

CMBS: The Next Shoe to Drop?

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The ability of landlords to refinance upcoming commercial mortgage-backed securities (CMBS) maturities has important implications for the commercial real estate industry. Contrary to what some in the media suggest, we do not believe that near-term CMBS maturities will cause a wave of “forced sales” of institutional class properties at distressed prices. We feel there is sufficient debt and equity capital from well-capitalized participants to meet near-term CMBS maturities for higher quality assets. While some property types face more immediate difficulties, we believe the majority of CMBS-related refinancing challenges will occur in 2015-2017 when a disproportionately large portion of CMBS loans (most of which were underwritten in 2005-2007 at peak commercial real estate values) mature.

Market Size & Maturities

Commercial mortgage-backed securities are bonds backed by mortgages on commercial real estate. These securities are an important source of debt capital for the commercial real estate industry (22% of total commercial real estate debt), second in size only to bank financing (58% of total commercial real estate debt).

U.S. Commercial Real Estate Debt \$3.1 Trillion of Debt

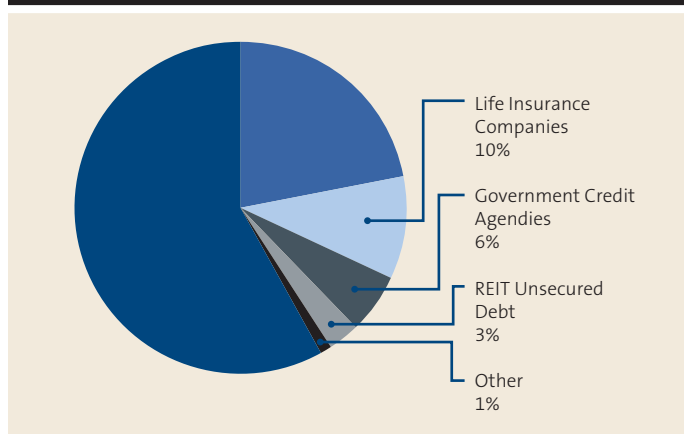


Exhibit 1

Source: PricewaterhouseCoopers (June 30, 2009)

Annual CMBS issuances peaked in 2007 at \$250 billion. New issuances then declined 91% to only \$21 billion in 2008 as the global financial crisis hit and underlying real estate fundamentals deteriorated.

CMBS Issuance by Year

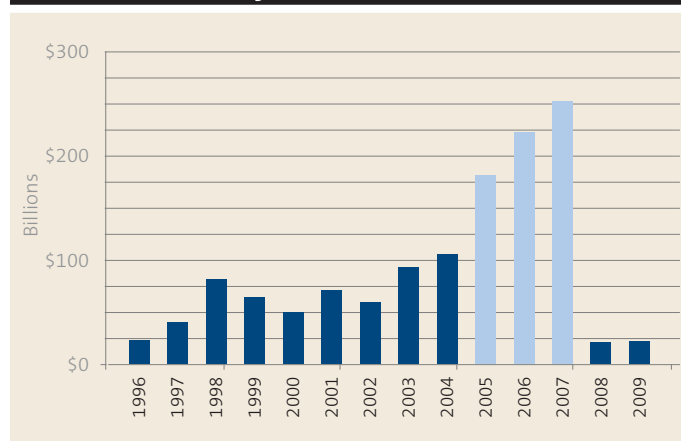


Exhibit 2

Source: Bloomberg (May 2010)

We believe the answers to three key questions will determine the impact of CMBS on the overall commercial real estate market:

1. Will borrowers be able to access new debt when these loans mature?
2. How much additional equity will be needed to refinance properties or, put another way, how large will losses be to CMBS holders?
3. Will defaults cause a surge of supply in properties for sale?

New Debt Capital

There is approximately \$40-\$70 billion of CMBS maturing per year through 2014. Barring another financial crisis, we believe debt markets can comfortably support near-term refinancing of institutional quality assets. We expect CMBS issuances to increase from 2008-2009 levels and have already begun to see insurance companies and large banks return to the market with attractive terms and rates.

The larger concern is the wave of 10-year mortgages issued in 2005-2007 that will mature between 2015 and 2017. We expect continued improvement in real estate fundamentals and debt capital markets to provide sufficient capital to finance high quality assets between now and then. This should take the form of CMBS issuances reaching approximately \$50-100 billion per year, increased lending from banks and insurance companies, and the continued growth of the REIT unsecured debt market.

CMBS Maturity by Year

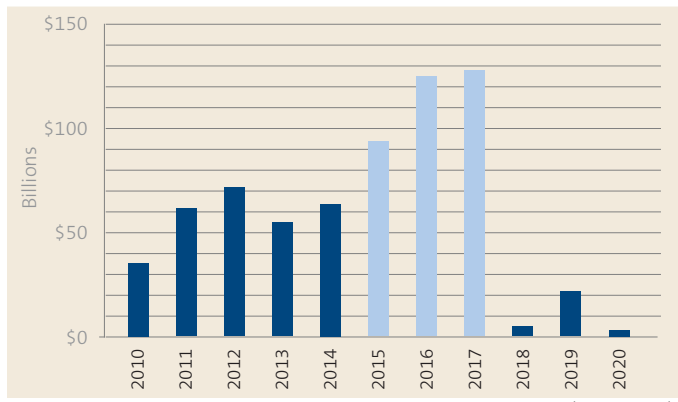


Exhibit 3 Source: Bloomberg (May 2010)

New Equity Capital/Losses for Debt Holders

According to the Moody's Commercial Property Index, commercial real estate values peaked in October 2007 and bottomed in October 2009, falling 44% over 24 months. Since then, values have increased by 3% through May 30, 2010. Many property values are the same today as they were in late-2002. This means that most properties financed between late-2002 and late-2009 have declined in value. Properties financed in 2005, 2006 and 2007 have lost on average 29%, 34% and 41% of their values through May 30, 2010, respectively.

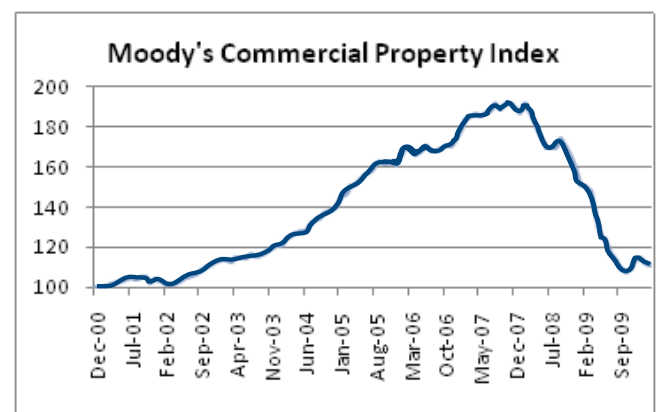


Exhibit 4 Source: Bloomberg (March 2010)

Given the size and timing of CMBS issuances/maturities and corresponding commercial property values, we estimate that there could be a \$150-200 billion shortfall in required equity at maturity to refinance all outstanding CMBS, the vast majority of which will occur in 2015-2017. This gap needs to be filled by either (1) CMBS bond holders realizing losses, (2) property owners putting in new equity, or (3) property owners selling property to a new owner that provides new equity.

CMBS Delinquencies by Property Type

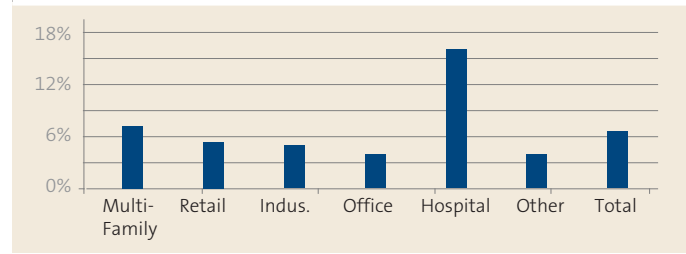


Exhibit 5 Source: Bloomberg (May 2010)

The 60+ day delinquency rate for the CMBS market was 6.5% in May 2010, up from 2.2% in May 2009. It is important to note that not all delinquencies will result in losses. The chart above includes all 60-day and 90-day delinquencies (together about three-quarters of total), as well as real estate in the possession of a lender as a result of foreclosure or forfeiture. Cumulative losses for CMBS mortgages issued between 1994 and 2001 have ranged from 0.7% to 2.3%. We expect delinquencies to continue to rise and that some portion of the delinquencies will ultimately result in losses.

CMBS Delinquencies by Vintage Year

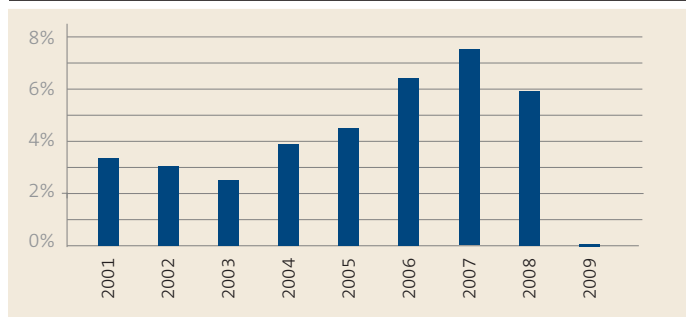


Exhibit 6 Source: Bloomberg (May 2010)

Forced Property Sales

If current delinquencies turn into defaults then special servicers will play a significant role in determining the fate of debt and equity holders. Remedies at the servicer's disposal include forced sale, loan modification or workouts like loan extensions, interest-rate reductions or principal forgiveness. The rules governing this process are very complex, vary by issuance and involve multiple parties with divergent interests. Generally, the goal is to preserve as much value as possible for the holders of the more junior tranches,* assuming they still have value.

Our estimate of \$150-200 billion shortfall in equity will have to come from either (1) losses to debt holders, (2) increasing prices of properties, or (3) new equity. Many lenders and services would rather postpone #1 (taking losses) in hopes that #2 (price appreciation) will help over the next few years and #3 (new equity) will become available to fill the gap. This rationale, however imperfect, has thus far prevented a flood of asset sales. In fact, most cash-rich REIT executives that we speak with complain about the lack of properties currently available on the market — “There's nothing to buy!”

Finally, to put transaction volumes in perspective, commercial real estate transactions rose steadily from \$100 billion in 2002 to \$522 billion in 2007. Transaction volume plummeted to \$52 billion in 2009, but we expect the market to return to a more normalized \$100+ billion per year. We feel that this provides ample demand/liquidity to handle institutional quality assets that may come to market. There will be pockets of “distress”,

most likely in hospitality, certain suburban office markets and poorly located class B and class C retail. However, we don't believe these pockets of distress will impact the pricing of the broader commercial real estate asset class.

Implications

In our view, the “overhang” created by the looming CMBS maturities will be a much bigger issue in 2015-2017. At that point, we expect stronger real estate fundamentals and capital markets. Between now and then, we expect very manageable delinquencies, defaults, losses and forced liquidations. In our view, poorly capitalized owners and CMBS holders of 2006-2007 issuances are in the toughest position. Those with access to debt and equity capital (like REITs) should be poised to benefit most.

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* Tranche: A part of an issue. A tranche sometimes refers to a single issue of a security released at different times. Tranches are important to collateralized mortgage obligations, which are backed by pools of mortgages. These mortgages are arranged in tranches that mature at different times, for instance in 10 years, 15 years, and 30 years.

Moodys/REAL commercial property index (CPPI) is a periodic same-property round-trip investment price change index of the U.S. commercial investment property market based on data from MIT Center for Real Estate industry partner Real Capital Analytics, Inc (RCA).

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