



# Our View

## Introduction



As expected, over the past three months global capital markets have continued to experience significant turbulence. The unwinding of a massive amount of financial leverage continues to play out without clear visibility as to the likely path of events. “Stay tuned” seems to be the most often used ending phrase as economic prognosticating becomes more precarious.

Because the U.S. economy is still by far the world’s largest, it remains a focus for analysts worldwide. Our considered view at this moment is to expect a protracted downturn in the U.S., driven by a housing market that has further to fall and an intractable credit seizure that is beginning to affect the “real” economy. Slowdown in the U.S. will affect global growth as the “decoupling” for which others had hoped will not fully materialize – firstly, the U.S. has been a massive importer of goods from a large number of foreign economies; and secondly, the excessive use of leverage and misperception of risk has been a pervasive developed-world (and in some cases emerging-world) phenomenon.

We are in the beginning stages of a commercial real estate repricing in developed countries; largely driven by dislocations in global economic structures (particularly affecting the availability of debt financing) and not as a result of significantly declining property fundamentals. Real estate fundamentals are relatively strong worldwide and the primary risks relate to pricing of all financial risk assets and not merely to the real estate asset class in isolation.

Consumer warning: Our readers should understand that we are long-term investors seeking attractive returns within the real estate sector. When we commit to an investment program, the average dollar is invested in 12 to 18 months (not immediately) and the average harvest date is 4 to 7 years after our initial investment decision. This requires in-depth, disciplined focus to seek greater understanding of the long-term drivers of investment value and diligence to filter out the headlines that sell media but provide little investing information.

This quarter we focus on two topics:

- The relative inability of the global central banks to influence the course of economic events this time around, resulting in a greater element of risk than in previous economic cycles; and
- The beginning stages of a repricing of commercial real estate in the U.S., which will result in deteriorating selling

opportunities but substantially improved purchasing opportunities down the road.

## The U.S Economy

While the U.S. presidential election process has proven to be unexpectedly engaging, the state of the economy has once again become the number-one topic of concern to the electorate. The reality is finally setting in that America is experiencing the first coast-to-coast housing recession since World War II at a time when consumers are financially overextended.

While we have viewed the housing problems as a relatively easy *Black Swan*<sup>1</sup> event to call, it took the consumer, and surprisingly many “professionals” in the housing and banking industry years to recognize the developing problem. It has been much more difficult to anticipate the likely course of events once the initial cracks appeared in the subprime market. For followers of the global economy, the past nine months have necessitated a bit

<sup>1</sup> Suggested reading: *The Black Swan: The Impact of the Highly Improbable* by Nassim Nicholas Taleb

of “continuing education” effort to understand arcane corners of the financial markets, keep up with events and attempt to anticipate future events.

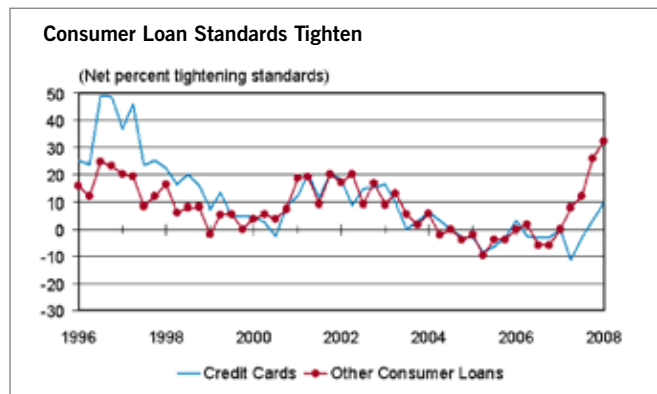
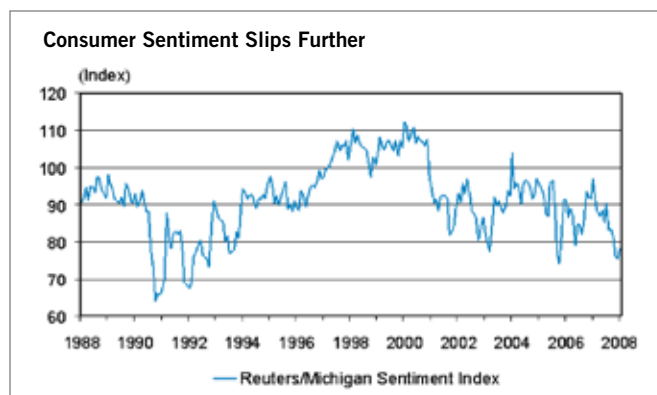
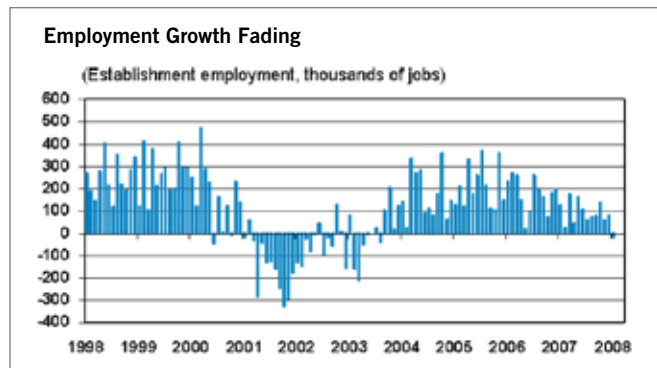
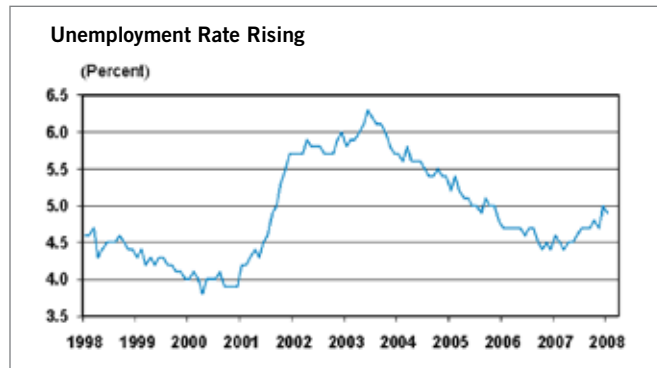


The consumer has now prudently (perhaps at times reluctantly) applied the brakes by reducing discretionary spending in favor of rebuilding his/her balance sheet. As the U.S. economy slows, economists attempt to predict whether the U.S. is headed for recession (commonly defined as two straight quarters of negative economic growth), its severity and what this eventual outcome implies regarding global growth. Some postulate that we are already in recession and behind it looms the specter of deflation or stagflation rather than a typical recovery. The basic questions relate to the influence of the housing market on the consumer, the ability of fiscal and economic stimulus to affect growth and the interrelationships among world economies.

In our view, whether the U.S. has entered or will enter a recession is relatively moot. The unemployment rate is rising, employment growth is fading, consumer sentiment is falling and consumer loan standards are tightening. Further, non-mortgage delinquencies (credit cards, student loans, indirect auto loans) are also increasing and corporate debt defaults are expected to increase over the next 18 months. The near term (the majority of 2008) will be unpleasant as the inability of businesses to expand because of lack of bank finance will make it feel like a recession.

The housing downturn, the prospect of a potential recession and the credit seizure have begun to take a toll on both business and consumer behavior as faith in stability and perpetual growth has turned to doubt about valuations and future income potential – all resulting in a more painful and longer lasting problem period than originally estimated.

The following charts, from Global Insight, Inc. indicate clear statistical deterioration from early 2007 to the present.



<sup>2</sup> Likelihood of a Recession is Given Better Odds, The Wall Street Journal, July 13, 2007.

We believe the U.S. economy has resiliency to navigate the mid-cycle correction and move back toward trendline GDP growth levels during 2009. However, the major remaining uncertainty is the continued malfunctioning of the credit system as leverage is reduced, risks repriced and asset valuations decline. The deleveraging process superimposed on the mid-cycle correction could, if mismanaged, lead to severe recession and the increased threat of deflation. However, neither is a foregone conclusion at this time.

### A CREDIT MARKET UPDATE

Extraordinary stimulative steps have been taken by the Fed and Congress in rapid fire order in terms of U.S. monetary and fiscal policy. These interventions have stemmed from the realization that restoring the credit market to its normal functionality is imperative. These central banks have implemented large interventions with open market operations, a Fed discount rate cut, large TAF<sup>2</sup> auctions and currency swap agreements. Further, the Fed has reduced the Federal Funds Rate by a cumulative 225 basis points, including a 75 basis point inter-meeting move in January. Nevertheless, over the past year, what began in the remote realm of U.S. sub-prime home loans has now metastasized to disrupt the entire credit system. Losses of \$175 billion have already been booked to date with as much as \$400 billion ultimately suggested by several participants. Although an emergency stimulus package from Washington in the form of \$107 billion in personal tax rebates and \$44 billion in extra depreciation may help a bit, in our view the net effect, at best, will be simply to bring forward some of 2009's growth into late 2008.

Such interventions represent a huge, risky and long duration challenge and it is likely that further intervention will be needed. But will it be enough? In our view, there is not much more one can ask of policy makers other than bailing out the banks or borrowers, which is not wise and unlikely. The banks appear damaged but solvent, and able to repair balance sheets as a result of rapid rate cuts

and massive amounts of equity capital still in the system, some of it from the heretofore low-profile sovereign wealth funds.



Despite aggressive response by the Fed, as well as the European Central Bank, from the beginning of August 2007, the price, terms and availability of credit have become less favorable.

The problem we face now is a downward spiral last seen in the early 90's – an era related primarily to a vastly overextended commercial real estate sector. This time however, the problem relates to the unwinding of massive amounts of leverage used to purchase securities, beginning with residential loans but extending to debt assets in all categories, resulting in mark-to-market losses as valuations decline. With credit spreads widening significantly, these mark-to-market losses at the commercial banks can reduce reserves which reduce the amount banks can lend, which results in less lending availability, margin calls, forced selling of securities, lower valuations, resulting in more losses, resulting in less lending, and so forth.

According to the Fed's senior loan officer survey, banks are tightening lending to commercial and industrial loans, and to commercial real estate loans. As reported in Morley Fund Management's U.S. outlook, "the damage to the banks' capital base, and the need to trim their loan book, appears to be having an across the board impact on business sentiment...The last time banks decided not to lend so much (in the early 1990s), it lasted for about two years."<sup>3</sup> Intuitively, this feels about right this time around.

### THE GLOBAL LIQUIDITY PYRAMID

Thoughtful and responsible persons have attempted to understand how debt securities have instantly deteriorated from AAA-rated to junk in credit quality, how the portfolio losses incurred by the major and supposedly sophisticated financial institutions can be so large, and how the financial system could have accommodated such carelessness.

<sup>2</sup> "Term Auction Facility," whereby the Federal Reserve auctions funds to depository institutions as a means to increase liquidity in the financial system and relieve pressure in the short-term inter-bank funds market.

<sup>3</sup> *US Economic Outlook, The Banking Crisis Hypothesis*, February 13, 2008, Morley Fund Management.



In our previous quarterly letter we began providing some background of the forces that have brought this credit seizure. We started by discussing the special role that securitization has played in the exponential growth of debt relative to GDP. We opined on the degradation in prudent loan underwriting and the shift in favor of capital market product engineering and distribution as opposed to the historical pattern of underwriting and retention by portfolio lenders.

A fuller understanding takes us beyond securitization and into the derivatives market as well as issues relating to the deregulation of financial institutions (resulting from the repeal of the U.S. Glass-Steagall Act); regulation; the explosion in technology, especially computing power and communications; financial modeling techniques; and the application of advanced mathematics (e.g., Black Scholes Options Model) to the pricing of securities.

Importantly, although securitization and derivatives were largely designed to reduce risk and lower borrowing costs, together they have grown to dwarf the size of the “real economy” for goods and services by turbo-charging the magnitude and interlinkings of today’s global financial system. So while derivatives may reduce the risk of any individual security, the resulting massive capital market limits the ability of the world’s central banks to influence economic activity.

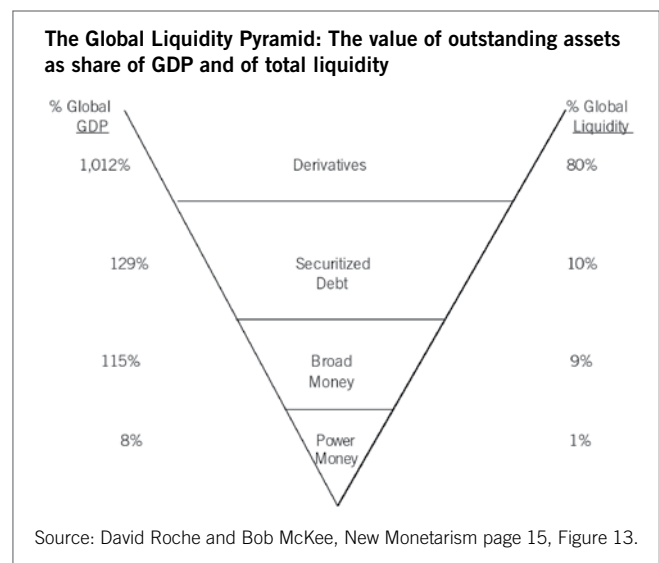
David Roche and Bob McKee, who are respectively the President and Chief Economist of the London headquartered consultancy of Independent Strategy, offer a clear and succinct explanation of derivatives and the new age of liquidity in what they refer to as the globe’s “New Monetarism.”<sup>4</sup>

Roche and McKee define derivatives as “a form of transactional capital that increases the depth of financial markets” while at the same time creating “liquidity that influences asset prices ... many derivatives allow an

investor to participate in 100% of the change in income or price of an underlying asset for a fraction of its cost ... Metaphorically, derivatives are to financial liquidity what tilting the basin is to water – they increase the sloshing in whatever direction the market is leaning: bullish or bearish.” They go on to explain, “in a long-running bull market, derivatives create multiple means for more players to invest in more assets in a more leveraged fashion. This increases the ‘investment power’ (purchasing power) of money. It is pretty obvious that if one can buy a security that represents 100% of an asset for 3 - 5% of the value of the asset, then an awful lot of liquidity has been freed up in relation to the underlying asset.”

Roche and McKee move past derivatives per se to then place this explosive tool in the context of global liquidity. They define liquidity “as any form of money that can be used to: buy goods or services; or invest in an asset in order to freeze the cost of (or the return on) holding an asset or a liability; or in order to transfer the risk to another party.”

Using a single dimension to graphically capture the full magnitude of today’s global liquidity, Roche and McKee portray a massive pyramid which they stand on its point. (See below)



<sup>4</sup> David Roche and Bob McKee, *New Monetarism* an Independent Strategy Publication, September 2007.

The Pyramid's components start with what they call "Power Money", essentially central bank reserves, at the tip and move up to include the world's total "Broad Money" (e.g., US's M-3 or MZN). It was these two categories of Power and Broad Money which provided more than sufficient liquidity until about 30 years ago to fuel the entire globe's GDP. Since the introduction of securitization in the late 1970's, followed by derivatives, which respectively equal 10% and 80% of global GDP, the world is now awash in liquidity that is generating more than we need to run the real global economy by a factor of approximately 10X.



Monetary and fiscal tools are generally designed to correct only the dysfunctions in the Power and Broad Money Categories not a capital market 10 times as large. Clearly we all need

to stop, take a deep breath, and appreciate how enormous and intricate the problem is and how long it is likely to take to fix it.

The first challenge is for the worldwide central banks, political leadership and senior managers at financial institutions to work toward timely solutions and coordinated policy implementation to address the broader de-leveraging challenge while minimizing, to the extent possible, damage to the real economy worldwide - obviously a Herculean task given the competing regional pressures (e.g., overheating in China, potential recession in Japan, inflation in India, etc.). Done well, a strengthened financial system should emerge.

The second challenge relates to the securitization and derivatives markets which are global in nature and diffused and therefore somewhat opaque. Two particular points of pressure to focus on lie within the Credit Default Swap ("CDS")<sup>5</sup> market: the settlement system and the monoline insurance companies that provide protection through CDS. The CDS market has expanded so dramatically that sometimes the volume of derivatives contracts can be 10 times bigger than the underlying cash bonds on which the CDS are based. There is considerable unease

about the ability of the CDS infrastructure to withstand a wave of defaults as the settlement system is not formalized and universal and is relatively untested. In an increasingly interlinked financial system defaults have a way of creating complex chain reactions. Both the U.S. Federal Reserve and the U.K.'s Financial Service Authority are on the case trying to introduce a more formal settlement system before a potential wave of defaults becomes overwhelming and extremely disruptive.

Monoline insurers, through CDS, provide insurance to investors against the possibility that their bonds may default. Having started in the municipal finance business, the monoline business on the margin has shifted to structured finance offering guarantees against the chance that complex bundles of mortgage-linked assets would default by writing CDS derivative contracts. According to Investment Strategy,<sup>6</sup> monoline insurance liabilities currently total \$2.2 trillion, of which \$572 billion relates to US structured finance.

With the subprime mortgage default rate now increasing, the CDS default contracts may be activated. Should the volume of claims grow so high as to damage the ratings of the monolines, the quality of insurance would be considered to have deteriorated, which would require write downs on bank inventory (potentially curtailing further lending) and potentially aggressive selling of securities on behalf of investment accounts mandated to own only AAA-rated paper (potentially reducing portfolio values and requiring margin calls on leveraged portfolios).



A reduction in ratings would result in an immediate loss to the banking system as the value of guarantees on debt obligations and derivatives declines, potentially requiring the banks to raise

more equity capital to keep ratios in line and/or potentially less credit capacity in the system. (Note: as of this writing Standard & Poors reaffirmed the AAA ratings on two large monoline insurance companies, MBIA and Ambac)

<sup>5</sup> A CDS contract in effect pledges to protect an investor against loss if default occurs.

<sup>6</sup> As reported in the *Financial Times*, February 21, 2008.

Given the implications of the pyramid, we should be prepared for continued large-magnitude dislocations, extensive political rhetoric (much of it counterproductive) and perhaps even a taxpayer driven solution such as the Resolution Trust Corporation of the 1990s to clear the market of devalued assets and restore sound functioning to the credit markets. Ultimately, one way or another, clearing asset prices will be discovered by the markets and a new basis will be established to generate further growth and investment returns. In the meantime, we note that markets have a tendency to overcorrect and in this case there is a good chance that for a time fear will outweigh greed and asset valuations may become too low before we reach equilibrium.

### Commercial Real Estate

Commercial real estate in the U.S. and the U.K. is showing signs of stress with transaction volumes significantly down as the credit market collapse dominates sentiment and pricing. Meanwhile, China deals with excess capital and an overheating economy, Japan is trying to hold onto a tenuous recovery, Brazil looks forward to an improving government fiscal position, India builds for an emerging middle class and much of eastern Europe continues to gain prominence. This quarter, our review remains focused on the U.S., the epicenter of the financial crisis where both debt and equity are signaling real estate valuation declines to come.

In terms of overall capital flows to commercial real estate, we are now in that transition period where a significant “bid/ask gap” exists between sellers and buyers. The former are holding out for yesterday’s higher prices while the latter, sensing the market shift, are offering lower prices. The shift from what had been a seller’s market to a buyer’s market is inevitable and eventually the “stall-out” that always precedes a market downshift will clear, the “bid/ask gap” will be resolved in favor of the bid side and prices will be reset lower. This will take a number of months to play out – likely well into 2009.

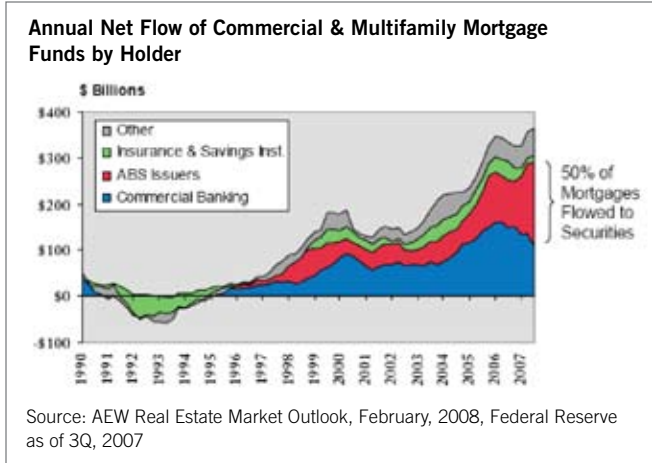
Why will the bid side win out? First, in our view target total returns for real estate on an unlevered basis, are not likely to decline as the intrinsic risk of owning real estate has neither significantly increased nor decreased. Second, the amount of debt financing available to any given project has declined. With a larger amount of relatively high-cost equity required for each acquisition, valuations must decline to meet the same return objective.

In the meantime, after a spectacular seven year run, the REITs reported a major down year for 2007 and are continuing to record annualized total returns at a -30% year-over-year pace. Further, highly leveraged portfolio and property acquisitions which were financed with bridge loans are experiencing extreme problems and well-publicized problems either closing or getting termed out. A Goldman Sachs Group study has preliminarily estimated total commercial real estate losses for all lenders to eventually be more than \$180 billion through 2009, assuming a 26% fall in commercial real estate prices. Clearly the markets are anticipating problems in the CMBS market as evidenced by the following graph.

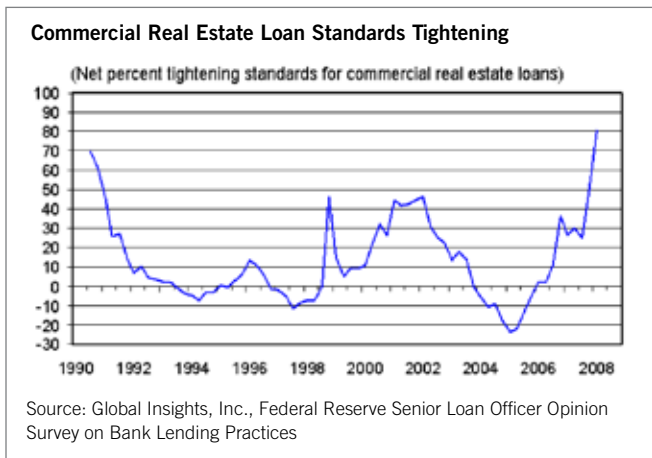


These spreads are expected to stay wide until the sale market increases volume and values become more transparent. To date in 2008, the CMBS market has failed to pick up steam. As we noted last quarter, the functioning of this market is necessary for capital flows and valuations to reach equilibrium in the near term. Interestingly, discussions with

real estate officers at life insurance companies who retain in portfolio the bulk of their commercial loans are reporting only modest work-outs and delinquencies.



The collapse of the CMBS market, which as indicated above recently represented 50% of mortgage loan underwriting, means that the highly leveraged buyers are gone and that available leverage is subject to more stringent underwriting standards. The chart below highlights that 80% of commercial real estate lenders have tightened loan standards, a greater percentage than in the early 1990s.



Nevertheless, this post securitization time period reminds us of the post tax shelter syndication/Japanese capital time period which was reminiscent of other post boom times in real estate.

The chart below, courtesy of AEW, is quite illustrative. For those of us who have experienced multiple real estate cycles, the underwriting standards of today appear reasonable while the Pre-Credit Crisis underwriting standards seem to be structured by loan officers more intent in making loans (and collecting fees) than having a successful loan pay off at the end of the day.

	<u>Pre-Credit Crisis</u>	<u>Jan. 2008</u>
Max LTV/LTC	70%-75%	60%
Min DSCR	1.05x	1.20x
NOI Underwriting	Borrowers Proforma NOI	Current in-Place NOI
Spreads	85-125 bps	200-225 bps
Loan Proceeds	Sized using I/O DSCR	Sized using Amortizing DSCR
Amortization	10 Years I/O	3 Years I/O on 10 Year Loan
Loan Requirements	Minimal	Requires Structuring (holdbacks, earn outs, TI escrows)

Source: AEW Real Estate Market Outlook, February, 2008

In the late 1980's to 1990s real estate crash, it was so apparent that the Savings & Loans as well as many of the equity providers had failed to align the financial interest of their management teams and investors. History has clearly repeated itself over the past four years. Now it's back to basics...

A topic certain to be on our radar this year will be the carrying values of properties within the portfolios of our investment managers. Fair value accounting will be the norm going forward for most fund managers necessitating valuations of properties that might have heretofore been carried at cost. This alone will be a contentious issue as investors attempt to report Net Asset Values. Further, we suspect that fund managers showing spectacular "unrealized returns" might have some explaining to do with regard to values and assumptions as the months progress.

## CRISIS: DANGER & OPPORTUNITY

So, what's an investor to do? Without repeating all the economic difficulties presented on prior pages, it's clear to us that 2008 will not be business as usual. Nevertheless, crisis breeds opportunity. With new development grinding to a halt in the U.S., we continue to believe that commercial real estate will emerge from the next two years somewhat bruised but unbowed, in general, with more rational valuations and solid fundamentals to start the next up-cycle.

In the mean time, existing owners will see valuations decline but operating performance will show only moderate declines. Therefore, unless you are forced to sell, this is definitely one of the few times that a "Hold" recommendation really means Hold.

For those considering new allocations to real estate the next two years may result as the best purchasing opportunity since the mid 1990s. But investors must remain patient, well capitalized and with armed with established lending

relationships. In our conversations with our investment managers, we are pleased that in general they remain disciplined in deploying capital – recognizing that it may take several months for pricing in the U.S. to properly correct before assets may be acquired at valuations that allow them to achieve target returns.



All this puts the focus on top quality property management to maintain healthy occupancy, control expenses, and generate distributable cash flow to the bottom line. In the long-term,

demographics, dramatically changing customer preferences for commercial space, the impact of technology, social changes brought about by globalization, traffic congestion and environmental issues are all merging together to project a strong but dramatically altered demand picture for professionally conceived, constructed and managed commercial real estate projects.

### For More Information

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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](http://www.madison-harbor.com).

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