METROPOLITAN REAL ESTATE EQUITY MANAGEMENT, LLC

RAMBLINGS ON THE US COMMERCIAL REAL ESTATE MARKETS
AUGUST 1, 2008

We are certainly in the midst of the most challenging financial market environment in years – for many professionals the most challenging environment since they entered the workforce. The daily news is negative on virtually all fronts – inflation, slowing growth, bank failures, Fannie and Freddie teetering, the bear stock market, and disappearing liquidity. Investors are understandably uncertain and often more than a bit scared. With this as a backdrop, we thought it might be useful to jot down a few observations, expectations and beliefs as discussed in our (more gray haired than we like to admit) investment committee over the past few months. Our apologies if the discussion is too basic or the conclusions too obvious, but there is such an increasing amount of noise in the market – some clearly denial, some just silly – that we thought basic isn't necessarily a bad thing.

The question we hear most often is: Is this one different? The answer is yes – and no. We expect that the current ugliness will be longer and deeper than either the Long Term Capital crisis or the post-9/11 period – more like the RTC Period of the early to mid 1990s. That said, the causes of this downturn are different, and we expect the dynamics of the market to play out differently as well. Those of us that were active in commercial real estate can remember the gloom and depression that pervaded the market discussion in 1991-1993. A large wave of new supply coming on line into a slowing economy drove occupancy and effective rental rates down substantially, and the RTC dumped massive portfolios of thrift properties at pennies on the cost dollar. Owners, lenders, and prospective investors speculated that it might take 20 years to absorb the excess office space in some markets. Liquidity dried up and only the infusion of capital from non-traditional sources – new opportunity funds and the newly formed CMBS market – provided any liquidity to the market. Today, excess supply isn't the issue in most markets, but a similar level of pessimism and uncertainty exists. Today the questions relate to how long it will take to wring the excess leverage out of the system and what will the consequences of this de-leveraging be? How many financial institutions will fail? Will the regulators be able to manage the effects of these failures, or will they 'cascade' through the system? When will the consumer be healthy? On top of these issues, oil recently trading near $150 a barrel continues to weigh on consumer pocket books and the market psyche. And the meltdown in the homebuilding business – a very different sector than income-producing commercial property – continues to generate negative headlines about "real estate". With all this noise, as in 1992, there is a lot of pessimistic speculation that the financial markets may not return to health for many years.

This is probably a good time for perspective – and a modest degree of optimism. First, we firmly believe that the US economy – and the US commercial real estate markets – will recover. (We will limit this discussion to our bailiwick, commercial property.) Construction costs, which may fall a bit during the current period of softness, will ultimately rise with inflation and rising replacement cost will support rising prices for well located, well built properties in major markets. Market rents will rise in line with replacement cost (or new construction will not provide an adequate return to investors and the supply spigot will remain off). Commercial mortgage financing will be readily available from banks, life insurance companies – and even Wall Street (albeit at traditional loan-to-value ratios, not the levels available 18 months ago). Whether the market will recover is not an issue; timing is the issue. Here we can only offer an educated guess.

Before the commercial property capital markets can return to 'normal', liquidity needs to return to the mortgage market. For this to happen, the banking community needs to finish the current process of balance sheet cleaning. The inventory of 'hung' paper needs to be written down to its true 'market' value, that is, the value at which it can be sold. And much of it needs to be sold to create capacity for new loan inventories. These new loans will be underwritten with cyclically conservative assumptions and they will serve as the fuel for the next round of CMBS activity. The first wave of new CMBS issuance will also be underwritten conservatively, both in terms of the loans included and the levels of structural subordination. This is what we hope – and believe – will happen. However, for this to unfold successfully, the process of cleaning up bank balance sheets has to be managed in an orderly manner. Few institutions can take the full write downs at one time, and we expect the periodic waves of write downs (and serial equity issuance and dilution of existing shareholders) to continue at least through the end of this year. It seems as though the Fed and Treasury are in agreement as to the need to manage this process in an orderly manner – to avoid panic (and to avoid the failure of any major institutions). This process could be quite costly to the US economy in the years to come, but the necessity of avoiding any sort of financial meltdown is too clear to warrant any sort of half-way measures. That being said, if we continue on this 'managed' path, we expect that it will take 12-18 months to get through most of the major balance sheet clean up on Wall Street. (The clean up of smaller, regional bank balance sheets may take a bit longer as the logistics of dealing with the highly fragmented banking system will likely be very challenging for the regulators.) We expect the CMBS market to start to show signs of life by early next year and to be fairly liquid and functional by the end of 2009.

As the mortgage market returns, (and it is no longer possible for investors to buy debt from banks with the expectation of equity returns,) we would expect the real estate equity market to start to show signs of life as well. Today, property sale activity is at a small fraction of the volume of a year ago. The few properties that trade are either core properties that appeal to a range of US and foreign buyers (who typically buy with little or no leverage) or forced sales in circumstances where the owner is unable to refinance maturing debt. As we go into 2009, we expect volume in the equity market to increase. This will be driven by capitulation – sellers will come to terms with asset values down at least 10% from peak levels in most markets – as well as an increase in the number of owners that need to raise equity (or sell) to repay maturing debt.

The wildcard in all of this is the economy – and by extension, real estate fundamentals. Thus far, most US commercial property markets remain healthier than we would normally expect given the sluggish economy. In the office markets, the largest commercial property investment sector, the level of new supply going into this slowdown was moderate in most markets, (in large part due to the rise in construction costs,) so we are starting from relatively full occupancy levels. In addition, in many major markets rents have close to doubled in the last several years and these rental increases are still working their way through rent rolls. On the margin, we definitely expect office market rents to fall in most markets as the economic slowdown plays out. However, we expect rents to remain high enough so that most rolling leases still roll up and property cash flows continue to rise. If the Fed is unable to avoid a financial panic, or the economy goes into a deep recession, we would expect the picture to be significantly more negative – but that doesn't seem to be the path we are on.

So what does this mean for private equity real estate fund investors?

First, we expect the value of properties purchased before mid-2007 to fall, on average, in 2008 and probably in 2009 as well. Whether there will be losses reported, in our view, is not the issue. The more important question is whether those losses will be 'unrealized' or 'realized'. We have lived through commercial property cycles in the US. Having survived prior cycles, we believe that well located property in economically viable markets with reasonable barriers to new supply will appreciate over time. Owners that can afford to carry these properties – that is, those that used reasonable leverage – and sell them in the next 'up cycle' will recover their capital and make a solid return (if the property was bought and managed reasonable well) or a modest but positive return (if the property was purchased late in the cycle without significant opportunity to renovate/reposition/upgrade). For these owners, the losses of the next couple of years will remain unrealized. There will also be realized losses for some investors. Owners that bought property at or near peak levels – and used excessive leverage – will be squeezed hard over the next two years. Some will lose the properties (and all their equity) to foreclosure. Others will be forced to pay down leverage, with additional collateral or cash from their own pockets, or by bringing in new mezzanine or equity capital, to refinance.

Second, we expect that cool headed, smart, well capitalized investors will make some excellent investments over the next couple of years. (Some of these investments will be made by vintage 2006 and 2007 funds that still have meaningful dry powder, the returns on which should help to offset any losses these funds incur on existing properties.) Initially, the best investment opportunities will be in buying existing debt. While the highest loan-to-value paper will likely suffer real, significant credit losses, within the more senior portions of the capital structure, (investment grade CMBS, "B" pieces of un-securitized mortgages, etc.,) there will be some great buys. To be successful, buyers need to carefully underwrite the property cash flows and value to determine the extent of the expected losses, and to understand how much debt the property can bear going forward. But that isn't enough. Successful investors will need to be very prudent in how they finance this paper; being 100% right on the value and credit analysis isn't helpful if you can't carry the position until the market recovers. For the un-securitized paper, investors will also have to be prepared for a (possibly messy) workout in which the different classes of creditors fight for control and to protect their positions. Investors that successfully navigate these rough waters should earn very attractive returns – at least mid/high teens and in many cases well into the 20s or 30s. However, distressed investing is risky. In the short term, many distressed debt investments will suffer volatility and incur un-realized mark-to-market losses. There will also be realized losses for some investors that jump in early or don't finance the positions conservatively enough. Maturity, or a workout prior to maturity, makes it difficult for long-term property appreciation to protect debt investors that don't have adequate collateral protection or can't properly protect their positions in a workout.

As existing debt inventories get closer to being liquidated, we expect opportunities to invest in equity to become increasingly available and in many cases very attractive. In many cases, we believe that these opportunities will be to invest senior equity (or mezzanine debt) to recapitalize overleveraged properties. There will also be opportunities to buy properties from forced sellers, (or from the institutions that hold the mortgages,) at attractive prices. Finally, we expect that risk will be very conservatively priced for some time. Skilled property managers that can renovate and lease properties in a choppy economic environment will likely have the opportunity to buy un-stabilized assets and earn very attractive returns managing them through to the next up market.

Finally, we will summarize our view of what it means to be a 'value investor'. First, it means ignoring the noise – that is, the collective mood, the Wall Street Journal headlines, etc. – and analyzing the long term fundamentals of an investment. Do I feel comfortable owning this asset at this basis when the market recovers? (That is the analysis early opportunity fund managers did in 1992 when they bought office buildings in Houston at $30 a square foot.) In this market, we believe that we will be able to buy assets at what will prove to be an excellent basis when the markets recover. Second, is the asset financed conservatively enough to last through a protracted period of softness? Finally, and this is important for both investment discipline and personal health, ignore the month-to-month mark. The level of near term volatility in the financial markets is extremely high and a great value investment could well trade down the day after you make it and stay there for a year. So what? We should – and do – plan to hold the investments we are making today until their respective sectors recover.

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