increased in the first half of 2010, creating opportunities for new loans. While a fraction of boom-era volumes, September year-to-date volume surpassed total 2009 volume, according to Real Capital Analytics. At the same time, more conservative underwriting standards reduced the number of potential borrowers who qualify. As mentioned, outside of the prime core markets and property types, lenders are able to be discerning in borrower and asset selection. Real Capital Analytics notes the preponderance of assumed debt or seller financing in year-to-date deals, which they attribute to the continued presence of credit constraint in the market, giving lenders an advantage over borrowers.

For both primary loans and CMBS, RCG expects loan-to-value ratios, inclusive of mezzanine loans, to be underwritten by up to 75.0%. Similarly, we expect other terms and covenants to remain conservative relative to the boom era. The cap rate pricing distinction we expect across the deal/asset quality spectrum is expected to be reflected in loan pricing and underwriting standards. As lenders compete for core top-city assets, loan-to-value ratios should move up and mortgage spreads are forecasted to narrow. With the exception of the tightening core market, we expect lenders to have

their pick of loans across property type, asset quality and location. Lenders able to identify opportunities within market inefficiencies are expected to do well. More borrowers will likely come to the table as lenders become more active. In addition, we expect equity and debt investors to widen their focus from core to value-added investment as net operating income rises. At the same time, we expect a wider range of investors to recognize the case for debt and equity investment as fundamentals improve, moving the landscape from a lender's market to a more competitive one, evenly balanced between borrowers and lenders by 2014.

Conclusion

The current environment is ideal for commercial debt investment across a wide spectrum ranging from traditional lending to rescue capital. The expected gap between mortgage maturities and new originations over the next few years will provide opportunities for investors with a variety of appetites for risk, from conservative lenders taking advantage of the availability of prime property loans to opportunistic investors willing to inject capital into the multitude of non-performing loans at higher rates of return. Loans originated over the forecast period will benefit from the following:

- Bottom-of-the-cycle origination, with property and loan-to-ratio values markedly lower than in the recent past
- A rising NOI environment
- Dry construction pipelines

These factors will mitigate the chance of default for new loans, enabling investors to benefit from a unique point in the real estate cycle.

For core investing, we recommend:

- Debt at 200 basis points or more with good debt coverage;
- Defensive loan portfolios with embedded rent growth and modest leverage.

For opportunistic investments, we recommend:

- Over-leveraged properties and portfolios that need equity restructuring.
- Mezzanine debt to fill capital gap;
- Development loans for apartments;
- Loans on single family land / housing / broken condos;