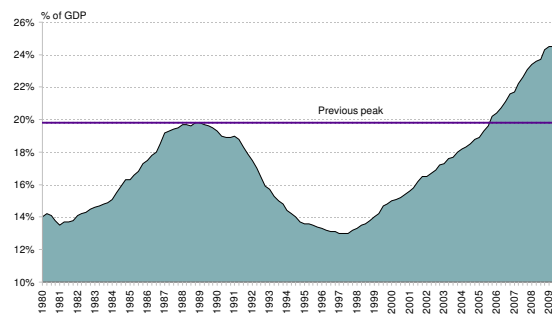


## Global Headwinds: US Real Estate Debt

Whilst the US economy started to recover in Q3 2009, it is not clear when this be true of the property markets. First, employment is a lagging indicator. Employers are not willing to risk adding new employees until they are certain that the recovery is sustainable. Adding hours or temporary workers is the preferred path to increase output in the short-run and this does not require additional space. Second, as the economy recovers interest rates will start to rise putting some upward pressure on yields. However, the biggest real estate headwind is the looming wave of both traditional commercial real estate (CRE) loans and commercial mortgage-backed securities (CMBS) that need to be refinanced over the next several years.

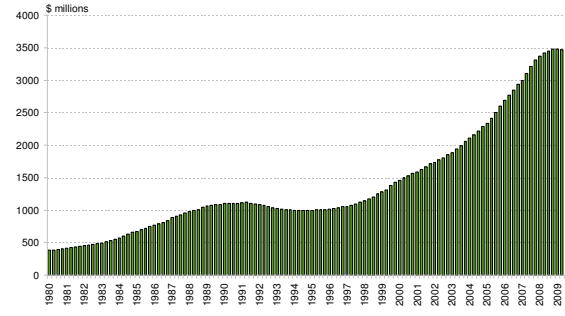
Grosvenor North America Research estimates that approximately \$770 billion of the \$1.4 trillion CRE bank loans coming due in the next five years will be “underwater.” Losses from these loans will range from \$225 to \$300 billion and while it will be far less than the \$1.1 trillion residential loan debacle, it will force the closure of scores of smaller local and regional banks whose primary asset base is CRE loans. With commercial real estate prices down 30% to 50% or more depending on the market and/or land use, the biggest surprise is that none of the nation’s “super-banks” are on the Federal Deposit Insurance Corporation (FDIC) watch list. However, even these banks are now experiencing real estate delinquency rates approaching ten percent with more expected as the year progresses.

**Chart 1: Commerical and multifamily loans**



Source: IHS Global Insight

**Chart 2: Commercial and multifamily loans outstanding**

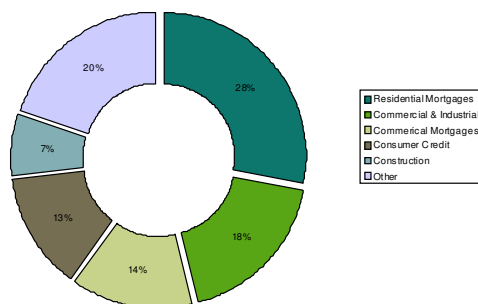


Source: Federal Reserve

Federal regulators in an attempt to avoid a crisis are allowing banks to extend loans that are in “technical” default but whose cash flows are sufficient to cover the building’s debt obligations after taxes. Unfortunately, this ‘extend and pretend’ approach to problem loans only works if the market recovery period is shorter than the ‘extend’ period. Since job levels are not expected to return to pre-recession levels until 2013 carrying these loans for an extended period will hamper lending and increase costs on future activity. This will hurt profitability and create a vicious circle that will delay the market’s recovery. In another sign that the FDIC is moving to quickly deal with the issue, there are moves to resurrect a Resolution Trust Corporation (RTC) style entity which would allow the government to quickly and efficiently sell off commercial real estate paper to interested investors.

In addition to foreclosed and “extended” CRE properties, the American property market must also deal with a rapidly worsening CMBS market. Virtually all CMBS pools securitised between 2007 and 2008 are underwater and delinquencies are quickly creeping into 2006 vintages as well. CMBS loans are much more complex than CRE loans since they are syndicated and once they default they are sent to a special servicer. Quite often, ownership rights become cloudy and alignment of interest issues quickly breakdown between the holders of

**Chart 3: Banks' loan profile - June 30, 2009**



Source: FDIC

various tranches. Like banks, special servicers can extend loans but at some point they must act in the best interest of the investors and this will eventually mean selling properties in a less than receptive market environment.

CMBS maturities will not peak until 2017 and 2018, but CMBS pools represent over 20% of the \$3.5 trillion commercial real estate debt market and \$31 billion of it is expected to mature in 2010 alone. Fortunately, because of pay offs, liquidations, and defeasances, the actual 2010 refinancing needs are only approximately \$18 billion. Not surprisingly, defaults are becoming commonplace with the most notable being Stuyvesant Village in New York, an 11,000 unit apartment complex which was bought for \$5.4 billion in 2006 and is now thought to be worth only \$1.8 billion according to Fitch Ratings.

Whilst CRE and CMBS loan defaults will be a serious problem, they will not bring down the banking system. However, they will put additional downward pressure on commercial property prices. Whilst this will create opportunities for well financed investors, the broader impact, via bank balance sheets, is negative for the economy.