



Overview



A RETURN TO RATIONALITY...

Is the global financial system on the brink of collapse? Is a recession imminent for the U.S.? Is U.S. commercial real estate about to go bust? Three resounding NOs! Nevertheless, this has hardly been a relaxing summer at the beach. What started as a sub-prime, housing sector-specific mess abruptly blossomed into a seizing of the broad credit markets and a precipitous drop in global equities.

Readers of this column may remember a few of our prior admonitions. For example, in May 2005 we noted “the situation is more fragile with risk factors not currently reflected in current valuations or spreads.” Likewise, in August 2005 we also expressed concern that “the seriousness of the housing bubble cannot be overstated...GDP growth will slow going forward.” Lastly, in May of 2006, we cautioned that the “tempering in home prices will present challenges to the sub-prime lending sector.” We believe that investors, globally, are finally being forced to re-assess risk and accordingly re-price financial assets.

Frightening to most and painful to many, this pricing correction was inevitable and necessary. Nonetheless, if allowed to run its natural course, it will ultimately prove beneficial for long-term economic well-being. Further, in the near-term, indiscriminate selling may result in opportunity for disciplined investors. However, for those of you yearning for a return to the good old days of 2002 – 2006, as we say in New York, “fuggedaboutit” ...

The U.S. Economy

A SUMMER SEIZURE...

The trillion-dollar question is whether the current financial crisis will spread to the wider U.S. economy or whether it can be contained. Are the market troubles the result of over-excited bankers and hedge fund managers or are we witnessing the market’s anticipation of a very real problem that has yet to feed through to the “real” economy?

We are clearly experiencing a malfunctioning credit system. At home, the one and three-month U.S. Treasury bill rates have collapsed to unprecedented low levels as investors seek a risk-free haven for their cash. It has disrupted the vital commercial paper market, including its normal functioning for creditworthy businesses. Even the highest grade corporate borrowers are experiencing problems

securing credit and/or rolling over their commercial paper to finance daily operations. It has brought into question the ability of private equity buyout firms to close on a record \$250 billion backlog of committed yet unfunded acquisitions. Lenders in the residential, commercial and corporate markets have all abruptly raised underwriting and valuation standards. Over 169 mortgage lenders have been forced to shut their doors. Hedge fund failures have increased along with the incidence of bailouts by some hedge fund sponsors. A growing number of unsuspecting investors here and abroad are waking up to discover that some of their AAA or AA rated investments are in fact not quality investments but actually are junk. Further, over the past month, volatility has been rife in world equity markets – over \$1 trillion in value has been bled out of the U.S. equity markets.

What is important to focus on is that the economy here at home and around the world remains healthy. This is not the normal late-cycle credit squeeze caused by a shortage of liquidity in the system. There is no shortage of capital, nor has the credit default rate – outside the sub-prime sector – shown any sudden increases. There is instead a shortage of lenders willing to lend due to a lack of information about the value of collateral and the ultimate size and distribution of losses, primarily in a small subsector of the credit markets. As highlighted above, it is important to note that investors have experienced huge losses in highly rated (AAA and AA) securities, which were considered relatively “safe.” The most immediate threat perhaps is to the banking system, as firms whose primary function is to supply the economy with credit now hoard it because they don’t know whether their counterparty is vulnerable. For the moment at least, investors have lost confidence in their ability to value complex structured credit products – resulting in dysfunctional credit markets. Dysfunction will continue until a reinvigorated price discovery process takes hold.



We do believe that this psychological problem is now severe enough to result in a slowdown in the global economy. However, the U.S. and global economies are healthy, growing and fundamentally sound and together should be capable of weathering the current storm within the U.S. financial system. Provided the credit crunch-induced re-pricing of assets proves to be manageable, we do not believe the U.S. is likely to suffer an economic recession. While this result is probable, it is far from a lead pipe cinch. This asset price bubble took quite a while to create and will also take time to deflate. Strong leadership on the part of the central banks, patience and cool heads on the part of investors, and the ability of the most extreme transgressors to absorb large losses will be determinative for the global financial system in order to successfully manage this correction. Eventually, markets will adjust away from an

excess of greed to a healthy reorientation with fear, assets will be re-priced, confidence will be restored and credit flows will resume.



THE CURRENT CYCLE

The current U.S. business cycle got underway in 2002. The Fed, as it has done in proceeding cycles in the 1980’s and 1990’s, was forced to raise rates in the face of escalating inflation. The purpose was to engineer a mid-cycle slowdown to prevent cyclical inflationary pressures from morphing into structurally higher inflation. To-date, the U.S. mid-cycle economic slowdown is proceeding on plan, inflationary pressures are unwinding (albeit not yet to the Fed’s complete satisfaction), energy prices are well below their early summer highs and continuing to decline, and the large GDP component meant to track changes in housing costs is declining as rental rates move lower. Finally, the employment picture, while beginning to show early signs of a slowdown, remains in a modestly healthy mode. The employment picture, as always, will bear close scrutiny going forward.

For the 12 months ending June 2007, U.S. real GDP grew at a 2% annual rate, including the anemic 0.6% first quarter 2007 estimate and the more robust 3.4% preliminary estimate for the second quarter. A 2% real GDP growth rate is soft, but it is still healthy and some distance away from turning negative. At the same time, the core inflation rate as monitored by the Fed is stubbornly tracking at 2%, which is at the upper level of the Fed’s desired 1% to 2% range. To-date, the Fed remains steadfast in holding the Fed Funds Rate (the rate at which member banks lend to each other) at 5 1/4% until it can see more convincing evidence that the inflation trendline is down (not flat at 2%) and certainly not up in direction. If core inflation declines comfortably into the Fed’s 1% to 2% range, the Fed, after being on hold for the past year, will then move to reduce the 5 1/4% Fed Funds Rate, enabling GDP to return to an annual 3% to 3 1/2% real growth rate.

Given our view of the situation, it is our preference that the Fed not drop the Fed Funds Rate ahead of schedule. As noted below, we believe the markets have reacted aggressively to the potential problem and will adjust. Notably, the hit to the U.S. stock market alone, in excess of \$1 trillion from the peak, is well in excess of the largest estimate of the sub-prime losses (approximately \$200 million). Further, inflationary pressures have not been eliminated. For example, one new issue on the horizon that bears watching is the deterioration of the deflationary pressures that have benefited the U.S., as China and India joined the world economic trading community. It may be too early to say that wage pressures in those countries will result in near-term increases in U.S. inflation, but it may not be too early to start thinking about it. Finally, the Fed coming to the rescue in this situation results in moral hazard - a situation in which someone insured against risks purposely engages in risky behavior, knowing that any costs incurred will be compensated by the insurer. A financial system which offers "rescue packages" may encourage borrowers and lenders to undertake low-quality or high-risk investments, thus increasing the likelihood of a crisis. The pain has to sting for the lessons to be learned...

crises always originate at the weakest link in the structure. This time it happened to be the sub-prime sector of the U.S. single family mortgage loan market. What started in a relatively small \$6 billion corner of the residential loan market was initially judged to be containable. It was peculiar, however, that the poor performance, including late payments and growing default rates, was first apparent in the most recently underwritten and securitized loan issues - done for the most part during 2006. Historically, this pattern emerges later in a loan's life and is often linked to employment downturns. Over time, these performance issues typically spread to the Alternative-A sub-segment and eventually to other segments of the securitized residential loan market. The chart below shows the dramatic change in residential mortgage delinquencies as we moved into 2006 and 2007.



THE CURRENT FINANCIAL CRISIS

For those of us who have been around for a while, the terms "nifty-fifty," "tax shelter syndication" and "dot-com" have special, not so positive, meanings. Soon enough, so will "flip this house." Somehow people repeatedly forget the old adage that trees don't grow to the sky.

We typically experience a financial crisis whenever the Fed raises rates. Remember, the Fed raised rates through a series of 17 consecutive 25 basis point increments ending July 2006, for a total of 425 basis points. Financial

The spark that eventually exploded this into a full-blown crisis was the July 17, 2007 letter from Bear Stearns to their investors informing them that as of June 30, the High-Grade Structured Credit Strategies Fund had lost 91% of its value, while the High-Grade Structured Credit Strategies Enhanced Leverage Fund had lost virtually 100%. All told, the losses were close to \$20 billion, including over \$1.5 billion of client equity. The reason cited was "the unprecedented declines in the valuations of a number of highly rated (AA and AAA) securities."¹ Not specifically mentioned was their huge sub-prime exposure.

¹ "Borrowing Trouble" by Alan Abelson, Up & Down Wall Street, Barron's July 23, 2007.

The market reaction was swift and sudden. If this could happen to a firm as large and competent in residential mortgage financing as Bear Stearns, who else stood in harm's way? As it is turning out, there are many, based on the reports not only from within the U.S. but from around the world, including Australia, U.K., Germany, France, China and the U.A.E. - as well as some of the best-known firms in global finance. As of this writing, the contagion has now infected the broader credit market including corporate direct loans, bonds, securitized loans and most recently the \$2.5 trillion commercial paper market, which now has almost 50% of its outstandings in mortgage related issues. This latter development has triggered central banks in the U.S., France, Germany, and the EU to extend emergency credit to member banks. On August 17, 2007, the U.S. Fed further intervened by dropping its 6¼% Discount Rate to 5¼% and openly encouraged banks to apply for loans using mortgages as collateral.

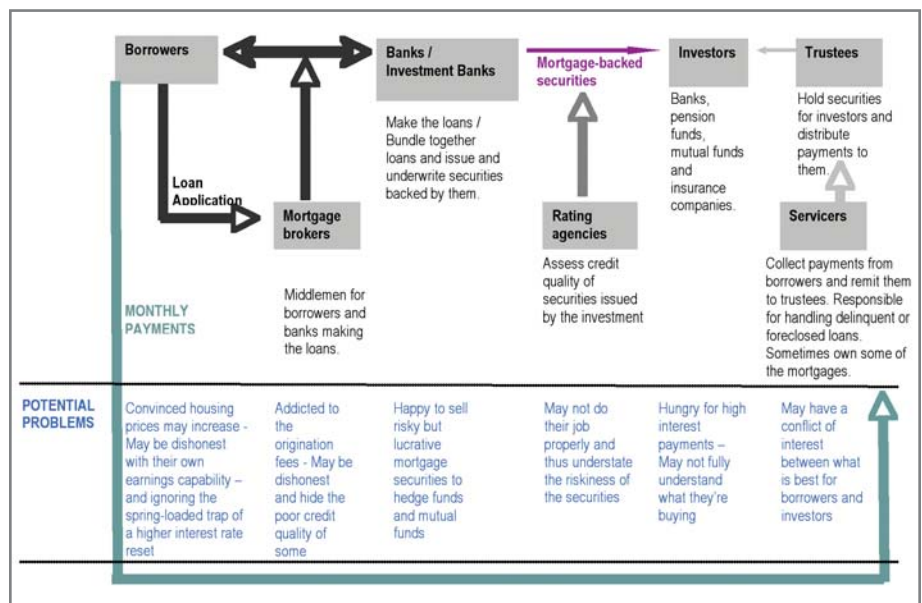
THE RESIDENTIAL MORTGAGE MARKET — SYSTEMIC FAULT LINES OR A GRAND COLLUSION?

It is now clear that within the residential sector, mortgage loans were made to unqualified borrowers, over-sized loans were made to borrowers who lacked the financial ability to service obligations of that nature, borrowers made minimal or no down payments, loans were made to speculators betting they could flip their “investment” in a rapidly escalating market of rising home prices and, lastly, borrowers either knowingly or unknowingly agreed to low interest only loans that later reset to “market interest rates.” In short, the entire residential mortgage system appears to have sacrificed prudent valuation and underwriting standards in favor of creating outsized loan volumes, securitizing pools of loans and often re-securitizing lower quality

securitized strips into second stage securitizations of collateralized debt obligations (CDO's).

Historically, mortgage portfolio lenders underwrote, valued and then held the loans throughout their life in their own institutional portfolio. For the past 30 years, this system has been supplemented through securitization techniques where lenders are enabled to sell a portion of their loan portfolio, receive cash and then recycle the proceeds by making new loans. This time, the task was handled, for the most part, away from traditional mortgage lending institutions and largely through the capital markets. Feeding on originations from a proliferation of storefront mortgage brokers, the investment banks pooled the loans into securities. These various housing-related securities, which carried high quality investment grade ratings, were then distributed throughout not only the broader U.S. investment community, but to investors in many countries throughout the world.

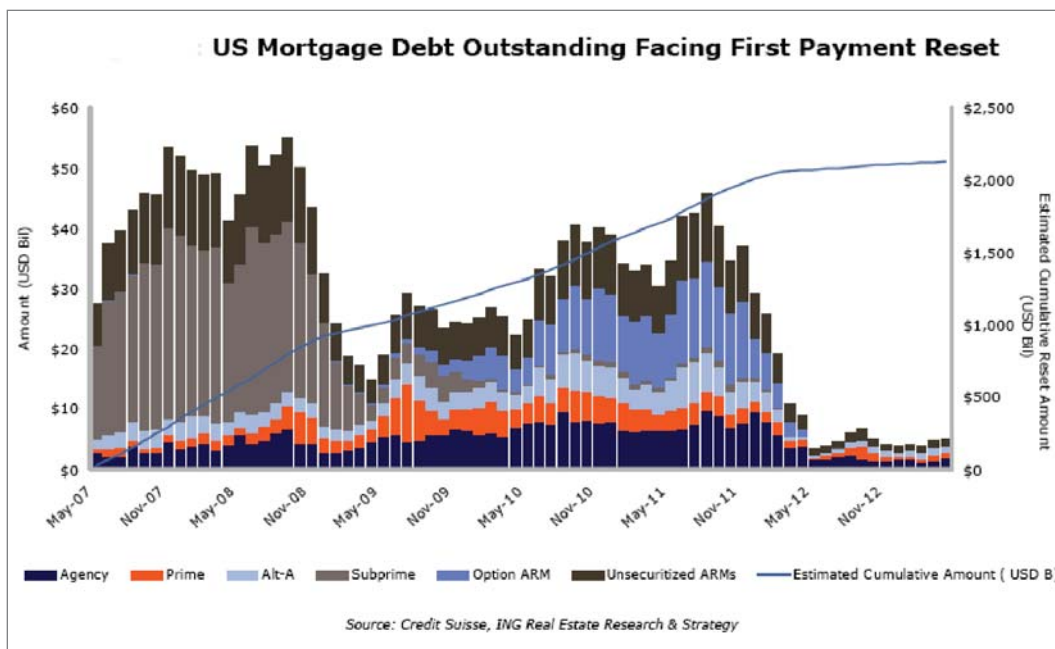
The system for securitizing mortgage-backed debt is complex. One positive aspect is that it results in a widespread dispersion of risk. One negative aspect is that there are several places along the way where it can break down. The following chart, adapted from the New York Times, highlights the key players and potential problems.



How long will the bad news regarding mortgage foreclosures and mortgage lender bankruptcies continue to flow? Well, 2008 is an election year, after all, so for that reason alone it's not likely to be out of the press. Near-term, credit problems are aggravating an already serious inventory problem in the overbuilt single-family residential market. According to Realtytrac's August report, foreclosures are up 93% over the past year. Further, the authoritative Case-Shiller House Price Index fell deep into negative territory - negative 3.2% year over year as of June 2007, compared with 2.8% through May 2007. In addition, while new home construction tumbled in July to the lowest pace in a decade, supplies remain high and demand keeps dropping. Sales of previously-owned homes also fell in July, to an annual rate of 5.75 million, a 5-year low. A Morgan Stanley analyst expects housing starts to decline 20% from July levels during the first half of 2008. More significantly, however, is the fact that many of the variable rate loans have yet to reset. The following chart, courtesy of ING, makes it clear that sub-prime bad news is likely to flow well into 2008 and that other adjustable rate loans have significant reset volume well into 2011. Moreover, most holders of residential securities have yet to mark their holdings to market ... Fasten your seatbelts!

There will be another time and place to analyze how and why this all went so badly wrong. For now, it is important to acknowledge that it has happened and on a massive scale. Unlike earlier financial crises that focused on single institutional failures (Penn Central, Continental Illinois Bank, LTCM) or foreign credit collapses (Russia, the Southeast Asia NIC's, Mexico or the various Latin America country collapses), the current crisis is more systemic and dwarfs earlier crises in its size and scope. Also, it involves the American homeowners and all that is implied by the achievement of the most hallowed U.S. dream – owning your own home. This latter aspect will no doubt bring political intervention in the midst of a presidential election cycle. It will certainly make the problem-solving that much more complex by increasing the risks that such intervention may further complicate and damage long-term market solutions.

Longer range, this event holds the strong possibility of being the cleansing effect that will restrain unwarranted risk taking and restore traditional investment underwriting, valuation and transaction structuring practices to the marketplace. Globally, the financial system still has the capital surplus that existed at the beginning of the summer,



in terms of debt and equity capacity. This should mean that capital can and will be mobilized to help re-cycle bad investments from those who can no longer hold them. This will ultimately lead to renewed confidence and a resumption of formal lending and investment, ideally with restored integrity and sound investment practices.

Most importantly, this is an opportunity to re-balance the mix of greed and fear in the investment marketplace. Fear is clearly in the ascendency following a long absence. Will it lead to better risk assessment going forward? There is a strong probability that this process is already underway. To the extent that desires for investment returns do become balanced with solid risk analysis, overly inflated asset prices will adjust downward. As Secretary Paulson recently commented, this problem, even if successfully managed, will take time, inflict some pain and also extract some penalty from the growth rate of the U.S. economy.

The U.S. Commercial Property Market

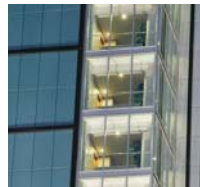
STEADY AS SHE GOES...

To-date, there is no evidence that the practices at work in the residential market were, or are currently, in place in the U.S. commercial real estate market. Was the global availability of abundant debt and equity capacity responsible for some over-inflation of property pricing? Yes. Especially where compression of capitalization rates over an extended period led to underwriting complacency. Most of this activity was at the margin of the commercial real estate market – although a frenzy of commercial property flips (with purchasers utilizing short-term borrowings) following the Equity Office Properties buyout is certainly troubling. Overall, however, it does not appear that the broad capital market abuses that came to affect the entire residential market have a parallel in the commercial sector.



All real estate equity investors are scrutinizing their existing holdings to determine whether their existing portfolios are properly configured in the light of what's unfolding in the broader financial market. Market uncertainty can be seen in the public markets where, after a seven year run, the public U.S. REIT market has a negative year-to-date return and the newly-introduced REIT markets in other countries are continuing their struggles to deliver positive investor returns.

On the credit side, commercial real estate lenders have quickly tightened lending standards and are brushing up valuation procedures. Some have gone so far as to break loan commitments and rate-locks. As a result, some borrowers who are strung out on bridge loans are experiencing problems refinancing and a growing number of committed acquisitions are either being cancelled or re-traded. Most importantly, the marginal commercial real estate investor, who was utilizing extremely high leverage to make acquisitions, is currently out of the market. As some of these highly-leveraged investors were the top bidders for property (particularly of secondary quality) during easy money times, capitalization rates for such properties will likely begin to rise (resulting in lower near-term valuations), reversing the declining trend of the prior two years.



With regard to fundamentals, the U.S. commercial real estate sector sits on a solid foundation. Generally speaking, supply and demand for space in all property sectors remains in equilibrium. While the US economy is slowing, job formation has remained positive, resulting in continued demand in all property types - particularly concentrated in the east coast, west coast and southern regions of the country. The only near-term demand shock from the credit crunch is likely to be in the money centers (New York) and mortgage banking centers (Orange County, San Diego, etc.), where staff reductions will result in sublet space availability. On the supply side, with the exception of rental apartments (where the shadow supply from the overbuilt condominium market is temporarily adding to rental supply), the pipeline for planned and under-construction projects poses no real threat of over-building at this time. Accordingly, most property sectors and regions continue to experience rising occupancy levels and increased rental rates.

Will we be reading some bad news about commercial real estate? To some extent, yes. Some high profile, highly-leveraged acquisitions will blow up, and some commercial securitizations will fail. There will likely be an increase in what

is an almost non-existent default rate for commercial mortgage loans. Finally, the rate of increases in property pricing, which had already begun to decelerate, will feel strong downward pressures. Ken Rosen of Rosen Consulting Group was recently quoted in The Institutional Real Estate Letter as saying that he expects that capitalization rates may increase by as much as 150 basis points over the next five years. We expect that this reversion to traditional returns will be in part driven by higher capitalization rates and by continued improvement in bottom-line cash flows at the property levels. Nevertheless, in the longer run, this will prove to be beneficial for a sector of the investment spectrum that is long-term in its duration and largely private in its capitalization and it will eventually lead to sounder valuations — The only aspect of the commercial real estate market that was beginning to gain a frothy tone over the past two years.

NEW OPPORTUNITIES

While we continue to feel that early 2007 will prove to be the market top for this cycle, it is quite possible that we will continue to witness new pricing records being set in some markets for certain properties. However, this will increasingly become the exception. Now that the process is in place to re-price the risks that are fundamentally inherent in commercial real estate, the question becomes, “Where are the new opportunities?”



As we believe that the excesses of the housing market were not largely replicated in commercial real estate, any indiscriminate tightening of credit to the commercial side may provide attractive entry opportunities to the alert investor. We continue to believe that a focus on cash flow growth, driven by demographics and attention to job formation, will serve as the most useful compass. We also believe that the survivors will be those parties who are well capitalized, experienced and connected. There will be a flight to quality across the board, a wash out of marginal players and more realistic underwriting and valuations. All good effects, thankfully, and perhaps unusually, taking place without having to suffer a crisis within commercial real

estate sector itself. Whew!

Commercial real estate is a good place to be invested long-term because of its cash flow and diversification benefits. Those investors who have the instincts and stomach to spot good value during this transitional phase should see solid investment opportunities in distressed buying. We must remember that the seeds of great performance are planted in difficult times.

Summary

Our world as we know it is not about to end, despite the screams from the financial sector. Just as the U.S. economy is moving into the final chapters of a mid-cycle slowdown, the bubble in the residential market has burst - causing a not unexpected financial crisis in the temporary seize-up in the credit market. The seriousness of this particular crisis cannot be underestimated given its scope, scale and complexity.

It is, in time, capable of being managed, but not without inflicting pain and negatively affecting the rate of economic growth. Properly managed, the longer-term benefits will enhance - not permanently damage - the financial system. It will help reconnect Wall Street to Main Street. Along with the large bubble in residential prices, there is the strong chance that other smaller bubbles on asset prices will be pricked and sounder valuations will result. Getting there from here will be tumultuous and volatile. Failures will abound – most deserved but also with some unsuspecting victims. Large scale market adjustments, while harsh at the time, are the devices that ultimately prove to be the most effective regulators of a market based economy. Excesses will be exorcised, rational investment practices and pricing will be restored. The world will go on.

On the commercial real estate side, we are buoyed by the opportunities being presented by this transition and will continue, as always, to invest with managers who have honed skills to improve the operating performance of commercial real estate rather than momentum investing, chasing the latest flavor of the month, or relying on unsound financial engineering.

For More Information

Edward Casal

Chief Executive Officer

+1 212.380.5530

ed.casal@madison-harbor.com

About Madison Harbor

Madison Harbor Capital is an independent investment firm serving institutional and high net worth investors with timely and distinctive real estate investment strategies through primary investments into newly formed real estate partnerships and secondary acquisitions of existing interests in real estate. The firm is led by real estate industry veterans Edward M. Casal, Chief Executive Officer and Russell H. Bates, Managing Director. For more information, please visit www.madison-harbor.com.

Madison Harbor Capital

405 Lexington Avenue, 47th Floor

New York, NY 10174