Madison Harbor Capital

Madison Harbor Capital, LLC

Our View

Introduction

As we approach year-end 2007, powerful crosscurrents in the financial landscape pose particularly unusual investing challenges. Recent increases in day-to-day stock market volatility from New York to Shanghai reflect investor jitters while significant changes in the pricing of commodities (particularly oil) and currencies (particularly the U.S. dollar) suggest that profound changes are afoot. Further, a continuing decline in the U.S. housing sector, declining economic sentiment, and a continued stream of inventory losses at financial intermediaries indicate increased uncertainties and heightened perception of risk emanating from a complex global financial system.

In this issue of *Our View* we focus on the continuing evolution of the global de-leveraging of the credit markets and the impact of an uncertain environment on the U.S. commercial real estate market. With an abundance of anxiety in the marketplace, we are including our updated view on important themes for exploiting current market conditions in the U.S. Subsequent issues will address how we are currently addressing real estate opportunities in both developed and emerging markets of Europe and Asia.

While all real estate is local, we believe global issues will have increasingly profound influences on the performance of commercial real estate going forward. We believe that the big changes — the "Black Swan" events — are under-appreciated and that investors would be well-advised to pay attention internationally, particularly to those regions that supply the financial community with capital and commodities.

Globally, it is a golden age of economic growth given the incorporation of the emerging markets into the world marketplace. Led by China and India, which are simultaneously experiencing industrial and technological revolutions, strong global economic growth is likely to continue at a massive scale for a prolonged period. The U.S. experience will be difficult for some time as unsustainable structural imbalances are ultimately (and, very likely, painfully) corrected. In particular, debt-laden consumers will be forced to reign in their spending, resulting in reversion of above trend-line economic growth to the long-term mean.

We are reminded of Stephen Covey's advice to separate the important from the non-important, and the urgent from the non-urgent.[1] From a headline perspective, the bursting of the U.S. housing bubble and resulting credit seizure certainly appear urgent and important. However, we believe that the long-run effects of the housing market depressurization are healthy in the long-term, and survivable. So, too, is the massive financial de-leveraging currently taking place in all asset classes. There is plenty of liquidity in the system on a global basis as well as in the U.S. – it is just not particularly free flowing at this moment due to structural issues in the syndication market that have made the pricing discovery process extremely difficult. These problems, if considered on an isolated basis will correct themselves over time without significant policy shifts on the part of any particular governing body.

Let's consider the important but not apparently urgent – the difficult issues that don't scream for attention but which fester and potentially result massive dislocations. In our view, the decline of the U.S. dollar versus the

[1] Stephen R. Covey, The 7 Habits of Highly Effective People

Euro of 41.8% since its peak in 2000 reflects U.S. fiscal policies which are unsustainable – particularly the massive government debt burden, the lack of control with regard to future governmental expenditures, as well as the overall levels of consumer debt. The erosion of global confidence in the U.S. as the lowest risk financial market and in the U.S. dollar as the *de facto* world currency will continue until the U.S. government and the electorate are prepared to make difficult decisions and restore prudence to its fiscal system.

The U.S. economy is clearly slowing and will continue to be sluggish for longer than we had previously assumed. We believe the housing correction is at about its half-way mark and the worsening credit crisis poses a series of real threats at a time of sub-par U.S. GDP growth. With inflation under control, the Fed still has the tools and the latitude to guide the economy through to the point where trend growth can be resumed. The Fed faces many challenges but can probably be counted on to get ahead of the curve and effectively support the U.S. economy once again.

U.S. Commercial real estate, thanks to its sound fundamentals, should perform well throughout the downturn and has the potential to improve dramatically as the economy returns to trend growth. However, commercial real estate is not immune to problems if it turns out, as we suspect, that weak loan underwriting has also infected the CMBS debt market. We continue to believe that private real estate equity returns will moderate from the performance of the past three years with valuation multiples declining and income component improving. The degree of difficulty to produce strong returns from investing in real estate has clearly intensified, although we anticipate that the fallout from the credit seizure will likely precipitate interesting opportunities for the nimble.

When we left last time, we encouraged you to "fasten your seat belts, return your tray tables and seatbacks to their upright positions as we encounter more turbulence ahead." That turned out to be good advice. We hasten to add the seatbelt sign will remain on for the foreseeable future.

The Big Picture

The question today is whether global growth can withstand a sharp and prolonged slowdown in the U.S. – still the dominant world economy. World economic growth is running at a 4.9% annual rate according to the International Monetary Fund. Through this year, the U.S. economy has begun to face hurricane force headwinds as the enormous credit bubble that fueled the growth over the first half of this decade begins to unwind and deflate. The U.S. economy has been undergoing a Fed-engineered, mid-cycle slowdown with annual GDP growth rate estimated to result in 1.5% to 2% growth, compared with 3.0% when it is operating at potential capacity. With the housing sector firmly in decline, we now expect the economy to operate at sub-par levels until late 2008 or early 2009. The abrupt unwinding of the credit bubble has increased the risk of recession over the past 90 days. The economic consensus now assigns a 36% probability for a recession occurring, with 25% of the economists predicting greater than a 50% chance.[2] Whether the U.S. enters recession or not, this correction is not likely to produce a soft landing; and a hard landing, if recession is to be avoided, will manifest itself in a prolonged and deeper period of sub-par GDP growth.

DEBT PROPULSION

For years, Jim Grant of Grant's Interest Rate Observer has tracked and warned about the challenges to the economy of overleveraging. In particular, Grant draws attention to the unprecedented rate of debt issuance in the first half of this decade by indicating "an additional dollar of American GDP growth has required – or at least, been

[2] Likelihood of a Recession is Given Better Odds, The Wall Street Journal, July 13, 2007.

associated with – the creation of $5 of new indebtedness.[3] Whereas nominal GDP has tacked on $4.2 trillion, nominal indebtedness has jumped by $21.3 trillion." Mark Faber's October 2007 Gloom Boom and Doom Report notes that "a closer examination of why consumption and corporate profits expanded rapidly in the last few years takes us back to [that] $21.3 trillion debt growth…In essence what occurred is that the U.S. went on a spending spree because of 'inflation' (money supply and debt growth), which was financed by growing debts and a liquidation of real estate and also financial assets."

Within the U.S. debt bubble, perhaps at its very core, was the virtual explosion of mortgage debt which at its peak grew at 13.3% annually while financial and non-financial U.S. debt were growing at just under 10% annually, according to Grant. Most of the mortgage debt was related to single family home lending. Relative to their incomes, U.S. consumers have continually increased their debt obligations as an increasingly sophisticated financial system has allowed more people more access to credit. This decade however, the numbers have become staggering. As illustrated in Chart 1, the ratio of U.S. household debt to disposable income has grown geometrically to above 130%.[4] Earlier this decade it was 100%, in the 1990s it was 80%.

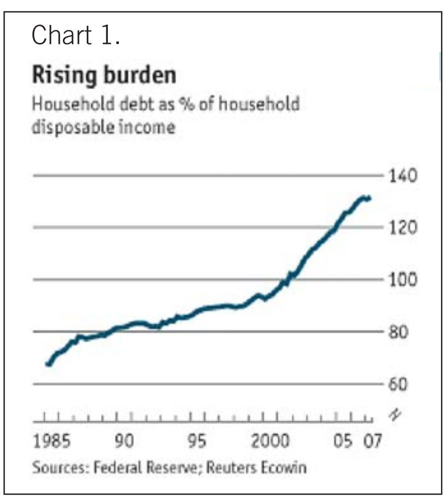


Chart 1.

Through heavy use of home mortgage refinancings, the consumer gained access to spendable capital which propelled consumer spending to equal 72% of U.S. GDP since 2001 and more than covered the 1% gap between expansive consumer spending growth and more modest growth in personal income growth.[5]

This leveraging of the consumer, and the government sector, certainly made the economy appear stronger than it would have been on a steady state basis (i.e., without additional leverage). Herein, of course, lies the obvious and serious problem: borrowing to spend without personal income growth can ultimately lead to disaster. Home foreclosure and personal bankruptcy statistics are likely to dominate the 2008 headlines.

The longer this condition continues, the greater the downside risk to the U.S. economy being able to resume trend GDP growth of 3% annually. The pressures to re-price, clear the market and resume normal credit flows will be intensified as year-end audits approach and lenders are further pressured to mark their loan assets to market.

Of note, a recently effective U.S. accounting rule, FASB 157, has strengthened materially the valuation rules for banks' Level 3 assets. Level 3 assets are those that trade so infrequently that there is virtually no reliable market price for them, and valuations for these assets are based on management assumptions. Those models are more art than science and are subject to each bank's judgment. While much of the attention of such Level 3 assets has been focused on mortgage-related assets, they also include complex derivative contracts, credit card receivables, loans linked to leveraged buyouts and asset backed commercial paper. As of November 15, the Level 3 disclosures will be accompanied by details regarding the basis on which they are classified. Further, client indemnification of their auditors will no longer be permissible effective January

3 "When the Debt Machine Coughs, Credit Creation, Cause & Effect," Grant's Interest Rate Observer, Vol. 25, No. 21, November 2, 2007, pp 6-7.
4 Getting worried downtown, The Economist November 15, 2007.
5 David Rosenberg, Markets & Investing, "Insight," Financial Times, November 15, 2007.

1, 2008. We expect more bad news from the financial intermediaries that are still holding much of these hard to value, not often traded securities.

HOUSING – NO SHELTER ANYTIME SOON

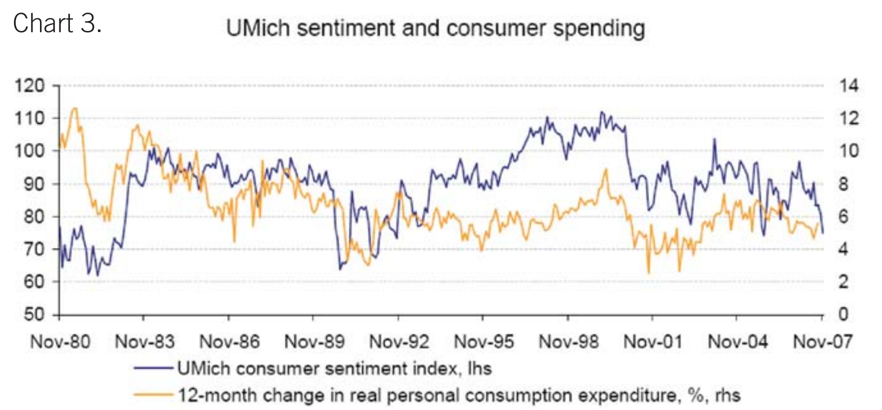
Because the U.S. housing bubble was such an important driver of the general U.S. economy, we must remain focused on its progress. Building permits, which tend to lead building starts by about a month, continue to fall. According to Lombard Street Research, building permits on a three-month annualized basis are now down by close to 50% since last July, the largest fall in a three-month period since the housing crash of early 1990s. With inventories now equal to 8.3 months of sales, builders are unlikely to start any substantial volume of houses any time soon. Chart 2 shows the 18-month decline in U.S. housing starts, a 40% decline from the peak – and with the continuing inventory build up, it is likely to fall further. Richard Brenner of Morgan Stanley, expects a further 25% decline, taking the pace of housing starts in 2008 to below 1 million units, the slowest pace since records began in 1959.[6]

As noted in last quarter's Our View, we expect delinquencies and foreclosures to increase as mortgage loans reset interest rates well into 2008. The Organization for Economic Cooperation and Development ("OECD") estimates that mortgage resets will probably peak in May of 2008. Nationally we can expect further reductions in home prices of between 10% and 15% below current levels. As a result, the U.S. housing sector will remain a drag on GDP through 2008 and into 2009, assuming that employment growth remains positive at today's modest levels.

Chart 2.

Source: Lombard Street Research

Chart 3.



Source: Lombard Street Research

ECONOMIC SENTIMENT – A NEGATIVE TREND LINE

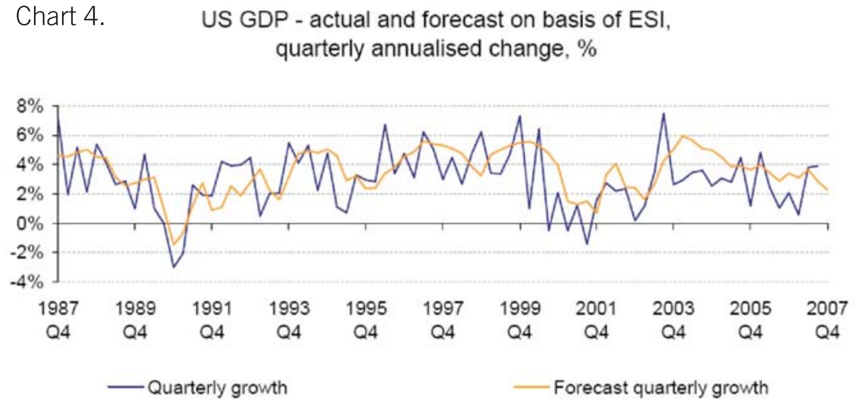
Problems in housing are being reflected in economic sentiment. The University of Michigan consumer sentiment index dropped to a 15-year low in November, excluding the aftermath of Hurricane Katrina.

Lombard Street Research takes the Michigan index and combines it with two ISM indices to produce a U.S. Economic Sentiment Index ("ESI"), which includes both consumer and business elements.[7] Shown below, the ESI is a reasonable coincident indicator of economic performance and is showing a clear trend downward. With the collapse of the U.S. housing bubble far from finished – and its impact on the consumer just getting started – the

[6] Richard Brenner, Morgan Stanley, "Housing: Enter the Bear Scenario" www.morganstanley.com/views 10-31-07.

[7] The Non-Manufacturing ISM Report on Business is a purchasing survey of the United States service economy, published by the Institute for Supply Management since June 1998.

Chart 4.



Source: Lombard Street Research

U.S. economy will take some time to recover from the 2002 – 2006 party.

REPRICING RISK AND A MASSIVE DELEVERAGING

As of this writing, the credit markets remained largely disrupted, with credit available only for the best borrowers who finance on a conservative basis. We anticipate that full functioning of the credit markets will take some time to occur as lack of confidence in valuations persists.

In his brilliant new book on financial crises, Richard Bookstaber points out, "more often than not, crises aren't the result of sudden economic downturns or natural disasters. Virtually all mishaps over the past decades had their roots in the complex structure of the financial markets themselves."[8] He adds, "the financial markets that we have constructed are now so complex, and the speed of transactions so fast that apparently isolated actions and even minor events can have catastrophic consequences."

The bid/ask pricing gap for many debt (and private equity) securities is wide, and we do not yet have the mechanisms in place that will eventually produce a market clearing price requisite to enable the credit markets to function in a normal capacity. Underwriting standards have been abruptly raised across the board and high yield lending operations have either failed or withdrawn from the markets.

ISI Group has been recording the number of institutions or funds that publicly acknowledged being damaged by the sub-prime contagion since this first hit the popular press headlines in mid-July 2007.[9] For the 16 weeks ending November 9, 2007, the hits have averaged approximately 50 per week, totaling 799 in aggregate. In fact, while sub-prime and Alt-A home mortgages have incurred the greatest damage to date, the entire home mortgage lending market has become negative in one form or other. Further, Freddie Mac the government-sponsored mortgage lending enterprise, said this month that enough borrowers were defaulting on loans made this year or last that it needed to mark down the value of the loans by $1.2 billion – none were sub-prime.

Losses in the distressed mortgage sector of the United States could reach $300 billion, only a portion of which has so far been accounted for by write-offs at major banks, according to a study released in November by the OECD. The concerns of faulty underwritings, lending structures and overly aggressive valuations have now reached into Collateralized Debt Obligations ("CDOs"); the leveraged loan market; the securitization of auto and credit card loans; the commercial paper market, especially that segment relating to mortgage backed short-term paper; the mono-line insurance and reinsurance companies who either credit enhanced or invested in sub-prime paper; the money market mutual funds; and most recently into the area of the CMBS market. In addition, credit spreads have gapped up dramatically for all but the highest quality corporate bonds. Finally, there is early evidence that some muni-bond issuers may be caught offside having arbitraged low rate tax-exempt borrowings by investing in high-yield securitizations.

[8] Richard Bookstaber, A Demon of Our Own Design, Markets, Hedge Funds and the Perils of Financial Innovation, 2007, John Wiley & Sons, Inc,. Publisher.

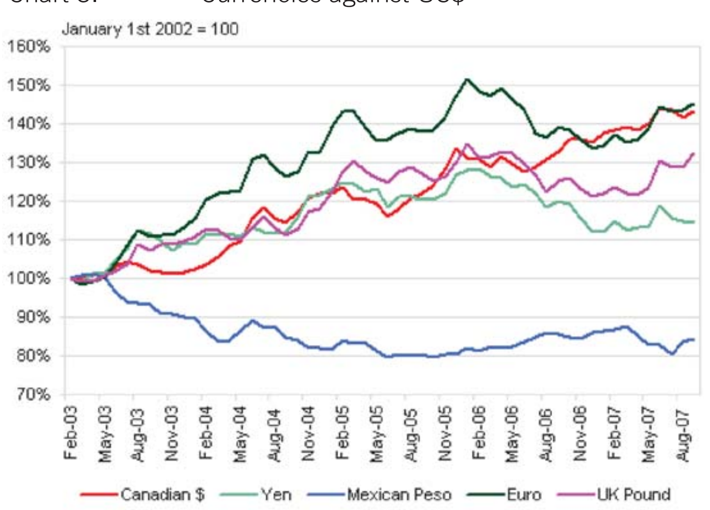
[9] International Strategy Investment Weekly Economic Report, November 12, 2007, page 15.

Bookstaber observes, "One of the curious aspects of worsening market crises and financial stability is that these events do not mirror the underlying real economy. In fact, while risk has increased for the capital markets, the real economy, the one we live in, has experienced the opposite." We concur and believe the pricing dislocations will present interesting investment opportunities for those paralyzed by the headline noise.

CURRENCY REALIGNMENT

While the U.S. pushes China to loosen its soft peg against the dollar and let the renminbi appreciate, other free-floating currencies have clearly already done so. The U.S. dollar isn't a safe haven at the moment, because most of the problems facing the world economy are coming out of the U.S. On October 26, 2000, the U.S. dollar peaked against the Euro at $0.8252 per Euro; on November 23, 2007 the rate was $1.481 dollars per Euro, a devaluation in the U.S. dollar of 41.8%. As shown in Chart 5 below, the Canadian dollar has experienced similar appreciation – an important issue as Canada is a major trading partner to the U.S. Further, the devaluation of the dollar is causing some country finance ministers (notably in the Gulf region, including Kuwait, which revalued its currency six months ago) to reconsider their currency pegs to the U.S. dollar as well – and whether they should be holding so many U.S. dollar reserves. The problems are developing because policies needed in one region (e.g., economic stimulus) may differ from those needed in another (e.g., fighting inflation). Potential changes regarding the U.S. dollar peg, and decisions to diversify reserve holdings are of major significance. While the U.S. dollar may not stay down long-term against the Euro, the very foundation of U.S. economic power in the world will be negatively affected if the U.S. currency loses its position as the global reserve currency.

Chart 5. Currencies against US$



Source:CBRE Torto Weaton Research, U.S. Federal Reserve.

Notwithstanding the massive effect of a shift in currency reserve holdings, currency valuations are important to real estate investors as they affect the level of overall imports and exports, which drive overall economic activity, as well as affect inflation rates. Further, international investors must consider whether there will be a reversion of currency values and what this may do to investment performance.

With the U.S. dollar now weak, we have to consider the effect on the U.S. export sector and how we wish to position investment portfolios going forward. Our view, as discussed below, is that export driven U.S. port cities will likely benefit long term (exports soared 16% in the third quarter) – and the import driven ones may suffer negative effects. (The weak U.S. dollar will boost exports, but at only 12% of GDP, exports are too small to make up for a weakening of consumer spending, which accounts for 70%.) Further, export led growth in emerging markets are likely to begin feeling the headwind of reduced demand from the U.S. (the largest consumer of the past decade) as well as increasing competition from U.S. manufacturing.

ALL EYES ON THE FED

A picture is emerging that indicates that, after 18 months of corrections, the U.S. may be no more than halfway through the correction cycle. With the U.S. dollar in decline, oil at over $90 per barrel and gold over $800 per ounce, the Fed is walking a tightrope trying to protect against a deflationary downside without reigniting inflation concerns – where buyers of U.S. debt will demand higher, not lower, interest rates. On a global basis, the situation is complicated because if U.S. borrowing rates decline, currencies in other countries may appreciate, negatively affecting their export growth. At the same time, other countries do not want to cut rates because of inflationary pressures within the U.S.

Since September, the Fed, has become more accommodative through reduction in the Fed Funds Rate and the Discount Rate, liberalization of the terms by which banks can borrow at the Fed's Discount Window and sharp recent increases in the annualized rate of growth in the money supply. According to Grant's, the money supply as measured by MZN has grown at 11.9% over the past 12 months, 13.7% over 6 months and 20.2% over 3 months.[10] Since October 31, 2007, the Fed has officially been in a neutral position – giving equal risk assessment weightings to rising inflation and slower growth. Subsequent events have produced a market run to quality in buying Treasuries while moving the yield curve down and into a more pronounced positive shape vs. the higher, negative yield curve that prevailed before the mid-cycle slowdown clicked-in. The market is clearly now more concerned about the slower growth risk and, at least for now, the Fed is no longer being perceived as acting in a pre-emptive manner. Given its aversion toward deflation and with core inflation in a better (if not ideal) range of 1.5% to 2.0%, the Fed is expected to continue to follow an accommodative pattern until the U.S. economy reinflates.

U.S. Commercial Real Estate

THE U.S. PROPERTY MARKET

U.S. commercial real estate fundamentals are quite sound, unlike the single family housing (including the condo) market. It is worth pointing out the circumstances in the U.S. commercial property market are not comparable to those in the for-sale residential market. The popular media and, at times, the financial press can paint "real estate" with a broad brush and fail to draw out the distinctions between these altogether separate markets.

The widely followed U.S. commercial private equity real estate indices such as the NCREIF index will register lower returns over the next twelve months than the past twelve, but we expect this will almost entirely be due to changes in valuation multiples as opposed to changes in property cash flow performance. New supply remains well in check, hampered by high construction costs and increasingly restrictive debt underwriting criteria.

As Torto Weaton points out "commercial real estate is no more related to residential real estate than auto sales, airline bookings, or myriad other industries that are affected by the economy."[11] Unlike the for-sale home market which is grossly overbuilt, commercial real estate is not. The U.S. supply and demand for space in most property sectors and geographic regions remain in solid equilibrium. While occupancies are not at peak levels, properties remain well-leased – at rental rates that are healthy and continuing to increase, albeit at a moderating rate. Leasing absorption remains strong but, again, at a somewhat slower pace as the economic slowdown takes hold. Demand does appear to be cooling somewhat in response to the economic slowdown. Property & Portfolio Research reports that during the third quarter, U.S. office demand registered 22.6 million sq. ft. down 16% from the 26.8 million sq. ft. of net absorption posted in the second quarter.[12] The fourth quarter is projected to show further decline.

Fortunately, the threat of overbuilding continues to be well controlled by the extraordinary high costs of replacement and the reduced lender appetite for speculative leasing risks. Not everything is rosy of course: markets with concentrated exposure to housing overhang, such as apartments in Florida (a condo construction Mecca) and offices in Orange County (a

[10] "When the Debt Machine Coughs, Credit Creation, Cause & Effect," Grant's Interest Rate Observer, Vol. 25, No. 21, November 2, 2007, pp 6-7.

[11] CBRE Torto Wheaton Research "Worry Don't Panic" November 16, 2007.

[12] Ibid.

mortgage lending center) are weak. On balance however, U.S. commercial real estate's balance sheet looks healthy with generally low debt/equity ratios plus an ample supply of committed but uninvested equity pools. (For instance, the IREI survey of pension plans from early 2007 showed $46 billion of U.S. equity allocated but not committed to real estate.)

Going forward, the U.S. employment picture will be key to maintaining a healthy commercial real estate market. Operating income will again be tested as the economy works through the next year or so of sub-par growth. In particular, the differentials between those regions that post solid job and population growth rates and those that do not will become more acute. Long run, we continue to have confidence in the fundamentals of U.S. commercial real estate and expect them to improve further as the U.S. economy works its way back to trend line growth in the 2009 – 2010 timeframe.

A BUYING OPPORTUNITY?

As we have been saying for some time, U.S. commercial properties are clearly at the upper end of any reasonable pricing range due to approximately 300 to 350 basis points of cap rate compression. However, as a result of upward pressure on the incremental cost of capital in the higher risk tranches of acquisition debt financing, some upward movement on the blended cost of capital is likely. A significant portion of the acquisition financing, which was previously filled by aggressively priced debt from securitized and mezzanine lenders, will need to be replaced by either higher cost equity or mezzanine debt (if available). However, we believe replacement capital will likely be much more cautious and sensitive to specific risks going forward, its incremental pricing will likely be more discriminating in terms of project quality, location, demographic trends, supply constraints and tenant credit quality than was the previous debt capital in the acquisition financing.

With cap rate compression of the last several years now on pause and likely to begin backtracking in response to higher borrowing costs, tighter lending standards, and increasingly rigorous assessment of risk, one has to consider whether the near term presents an attractive purchasing period. We think so.

With the U.S. market not overbuilt, new supply limited and continued positive space absorption and rising rents, we see negligible downside risks of any major collapse in fundamentals provided the U.S. economy avoids recession and works its way back to stronger GDP growth over the next two years. While near-term returns for stabilized properties will moderate somewhat from the level achieved in the prior three years, we expect that the next 18 months may present buying opportunities. Those players that had patience and were unwilling to finance sufficiently and aggressively to win 35-participant auctions will have an opportunity to utilize their long-term, informed knowledge of the industry to acquire properties at much more attractive valuations than might have been available six short months ago.

U.S. PROPERTY SECTOR ROUND UP

While we strongly advocate broadly diversified portfolios within the property asset class, this does not mean we advocate an indexing strategy. Future market activity is clearly visible to those willing to undertake the effort and property sectors and regions should be tactically over or under-allocated depending on circumstances at the time. The following represents our current thinking with regard to the U.S. property sectors.

• **Office – focus on Central Business District and technology markets.** Fundamentals remain strong. However, the pace of absorption may have peaked nationally. Going forward downtown locations will likely outperform suburban due to low levels of new supply. Markets such as New York, San Francisco, San Jose and Seattle continue to lead. As the office sector is the most sensitive sector to the economic cycle, near-term performance may suffer if the economic growth underperforms expectations.

• **Multifamily – crosscurrents at work.** Demand for traditional rental apartments will see a near-term boost as growing numbers of buyers drop out of homeownership due to foreclosures, interest rate resets and tightening lending practices. Further, demographic drivers, including an increase in the base of college students and continuing high foreign immigration, are contributing to positive demand trends as well. This is good. On the other hand, unsold homes – and especially the rising glut of unsold condominiums – now represent a rental alternative (or a "shadow market") for those preferring or needing to rent. Accordingly, a high degree of selectivity is needed. Investors should focus on markets with high growth and/or a low inventory of unsold homes and a thin pipeline of new condominium projects under construction.

• **Distribution Warehouse – capitalize on trade with port cities.** Warehouses remain a relatively healthy and steady sector. Although personal consumption expenditures may not experience significant growth, demand continues on a relatively steady (if somewhat moderating) pace. Further, international trade volume is expanding at a steady pace as the weaker U.S. dollar continues to support export growth and U.S. demand remains supportive of import growth. Export driven port cities, high tech centers and regional distribution centers should outperform.

• **Retail – focus on necessity goods.** We consider the retail sector the most vulnerable to the slowdown in the heretofore consumer-led U.S. economy. Supply has largely kept up with demand, while retail sales growth has decelerated. We believe that the housing slowdown, slower job growth, elevated household debt burdens and energy prices are likely to reduce consumer spending. At this time, we are narrowly focused on necessity retail formats as the most attractive.

As we look at current investments against this view of the respective property sectors, we feel rather comfortable that our portfolio investments are well poised to weather the upcoming storms of 2008.

INVESTING THEMES WITHIN THE U.S

Constructing a well-positioned private equity investment portfolio requires converting an understanding of long-term trends to investment themes, and ultimately to individual investment choices. The following themes drive our current selection process when allocating available capital commitments to opportunities in the U.S.:

• **Seller Distress** – With the credit markets still dislocated, opportunities are increasing to acquire or recapitalize fundamentally sound properties in all property sectors.

• **Defensive** – With consumer sentiment low and household balanced sheets stressed, we are currently focused on necessity goods and services (e.g., groceries, health care) rather than discretionary items (e.g., fashion goods).

• **Currency Realignment** – Shifts in currencies may result in long-term changes in trade positions and increasing demand for certain properties in certain trade dominated locations.

• **Urbanization** – Globalization, continued expansion of the service sector and increasing commuting difficulties and costs will benefit urban locations over suburban sprawl.

• **Demographic Shifts** – As the baby boomers age, and the echo boomers graduate from college, demand for property types will evolve.

• **Secondary and Recapitalization Transactions** – As global institutional investors in private equity real estate rationalize their current portfolio exposure to the U.S., we believe there will be opportunities to provide liquidity to such investors. We further believe that dislocations in the property markets will present opportunities to recapitalize high-quality real estate ventures.

A WILD-CARD, CMBS RECOVERY

As commercial real estate will forever be capital intensive, even with modest debt requirements, the CMBS market must recover successfully for the real estate capital markets to function efficiently because there is not enough portfolio lending capacity to absorb the CMBS position.

CMBS accounts for approximately 25% of the outstanding U.S. commercial mortgage market. In recent years, approximately 50% of annual new loan volume was funded via CMBS. However, new issuance has been largely curtailed. Issuance for October 2007 fell to $6.3 billion, down 84% from the record high of $38.5 billion in March 2007. According to Lisa Pendergast of RBS Greenwich Capital, 2007 will likely set a record $245 billion issuance volume and then drop to $100 billion in 2008, the lowest level since 2004. For transaction volumes to be restored, new financing sources in the form of debt or equity will be required. Even with the ample supply of equity, how will U.S. commercial real estate finance itself if securitization fails to pass this test? Stay tuned.

Shoddy loan underwriting is perhaps the most important carryover factor with the residential market. This will be the first time CMBS securitizations are tested and actually stressed since their emergence in scale 15 years ago. While ours is currently a minority view, we believe that there has to be a lot of poorly written CMBS paper which will prove difficult to refinance as bullet loans mature and/or if commercial market fundamentals weaken near-term. Let's hope that the commercial underwriters for securitizations weren't sitting too close to their single family associates, but in all likelihood they probably were.

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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**.

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