Accessing US Real Estate: Navigating the Capital Stack Maze

Investment in US Real Estate & Debt
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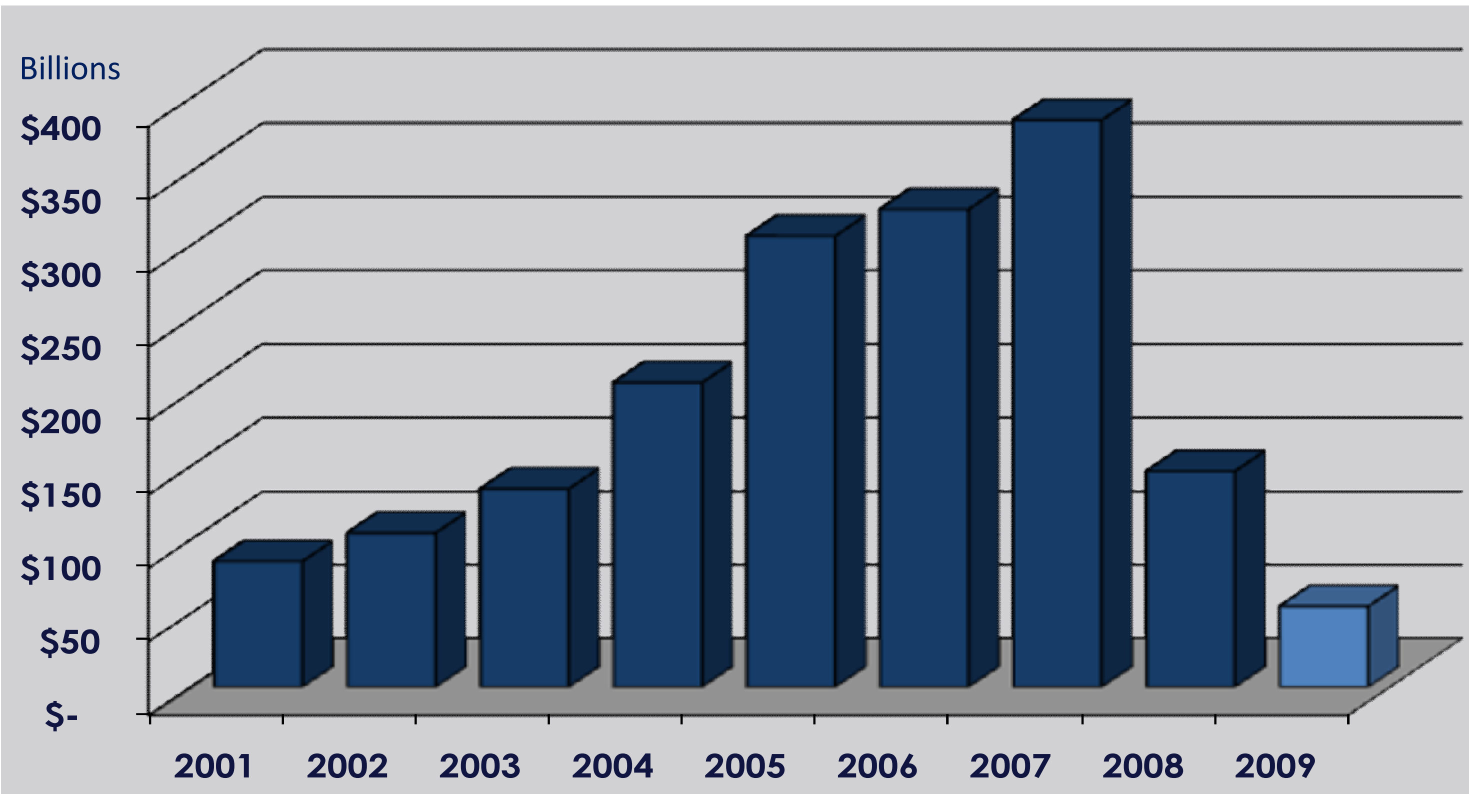
Accessing US Real Estate: Navigating the Capital Stack Maze

COMPLEXITY

Complexity
US Transaction Volume (2001-2009)

- Transaction volume increased rapidly, doubling between 2004 and 2007.

Annual US Transaction Volume – All Core & Hotel



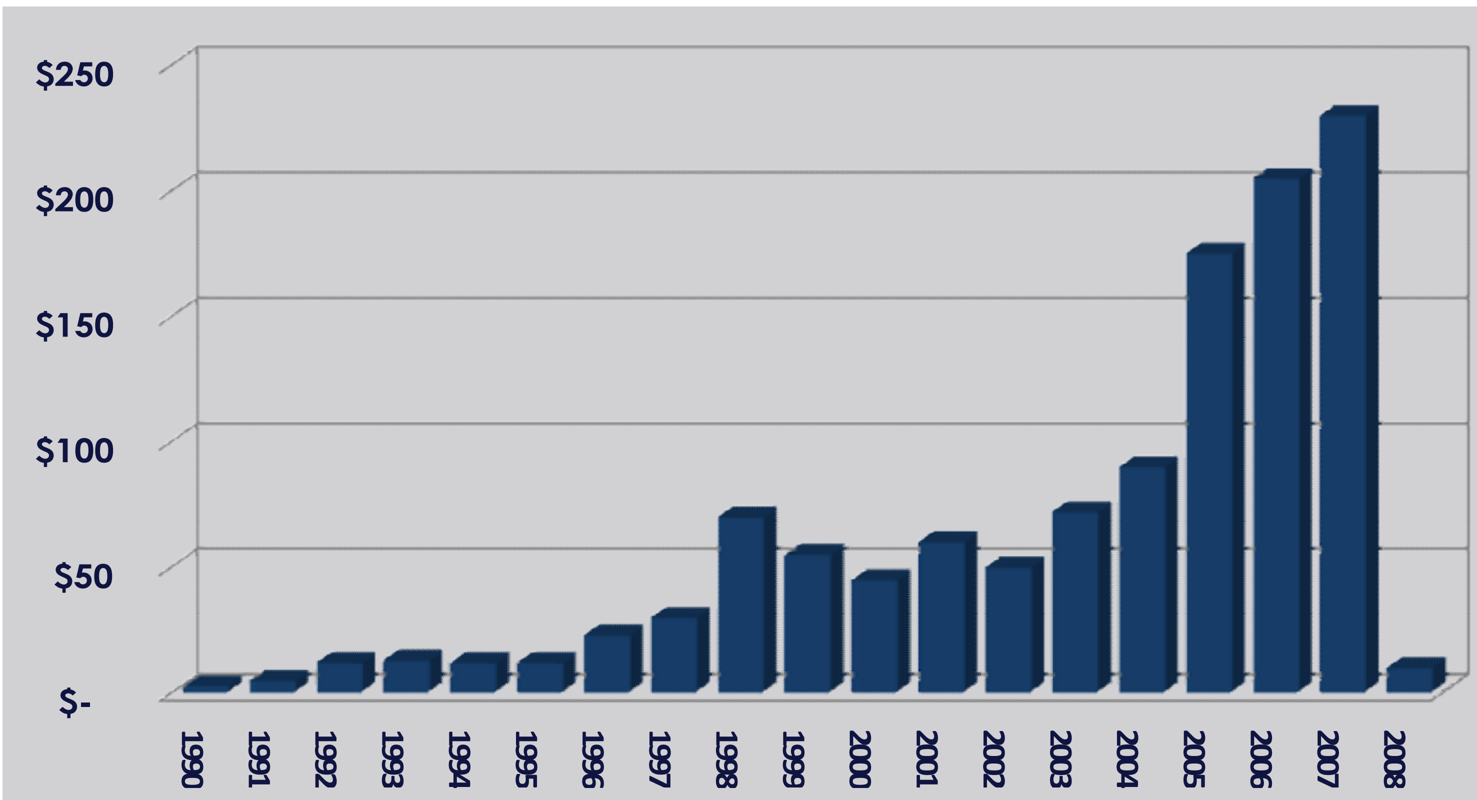
Source: Real Capital Analytics

Complexity

US CMBS Issuance (1990-2008)

- CMBS issuance increased dramatically, tripling between 2004 and 2007.

US Commercial Mortgage Backed Securities (CMBS) Issuance



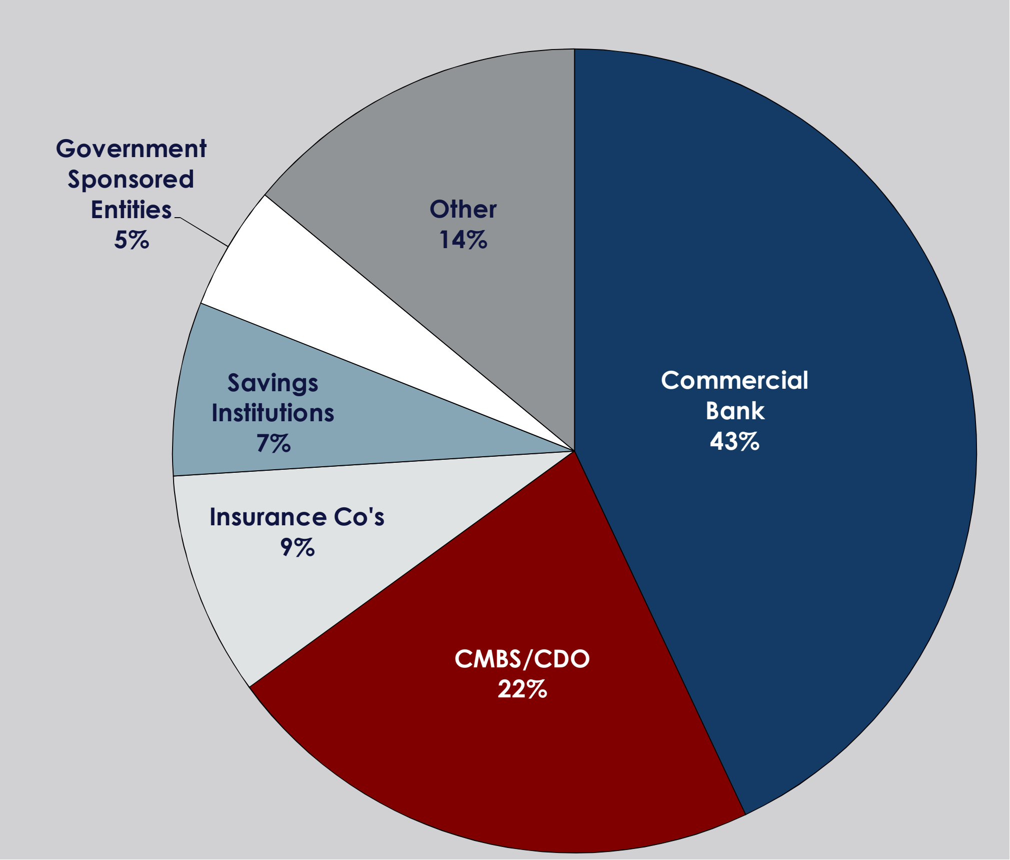
Source: Commercial Mortgage Alert and Property & Portfolio Research Data

Complexity

Total Debt Issuance with Breakdown of Financing Sources

- CMBS made up approximately 22% of commercial real estate debt, with insurance companies and banks issuing and holding more than 52% in aggregate.

Lender Composition of Fixed Income Markets
US$3.4 Trillion - 2008



Source: Holiday Fenoglio Fowler, LP 2008

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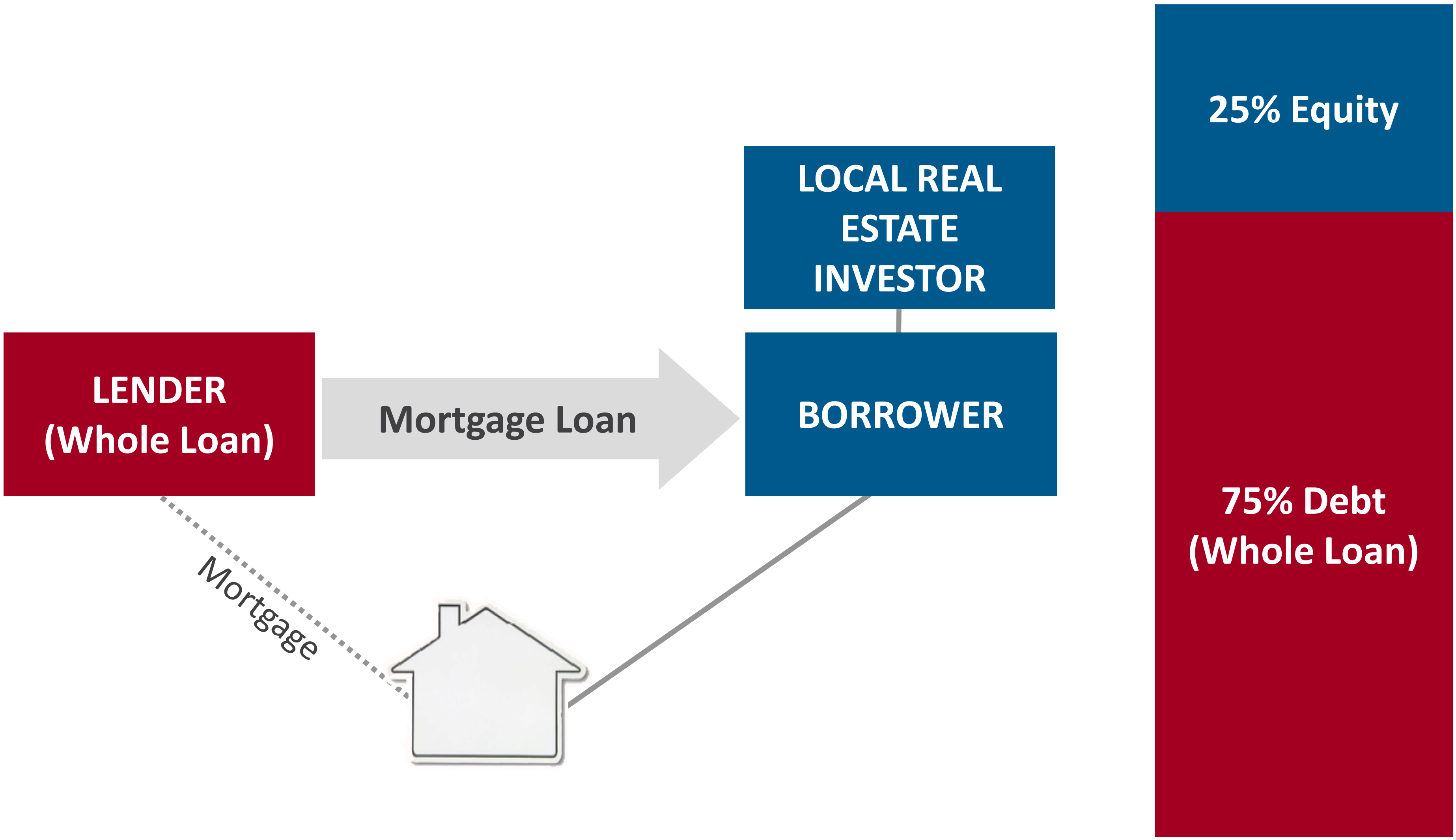
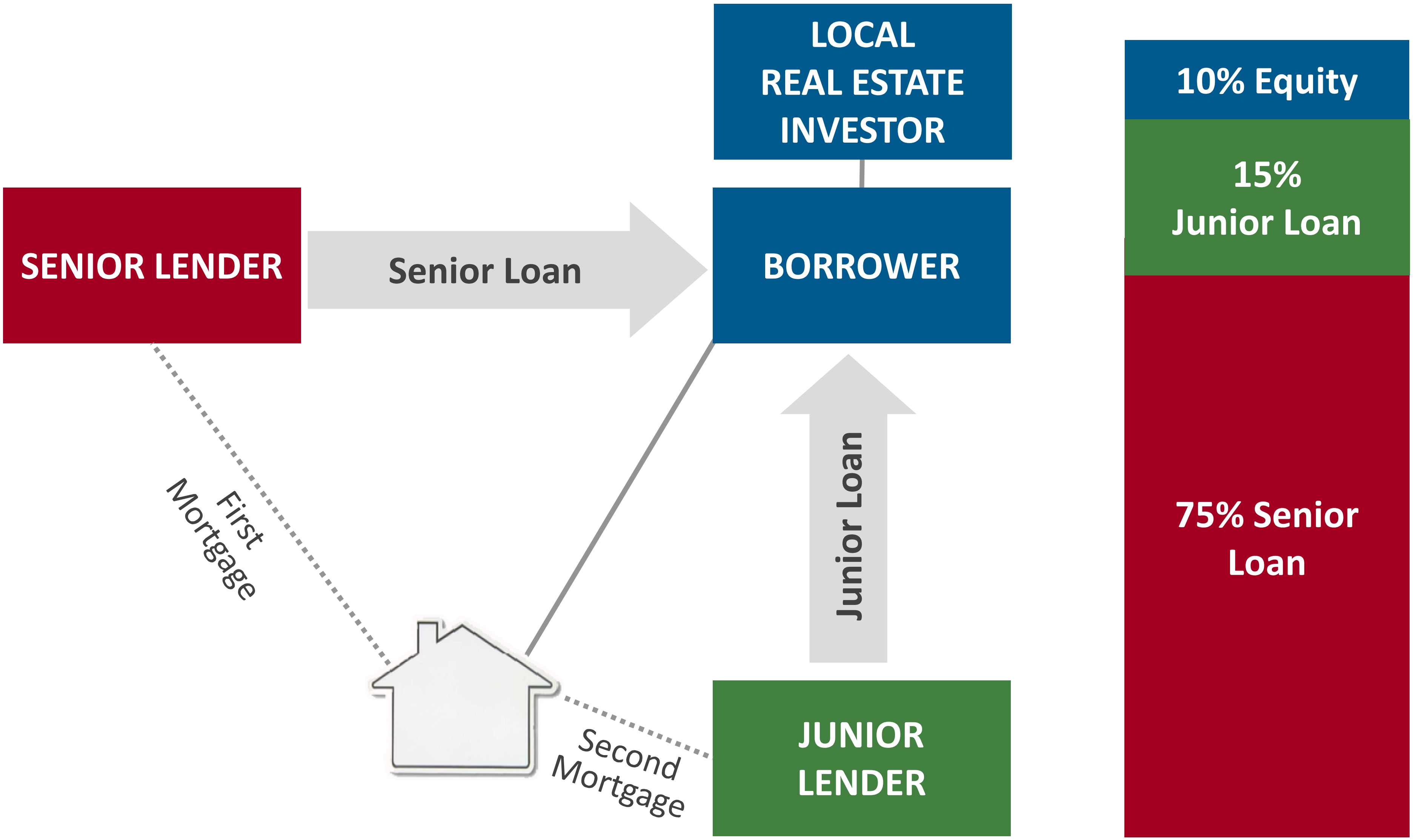
Complexity

Capital Stack — Simple Whole loan, 1 Borrower, 1 Lender



Complexity

Capital Stack — Two Multiple Mortgages



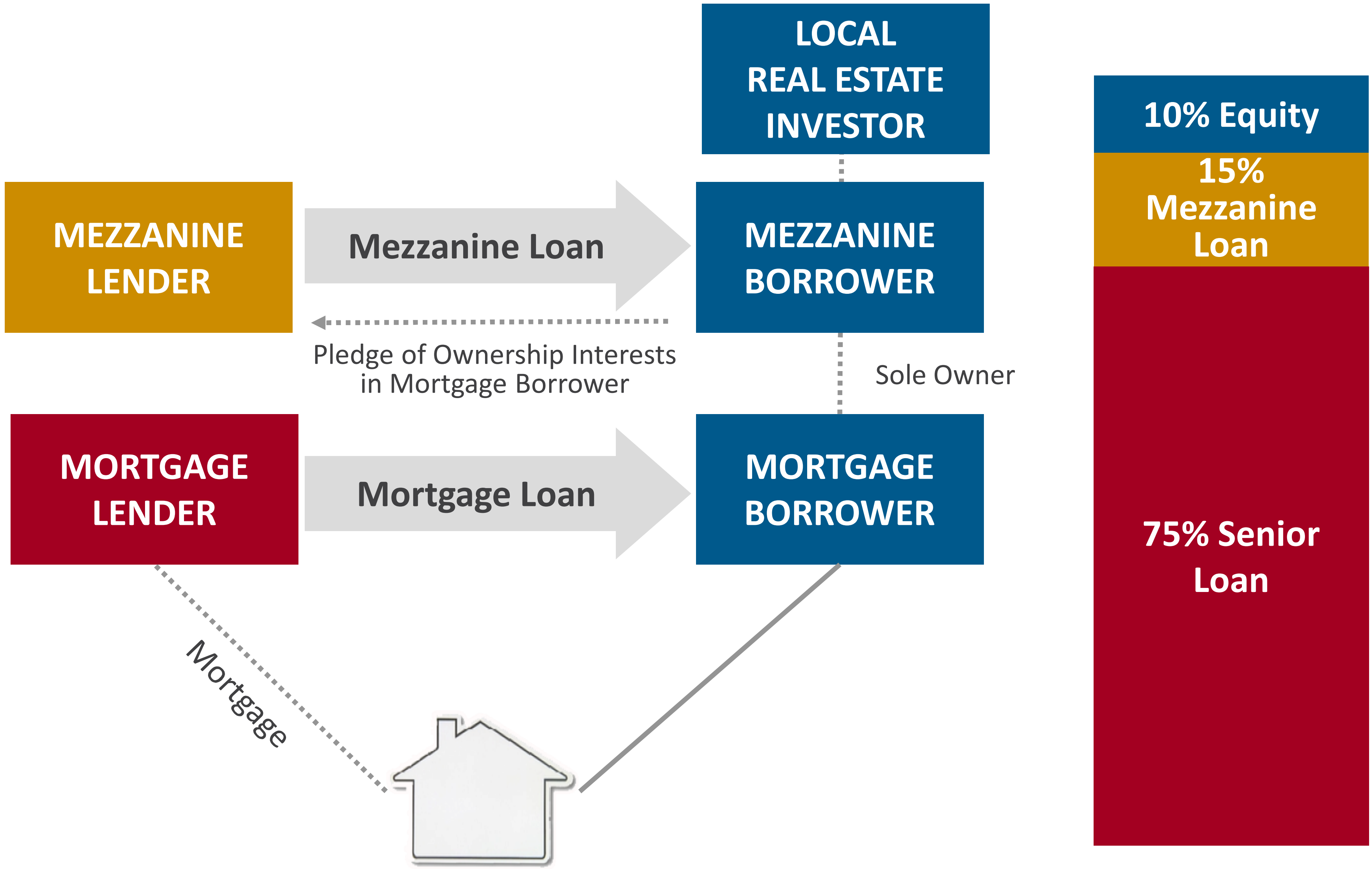
Complexity

Capital Stack — Two Multiple Mortgages cont'd.

- Inter-creditor issues, increased risk of default and cash flow pressure.
- Junior loans were a way to decrease equity requirement for local real estate investors.

Complexity

Capital Stack — Mortgage and Mezzanine Loans



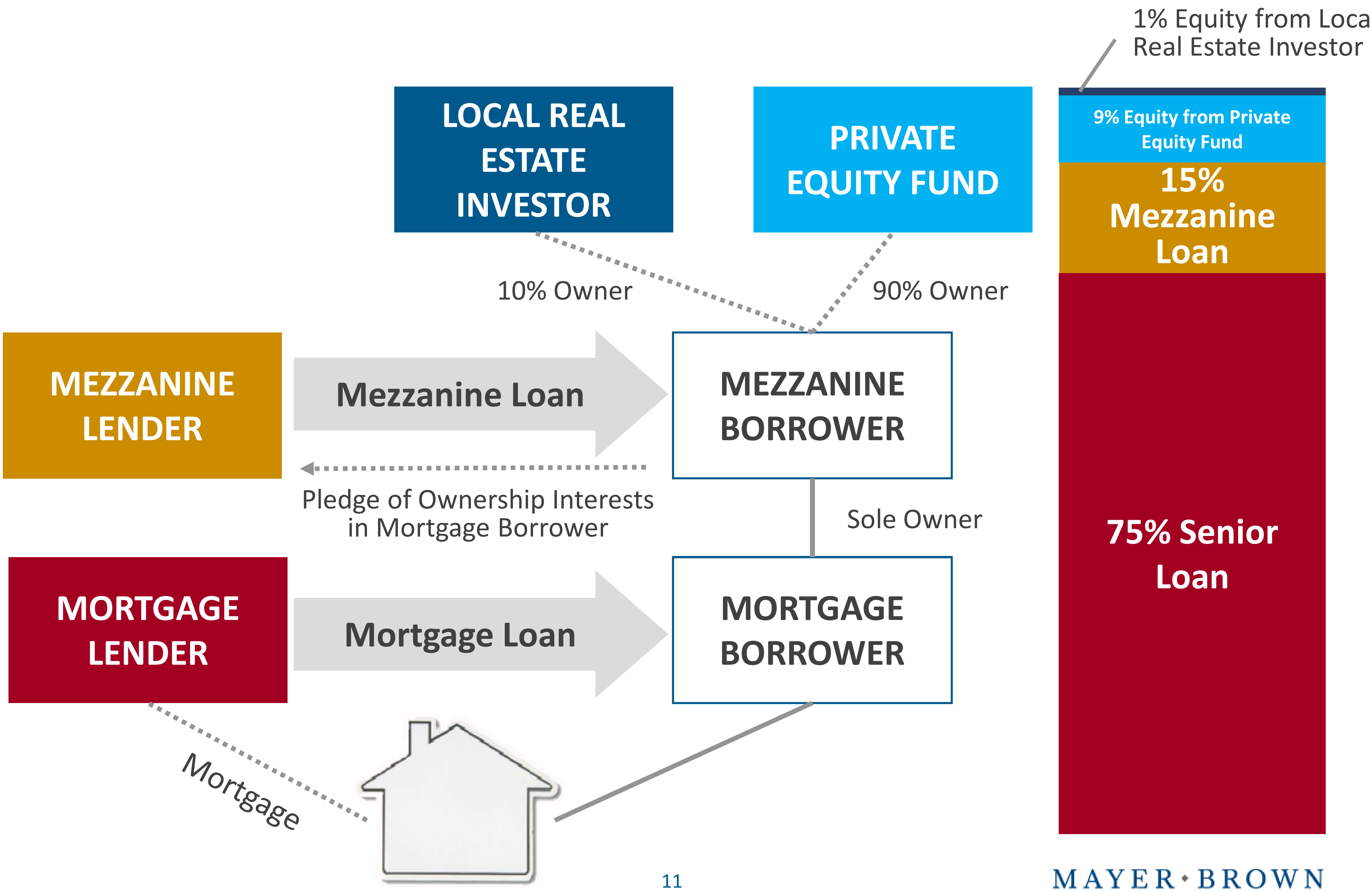
Complexity

Capital Stack — Mortgage and Mezzanine Loans cont'd.

- Mezzanine tranche was added to appease securitization restrictions (different borrower, no additional lien on the real estate assets).
- There are still inter-creditor issues and added pressure on the property cash flow, but all of this is "behind the scenes" due to the second borrower and equity pledge (rather than real estate pledge).

Complexity

Capital Stack — JV Equity, Mortgage and Mezzanine Loans

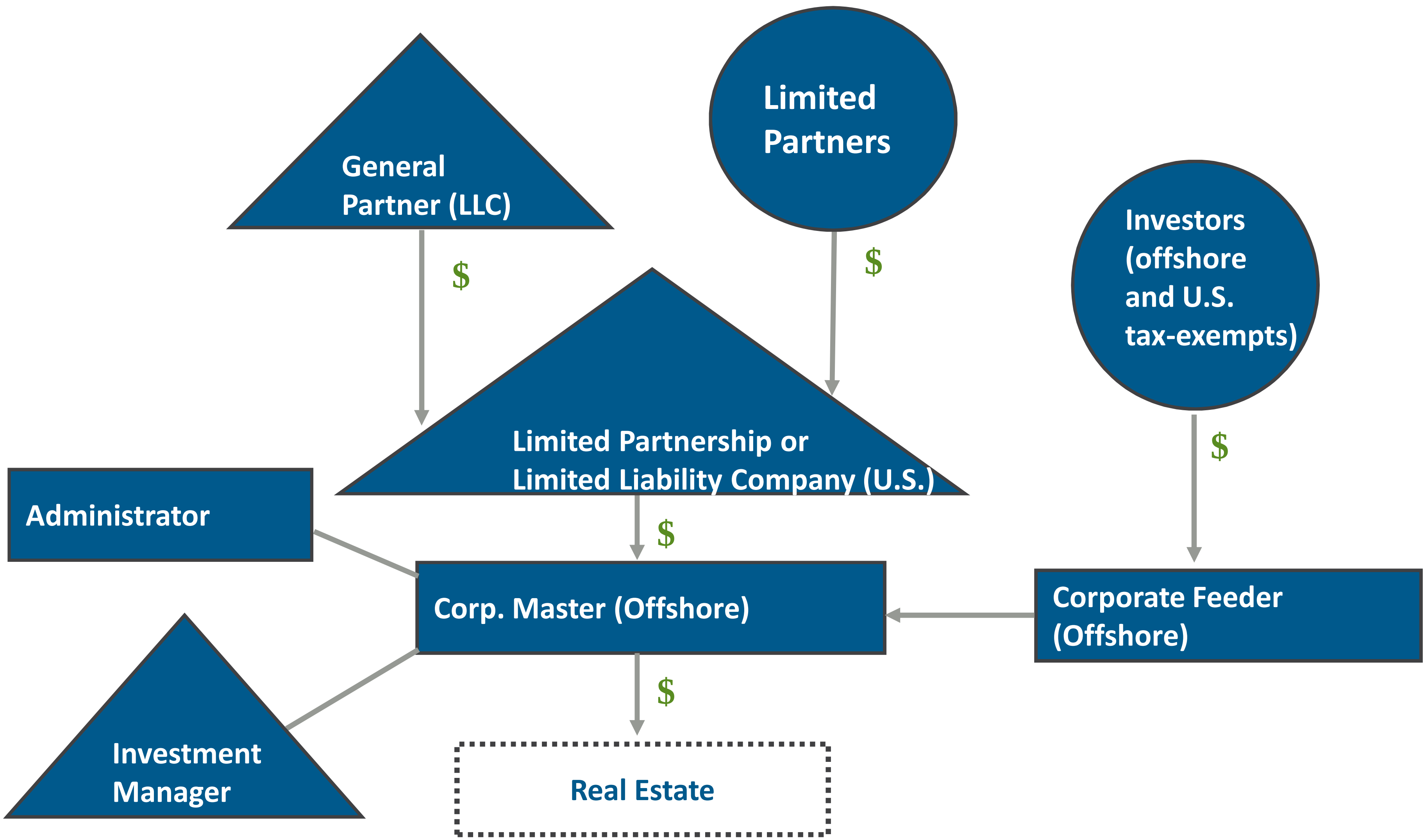


Complexity

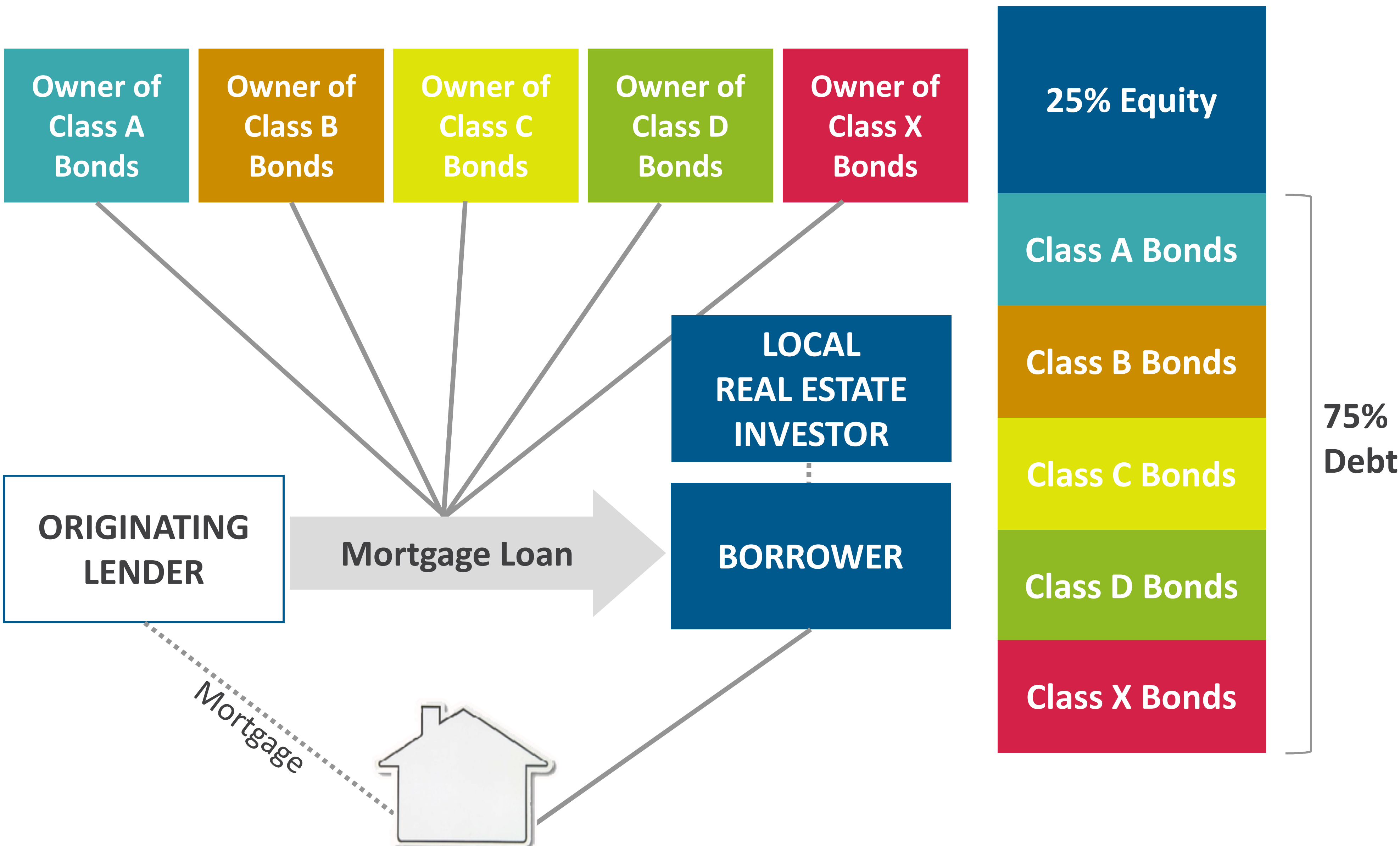
Capital Stack — JV Equity, Mortgage and Mezzanine Loans cont'd.

- Further reduced the equity requirement of local real estate investor.
- Adding an additional equity source bifurcates the risk.
- Over time, as asset prices increased on the open market, private equity money took on additional risk (entitlement, construction) to get access to product well in advance of the bidding war that would take place once the asset went to market at stabilization. Many times the private equity funds used the fund's credit to backstop construction loans.
- Many private equity funds executed on this strategy so that LP investors have small pieces of many deals across the country. Diversification was intended to reduce risk, but seriously hurt the LPs when the recession hit.

Complexity
Example Fund Structure



Complexity
Capital Stack — Securitization



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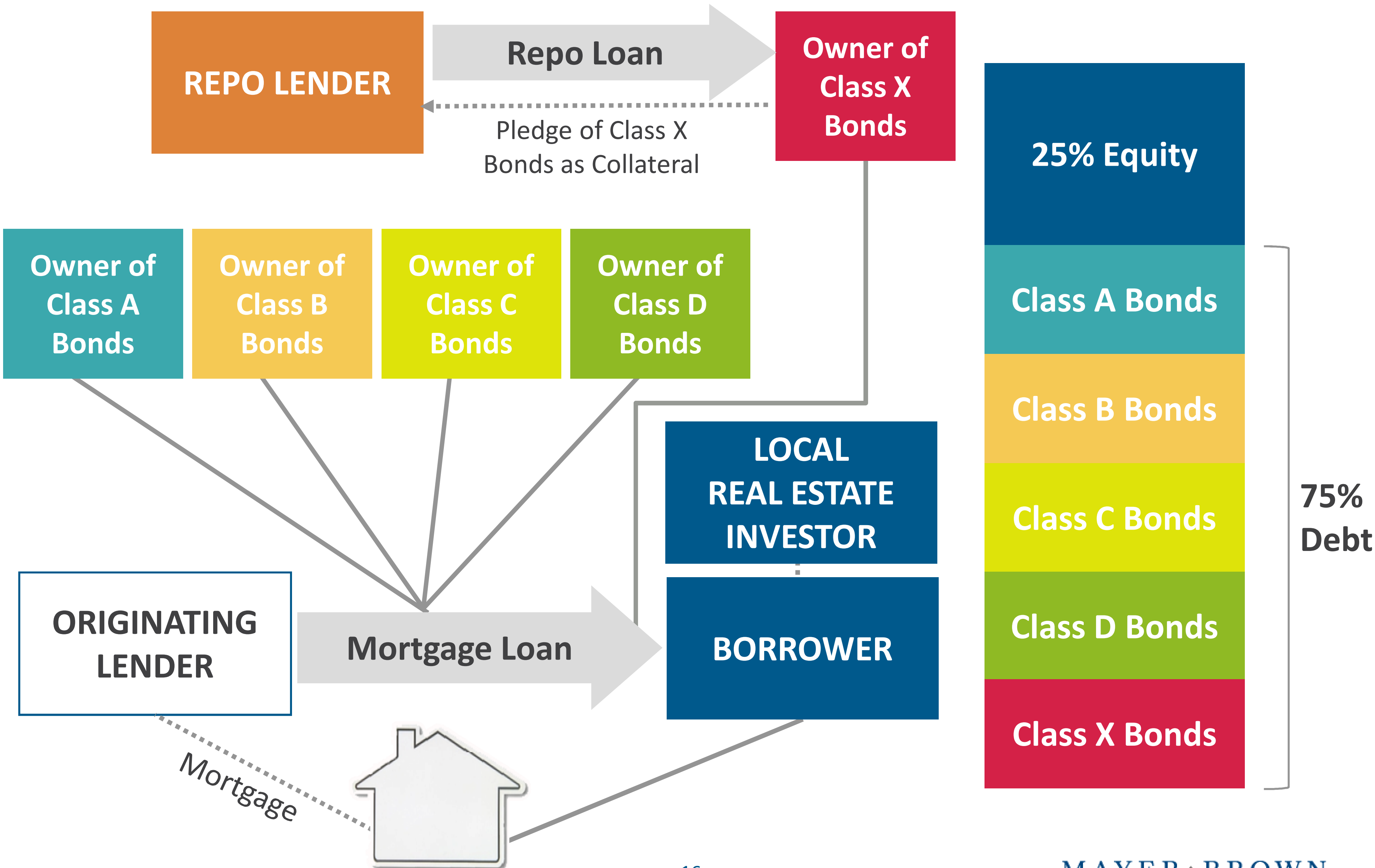
Complexity
Capital Stack — Securitization cont'd.

- The originating lender transfers the loan to a securitization trust. Capital market investors purchase securities issued by the securitization trust and rated by one or more rating agencies.
- One of the benefits of securitization was the perception that all cash flow is created equal (e.g. one dollar in Des Moines is the same as one dollar in Miami, Washington DC and New York) however, as we are seeing, the quality of the real estate and the market in which it is located is still important.

Complexity

Capital Stack — Securitization & Repo Financing



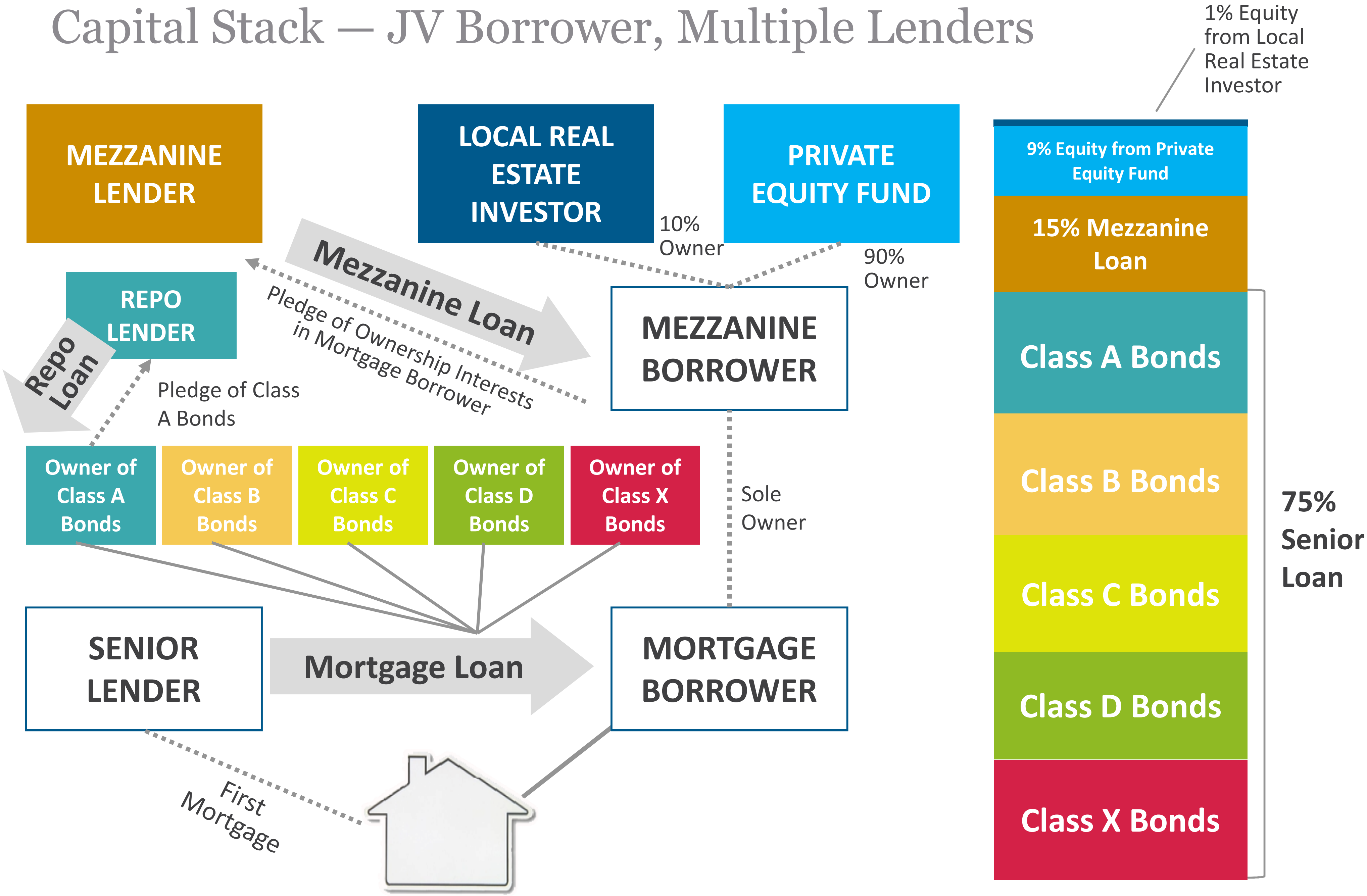
Complexity

Capital Stack — Securitization & Repo Financing cont'd.

- Additional party (repo lender).
- Holder of CMBS tranche that pledges holding as collateral for repo financing may have to satisfy collateral call by selling their holdings.

Complexity

Capital Stack — JV Borrower, Multiple Lenders

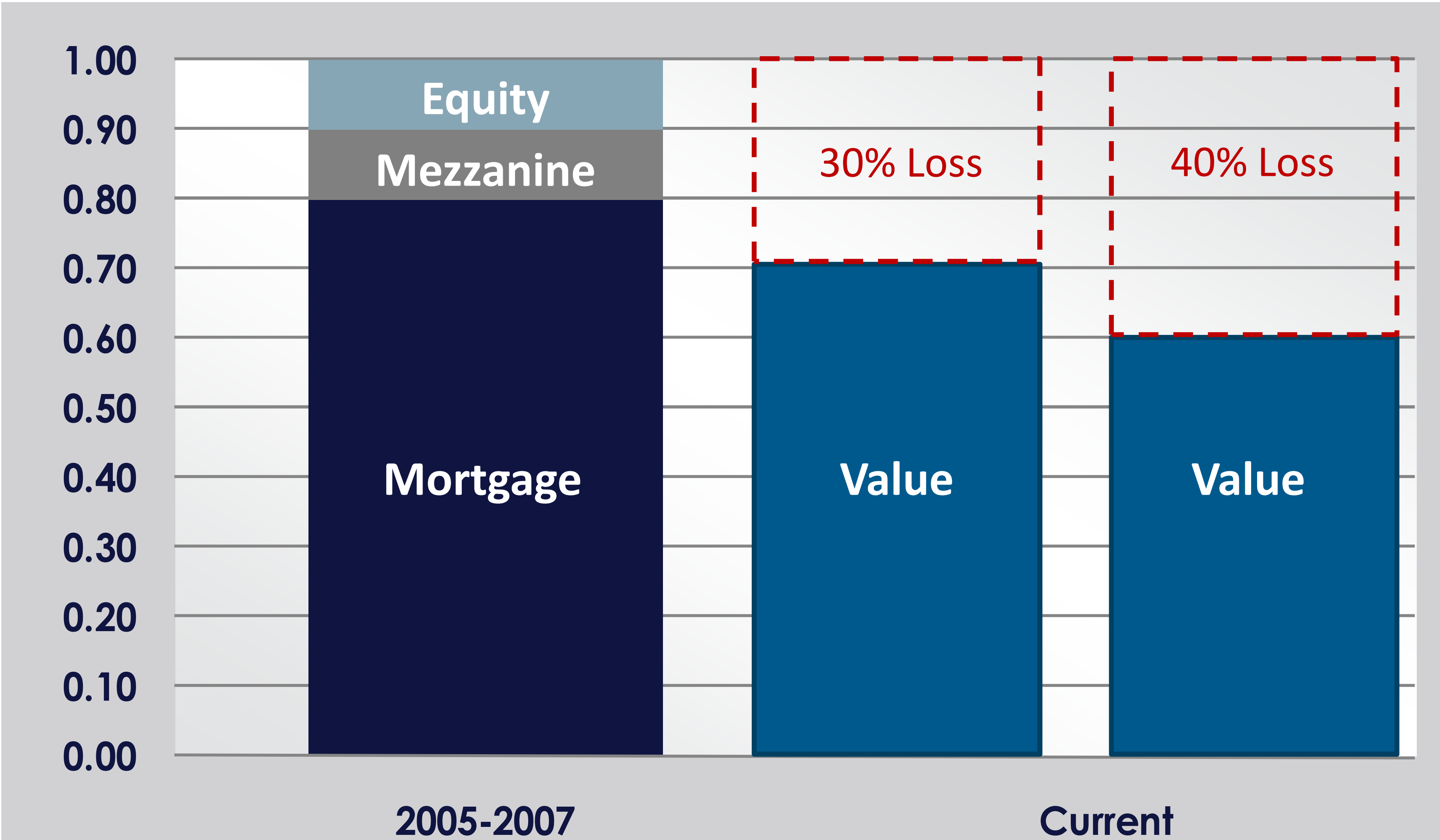


Complexity

Capital Stack — JV Borrower, Multiple Lenders cont’d.

- Ultimate “fractured capital stack.”
- Nobody has full risk (private equity sponsor generally has the most to lose, if they have used their balance sheet to obtain construction financing).

Complexity
Loss of Value



Complexity

Loss of Value cont'd.

- Just because a tranche is out of the money does not necessarily mean they are out of the picture (appraisal rights, etc.).
- Additional legal rights and remedies.
- Contractual tensions between different members of the capital stack (hedge fund repo, mezzanine vs. senior lender vs. senior tranche holders vs. junior tranche holders, FDIC vs. lenders, private equity funds and their limited partner investors, private equity and local real estate investor).
- Construction loans add an additional layer of complexity and potential for disagreement.

Complexity

Real Estate Asset Stress (Fundamentals)

- Office (unemployment, downsizing).
- Retail (drop in consumer spending, lack of small business financing).
- Apartments (children moving home, more people living together to save on rent).
- Hotels (drop in business, leisure travel).
- Condos (no buyers, no lenders).
- Fixed or Increasing Real Estate Taxes.
- Maintenance Costs.

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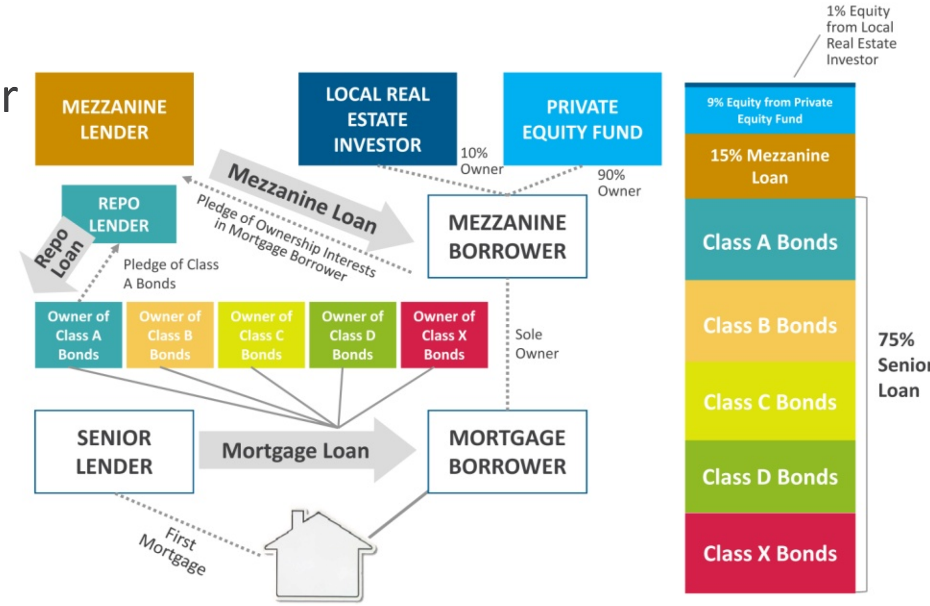
STAGNATION (2009)

Stagnation

Consequences of the Fractured Capital Stack



- All of the players are trying to understand their options and leverage points.
- Nobody wants to move because they don't know if it's the right move.
  - There is fear that the wrong move could result in liability on the part of the prime mover.
  - JV parties are reluctant to force out operating partners (reputational risk, additional asset management responsibility without the necessary team).
  - Banks do not want to foreclose (they are not in the real estate business and do not want to write down the value of the asset to the detriment of their required capital reserves).
  - Junior tranche holders lose their rights (e.g. right to select special servicer) once the value of the underlying real estate declines to the point where their tranche is underwater. Most co-lender agreements include specific appraisal mechanisms to determine which tranche is the most junior tranche that is in the money.
- FDIC reluctance.

Stagnation
Loan Maturities

- Approximately $1.2 Trillion in loan maturities over the next 4 years.

Annual maturities ($ billion) in CMBS, banks and life companies

Year	CMBS - Fixed Rate	CMBS - Floating Rate	Insurance Company	Bank/Thrift*
2009	17.6	1.5	16.8	168.1
2010	32.2	6.2	19.8	188.3
2011	44.1	17.8	23.1	210.9
2012	57.6	17.7	26.1	236.2
2013	40.9	0.7	24.8	264.6
2014	54.2		20.6	
2015	104.5		25.7	
2016	133.9		27.3	
2017	148.2		21.4	
2018	6.1		16.3	
Total ($bn)	**639.3**	**43.9**	**221.9**	**1,068.2**

* Maturity timing is estimated

Source: Deutsche Bank, Intex, Trepp, Mortgage Bankers Association, Federal Reserve

Stagnation

Extend and Pretend (aka Delay and Pray)

- Maturity defaults - lenders prefer to extend loans that are reaching maturity rather than foreclose or otherwise take title.
- Fed, FDIC and OCC have validated this strategy (reference "Policy Statement on Prudent Commercial Real Estate Loan Workouts").
- FDIC lacked capacity in 2009 to take over failed banks.
- Monetary default/real estate fundamentals and insufficient cash flow will force banks into action, leading to Bank failures.

Stagnation
Bank Failures

- Approximately 140 bank failures in 2009. Primarily regional banks with heavy emphasis on construction loans.
- FDIC has seized approximately $80 billion in loan assets (exclusive of deposits and other assets) but has only sold approximately $11 billion of them.
- FDIC becomes more aggressive as underlying cash flow deteriorates.

Accessing US Real Estate: Navigating the Capital Stack Maze

OPPORTUNITY (2010-2015)

Opportunity

Opportunity

Predictions

- Deals will get done – assets will be sold, loans will be made.
- Real opportunities existing in understanding the capital stack and how/why we got here and understanding how to navigate the capital stack to get to the real estate.

Opportunity
Key Areas of Complexity

- Experienced team of service professionals with unique skill sets will be critical to tapping these opportunities.
- Specialties include:
  - Real Estate and Real Estate Finance (inter-creditor issues)
  - Bankruptcy and Workouts
  - Joint Ventures
  - Securitization
  - Tax Structuring