Madison Harbor Capital

Madison Harbor Capital, LLC

Our View

Introduction

For those of us living in the great Northeast, winter came late, stayed forever and all but erased spring by suddenly erupting into early summer, just as the calendar turned into May. Now the trees are leafing out, the pansies have survived, the fruit trees are in bloom and the forsythia is in full yellow flower. Reliably, baseball opened on time, juggled the early schedule around a few late snowstorms and is now creating some early season pennant drama.

All of this leads this writer to thoughts of one of baseball's greatest money players and all-around wise philosopher – Yogi Berra. Amongst a lifetime of memorable observations Yogi opined, "When you come to a fork in the road . . . take it." We believe the U.S. commercial real estate market is at a "fork" and we want to tell you about the road we have taken.

The Economy

Globally, the world economy expanded by 5.4% during 2006. According to the International Monetary Fund's just issued *World Economic Outlook*, this shared expansion "remains on track for robust growth in 2007 and 2008." The advanced economies grew at 3.1% and the developing economies at almost 8%, with China and India leading the way at 10.7% and 9.2% respectively. Overall, the developing economies now total 29% of world GDP and 86% of world population.

Commenting on the IMF report, Martin Wolf[1] endorses its positive tone because "the underlying drivers of economic growth are indeed very strong; particularly, the integration of economies and the incorporation of Asia's vast population into the world economy." Wolf, however, goes on to remind us that with all of this growth, serious imbalances continue to prevail, all of which heighten the risk of unplanned shocks and surprises. This sober warning is further reinforced by this spring's coincidental publication of *Black Swan*, Nassim Taleb's sequel to his iconoclastic *Fooled By Randomness*. It was Taleb's first book published in 2004 that challenged conventional investment wisdom by reminding us about the role of luck – good and bad. It led us to reflect anew on risk and not just the reward side of investing. Solid risk assessment remains an imperative in an otherwise robust period of global growth.

FED ENGINEERED SLOWDOWN IN PLACE

At home, the mid-recovery slowdown is fully in place with a preliminary estimate of Q1 2007 real GDP growth of 1.3% (2.1% year-over-year) along with a 1.5% growth forecast for the balance of 2007. This is being driven by the weak housing and auto markets. Gasoline prices at the pump have risen over 40% year-to-date. This, combined with the continued decrease in the amount of Mortgage Equity Withdrawal (MEW) currently running at a $386 billion annual rate compared to its $864 billion peak in early 2006, is working to lower general consumer spending. April retail sales, in nominal terms, continued their recent month-over-month pattern of decline, leaving them up only 2.5% measured year-over-year. Finally, the most recent February reading from the Case-Shiller House Price Index printed a 1.6% year-over-year decline, which is likely to make consumers even more cautious in planning future retail expenditures.

[1] "Risks and Rewards of the World Economy's Golden Era." *Financial Times*, May 2, 2007.

Business spending is increasing but not at projected rates. When it does occur, it is being spent primarily at non-U.S. locations. The employment picture, which never saw large scale growth in the early years of this recovery, has held steady until the last 4 to 6 weeks, when claims for unemployment ticked up based on the prior four week averages. The unemployment rate ticked up from 4.4% to 4.5%. Most importantly, the Employment Cost Index for Q1 2007 indicated that labor costs remain under control. This should be particularly reassuring for the Federal Reserve, providing tangible evidence that cyclical inflation has not become structurally imbedded in wages and prices.

INFLATION'S TREND ENCOURAGING BUT NOT YET PERSUASIVE TO FED

As for inflation, the most recent readings are encouraging. Its rate of increase is becoming more subdued. The Fed's most closely watched inflation index, the Core Consumption Price Deflator, is currently running at 2.1%, with the Fed holding rates 5.25% until it sees persuasive evidence of sustainable sub-2% trendline.

For the economy, the most likely case is for neither boom nor bust but instead a continued muddle forward with sub-par growth until inflation flashes a convincing "all clear" over the next few months. Until then, the risk remains greater toward the downside than the upside for the economy. The wild cards that bear continued close scrutiny are threats of a significant breakout on the jobs front, a dramatic increase in the dollar's rate of decline, or the housing correction running out of control. None of these occurrences appear likely at this point.

THOUGHTS WORTH HEEDING

Two speeches delivered in the past several weeks draw attention to the downside risk in our most likely case of a muddle forward scenario. At Grant's Spring Investor Conference on April 23, 2007, David Rosenberg, Merrill Lynch's Chief North American Economist, reminded the audience that with the preliminary Q1 2007 GDP growth estimate of 1.3%, "this was the fourth consecutive quarter of sub-3% sequential real GDP growth[2]" – a trend which is not sustainable. He further went on to predict that "something is going to break in one direction or another." He noted that while the co-incident and trailing economic indicators were all confirming the mid-recovery slowdown, the leading indicators "are faltering again – down 3 months in a row" which his experience tells him points strongly in the direction of "a meaningful slowing in growth – if not a recession."

The other speech was delivered a few weeks earlier at Yeshiva University by Henry Kaufman. Kaufman was Solomon Brothers' lead economist during the late 1970's and 1980's. Kaufman made the point that while "money counts, credit matters." Credit has always been Henry Kaufman's area of special emphasis and he wanted his audience to know that credit expansion is what has driven the run-up in most asset prices and it will be credit contraction that will take many of those same prices back down again.

Two very bright, experienced, intellectually honest market observers. Two important risks to our most likely scenario. Either risk may manifest itself. For now we believe that if the Fed can avoid prematurely lowering the target Fed Funds Rate to address either of these two risks and instead maintain the 5.25% Fed Funds rate target until it is convinced inflation is back to within acceptable bounds, we will begin moving back to full potential GDP growth of 3%+ in late 2007.

The Real Estate Market

The real estate market is predictably being tested by the economy's mid-recovery slowdown. Slower growth translates into moderating demands for commercial space in the retail, office and industrial sectors. Record

[2] *Grant's Interest Rate Observer,* May 4, 2007, p.2.

inventory of unsold single family homes and the collapse of the national condominium market dampen demand for multi-family apartment rentals. Soaring hotel/motel nightly room rates encourage development of a new supply of moderately priced new hotel/motel inventory, which will soften the occupancy rates and room revenues.

Space absorption continues but at a moderating rate. Except for new hotel inventories, high replacement costs continue to closely control the supply of new space in all other property types. Even with the above mentioned current trends, commercial real estate's fundamentals remain in positive, yet somewhat moderating, territory.

The front pages still broadcast new records for certain acquisitions but even here there is a whiff of softening in the air. It turns out that Blackstone only really sought a fraction of the EOP portfolio for long-term ownership. More than half of the assets originally acquired were quickly re-traded to standby buyers - and in many cases re-traded a third time to yet another tier of standby buyers. Big deal? Certainly, but as the story evolves it reads more and more like a trading exercise enabled by a flood of credit. This may eventually be seen as a market top in property prices.

PRICE ADJUSTMENT?

What makes us feel this way? The NCREIF Q1 2007 Property Index reported a decline from 4.5% Q4 2006 to 3.6%. The income component was 1.4%, down only 8 basis points, with 90% of the decline coming from an 81 basis point reduction in the rate of appreciation. Year-to-date, the stock market indices moved up during January-February, gave the gain back in March and rallied again in April and the first week of May to 6.2% for the S&P 500, 6.4% for the DJIA and 6.5% for the NASDAQ. Meanwhile the MSCI U.S. REIT index is up only 1.6%.

CREDIT ADJUSTS

Most importantly, we see the changes in the credit markets where lenders have tightened loan underwriting standards. A slow 2007 start in new issuance of commercial mortgage backed securities ("CMBS") reflects stiffened loan underwriting standards, higher levels of care at the rating agencies and demands by investors for better pricing. As reported by *Commercial Real Estate Direct*, new CMBS for Q1 2007 was $18 billion, compared with $38 billion in Q1 2006. In short, credit for commercial real estate remains available, but the easy days appear to either be over for this cycle or at least on hold while investors recalibrate the risk and reward equations. Defaults remain low at present, but there are a rash of highly publicized re-ratings of outstanding issues by the rating agencies. There have also been a growing number of re-priced new issues involving prominent companies like GMAC and G.E.

While the overall balance sheet for the U.S. commercial property market remains sound, there have been, particularly over the past three years, abusive uses of credit by some borrowers. Despite an abundance of equity, the credit markets proved just too tempting for some as money grew so abundant, cheap and easy to get. As a result, it didn't take much of a blip for any given over-leveraged property or portfolio to produce negative consequences - and that's what we are witnessing.

Corrections like these always start with the weakest links. The match that lit this cycle's fire began in the sub-prime and Alternative A sectors of the single family residential securitization markets. More specifically, it was ignited by the first loss positions held mostly in CDO formats. That story has been covered in excruciating detail by the financial and mainstream press but is probably only halfway through its corrective stage. Since many of these same securitization techniques were used for CMBS, it is logical there are some fires smoldering there. While underwriting, rating

[2] Grant's Interest Rate Observer, May 4, 2007, p.2.

and pricing do not appear to have been as badly abused in commercial real estate as in home loans, those loans and securitizations which were done sloppily are now being brought to light. New underwritings are all being held to higher standards.

This commercial correction on the credit side, if contained within limits, could ultimately be a good cleansing device and a step toward more rational commercial property prices. In the meantime, the operators must successfully manage their properties through this period of economic slowdown and prepare for the resumption of trendline GDP growth in 2008.

Summary

Long range, the drivers remain in place for solid and sustainable economic growth. The U.S. is approximately half way through a mid-recovery correction. The threat of inflation is slowly receding. This correction has unearthed a huge housing bubble which is now being deflated, but will remain a drag on the economy for an extended period. It has also brought attention to the edges of commercial real estate which have abused the use of leverage. As this is corrected, it should rationalize prices, ultimately bringing them back in line with the traditional returns real estate has historically produced when its operating fundamentals are sound and supply and demand for space is in equilibrium. With constrained new development and increased functional obsolescence, demand for space from an economy growing at 3% annually should eventually prove attractive for private real estate equities, considering the demographic and technological advantages of the U.S.

As the economy navigates its way through the mid-recovery slow-down, commercial real estate faces a "fork in the road." It is being tested by moderating tenant demand for space and by stiffened underwriting standards from the lenders. How will equity investors react? Will they ignore this wake-up call and continue to bid up prices further compressing capitalization rates? Or will they use this period to reassess risks and raise their return expectations through either higher capitalization rates or increased annual returns?

We continue to believe in the latter road. Once the Fed becomes convinced that inflation can be sustained in the 1% to 2% range, it will reduce rates and GDP growth will rebound from the 1½-2% range to a sustainable growth rate of 3%. This, in turn, will create increased tenant demand for space leading to higher occupancies, rental increases and growing cash flows. Along this path, it would be advantageous if the commercial real estate market can wring out the leverage abuses and errant pricing that exists at the edges of today's market.

We came to our "fork in road" three years ago and, per Yogi Berra's advice, "we took it." We adopted a strategy that stressed the fundamentals in the hands of experienced operators which focused on growing top line rental revenues and bottom line cash flows. We respect the prudent use of credit. Operators' cash flows will always be highly valued by investors, no matter what the daily foibles are for property pricing. We'll leave that to the traders to fight over and remain focused on operators who increase cash flow and produce real, not inflated, values. Time will tell with our chosen road. Even with this temporary slowing in the economy, we remain confident in our choice.

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 and Richard W. Maine as Co-Managing Partners, as well as Russell H. Bates, Partner in charge of real estate underwriting. The firm focuses on providing investors with a proper balance of risk and return through a high level of diversification. Madison Harbor's principals collectively have over 130 years in commercial real estate and capital markets experience. For more information, please visit **www.madison-harbor.com**.