



Opportunities in a Workout Environment

Fall 2010

Since we wrote about this subject last fall there have been some changes in the workout environment. However, by and large these changes have been relatively modest. This update incorporates these changes.

Over the next two to three years a substantial percentage of commercial real estate balance sheets in the U.S. and Western Europe will need to be restructured. New capital will be required to accomplish this, and we believe that providers of that capital are in a position to enjoy very attractive returns, particularly on a risk-adjusted basis.

Pricing at the peak of the cycle was fueled by abundant, and often excessive, leverage, provided with the help of creative Wall Street structuring. In a near-zero LIBOR environment, the majority of these loans (excluding construction loans) may continue to perform for some time. However, at the earlier to occur of maturity and the time when the property needs capital (e.g., a tenant improvement allowance to fill a vacant space) the chances of default are high. Whether the default happens at or before maturity, the problem is a lopsided balance sheet, and it needs to be corrected before the property can be refinanced, sold, or in many cases even properly maintained. For this to happen, the property needs to be recapitalized with a healthy and sustainable amount of debt, and the inherent loss of value needs to be absorbed by the owner, the lender, or most often a combination of the two.

The mechanism for achieving this recapitalization and the opportunity for new investors to profit from the transaction differs by the type of entity that holds the loan and by the individual institution. Banks and other traditional lenders such as life companies are constrained in the choices they can make by regulators, the extent to which they have the capital to absorb the loss and, to a growing degree, staffing. CMBS lenders have different constraints related to tax and other specific rules underlying the securitizations. That said, these constraints are proving to be less restrictive than originally anticipated, as regulators are encouraging lenders not to panic and instead to work out non-performing assets with the objective of maximizing recoveries (and absorbing the losses over time).

Bank and Other Balance Sheet Debt

We are currently seeing a wide range of distressed commercial real estate opportunities from commercial banks, including sales of foreclosed assets, loan sales, and restructurings. As we get deeper into the pool of assets that will require some form of workout, we expect the mix of opportunities to vary (e.g., the percentage of loan sales vs. foreclosed asset sales) but the overall volume of opportunities should continue to grow for some time. In addition, as the FDIC continues to work through its substantial pipeline of troubled banks we expect to see the current moderate pace of large bulk loan portfolio sales accelerate.

If a bank does not wish to pursue a foreclosure with respect to a non-performing asset, and it has the capital to absorb the full loss, the simplest execution is to sell the loan at a discount, either individually

or in a pool. For both sub-performing loans (i.e., those that are likely to default in the future) and non-performing loans, prices will likely reflect a substantial discount to both replacement cost and the expected value of the property when the real estate recession ends.

Opportunistic investors have a range of choices for participating in and benefitting from this process:

1. Acquire the whole loan from the bank and pursue a workout with the borrower. The workout generally has one of the following outcomes:
 - *Discounted payoff:* The borrower puts up or raises sufficient capital to pay off the loan at an amount less than the full amount of the unpaid principal balance but sufficiently greater than the price the acquirer paid to the bank to generate an attractive return to the holder. In this case, the loan purchaser avoids both the process of foreclosure and any real estate related issues that need to be addressed. (In negotiating with the borrower, the holder of the loan may have additional leverage to the extent the borrower has personally guaranteed some or all of the principal balance of the loan.)
 - *Foreclose and own the asset:* In cases where the loan holder and the borrower cannot come to terms on a discounted payoff, or the borrower is unable to raise the capital required for the payoff, foreclosure or a deed in lieu of foreclosure may be pursued. Should this action be taken, the investor will have to deal with any property related issues but will also have the potential to capture the full value of both property enhancements and an ultimate recovery in market values.
2. Finance the “gap” between the cost of the whole loan purchase and the amount of a new first mortgage financing that can be obtained from a traditional lender (life insurance company, Fannie/Freddie, etc.) plus whatever supplemental capital the asset may require.
3. Provide the full amount needed to buy the loan in the form of a new first mortgage within a new capital structure that includes funds to maintain the asset.

Some investors will only want to own the most senior portion of the new capital structure at returns that are currently in the mid single digit range. We believe the 50%-75% loan-to-value portion of these new capital structures, with expected returns in the mid to high teens, provides a more attractive risk/reward scenario given the very conservative level of new senior debt and current valuations. Indeed, many of these positions may be *created* by buying the whole loan and financing it through the sale of a matched-term senior participation, or “A-Note,” leaving the investor with the “B-Note” position. These moderately leveraged positions may also be created by financing the whole loan directly on balance sheet which, if conservatively structured—non-recourse, long term, no mark-to-market—can also be attractive.

There are many variations on the above themes, including solutions for banks that are able to tolerate some, but not all, of the implied capital loss. For example, a lender may choose to extend the term and/or reduce the remaining principal amount of an existing loan, essentially converting a sub- or non-performing loan into a new performing loan. This is likely to be done in tandem with an equity infusion by the existing borrower or a new third party investor whose money may have priority rights to cash flows, even over all or a portion of the senior debt. (One increasingly common approach is for the bank to split its original loan into a new, “right-sized” first mortgage with the remaining portion of

the loan converted to a mezzanine loan or other similar junior claim. Not only does this allow new money to invest behind a reasonable amount of senior debt, if done properly it may limit the amount of the bank's non-performing asset to the junior portion of the loan.)

Regardless of which of the above structures is employed, opportunistic new investors have three basic risk/return positions from which to choose in these restructurings: (i) junior debt at a very attractive basis that is likely to perform to maturity and generate a fixed (typically mid to high teens) coupon; or (ii) a position between the debt and equity (either mezzanine or preferred equity) in which the investor is likely to earn an attractive fixed return (at the moment high teens) and may also have senior rights to cash flows and participate in the expected recovery of property values; or (iii) 100% ownership of the property.

There are clearly risks in investing in a distressed environment and certain skills are required to execute successfully. It is easy to talk about a "loan to own" purchase of a note, but few managers have both the expertise to work through the financial maze (note purchase, foreclosure, potential bankruptcy, etc.) and the property expertise to restore to health a property that has likely been neglected for an extended period in a difficult operating environment. Even managers that do have the skills to accomplish their program must utilize a financing structure that provides sufficient term such that the new investor does not wind up in a second workout before the market recovers.

Securitized Debt

CMBS lenders do not have the regulatory or capital issues faced by banks; at the same time, special servicers are constrained by a range of tax and structural rules. Therefore, while we expect a similarly high percentage of CMBS loans to default (vis-à-vis bank loans) the range of opportunities to participate in a workout of a securitized mortgage will likely be narrower than with loans held by a bank. Given the size and fragmentation of the bank mortgage market, as well as the wider range of structural possibilities the bank market offers for an opportunistic investor, we expect to see a much broader range of workout discussions in the bank market than in the CMBS market. That said, the handful of large CMBS special servicers will have a huge volume of problems to solve, and there is likely to be an increasing volume of loan sales, foreclosures, and other distressed investment opportunities coming from these servicers.

While we are seeing an increasing volume of interesting investment opportunities, we have not seen attractive opportunities to buy CMBS bonds for several quarters. When the PPIP program began, CMBS bond spreads tightened to levels that in our view are no longer attractive. Going forward, we believe that trading of CMBS securities will remain very illiquid and volatile. As defaults rise over the coming quarters, we may see attractive investment opportunities in inefficiently priced bonds from time to time (particularly at times when government sponsored programs, such as PPIP, are on the sidelines). Managers that have the ability to underwrite each underlying loan and the related real estate collateral in a large portfolio will be well positioned to capitalize on these opportunities.

Conclusion

Property values are severely depressed and are likely to remain so for at least the next couple of years as workouts play out. However, we believe that they will ultimately recover, and investors who participate in these recapitalizations should have the opportunity to earn outsized returns in any of the above risk/return approaches. Regardless of what drives the restructuring, the window of opportunity

to benefit from the workout of distressed debt has opened and is expected to remain open for the next 24-36 months. Tenacity, diligence, and patience remain critical for those looking to participate in and benefit from the progression.

- David Sherman, President and Chief Investment Officer

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